APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
June 10, 2008

**Securities and Exchange Commission**
**Washington, D.C. 20549**

**Form 10-Q**

(Mark One)

[X] Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

**For the Period Ended May 2, 2008**

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from ____________________to ____________________.

Commission file number 0-21236

**Applied Signal Technology, Inc.**
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **California** | **77-0015491** |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

**400 West California Avenue, Sunnyvale, CA 94086**
(Address of principal executive offices)

**(408) 749-1888**
(Registrant's telephone number, including area code)

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

| | |
|---|---|
| ü | |
| **Yes** | **No** |

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (check one):

| | | |
|---|---|---|
| | ü | |
| **Large accelerated filer** | **Accelerated filer** | **Non-accelerated filer** |

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Act).

| | |
|---|---|
| | ü |
| **Yes** | **No** |

The number of shares of the Registrant's common stock outstanding as of May 2, 2008, was 12,584,201.

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## Applied Signal Technology, Inc.

# Part I. Financial Information

## Item 1: Condensed Consolidated Financial Statements

**Applied Signal Technology, Inc.**
**Statements of Operations (unaudited)**
(in thousands, except per-share data

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **May 2, 2008** | **May 4, 2007** | **May 2, 2008** | **May 4, 2007** |
| Revenues from contracts | $45,284 | $41,054 | $88,009 | $84,598 |
| Operating expenses: | | | | |
| Contract costs | 31,492 | 28,583 | 60,863 | 57,443 |
| Research and development | 3,554 | 3,410 | 6,533 | 6,995 |
| General and administrative | 7,403<br>----------- | 6,585<br>----------- | 15,398<br>----------- | 14,544<br>----------- |

| | | | | |
|---|---|---|---|---|
| Total operating expenses | 42,449<br>----------- | 38,578<br>----------- | 82,794<br>----------- | 78,982<br>----------- |
| | | | | |
| Operating income | 2,835 | 2,476 | 5,215 | 5,616 |
| Interest income, net | 147<br>----------- | 105<br>----------- | 380<br>----------- | 265<br>----------- |
| Income before provision for income taxes | 2,982 | 2,581 | 5,595 | 5,881 |
| Provision for income taxes | 967<br>----------- | 1,001<br>----------- | 2,092<br>----------- | 2,438<br>----------- |
| | | | | |
| Net income | $2,015<br>======= | $1,580<br>======= | $3,503<br>======= | $3,443<br>======= |
| | | | | |
| Net income per common share: | | | | |
| Basic | $0.16 | $0.13 | $0.28 | $0.29 |
| Diluted | $0.16 | $0.13 | $0.28 | $0.28 |
| | | | | |
| Number of shares used in calculating net income per common share: | | | | |
| Basic | 12,400 | 12,039 | 12,371 | 12,006 |
| Diluted | 12,523 | 12,285 | 12,513 | 12,228 |

See “Notes to Condensed Consolidated Financial Statements.”

**Applied Signal Technology, Inc.**
**Balance Sheets**
(in thousands, except share data)

| Assets | May 2, 2008 (unaudited) | October 31, 2007† |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $7,129 | $5,250 |
| Short term investments | 27,719<br>----------- | 29,683<br>----------- |
| Total cash, cash equivalents, and short-term investments | 34,848 | 34,933 |
| Accounts receivable: | | |
| Billed | 23,696 | 25,097 |
| Unbilled | 19,451<br>----------- | 19,379<br>----------- |
| Total accounts receivable | 43,147 | 44,476 |
| Inventory | 9,739 | 5,944 |

| | | |
|---|---|---|
| Refundable income taxes | — | 647 |
| Prepaid and other current assets | 9,572<br>----------- | 9,760<br>----------- |
| Total current assets | 97,306 | 95,760 |
| Property and equipment, at cost: | | |
| Machinery and equipment | 42,648 | 41,075 |
| Furniture and fixtures | 4,753 | 4,676 |
| Leasehold improvements | 17,282 | 14,584 |
| Construction in process | 234<br>----------- | 2,230<br>----------- |
| | 64,917 | 62,565 |
| Accumulated depreciation and amortization | (48,454)<br>----------- | (46,096)<br>----------- |
| Property and equipment, net | 16,463 | 16,469 |
| Long-term investments | 7,961 | 4,114 |
| Goodwill | 19,964 | 19,964 |
| Intangible assets, net of accumulated amortization | 293 | 616 |
| Long-term deferred tax asset | 5,465 | 5,021 |
| Other assets | 771<br>----------- | 789<br>----------- |
| Total assets | $148,223<br>======= | $142,733<br>======= |

**Applied Signal Technology, Inc.**
**Balance Sheets (continued)**
(in thousands, except share data)

| Liabilities and Shareholders' Equity | May 2, 2008 (unaudited) | October 31, 2007† |
|---|---|---|
| Current liabilities: | | |
| Accounts payable | $3,392 | $3,848 |
| Accrued payroll and related benefits | 13,109 | 13,135 |
| Note payable | 1,429 | 1,429 |
| Income taxes payable | — | 14 |
| Other accrued liabilities | 2,344<br>----------- | 1,997<br>----------- |
| Total current liabilities | 20,274 | 20,423 |
| Long-term note payable | 4,524 | 5,357 |

| | | |
|---|---|---|
| Accrued rent | 2,597 | 1,658 |
| Other long-term liabilities | 1,297 | 459 |
| Shareholders' equity: | | |
| Common stock and additional paid-in capital, no par value: 20,000,000 shares authorized; issued and outstanding shares: 12,584,201 at May 2, 2008, and 12,388,422 at October 31, 2007 | 66,230 | 61,849 |
| Retained earnings | 53,309 | 52,953 |
| Accumulated other comprehensive income | (8) | 34 |
| Total shareholders' equity | 119,531 | 114,836 |
| Total liabilities and shareholders' equity | $148,223 | $142,733 |

† The balance sheet at October 31, 2007 has been derived from the audited financial statements at that date but does not include all of the information required by accounting principles generally accepted in the United States for complete financial statements.

See "Notes to Condensed Consolidated Financial Statements."

**Applied Signal Technology, Inc.**
**Statements of Cash Flows (unaudited)**
(in thousands)

| | Six Months Ended | |
|---|---|---|
| | **May 2, 2008** | **May 4, 2007** |
| **Operating Activities** | | |
| Net income | $3,503 | $3,443 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Depreciation and amortization | 3,065 | 2,797 |
| Stock-based compensation | 2,805 | 2,222 |
| Excess tax benefits from stock-based payment arrangements | (21) | (54) |
| Changes in: | | |
| Accounts receivable | 1,329 | 1,923 |
| Refundable income taxes | 752 | — |
| Inventory, prepaid expenses, and other assets | (4,154) | (2,805) |
| Accrued lease incentives | 877 | — |
| Accounts payable, taxes payable, and accrued liabilities | 338 | (4,329) |
| Net cash provided by operating activities | 8,494 | 3,197 |

| | | |
|---|---|---|
| **Investing Activities** | | |
| Purchases of available-for-sale securities | (50,236) | (39,466) |
| Maturities of available-for-sale securities | 48,217 | 39,540 |
| Additions to property and equipment | (2,383) | (1,085) |
| Net cash used in investing activities | (4,402) | (1,011) |
| **Financing Activities** | | |
| Issuances of common stock | 1,721 | 2,399 |
| Excess tax benefits from stock-based payment arrangements | 21 | 54 |
| Term loan | (833) | (834) |
| Dividends paid | (3,122) | (3,008) |
| Net cash used in by financing activities | (2,213) | (1,389) |
| Net increase in cash and cash equivalents | 1,879 | 797 |
| Cash and cash equivalents, beginning of period | 5,250 | 4,194 |
| Cash and cash equivalents, end of period | $7,129 | $4,991 |
| Supplemental disclosures of cash flow information: | | |
| Interest paid | $204 | $295 |
| Income taxes paid | $3,280 | $1,674 |

See "Notes to Condensed Consolidated Financial Statements."

**Applied Signal Technology, Inc.**
**Notes to Condensed Consolidated Financial Statements (unaudited)**
**May 2, 2008**

### Note 1: Summary of Significant Accounting Policies

### Description of Business and Basis of Presentation

Applied Signal Technology, Inc. (AST) provides advanced digital signal processing products, systems, and services in support of intelligence, surveillance, and reconnaissance (ISR) for global security. We provide processing of both man-made and naturally occurring signals. The processing of man-made signals includes communications intelligence (COMINT) and electronic intelligence (ELINT). The processing of natural signatures includes the use of sonar, radar, magnetic, and chemical sensors to detect changes in the environmental phenomenology. Our primary customer is the United States Government. We develop and manufacture sophisticated receivers and signal processing equipment that use advanced software.

The majority of all of our revenues were from contracts with the United States Government or prime contractors for the United States Government.

The accompanying unaudited, condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements, and should be read in conjunction with the financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended October 31, 2007. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three-month and six-month periods ended May 2, 2008, are not necessarily indicative of the results that may be expected for the year ending October 31, 2008. The balance sheet at October 31, 2007, has been derived from the audited financial statements at that date but does not include all of the information required by accounting principles generally accepted in the United States for complete financial statements.

### Estimates

The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ significantly from those estimates.

### Principles of Consolidation

The financial statements include the accounts of AST and its wholly owned subsidiary, Dynamics Technology, Inc. (DTI). All significant intercompany transactions have been eliminated.

### Revenues and Contract Accounting

***Revenues and cost recognition***. The majority of our contracts are accounted for in accordance with the American Institute of Certified Public Accountants (AICPA) Statement of Opinion 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts.* These contracts are executed by using written contractual arrangements, most of which require us to design, develop, manufacture, and/or modify our complex products and perform related services according to specifications provided by the customer. A limited number of standalone software contracts are recognized in accordance with the AICPA Statement of Opinion 97-2, *Software Revenue Recognition* (SOP 97-2). In accordance with SOP 97-2, we may, at times, record an amount of deferred revenue associated with contracts that are billed and for which customers have paid in advance of performance requirements set forth in these contracts.

As a supplier to United States Government, we are required to comply with numerous regulations, including those governing security and contracting practices. Failure to comply with these procurement regulations and practices could result in fines being imposed against us or our suspension for a period of time from eligibility for bidding on, or for award of, new government contracts. Among the causes for the suspension are violations of various statutes, including those related to procurement integrity, export control, United States Government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign corruption. The government may investigate and make inquiries of our business practices and conduct audits of contract performance and cost accounting. The government audits and investigations can take several years to complete. Depending on the results of these audits and investigations, the government may make claims against us or take exception to certain costs we determined to be recoverable. In the period management determines recoverability is not likely, operating income would be reduced.

We account for cost-reimbursement contracts by charging actual labor, materials, and other direct costs, plus estimated indirect costs of operations as incurred (incurred costs), including overhead, research and development, and general and administrative expenses. We do not apply indirect costs to subcontract costs that are in excess of $250,000 and meet certain other predetermined criteria.

We recognize contract revenues and profits on cost-reimbursement contracts by applying an estimated fee rate to all incurred costs on an individual contract basis. Fee calculations are based on either negotiated fee amounts or management’s assessment of the fee amounts that are likely to be earned. On cost-reimbursement contracts, we may bear unexpected cost increases for purposes of maintaining customer relationships. Historically, the effect on operating results and financial condition from cost-reimbursement losses has been minimal.

Our policy for recognizing interim award fees on our cost-plus-award-fee contracts is based on management’s assessment as to the likelihood that the award fee or an incremental portion thereof will be earned, on a contract-by-contract basis. Management bases its assessments on numerous factors including contract terms, nature of the work to be performed, our relationship and history with the customer, our history with similar types of projects, and our current and anticipated performance on the specific contract. No award fee is recognized in whole or in part until management determines that it is probable that the award fee or portion thereof will be earned. Historically, management’s estimates have generally been consistent with the actual fees awarded. However, changes in facts and circumstances could arise within an award fee period, causing management to either lower or raise the award fee estimate in the period in which the changes occur.

Some of our contracts are performed under time-and-materials contracts on a level-of-effort basis. We recognize revenue for these contracts by applying a negotiated billing rate to the level of effort.

We account for fixed-price contracts by using the percentage-of-completion method. Under this method, we charge labor, materials, and other direct costs, plus estimated indirect costs of operations, as they are incurred. Each period, we recognize as revenue a portion of the contract revenue, based on estimated profits and the degree of completion of the contract as measured by a comparison of the actual costs incurred and the estimated costs to complete. On fixed-price contracts, we bear the risk of any unexpected increases in the cost to develop or manufacture a product; whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies, or other factors, and these costs could have a materially adverse effect on our results of operations.

The following table represents our revenue concentration during the respective periods by contract type.

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | May 2, 2008 | May 4, 2007 | May 2, 2008 | May 4, 2007 |
| Cost-reimbursement contracts | 72% | 70% | 72% | 73% |
| Fixed-price contracts | 10% | 15% | 9% | 16% |
| Time-and-materials contracts | 18% | 15% | 19% | 11% |

Five contracts represented an aggregate of 60% of revenues for each of the three-month and six-month periods ended May 2, 2008. Three of these contracts were indefinite-delivery-indefinite-quantity contracts (IDIQ). Under the terms of this type of contract, the government may issue individual delivery orders (DOs) for goods or services that they require. Each DO is treated as a separate contract, which may be awarded on a cost-reimbursable, fixed-price, or time-and-materials basis. We aggregate the DOs under each IDIQ contract for purposes of distinguishing significant revenue concentrations. Five contracts represented an aggregate of 50% and 52% of revenues for the three-month and six-month periods ended May 4, 2007. Four of these contracts were IDIQ contracts. In addition, one of the five contracts in each of fiscal years 2008 and 2007 was a time-and-materials contract, which significantly increased the revenue concentration of time-and-materials contracts during fiscal year 2008. All of the other contracts referenced were cost-reimbursement contracts.

For those contracts in which all of the terms have not yet been finalized, revenue does not include an estimated fee rate on cost.

Management reviews contract performance, costs incurred, and estimated completion costs regularly. Revenues and profits are adjusted on all contracts in the period in which changes, including anticipated losses, become determinable.

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and costs incurred in connection with ongoing contracts for which contract modifications have not been defined or completed at the end of the reporting date. These costs are included in other current assets on the balance sheet. Precontract costs for the periods ended May 2, 2008, and October 31, 2007, were approximately $3,157,000 and $4,465,000, respectively. Approximately $3,406,000 of the October 31, 2007, balance was recognized as revenue during the first six months of fiscal year 2008.

We have one licensing agreement for which we accrue royalties upon sales of our licensed product. Since there are essentially no costs associated with this agreement, operating income will increase by the same amount of revenue that we recognize.

***Indirect rate variance adjustments to operations***. We record contract revenues and costs of operations for interim reporting purposes based on annual targeted indirect rates. At year end, the revenues and costs are adjusted for actual indirect rates. During our interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. All timing-related indirect spending variances are removed from contract costs, research and development, and general and administrative expenses, and are included in inventory as part of work in process during these interim reporting periods. These rates are reviewed regularly, and we record adjustments for any material, permanent variances in the period they become estimable.

Our accounting policy for recording indirect rate variances is based on management's belief that variances accumulated during interim reporting periods will be absorbed by expected contract activities during the remainder of the year. We consider the rate variance to be unfavorable when our actual indirect rates are greater than our annual targeted rates. In contrast, a favorable rate variance occurs when our actual indirect rates are lower than our annual targeted rates. During interim reporting periods, unfavorable rate variances are recorded as reductions to operating expenses and increases to work-in-process inventory. Favorable rate variances are recorded as increases to operating expenses and decreases to work-in-process inventory.

If we anticipate that actual contract activities will be different than planned levels, there are alternatives we can utilize to absorb the variance: we can adjust our planned indirect spending during the year, modify our billing rates to our customers through the Defense Contract Audit Agency in accordance with Federal Acquisition Regulations, or record adjustments to expense based on estimates of future contract activities for the remainder of the fiscal year.

If our rate variance is unfavorable, the modification of our billing rates will likely increase revenue and operating expenses, and decrease the unfavorable indirect rate variance accumulated in inventory. Fee percentages on fixed-price and time-and-materials contracts will generally decline as a result of any increase to indirect costs. Fee percentages on active cost-reimbursable contracts will generally be unaffected as a result of any increase to indirect costs. Fee percentages on completed cost-reimbursable contracts will generally be reduced. If our rate variance is favorable, the modification of our billing rates will decrease revenue and operating expenses, and decrease the favorable indirect rate variance accumulated in inventory. In this event, fee percentages on fixed-price and time-and-materials contracts will generally increase. Fee percentages on cost-reimbursable contracts will generally be unaffected as a result of any reduction to indirect costs, due to the fact that programs will typically expend all of the funds available. Any impact on operating income, however, will depend on a number of other factors, including mix of contract types, contract terms, anticipated performance on specific contracts, and anticipated changes in inventory.

At May 2, 2008, the unfavorable rate variance was approximately $2,302,000. The fiscal 2008 rate variance includes approximately $1,180,000 of severance costs that we expect to pay to our former Chief Executive Officer. Please see “Note 9: Change in Management” for further details. At May 4, 2007, the unfavorable rate variance was approximately $4,191,000.

***Accounts receivable and allowance for bad debt***. Accounts receivable are segregated between billed and unbilled accounts. For cost-reimbursement contracts, we bill incurred costs and a portion of our fees on a regular basis. Under fixed-price contracts, we bill contract costs on a milestone or unit of delivery basis. Unbilled amounts result from our recognition of contract revenue in advance of contractual billing or progress billing terms.

When evaluating our need for a bad debt allowance, we consider our customer base and their payment history. The majority of our revenues are generated from the United States Government and therefore credit risk is minimal. We record allowances for bad debt as a reduction to accounts receivable and an increase to bad debt expense. These allowances are recorded in the period a specific collection problem is identified. Once the receivable is deemed uncollectible, the allowance is reversed and the receivable is written off to bad debt expense.

During the first six months of fiscal year 2008 and fiscal year 2007, there was no material charge to bad debt expense.

***Inventory valuation and disposal***. Typical life cycles of our equipment are eight to ten years or more. In addition, we maintain spare parts in order to repair the equipment. We evaluate our inventory quarterly at interim reporting periods, and assess our ability to sell our products, which includes raw materials. Historically, we have sold our inventory at or above cost, so there was typically no decrement in valuation. When we determine that a product has reached the end of its life cycle or there is no longer a need for a certain product, typically, we will dispose of any remaining inventory, and record the associated reduction to inventory.

In the second quarter of fiscal year 2008, we recorded a write-down of approximately $935,000 to reflect the estimated market value of one inventoried product.We include any charges associated with these reductions to work in process and finished goods in contract costs in our statement of operations. Disposals associated with our raw material represent a minor amount, which is included in general and administrative expenses on the statement of operations due to the fact that raw materials could be used in a variety of situations other than contract costs, including R&D. Disposals of inventory were not significant during the first six months of fiscal years 2008 and 2007.

## Income Taxes

Our income tax expense at interim reporting periods is based on our estimated annual effective tax rate and any discrete items that occur during any interim period. We calculate this estimated tax rate based on the projected net income at the end of the fiscal year, and review it at each reporting period. At the end of the fiscal year, we adjust income tax expense for actual results. Our effective tax rate can differ from the statutory rate primarily due to the non-deductible nature of certain types of stock-based compensation expense. Please refer to “Note 7: Provision for Income Taxes” for the current year effective tax rate.

## Price Redetermination

As a government contractor, we are subject to price redetermination on certain fixed-price contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. We did not incur any price redeterminations on any of our contracts during the first six months of fiscal year 2008 or the full fiscal year of 2007.

## Cash Equivalents and Investments

We consider all highly liquid debt instruments purchased with an original maturity date of three months or less to be cash equivalents.

Our remaining securities are classified as available for sale and are carried at fair market value in short-term and long-term investments. At May 2, 2008, all of our short-term and long-term investments consisted of municipal securities. Substantially all of our investments in the municipal securities are with A-1/SP-1/AAA (Standard & Poor’s), P-1/MIG-1/Aaa (Moody’s), and F-1/AA/AAA (Fitch) rated issuers.

Our investment policy prohibits our investment in auction rate securities, mortgage-backed securities, and asset-backed securities. Insured municipal notes or bonds are also prohibited, with the exception of daily and weekly variable rate demand notes that contain a hard put feature.

At the time of purchase, management determines the appropriate classification of these securities and re-evaluates such designation as of each balance sheet date. Unrealized gains and losses, net of tax, are reported in shareholders' equity as part of comprehensive income. The cost of securities sold is based on the specific identification method. The fair value of short-term and long-term investments is determined based on quoted market prices for the respective securities. Realized gains and losses on sales of available-for-sale securities were not material for the first six months of fiscal year 2008 or fiscal year 2007.

The following tables summarize our cash, cash equivalents, short-term securities, and long-term securities (in thousands).

| | May 2, 2008 | | |
|---|---|---|---|
| | **Amortized Cost** | **Gross Unrealized Gains** | **Estimated Fair Market Value** |
| Cash and cash equivalents | $7,129 | $— | $7,129 |
| Available-for-sale securities: | | | |
| Short-term tax exempt | 27,671 | 48 | 27,719 |
| Long-term tax exempt | 7,946 | 15 | 7,961 |
| | $42,746 | $63 | $42,809 |

| | October 31, 2007 | | |
|---|---|---|---|
| | **Amortized Cost** | **Gross Unrealized Gains** | **Estimated Fair Market Value** |
| Cash and cash equivalents | $5,250 | $— | $5,250 |
| Available-for-sale securities: | | | |
| Short-term tax exempt | 29,671 | 12 | 29,683 |
| Long-term tax exempt | 4,108 | 6 | 4,114 |
| | $39,029 | $18 | $39,047 |

The following table summarizes the effective maturities of our available-for-sale investments (in thousands).

| | **May 2, 2008** | **October 31, 2007** |
|---|---|---|
| Due in one year or less | $27,719 | $29,683 |
| Due in one to two years | 7,961 | 4,114 |
| | $35,680 | $33,797 |

**Restricted Cash**

We had restricted cash balances of approximately $559,000 and $562,000 at May 2, 2008, and at October 31, 2007, respectively. These balances include contributions made by our employees residing in California for disability funds. These contributions were paid in lieu of participating in the state-sponsored disability program.

Approximately $206,000 and $194,000 was included in prepaids and other current assets at May 2, 2008, and at October 31, 2007, respectively. Approximately $353,000 and $368,000 was included in other assets at May 2, 2008, and at October 31, 2007, respectively.

### Property and Equipment

Machinery and equipment, as well as furniture and fixtures, are depreciated by using the straight-line method over the estimated useful lives of the assets, ranging up to five years. Leasehold improvements are amortized by using the straight-line method over the lesser of the useful life of the assets or the lease term. Construction in process includes costs incurred to build a portion of our leasehold improvements and test equipment.

### Goodwill and Long-Lived Asset Valuation

***Goodwill valuation***. We test goodwill for possible impairment on an annual basis and at any other time if events occur or circumstances indicate that the current carrying amount of goodwill may not be recoverable. Circumstances that could trigger an impairment test include, but are not limited to, a significant adverse change in the business climate or legal factors, an adverse action or assessment by a regulator, unanticipated competition, and loss of key personnel.

To perform the goodwill impairment test, we determine the fair value of the reporting unit and compare the fair value to the reporting unit’s carrying value. We believe AST is one reporting unit, and therefore, we compare the fair value of AST to the total net asset value on our balance sheet. If our total net asset value were to exceed our fair value, we would perform the second step of the impairment test. In the second step, we would compare the implied fair value of our goodwill to our carrying amount. If no impairment exists under step one, then step two is not necessary.

No indicators of impairment were identified at May 2, 2008.

***Long-lived asset valuation (property, plant and equipment, and intangible assets)***. We will test long-lived assets or asset groups for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. Circumstances that could trigger a review include, but are not limited to, significant decreases in the market price of the asset, significant adverse changes in the business climate or legal factors, accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of the asset, current period cash flow or operating losses combined with a history of losses or a forecast of continuing losses associated with the use of the asset, and current expectation that the asset will more likely than not be sold or disposed of significantly before the end of its estimated useful life.

We assess recoverability based on the carrying amount of the asset and its fair value, which is generally determined based on the sum of the undiscounted cash flows expected to result from the use and the eventual disposal of the asset. We recognize an impairment loss when the carrying amount is not recoverable and exceeds fair value.

No indicators of impairment were identified at May 2, 2008.

### Net Income Per-Share Data

Basic net income per share is determined by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is determined by dividing net income by the weighted average number of common shares used in the basic earnings per share calculation, plus the number of common shares that would be issued assuming conversion of all potentially dilutive securities outstanding under the treasury stock method.

The per-share data is as follows (in thousands, except per-share amounts):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | May 2, 2008 | May 4, 2007 | May 2, 2008 | May 4, 2007 |
| **Numerator**: | | | | |
| Net income | $2,015<br>======= | $1,580<br>======= | $3,503<br>======= | $3,443<br>======= |
| **Denominator**: | | | | |
| | | | | |

| | | | | |
|---|---|---|---|---|
| Shares used to compute net income per common share – basic | 12,400 | 12,039 | 12,371 | 12,006 |
| Effect of dilutive stock options | 123 | 246 | 142 | 222 |
| Shares used to compute net income per common share – diluted | 12,523 | 12,285 | 12,513 | 12,228 |
| | | | | |
| Net income per common share – basic | $0.16 | $0.13 | $0.28 | $0.29 |
| Net income per common share – diluted | $0.16 | $0.13 | $0.28 | $0.28 |

We excluded approximately 1,163,000 and 1,075,000 potential common shares for the three-month and six-month periods ended May 2, 2008, from the diluted net income per common share computation, as their effect would be antidilutive. For the same periods in fiscal year 2007, we excluded 921,000 and 960,000 potential common shares, respectively, from the diluted net income per common share computation for the same reason.

### Comprehensive Income

The components of comprehensive income, net of tax, are as follows (in thousands):

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **May 2, 2008** | **May 4, 2007** | **May 2, 2008** | **May 4, 2007** |
| Net income | $2,015 | $1,580 | $3,503 | $3,443 |
| Unrealized gain (loss) on securities | (51) | (3) | 45 | (7) |
| Derivative gain (loss), net of tax | 37 | (27) | (87) | (2) |
| Comprehensive income | $2,001 | $1,550 | $3,461 | $3,434 |

The accumulated other comprehensive income balance as of May 2, 2008, was a loss of approximately $8,000, and as of October 31, 2007, was a gain of approximately $34,000.

### Dividends

We have paid dividends at the rate of $0.50 per share per annum, payable quarterly, since fiscal year 2004. However, the dividend is subject to approval by the Board of Directors and is reviewed quarterly. Dividends were paid on February 15, 2008, and May 16, 2008, to shareholders of record at February 1, 2008, and May 2, 2008, and are expected to be paid on August 15, 2008, and November 14, 2008, to shareholders of record at August 1, 2008, and October 31, 2008.

We paid dividends of approximately $3,122,000 during the first six months of fiscal year 2008 and approximately $3,008,000 during the first six months of fiscal year 2007.

At May 2, 2008, and October 31, 2007, accrued dividends of approximately $1,573,000 and $1,549,000, respectively, were included in other accrued liabilities on the accompanying balance sheet.

### Stock-Based Compensation

We have stock-based compensation programs that enable our Board of Directors to award employee equity incentives. These programs include restricted stock awards and incentive and non-statutory stock options granted under various plans. Restrictions on the restricted stock awards typically lapse in four equal annual installments, on each anniversary of the grant date, conditioned on continued employment. The restrictions for the majority of the fiscal year 2007 awards to non-employee directors will lapse in three equal annual installments. Stock options granted in 2006 and prior years are generally time based, typically vesting 20% on each anniversary of the grant date over five years, and expiring eight or ten years from the grant date, conditioned on continued employment.

Additionally, we have an Employee Stock Purchase Plan (ESPP) that allows employees to purchase shares of common stock at 85% of the fair market value at the lower of either the date of enrollment or the date of purchase. For offering periods beginning prior to June 1, 2007, our ESPP had a twenty-four-month offering period with four six-month purchase periods within each offering period. If the fair market value on the purchase date was lower than the fair market value on the offering date, all participants were withdrawn from the offering period and re-enrolled into a new offering period. Effective, May 31, 2007, we modified our ESPP such that the length of all offering periods, beginning June 1, 2007, is six months. Consequently, there is no reset feature associated with the new offering periods. As a result of the modification to the ESPP, the December 1, 2006, offering period, originally scheduled to end on November 30, 2008, was the final twenty-four-month offering.

Our closing stock price on the November 30, 2007, ESPP purchase date was lower than the closing stock price on the December 1, 2006, offering date. Therefore, 361 participants were re-enrolled from the original twenty-four- month offering period ending on November 30, 2008, into a new six-month offering period, beginning December 1, 2007, and ending May 31, 2008. This re-enrollment effectively canceled the final six-month purchase period of the original twenty-four-month offering. Therefore, the remaining unamortized compensation amount associated with this final purchase period, approximately $382,000, was immediately recognized on December 1, 2007. In addition, as a result of the modification, approximately $91,000 of incremental compensation cost was generated at December 1, 2007, of which we recognized $45,000 during the second quarter and $77,000 during the first six months of fiscal year 2008.

On November 15, 2007, one of our non-employee directors retired. Immediately prior to his retirement, we accelerated the vesting of all unvested shares of his restricted stock and stock option awards. In addition, we extended the remaining exercise period of all vested and unexercised options from ninety days to one year. As a result, our stock compensation expense associated with these modified equity awards was approximately $80,000 higher than it would have been had the awards not been modified.

In addition, we expect to record additional stock based compensation expense during the third quarter of fiscal year 2008, associated with the acceleration of unvested stock options and restricted stock for our former Chief Executive Officer. For further information please see “ Note 9: Change in Management.”

As of May 2, 2008, there were a total of approximately 1,134,837 shares reserved for future issuance under the equity incentive and ESPP plans.

We adopted the provisions of SFAS 123 (revised 2004), *Share-Based Payment* (SFAS 123R), in fiscal year 2006, using the modified prospective transition method. Stock-based compensation expense for awards granted subsequent to November 1, 2005, was based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. For awards granted prior to, but not yet vested, as of November 1, 2005, stock-based compensation expense was based on the grant-date fair value previously estimated in accordance with the original provisions of SFAS 123. We recognize the stock compensation expense on a straight-line basis over the requisite service period of the award, which generally equals the vesting period of each grant.

The following table sets forth the total stock-based compensation expense resulting from the grant of stock options, restricted stock awards, and purchases under ESPP included in our condensed consolidated statements of operations (in thousands, except share data).

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **May 2, 2008** | **May 4, 2007** | **May 2, 2008** | **May 4, 2007** |
| Contract costs | $692 | $587 | $1,685 | $1,231 |
| Research and development | 58 | 56 | 111 | 110 |
| General and administrative | 425 | 433 | 1,009 | 881 |
| Stock-based compensation expense before income taxes | $1,175 | $1,076 | $2,805 | $2,222 |
| Income taxes | (232) | (217) | (492) | (459) |
| Stock-based compensation expense after income taxes | $943 | $859 | $2,313 | $1,763 |
| Reduction to basic net income per share | $0.08 | $0.07 | $0.19 | $0.15 |
| Reduction to diluted net income per share | $0.08 | $0.07 | $0.18 | $0.14 |

There were no options granted during the first six months of fiscal year 2008 or fiscal year 2007. The fair value of offering periods for future purchases under the ESPP was estimated based on the Black-Scholes valuation model by using the following weighted average assumptions:

| | Employee Stock Purchase Plan | |
|---|---|---|
| | Six Months Ended May 2, 2008 | Six Months Ended May 4, 2007 |
| Risk-free interest rate | 3.3% | 4.8% |
| Expected life (years) | 0.50 | 1.3 |
| Expected volatility | 49% | 37% |
| Expected dividends | 3.5% | 2.8% |
| Weighted average fair value | $3.61 | $4.87 |

Our determination of the grant date fair value of stock-based compensation using an option pricing model and the resulting compensation expense that is recognized are affected by our stock price as well as assumptions regarding a number of variables. These factors include, but are not limited to, our expected stock price volatility, the projected life, the expected dividend yield, and the risk-free interest rate. Changes in the assumptions can materially affect the estimated fair value and the expense recognized.

The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at the ESPP offering date.

For our ESPP offering periods beginning prior to June 1, 2007, the expected life was based on the six-month purchase periods within each twenty-four-month offering period. Offering periods beginning after that date have a single six-month purchase period and we use an expected life of six months.

Our computation of expected volatility reflects a combination of historical and market-based implied volatility consistent with SFAS 123R and Staff Accounting Bulletin 107. We determined that the combination of historical and market-based implied volatility provides a more accurate reflection of our market conditions and is more representative of future stock price trends than employing solely historical volatility.

The expected dividend yield is calculated by taking the total expected annual dividend payout divided by the average stock price.

Stock-based compensation expense recognized in the consolidated statement of operations in the first six months of fiscal years 2008 and 2007 reflects estimated forfeitures, which are based on historical option forfeitures.

The net cash proceeds associated with our ESPP were $1,554,000 for the six-month period ended May 2, 2008, and $1,805,000 for the six-month period ended May 4, 2007. Unrecognized compensation cost associated with our ESPP as of May 2, 2008, is approximately $152,000 and is expected to be recognized over a weighted average period of 0.08 years.

Stock option activity for the six months ended May 2, 2008, is as follows:

| | Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding at October 31, 2007 | 1,409,724 | $18.33 |
| Grants | — | |
| Exercised | (17,233) | $9.71 |
| Forfeitures or expirations | (46,327)<br>----------- | $22.02<br>----------- |
| Outstanding at May 2, 2008 | 1,346,164 | $18.32 |
| Exercisable at May 2, 2008 | 1,030,534 | $17.27 |

Net cash proceeds from the exercise of stock options were approximately $167,000 for the six-month period ended May 2, 2008, and approximately $594,000 for the six-month period ended May 4, 2007.

As of May 2, 2008, approximately $2,756,000 of total unrecognized compensation costs related to unvested stock options is expected to be recognized over a weighted average period of 2.16 years.

The following table summarizes our restricted stock grant activity for the six months ended May 2, 2008.

| Nonvested Shares | Shares | Weighted Average Grant Date Fair Value Per Share |
|---|---|---|
| Nonvested at October 31, 2007 | 163,266 | $17.35 |
| Grants | 47,000 | $14.20 |
| Vested | (32,161) | $12.83 |
| Forfeitures | (3,799) ----------- | $17.94 |
| Nonvested at May 2, 2008 | 174,306 | $16.46 |

The fair value of our restricted stock is based on our closing stock price on the date of grant. Our unrecognized compensation cost related to nonvested (restricted) stock is $2,360,000, and is expected to be recognized over a weighted average period of 2.47 years.

We realized an income tax benefit from stock options exercised and restricted stock vested of approximately $48,000 during the first six months of fiscal year 2008. We realized a tax benefit of approximately $91,000 during the same period of fiscal year 2007. In accordance with SFAS 123R, we present excess tax benefits from the exercise of stock options and the vesting of restricted stock, if any, as financing cash flows rather than operating cash flows.

**Recent Accounting Pronouncements**

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157, *Fair Value Measurement*. SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances disclosures about fair value measurements. The statement will be effective for our fiscal year beginning November 1, 2008. We are evaluating the impact adopting SFAS 157 will have on our financial statements.

In February, 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value. It also establishes presentation and disclosure requirements to facilitate comparisons between companies using different measurement attributes for similar types of assets and liabilities. The statement will be effective for our fiscal year beginning November 1, 2008. We are evaluating the impact adopting SFAS 159 will have on our financial statements.

In June 2007, the FASB ratified Emerging Issues Task Force (EITF) Issue No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities (EITF 07-3). EITF 07-3 requires non-refundable advance payments for goods and services to be used in future research and development activities to be recorded as an asset, with the payments expensed when the research and development activities are performed. EITF 07-3 applies to new contractual arrangements entered into in fiscal years beginning after December 15, 2007. We believe that adoption of EITF 07-3 will not have a material effect on our financial position, results of operations, or cash flows.

In December 2007, the FASB issued SFAS 141R, *Business Combinations*. SFAS 141R replaces SFAS 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. The statement will apply prospectively to business combinations occurring in our fiscal year beginning November 1, 2009. We are evaluating the impact adopting SFAS 141R will have on our financial statements.

In March 2008, the FASB issued SFAS 161*, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. SFAS 161 requires enhanced disclosures about derivatives on a quarterly basis, including qualitative disclosures about objectives and strategies for using derivatives, and quantitative disclosures about the fair value of derivatives, as well as gains and losses on derivative instruments. It also requires disclosures about the volume of derivative activity and credit-risk-related contingent features in derivative agreements. SFAS 161 does not change the accounting treatment for derivative instruments, and therefore, the adoption will not have any impact on our financial position, results of operations, or cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008**.**

**Note 2: Inventory**

Inventories are stated at the lower of average cost or market and consisted of the following (in thousands):

| | May 2, 2008 | October 31, 2007 |
|---|---|---|
| Raw materials | $756 | $904 |
| Work in process | 8,022 | 4,597 |
| Finished goods | 961 | 443 |
| | $9,739 | $5,944 |

At May 2, 2008, the unfavorable indirect rate variance included in work in process was approximately $2,302,000. The fiscal 2008 rate variance includes approximately $1,180,000 of severance costs that we expect to pay to our former Chief Executive Officer. Please see “Note 9: Change in Management” for further details.

During the second quarter of fiscal year 2008, inventory activity included a write-down of approximately $935,000 of work-in-process inventory. Disposal activities were not significant during the first six months of fiscal years 2008 and 2007.

### Note 3: Goodwill and Intangible Assets

***Goodwill***. Under SFAS 142, *Goodwill and Other Intangible Assets*, goodwill is not subject to amortization. Rather, we evaluate goodwill for impairment at least annually or more frequently if events and changes in circumstances suggest that the carrying amount may not be recoverable. No impairment was recognized in the first six months of fiscal year 2008.

***Intangible assets***. Information on our identifiable intangible assets that are subject to amortization is presented in the table below (in thousands).

| | | | May 2, 2008 | |
|---|---|---|---|---|
| | Useful Life | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Identifiable intangible assets that are subject to amortization: | | | | |
| Customer relationships | 3 years | $1,720 | $(1,625) | $95 |
| Existing technology | 5 years | 340 | (193) | 147 |
| Patent | 18 years | 60 | (9) | 51 |
| Total | | $2,120 | $(1,827) | $293 |

All of our acquired identifiable intangible assets are subject to amortization and have originally estimated useful lives as noted in the table above. Amortization expense associated with our intangible assets was approximately $161,000 and $323,000 for the second quarter and first six months of fiscal year 2008, respectively, and $161,000 and $322,000, for the same periods in fiscal year 2007, respectively.

As of May 2, 2008, the estimated future amortization expense for acquired identifiable intangible assets is as follows (in thousands):

| Fiscal Years | |
|---|---|
| Remainder of 2008 | 131 |
| 2009 | 71 |
| 2010 | 49 |
| 2011–2023 | 42 |
| Total | $293 |

The goodwill and identifiable intangible assets are related to our July 2005 acquisition of Dynamics Technology, Inc. (DTI).

**Note 4: Borrowing Arrangements**

***Revolving line of credit***. At May 2, 2008, we had a revolving line of credit (Line of Credit) under which Wells Fargo Bank (Wells Fargo), could advance funds to us, up to a maximum principal amount of $3 million. The Line of Credit was renewed on February 21, 2008, and it will expire on March 1, 2009.

At May 2, 2008, we had two standby letters of credit under the Line of Credit totaling approximately $1,371,000. One letter of credit, related to our Sunnyvale, California facilities lease, had a committed balance of approximately $1,221,000 at May 2, 2008. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at May 2, 2008. We do not pay interest on the amounts associated with the standby letters of credit.

As a result of the committed but unused funds associated with the two letters of credit, the total amount under the Line of Credit available for borrowing was approximately $1,629,000. No fees or interest were associated with this unused portion. Borrowings under the Line of Credit bear interest at Wells Fargo's reference rate ( 5% at May 2, 2008), and interest on those borrowings is payable monthly. As security for our indebtedness under the Line of Credit, we have granted to Wells Fargo a security interest in our cash and marketable securities maintained with an affiliate of Wells Fargo.

***Term loan and interest rate swap***. Effective July 1, 2005, and in connection with the acquisition of DTI, we entered into a term loan with Wells Fargo in the principal amount of $10 million, plus interest, the proceeds of which were used for acquisition financing (the Term Loan). The Term Loan bears interest at a fixed rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) ( 2.72% at May 2, 2008). Our Term Loan is for a seven-year term ending on July 1, 2012, with monthly payments of principal and interest.

As security for our indebtedness under the Term Loan, we have granted to Wells Fargo a security interest in our accounts receivable, general intangibles, inventory, and equipment.

We are required to maintain certain financial covenants setting forth minimum ratios for quick ratio and fixed charge coverage and maximum ratios for total liabilities to tangible net worth. As of May 2, 2008, we were in compliance with these covenants.

We are exposed to market risk from changes in interest rates on the Term Loan, and manage this exposure through the use of an interest rate swap agreement with Wells Fargo. By locking in a fixed rate for the entire term of the loan, this strategy decreases the variability of earnings and cash flows resulting from interest rate fluctuations and lowers the overall borrowing costs should interest rates rise. The interest rate swap is designated as a cash flow hedge and is accounted for under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). No losses on the agreement due to counterparty credit issues are anticipated. Under this swap, we pay an interest rate of 4.33%, per annum, over the seven-year term of the loan and receive an average floating rate of LIBOR on the notional amount of the loan. Thus, we exchanged a variable rate obligation for a fixed interest obligation, resulting in an effective interest rate of 6.08%.

The effective portion of the cash flow hedge is reported as other comprehensive income and reclassified into earnings in the same period during which the hedged transaction affects earnings. At May 2, 2008, the effective portion of the cash flow hedge was a deferred net loss of approximately $71,000, net of taxes. Over the next twelve months, we expect to reclassify approximately $87,000 of the loss to interest expense as principal on the Term Loan is repaid and the related swap-instrument notional amount is reduced.

We assess effectiveness of the hedge instrument regularly. The ineffective portion of the gain or loss, if there is one, would impact earnings as it occurs. There is no ineffective portion of the outstanding swap as of May 2, 2008.

**Note 5: Contractual Obligations**

The following table sets forth our contractual obligations, excluding interest payments on our debt, as of May 2, 2008 (in thousands).

| | | Payments Due by Period | | | |
|---|---|---|---|---|---|
| | **Total** | **Less than 1 Year** | **1–3 Years** | **3–5 Years** | **More than 5 Years** |
| Operating lease obligations | $40,530 | $7,553 | $14,783 | $9,872 | $8,322 |
| Loan obligations – principal | 5,953 | 1,429 | 2,857 | 1,667 | — |
| Purchase obligations | 5,636<br>----------- | 5,636<br>----------- | —<br>----------- | —<br>----------- | —<br>----------- |

| | | | | | |
|---|---|---|---|---|---|
| Total | $52,119<br>======= | $14,618<br>======= | $17,640<br>======= | $11,539<br>======= | $8,322<br>======= |

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2009 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses. During the first six months of fiscal year 2008, approximately $998,000 of the cost for our leasehold improvements was funded by the landlord of our new facility in Torrance, California. This was determined to be a lease incentive. This lease incentive reduces our rent expense and will be amortized on a straight-line basis over the remaining period of our operating lease that ends in fiscal year 2015. This reduction to rent expense is generally equal to the increased amortization expense of the associated leasehold improvements.

### Note 6: Segment Reporting

We have reviewed our business operations and determined that we operate in a single homogeneous business segment. Each of our divisions sells similar products and services with similar economic characteristics to similar classes of customers, primarily to the United States Government, its agencies, or prime contractors for the United States Government. The technologies and the operations of our divisions are highly integrated. Revenues and costs are reviewed monthly by management on an individual contract basis as a single business segment.

### Note 7: Provision for Income Taxes

We adopted FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48) effective November 1, 2007. FIN 48 describes a two-step approach to recognizing and measuring uncertain tax positions. The first step is to determine whether it is more likely than not that a tax position accounted for under SFAS 109 will be sustained upon examination. The second step is to measure and recognize the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. We determined that there were no unrecognized tax benefits to be recorded upon adoption of FIN 48 or at May 2, 2008.

We record interest or penalties related to income taxes as a component of income tax expense in our financial statements. The amount of net interest recognized during the six months ended May 2, 2008, and May 4, 2007, as well as the amount of accrued interest at May 2, 2008, was not material. No penalties were recorded in those periods.

In general, our income tax returns are subject to examination by U.S. federal, and state tax authorities for fiscal years 2003 and forward.

Our provision for income taxes for the second quarter and first six months of fiscal year 2008 was approximately $967,000 and $2,092,000, respectively, with an estimated annual effective tax rate of 45.3%. During the first six months of fiscal year 2008, we reduced our income tax expense by approximately $440,000. This reduction was primarily related to the filing of an Application for Change in Accounting Method with the Internal Revenue Service (IRS) under the automatic-consent provisions, during the second quarter of fiscal year 2008. Based upon the change in method filed with the IRS, we re-measured our deferred tax asset balance related to the determination of tax basis depreciation on certain property and equipment assets as of October 31, 2006. This led to a tax benefit of approximately $333,000, which was recorded as a discrete item during the second quarter of fiscal year 2008.

Our provision for income taxes for the second quarter and first six months of fiscal year 2007 was approximately $1,001,000 and $2,438,000, respectively, representing an estimated annual effective tax rate of 44.0%. During the first six months of fiscal year 2007, we reduced our income tax expense by approximately $163,000, primarily due to the benefit of releasing a reserve associated with our California research and development tax refund of approximately $126,000.

### Note 8: Contingencies

***Product warranties***. Our products are warranted against defective workmanship and materials for a period of one year from the date of acceptance by the original purchaser. Warranty costs in the second quarter and first six months of fiscal year 2008 were approximately $52,000 and $109,000, respectively. For the same periods of fiscal year 2007 warranty costs were approximately $64,000 and $146,000, respectively.

***Guarantees***. From time to time, we enter into certain types of contracts that contingently require us to indemnify parties against third-party claims. These contracts primarily relate to (i) certain real estate leases, under which we may be required to indemnify property owners for environmental and other liabilities, and other claims arising from our use of the applicable premises; and (ii) certain agreements with our officers, directors, and employees under which we may be required to indemnify such persons for liabilities arising out of their employment relationship. The terms of such obligations vary. Generally, a maximum obligation is not explicitly stated. Because the obligated amounts of these types of agreements often are not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on the balance sheets as of May 2, 2008, or October 31, 2007.

***Legal proceedings***. On March 11 and July 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California. The cases were considered as *In re Applied Signal Technology Inc. Securities Litigation*, Master File No. 4:05-cv-1027 (SBA). The amended consolidated complaint is brought on behalf of a putative class of persons who purchased our Company's securities during a class period of August 24, 2004, through February 22, 2005. The complaints name us, our former Chief Executive Officer, and our Chief Financial Officer as defendants, and allege that false and misleading statements regarding us were issued during the class period. On February 8, 2006, the Court dismissed the case with prejudice. On June 5, 2008, the Ninth Circuit reversed the dismissal and remanded to the District Court. We intend to contest this litigation vigorously. Any future unfavorable outcome of the litigation could have an adverse impact on our business, financial condition, and results of operation. At this time, we cannot estimate the amount of possible loss or range of loss that might be incurred as a result of this proceeding.

### Note 9: Change in Management

Mr. Gary L. Yancey, our former Chairman and Chief Executive Officer, resigned as an executive officer and as a member of the Board of Directors, effective May 1, 2008. His final date of employment with us was May 30, 2008. Mr. William Van Vleet III, our Chief Operating Officer, is serving as Acting Chief Executive Officer on an interim basis until a successor is appointed. In addition, Mr. John P. Devine, a director since 1995, has been named non-executive Chairman of the Board of Directors. In connection with his departure, on May 23, 2008, we entered into a Severance Agreement and General Release of Claims with Mr. Yancey, under which, we will provide to Mr. Yancey certain separation benefits as a result of the termination of his employment. These benefits are payable to Mr. Yancey pursuant to his participation in the Company's Executive Retention and Severance Plan of August 19, 2004, and as a result of which, we will pay to Mr. Yancey in monthly installments an amount equal to 24 months of his base salary and 100% of his annual bonus, with the bonus determined as the aggregate amount that would be earned by him during fiscal year 2008 if all applicable performance goals were achieved. We will also continue health and other similar benefits until Mr. Yancey reaches age 65.

As a result, we recognized accrued severance of approximately $1,180,000 during the second quarter of fiscal year 2008, which increased accrued payroll liabilities by approximately $478,000 and other long-term liabilities by approximately $702,000. In addition, management believes that severance expense is recoverable through our indirect rates, and therefore we increased our indirect rate variance included in inventory by approximately $1,180,000.

In addition, we have agreed that all outstanding but unvested options to purchase Company common stock and all unvested restricted stock awards held by Mr. Yancey will vest in full immediately as of May 30, 2008. In addition, the period of exercisability of any vested stock options held by Mr. Yancey has been extended to two years from the date of termination of employment or expiration of the individual option grant, whichever occurs first. Therefore, we expect to recognize stock-based compensation expense of approximately $331,000 during the third quarter of fiscal year 2008, associated with the modifications to Mr. Yancey's equity awards.

## Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

The following information should be read in conjunction with the attached condensed financial statements and notes thereto, as well as our Annual Report on Form 10-K for the year ended October 31, 2007.

This quarterly report on Form 10-Q contains forward-looking statements made pursuant to the provisions of Section 21E of the Securities Exchange Act of 1934. These forward-looking statements are based on management's current expectations and beliefs, including estimates and projections about our industry. Forward-looking statements may be identified by the use of terms such as "anticipates," "expects," "intends," "plans," "seeks," "estimates," "believes," and similar expressions, although some forward-looking statements are expressed differently. Statements concerning financial position, business strategy, and plans or objectives for future operations are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties, and assumptions that are difficult to predict and may cause actual results to differ materially from management's current expectations. Such risks and uncertainties include those set forth in this document under "Item 1A, Risk Factors." The forward-looking statements in this report speak only as of the time they are made and do not necessarily reflect management's outlook at any other point in time. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events, or for any other reason. However, readers should carefully review the risk factors set forth in other reports or documents we file from time to time with the Securities and Exchange Commission (SEC).

### Description of Business

Applied Signal Technology, Inc. (AST) provides advanced digital signal processing products, systems, and services in support of intelligence, surveillance, and reconnaissance (ISR) for global security. We provide processing of both man-made and naturally occurring signals. The processing of man-made signals includes communications intelligence (COMINT) and electronic intelligence (ELINT). The processing of natural signatures includes the use of sonar, radar, magnetic, and chemical sensors to detect changes in the environmental phenomenology. Our primary customer is the United States Government. We develop and manufacture equipment for both the collection and processing of signals.

COMINT derives intelligence from telecommunications signals. Our COMINT signal collection equipment consists of sophisticated receivers that scan through potentially thousands of cellular telephone, microwave, ship-to-shore, and military transmissions in the radio frequency (RF) spectrum with the goal of collecting certain specific signals. Our COMINT signal processing equipment uses advanced software and hardware to evaluate characteristics of the collected signals and selects those most likely to contain relevant information. At inception, our efforts were primarily focused on COMINT processing equipment. Over time, we have broadened our scope to add specialized collection equipment and complete signal processing systems and related services.

ELINT derives intelligence from signals associated with weapons systems. Our investment in ELINT is directed toward the development of equipment for the collection and processing of weapons systems signals. This equipment will be able to scan the radar bands associated with weapons systems and determine the type of system and its precise location for battlefield characterization and force protection. The equipment will also analyze the command and control signals associated with these weapons systems to provide information about battlefield readiness. Our ELINT initiatives are new and to date we have derived no revenue from the sale of ELINT products or services.

Sensor signal processing observes changes in physical phenomena that can provide an indication of activities of concern to global security. Examples of these phenomena are detection of chemicals that might be used for explosive devices or the detection of sub-terrain ferrous materials that might indicate an underground facility for weapon manufacturing. Our sensor processing equipment provides automatic detection of physical abnormalities in both marine and terrestrial environments.

The majority of our revenues were from contracts with the United States Government, its agencies, or prime contractors for the United States Government.

### Critical Accounting Policies and Estimates

***General***. Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements. These condensed consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates. We believe that the estimates, assumptions, and judgments involved in the accounting policies described below have the greatest potential impact on our condensed consolidated financial statements and, therefore, consider these to be critical accounting policies. See “Notes to Condensed Consolidated Financial Statements, Note 1: Summary of Significant Accounting Policies,” included elsewhere in this report for more information about these critical accounting policies, as well as descriptions of other significant accounting policies.

***Revenue and cost recognition***. The majority of our contracts are accounted for in accordance with the AICPA Statement of Opinion 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts* (SOP 81-1). These contracts are executed by using written contractual arrangements, most of which require us to design, develop, manufacture, and/or modify our complex products, and perform related services according to specifications provided by the customer. A limited number of standalone software contracts are recognized in accordance with the AICPA Statement of Opinion 97-2, *Software Revenue Recognition* (SOP 97-2). In accordance with SOP 97-2, we may, at times, record an amount of deferred revenue associated with contracts that are billed and for which customers have paid in advance of performance requirements set forth in these contracts.

As a supplier to United States Government, we are required to comply with numerous regulations, including those governing security and contracting practices. Failure to comply with these procurement regulations and practices could result in fines being imposed against us or our suspension for a period of time from eligibility for bidding on, or for award of, new government contracts. Among the causes for the suspension are violations of various statutes, including those related to procurement integrity, export control, United States Government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign corruption. The government may investigate and make inquiries of our business practices and conduct audits of contract performance and cost accounting. The government audits and investigations can take several years to complete. Depending on the results of these audits and investigations, the government may make claims against us or take exception to certain costs we determined to be recoverable. In the period management determines recoverability is not likely, operating income would be reduced.

We account for cost-reimbursement contracts by charging actual labor, materials, and other direct costs, plus estimated indirect costs of operations as incurred (incurred costs). Indirect costs include overhead, research and development, and general and administrative expenses. Stock compensation expense is generally not reimbursable under these contracts. We do not apply indirect costs to subcontract costs that are in excess of $250,000 and that meet certain other predetermined criteria.

We recognize contract revenues and profits on cost-reimbursement contracts by applying an estimated fee rate to all incurred costs on an individual contract basis. Fee calculations are based on either negotiated fee amounts or management’s assessment of the fee amounts that are likely to be earned. On cost-reimbursement contracts, we may bear unexpected cost increases for purposes of maintaining customer relationships. Historically, the effect on operating results and financial condition from cost-reimbursement losses has been minimal.

Our policy for recognizing interim fees on our cost-plus-award-fee contracts is based on management's assessment as to the likelihood that the award fee or an incremental portion of the award fee will be earned, on a contract-by-contract basis. Management bases its assessments on numerous factors, including contract terms, nature of the work to be performed, our relationship and history with the customer, our history with similar types of projects, and our current and anticipated performance on the specific contract. No award fee is recognized until management determines that it is probable that an award fee or a portion thereof will be earned. Historically, management's estimates have generally been consistent with the actual fees awarded. However, changes in facts and circumstances could arise within an award fee period, causing management to either lower or raise the award fee estimate in the period in which the changes occur.

Some of our engineering services are performed under time-and-materials contracts on a level-of-effort basis. We recognize revenue for these contracts by applying a negotiated billing rate to the level of effort.

We account for fixed-price contracts by using the percentage-of-completion method. Under this method, we charge labor, materials, and other direct costs, plus estimated indirect costs of operations, as they are incurred (incurred costs). Each period, we recognize as revenue a portion of the contract revenue, based on estimated profits and the degree of completion of the contract as measured by a comparison of the actual costs incurred and the estimated total costs to complete. On fixed-price contracts, we bear any unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies, or other factors, and these costs could have a materially adverse effect on results of operations and financial condition.

For those contracts in which all of the terms have not yet been finalized, revenue does not include an estimated fee rate on cost.

Management reviews contract performance, costs incurred, and estimated completion costs regularly. We adjust revenues and profits on all contracts in the period in which changes, including anticipated losses, become determinable.

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and costs incurred in connection with ongoing contracts for which contract modifications have not been defined or completed at the end of the reporting date. These costs are included in other current assets on the balance sheet. Precontract costs for the periods ended May 2, 2008, and October 31, 2007, were approximately $3,157,000 and $4,465,000, respectively. Approximately $3,406,000 of the October 31, 2007, balance was recognized as revenue during the first six months of fiscal year 2008.

We have one licensing agreement for which we accrue royalties upon sales of our licensed product. Since there are essentially no costs associated with this agreement, operating income will increase by the same amount of revenue that we recognize.

***Indirect rate variance adjustment to operations***. We record contract revenues and costs of operations for interim reporting purposes based on annual targeted indirect rates. During our interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. Timing-related indirect spending variances are removed from contract costs, research and development, and general and administrative expenses, and are included in inventory as part of work in process during these interim reporting periods. These rates are reviewed regularly, and we record adjustments for any material, permanent variances in the period they become estimable. We believe that this method is the preferred practice used within our industry. At year-end, we adjust the revenues and costs for actual indirect rates.

Our accounting policy for recording the indirect rate variance is based on management's belief that variances accumulated during interim reporting periods will be absorbed by expected contract activities during the remainder of the year. We consider the rate variance to be unfavorable when our actual indirect rates are greater than our annual targeted rates. In contrast, a favorable rate variance occurs when our actual indirect rates are lower than our annual targeted rates. During interim reporting periods, we record unfavorable rate variances as reductions to operating expenses and increases to work-in-process inventory. We record favorable rate variances as increases to operating expenses and decreases to work-in-process inventory.

If we anticipate that actual contract activities will be different than planned levels, there are alternatives we can utilize to reduce the variance: we can adjust some of our planned indirect spending during the year, request a modification of our billing rates to our customers through the Defense Contract Audit Agency any time during the fiscal year in accordance with Federal Acquisition Regulations, or record adjustments to expense based on estimates of future contract activities for the remainder of the fiscal year.

If our rate variance is unfavorable, the modification of our billing rates will likely increase revenue and operating expenses, and decrease the unfavorable indirect rate variance accumulated in inventory. Fee percentages on fixed-price and time-and-materials contracts will generally decline as a result of any increase to indirect costs. Fee percentages on active cost-reimbursable contracts will generally be unaffected as a result of any increase to indirect costs. Fee percentages on completed cost-reimbursable contracts will generally be reduced. If our rate variance is favorable, the modification of our billing rates will decrease revenue and operating expenses, and decrease the favorable indirect rate variance accumulated in inventory. In this event, fee percentages on fixed-price and time-and-materials contracts will generally increase. Fee percentages on cost-reimbursable contracts will generally be unaffected as a result of any reduction to indirect costs, due to the fact that programs will typically expend all of the funds available. Any impact on operating income, however, will depend on a number of other factors, including mix of contract types, contract terms, anticipated performance on specific contracts, and anticipated changes in inventory.

At May 2, 2008, the unfavorable inventoried indirect variance was approximately $2,302,000. The fiscal 2008 rate variance includes approximately $1,180,000 of severance costs that we expect to pay to our former Chief Executive Officer. Please see “Note 9: Change in Management” for further details. At May 4, 2007, the unfavorable inventoried indirect rate variance was approximately $4,191,000.

***Income taxes***. Our income tax expense at interim reporting periods is based on our estimated annual effective tax rate and any discrete items that occur during any interim period. We calculate this estimated tax rate based on the projected net income at the end of the fiscal year, and review it at each reporting period. At the end of the fiscal year, we adjust income tax expense for actual results. Our effective tax rate can differ from the statutory rate primarily due to the non-tax-deductible nature of certain types of stock-based compensation expense. Please refer to “Notes to Condensed Consolidated Financial Statements, Note 7: Provision for Income Taxes” for the current year effective tax rate.

***Allowance for bad debt***. Since the majority of our revenues are generated from the United States Government, its agencies, or prime contractors for the United States Government, we regard the credit risk of our business to be minimal. We record allowances for bad debt as a reduction to accounts receivable and an increase to bad debt expense. These allowances are recorded in the period a specific collection problem is identified. Once the receivable is deemed uncollectible, the allowance is reversed and the receivable is written off.

During the first six months of fiscal year 2008 and fiscal year 2007, there was no material charge to bad debt expense.

***Inventory valuation and disposal***. We provide advanced digital signal processing products and systems to the United States Government. Typical life cycles of our equipment are eight to ten years or more. In addition, we maintain spare parts in order to repair the equipment. We evaluate our inventory quarterly, at interim reporting periods, and assess our ability to sell our equipment, which includes raw materials. Historically, we have sold our inventory at or above cost, so there was typically no decrement in valuation. When we determine that a product has reached the end of its life cycle or there is no longer a need for a certain product, typically, we will dispose of any remaining inventory, and record the associated reduction to inventory.

In the second quarter of fiscal year 2008, we recorded a write-down of approximately $935,000 to reflect the estimated market value of one inventoried product; these charges were included in contract costs in our statement of operations. Disposals associated with our raw materials represent a minor amount and are included in general and administrative expenses on the statement of operations due to the fact that raw materials could be used in a variety of situations other than contract costs, including R&D.

Disposal activities were not significant during the first six months of fiscal years 2008 and 2007.

***Price redetermination***. As a government contractor, we are subject to price redetermination on certain fixed-price contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. During the first six months of fiscal years 2008 and 2007, we did not incur any price redeterminations on any of our contracts.

***Goodwill valuation***. We test goodwill for possible impairment on an annual basis and at any other time if events occur or circumstances indicate that the current carrying amount of goodwill may not be recoverable. Circumstances that could trigger an impairment test include, but are not limited to, a significant adverse change in the business climate or legal factors, an adverse action or assessment by a regulator, unanticipated competition, and loss of key personnel.

The determination as to whether a write down of goodwill is necessary involves significant judgment based on the short-term and long-term projections of the future performance as well as estimating discount rates.

To perform the goodwill impairment test, we determine the fair value of the reporting unit and compare the fair value to the reporting unit’s carrying value. We believe AST is one reporting unit, and therefore, we compare the fair value of AST to the total net asset value on our balance sheet. If our total net asset value were to exceed our fair value, we would perform the second step of the impairment test. In the second step, we would compare the implied fair value of our goodwill to our carrying amount. If no impairment exists under step one, then step two is not necessary.

No indicators of impairment were identified at May 2, 2008.

***Long-lived asset valuation (property, plant and equipment, and intangible assets)***. We will test long-lived assets or asset groups for recoverability when events or changes in circumstances indicate that their carrying amount may not be recoverable. Circumstances that could trigger a review include, but are not limited to, significant decreases in the market price of the asset, significant adverse changes in the business climate or legal factors, accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of the asset, current period cash flow or operating losses combined with a history of losses or a forecast of continuing losses associated with the use of the asset, and current expectation that the asset will more likely than not be sold or disposed of significantly before the end of its estimated useful life.

We assess recoverability based on the carrying amount of the asset and its fair value, which is generally determined based on the sum of the undiscounted cash flows expected to result from the use and the eventual disposal of the asset. We recognize an impairment loss when the carrying amount is not recoverable and exceeds fair value.

No indicators of impairment were identified at May 2, 2008.

***Share-based payment***. We adopted SFAS 123 (revised 2004), *Share-Based Payment* (SFAS 123R), at the beginning of fiscal year 2006. Applying this complex standard to value equity-based compensation requires us to use significant judgment and to make estimates, particularly for the assumptions used in the Black-Scholes valuation model, such as stock price volatility and expected option lives, as well as for the expected option forfeiture rates.

We elected to use the modified prospective transition method. Stock-based compensation expense for awards granted subsequent to November 1, 2005, was based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. For awards granted prior to, but not yet vested, as of November 1, 2005, stock-based compensation expense was based on the grant-date fair value previously estimated in accordance with the original provisions of SFAS 123. We recognize the stock compensation expense over the requisite service period of the award, which generally equals the vesting period of each grant.

We have an Employee Stock Purchase Plan (ESPP) that allows employees to purchase shares of common stock at 85% of the fair market value at the lower of either the date of enrollment or the date of purchase. For offering periods beginning prior to June 1, 2007, our ESPP had a twenty-four month offering period with four six-month purchase periods within each offering period. If the fair market value on the purchase date was lower than the fair market value on the offering date, all participants were withdrawn from the offering period and re-enrolled into a new offering period. Effective, May 31, 2007, we modified our ESPP such that the length of all offering periods, beginning June 1, 2007, is six months. Consequently, there is no reset feature associated with the new offering periods. As a result of the modification to the ESPP, the December 1, 2006, offering period, ending on November 30, 2008, was the final twenty-four month offering.

Our closing stock price on the November 30, 2007, ESPP purchase date was lower than the closing stock price on the December 1, 2006, offering date. Therefore, 361 participants were re-enrolled from the original twenty-four-month offering period ending on November 30, 2008, into a new six-month offering period, beginning December 1, 2007, and ending May 31, 2008. This re-enrollment effectively canceled the final six-month purchase period of the original twenty-four-month offering. Therefore, the remaining unamortized compensation amount associated with this final purchase period, approximately $382,000, was immediately recognized on December 1, 2007. In addition, as a result of the modification, approximately $91,000 of incremental compensation expense was generated at December 1, 2007, of which we recognized $45,000 during the second quarter and $77,000 during the first six months of fiscal year 2008.

On November 15, 2007, one of our non-employee directors retired. Immediately prior to his retirement, we accelerated the vesting of all unvested shares of his restricted stock and stock option awards. In addition, we extended the remaining exercise period of all vested and unexercised options from ninety days to one year. As a result, our stock compensation expense associated with these modified equity awards, was approximately $80,000 higher than it would have been had the awards not been modified upon retirement.

The following table sets forth the total stock-based compensation expense resulting from stock options, restricted stock, and ESPP included in our condensed consolidated statements of operations (in thousands, except share data).

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | **May 2, 2008** | **May 4, 2007** | **May 2, 2008** | **May 4, 2007** |
| Contract costs | $692 | $587 | $1,685 | $1,231 |
| Research and development | 58 | 56 | 111 | 110 |
| General and administrative | 425 | 433 | 1,009 | 881 |
| Stock-based compensation expense before income taxes | $1,175 | $1,076 | $2,805 | $2,222 |
| Income taxes | (232) | (217) | (492) | (459) |
| Stock-based compensation expense after income taxes | $943 | $859 | $2,313 | $1,763 |

| | | | | |
|---|---|---|---|---|
| Reduction to basic net income per share | $0.08 | $0.07 | $0.19 | $0.15 |
| Reduction to diluted net income per share | $0.08 | $0.07 | $0.18 | $0.14 |

Assumptions used in the Black-Scholes model are the expected stock price volatility over the expected life of the awards, the projected employee stock option's life, the expected dividend yield, and the risk-free interest rate. Changes in the subjective assumptions can materially affect the estimated value of the stock awards. Historical volatility, market-based implied volatility, or a combination of both will be considered when projecting the expected stock price volatility for both stock options and purchases under our ESPP. We determined that the combination of historical and market-based implied volatility provides a more accurate reflection of our market conditions and is more representative of future stock price trends than employing solely historical volatility. For our ESPP offering periods beginning prior to June 1, 2007, the expected life was based on the six-month purchase periods within each twenty-four-month offering period. Offering periods beginning after that date have a single six-month purchase period and we use an expected life of six months. The risk-free interest rate is based on the Federal Reserve Bank's constant maturities daily interest rate in effect at the ESPP offering date.The expected dividend yield is calculated by taking the total expected annual dividend payout divided by the average stock price per share.

The fair value of our restricted stock is based on our closing stock price on the date of grant.

Please refer to "Notes to Condensed Consolidated Financial Statements, Note 1: Summary of Significant Accounting Policies, Stock-Based Compensation" for additional information.

### Overview

We believe that there continues to be an interest in ISR by the United States Government to respond to the threat of terrorist activities and the war against terrorism, and that we are well positioned to benefit from the spending that might result. We believe that our COMINT and sensor processing markets have strong growth potential and that our move into the ELINT marketplace provides us an opportunity to diversify into a complementary business. As a result of this anticipated growth, we expect to make additional investments of capital and management resources, including additional personnel and facilities.

We continue to focus our operations on assuring program performance, meeting staffing requirements, maintaining a competitive cost structure, and diversifying our marketplace. Our customers continue to come to us with new requirements for ISR solutions, weighted heavily toward new developments. A significant portion of our revenue continues to be generated by cost-reimbursable contracts that tend to be developmental in nature, and require highly specialized, technical skill sets. We believe that this trend will continue in fiscal year 2008.

At the end of the second quarter of fiscal year 2008 Mr. Gary L. Yancey, our former Chairman and Chief Executive Officer, resigned as an executive officer and as a member of the Board of Directors, effective May 1, 2008. His final date of employment with us was May 30, 2008. Mr. William Van Vleet III, our Chief Operating Officer, is serving as Acting Chief Executive Officer on an interim basis until a successor is appointed. In addition, Mr. John P. Devine, a director since 1995, has been named non-executive Chairman of the Board of Directors.

In connection with his departure, on May 23, 2008, we entered into a Severance Agreement and General Release of Claims with Mr. Yancey, under which, we will provide to Mr. Yancey certain separation benefits as a result of the termination of his employment. These benefits are payable to Mr. Yancey pursuant to his participation in the Company's Executive Retention and Severance Plan of August 19, 2004, and as a result of which, we will pay to Mr. Yancey in monthly installments an amount equal to 24 months of his base salary and 100% of his annual bonus, with the bonus determined as the aggregate amount that would be earned by him during fiscal year 2008 if all applicable performance goals were achieved. We will also continue health and other similar benefits until Mr. Yancey reaches age 65.

As a result, we recognized accrued severance of approximately $1,180,000 during the second quarter of fiscal year 2008, which increased accrued payroll liabilities by approximately $478,000 and other long-term liabilities by approximately $702,000. In addition, management believes that severance expense is recoverable through our indirect rates, and therefore we increased our indirect rate variance included in inventory by approximately $1,180,000.

In addition, we have agreed that all outstanding but unvested options to purchase Company common stock and all unvested restricted stock awards held by Mr. Yancey will vest in full immediately as of May 30, 2008. In addition, the period of exercisability of any vested stock options held by Mr. Yancey has been extended to two years from the date of termination of employment or expiration of the individual option grant, whichever occurs first. Therefore, we expect to recognize stock-based compensation expense of approximately $331,000 during the third quarter of fiscal year 2008, associated with the modifications to Mr. Yancey's equity awards.

### Three and Six Months Ended May 2, 2008, Compared to Three Months and Six Months Ended May 4, 2007

***Revenues and backlog***. Revenues for the second quarter of fiscal year 2008 were approximately $45,284,000, a 10.3% increase from revenues of approximately $41,054,000 recorded in the second quarter of fiscal year 2007. Revenues for the first six months of fiscal year 2008 were approximately $88,009,000, a 4.0% increase from revenues of approximately $84,598,000 recognized during the same period of fiscal year 2007. Revenues generated by our development programs increased by approximately $6,377,000 and $8,768,000 during the second quarter and first six months of fiscal year 2008, respectively, compared to the same periods in fiscal year 2007. This increase was offset by a decline in product sales by approximately $3,171,000 and $7,250,000 during the second quarter and first six months of fiscal year 2008 compared to the same periods of fiscal year 2007.

Our revenues include royalty income associated with one licensing agreement. We recorded royalty income of approximately $1,396,000 during the second quarter of fiscal year 2008, compared to approximately $372,000 during the same period of fiscal year 2007. Royalty income for the first six months of fiscal year 2008 was approximately $2,511,000, compared to approximately $619,000 during the same period of fiscal year 2007.

New orders received during the second quarter of fiscal year 2008 were approximately $48,150,000, an increase of 28.0% from approximately $37,631,000 in new orders received during the same period of fiscal year 2007. New orders received during the first six months of fiscal year 2008 were approximately $75,039,000, a decrease of 2.3% from approximately $76,780,000 in new orders received during the same period of fiscal year 2007. Our backlog consists of the uncompleted portions of existing contracts (excluding unexercised contract options). At May 2, 2008, ending backlog was approximately $113,737,000, representing a 10.2% decrease from ending backlog of approximately $126,708,000 at October 31, 2007. Reported backlog includes both funded and unfunded portions of contract values. There is no assurance or obligation that contracts will be fully funded. To the extent that contracts are not fully funded, there will be a reduction to backlog in a future period.

Our contracts can be fixed-price contracts, where we agree to deliver equipment for a fixed price and assume the risk of cost overruns; cost-reimbursement contracts, where we are reimbursed for our direct and indirect costs and paid a negotiated profit; or time-and-materials contracts, where we recognize revenue for these contracts by applying a negotiated billing rate to the level-of-effort. Cost-reimbursement and time-and-materials contracts typically do not return as high a profit margin as fixed-price contracts, and accordingly, our profit margin will be affected by the mix of our orders by contract type.

The following table represents our revenue concentration during the respective periods by contract type.

| | —— Three Months Ended —— | | —— Six Months Ended —— | |
|---|---|---|---|---|
| | **May 2, 2008** | **May 4, 2007** | **May 2, 2008** | **May 4, 2007** |
| Cost-reimbursement contracts | 72% | 70% | 72% | 73% |
| Fixed-price contracts | 10% | 15% | 9% | 16% |
| Time-and-materials contracts | 18% | 15% | 19% | 11% |

Five contracts represented an aggregate of 60% of revenues for each of the three-month and six-month periods ended May 2, 2008. Three of these contracts were indefinite-delivery-indefinite-quantity contracts (IDIQ). Under the terms of this type of contract, the government may issue individual delivery orders (DOs) for goods or services that they require. Each DO is treated as a separate contract, which may be awarded on a cost-reimbursable, fixed-price, or time-and-materials basis. We aggregate the DOs under each IDIQ contract for purposes of distinguishing significant revenue concentrations. Five contracts represented an aggregate of 50% and 52% of revenues for the respective three-month and six-month periods ended May 4, 2007. Four of these contracts were IDIQ contracts. In addition, one of the five contracts in each of fiscal years 2008 and 2007 was a time-and-materials contract, which significantly increased the revenue concentration of time-and-materials contracts during fiscal year 2008. All of the other contracts referenced were cost-reimbursement contracts.

***Contract costs***. Contract costs consist of direct costs incurred in the performance of the contract, including labor, materials, and estimated overhead costs. Contract costs were approximately $31,492,000, or 69.5 % of revenues, for the second quarter of fiscal year 2008 compared to approximately $28,583,000, or 69.6 % of revenues, for the same period of fiscal year 2007. Contract costs were approximately $60,863,000, or 69.2% of revenues, for the first six months of fiscal year 2008 compared to approximately $57,443,000, or 67.9% of revenues, for the same period of fiscal year 2007. Contract costs increased in absolute dollars during the second quarter and first six months of fiscal year of fiscal year 2008 compared to the same periods of fiscal year 2007 primarily due to increased activity with development programs. In addition, we recorded an inventory write-down during the second quarter of fiscal year 2008, which increased contract costs by approximately $935,000.

***Research and development (R&D)***. Company-directed investment in research and development consists of expenditures recoverable from customers through our billing rates and expenditures funded by us from operations. For interim reporting periods, R&D expenses include labor, materials, and estimated overhead costs. R&D expenses were approximately $3,554,000, or 7.9 % of revenues, for the second quarter of fiscal year 2008 compared to approximately $3,410,000, or 8.3% of revenues, for the same period of fiscal year 2007. During the first six months of fiscal year 2008, R&D expenses were approximately $6,533,000, or 7.4% of revenues, compared to approximately $6,995,000, or 8.3% of revenues, during the first six months of 2007. R&D expenses decreased in absolute dollars and as a percentage of revenues during the first six months of fiscal year 2008 primarily due to directing our efforts toward meeting our contractual obligations.

***General and administrative (G&A)***. General and administrative expenses include administrative salaries, costs related to marketing and proposal activities, costs associated with product warranties, and other administrative costs. We record G&A expenses based on annual targeted indirect rates applied to our quarterly revenue base, for interim reporting periods. G&A expenses were approximately $7,403,000, or 16.4 % of revenues, for the second quarter of fiscal year 2008, compared to approximately $6,585,000, or 16.0% of revenues, for the same period of fiscal year 2007. During the first six months of fiscal year 2008, G&A expenses were approximately $15,398,000, or 17.5 % of revenues, compared to approximately $14,544,000, or 17.2% of revenues, during the first six months of 2007. G&A expenses increased during the first six months of fiscal year 2008 primarily due to the applied G&A rate on an increased contract base.

***Interest income and other, net***. Net interest income for the second quarter of fiscal year 2008 was approximately $293,000, representing an immaterial difference to net interest income of approximately $289,000 for the second quarter of fiscal year 2007. Interest income recognized during the first six months of fiscal year 2008 was approximately $665,000 compared to interest income of approximately $622,000 during the first six months of 2007.

***Interest expense***. Interest expense for the second quarter of fiscal year 2008 was approximately $146,000 compared to approximately $184,000 of interest expense in the second quarter of fiscal year 2007. Interest expense incurred during the first six months of fiscal year 2008 was approximately $285,000 compared to interest expense of approximately $357,000 during the first six months of fiscal year 2007.

***Provision for income taxes***. Our provision for income taxes for the second quarter and first six months of fiscal year 2008 was approximately $967,000 and $2,092,000, respectively, representing an estimated 45.3% annual effective tax rate. Our provision for income taxes for the second quarter and first six months of fiscal year 2007 was approximately $1,001,000 and $2,438,000, respectively, representing an estimated 44% annual effective tax rate. The difference in our estimated annual effective tax rate at May 2, 2008, from our effective tax rate at May 4, 2007, was primarily due to a projected decrease in our domestic manufacturing credit. During the first six months of fiscal year 2008, we reduced our income tax expense by approximately $440,000. This reduction was primarily related to the filing of an Application for Change in Accounting Method with the Internal Revenue Service (IRS) under the automatic-consent provisions, during the second quarter of fiscal year 2008. Based upon the change in method filed with the IRS, we re-measured our deferred tax asset balance related to the determination of tax basis depreciation on certain property and equipment assets as of October 31, 2006. This led to a tax benefit of approximately $333,000, which was recorded as a discrete item during the second quarter of fiscal year 2008. During the first six months of fiscal year 2007, we recorded discrete items resulting in tax benefits of approximately $163,000, including the benefit of a research and development tax refund from the state of California of approximately $126,000.

## Analysis of Liquidity and Capital Resources

Our primary sources of liquidity during the first six months of fiscal year 2008 were cash flows generated from operations, the issuance of common stock through exercise of options granted under our employee stock option plans, and stock purchases under our ESPP.

***Net cash from operating activities***. Net cash from operating activities has varied significantly from quarter to quarter. These quarter-to-quarter variances are primarily the result of changes in net income and operating assets and liabilities. Operating activities provided cash of approximately $8,494,000 and $3,197,000 during the first six months of fiscal years 2008 and 2007, respectively. Net income for the first six months of fiscal year 2008 was approximately $3,503,000 compared to net income of approximately $3,443,000 for the comparable period of fiscal year 2007.

Accounts receivable balances decreased during the first six months of fiscal year 2008 by approximately $1,329,000 and by approximately $1,923,000 during the same period in fiscal year 2007. During the first six months of fiscal year 2008, we generated revenues of approximately $88,009,000 and collected approximately $88,745,000. During the first six months of fiscal year 2007, we generated revenues of approximately $84,598,000 and collected approximately $86,521,000.

Inventory, prepaid expenses, and other assets increased during the first six months of fiscal year 2008 by approximately $4,154,000 and during the first six months of fiscal year 2007 by approximately $2,805,000. Inventory balances increased by approximately $3,795,000 during the first six months of fiscal year 2008. The increase in inventory included an increase to the indirect rate variance of approximately $2,302,000; an increase to work-in-process inventory of approximately $2,058,000; and a reduction due to an inventory write-down of approximately $935,000. During the first six months of fiscal year 2008, precontract costs decreased other current assets by approximately $1,308,000. During the first six months of fiscal year 2007, precontract costs decreased other current assets by approximately $3,215,000 and the indirect rate variance included in inventory increased by approximately $4,191,000.

During the first six months of fiscal year 2008, we received a payment of approximately $877,000 for lease incentives associated with our facility in Torrance, California.

Accounts payable, taxes payable, and accrued liabilities balances increased by approximately $338,000 during the first six months of fiscal year 2008 and decreased by approximately $4,329,000 during the first six months of fiscal year 2007. The increase during the first six months of fiscal year 2008 included a severance accrual for our former Chief Executive officer of approximately $1,180,000. Approximately $478,000 was included in accrued payroll liabilities and approximately $702,000 was included in other long-term liabilities.

Accounts payable and other accrued liabilities increased by approximately $365,000 during the first six months of fiscal year 2008. During the same period in fiscal year 2007, accounts payable and other accrued liabilities balances decreased by approximately $1,879,000, primarily due to decreased outstanding procurements. Accrued payroll liabilities decreased by approximately $26,000 during the first six months of fiscal year 2008, and decreased by approximately $2,450,000 during the same period in fiscal year 2007. Accrued salaries decreased during the first six months of fiscal year 2008 by approximately $584,000 and decreased during the same period of fiscal year 2007 by approximately $1,919,000. The difference in activities for accrued salaries was due to the timing of our bi-weekly payroll.

***Net cash from investing activities***. Investing activities used cash of approximately $4,402,000 during the first six months of fiscal year 2008. During the same period of fiscal year 2007, investing activities used cash of approximately $1,011,000. During the first six months of fiscal year 2008, we purchased approximately $50,236,000 of investment securities and approximately $48,217,000 matured. During the same period of fiscal year 2007, we purchased approximately $39,466,000 of investment securities and approximately $39,540,000 matured.

***Net cash from financing activities***. Financing activities used cash of approximately $2,213,000 during the first six months of fiscal year 2008 and used cash of approximately $1,389,000 during the same period in fiscal year 2007. The difference in financing activities between the first six months of fiscal years 2008 and 2007 is due to a decrease in the amount of proceeds from our employee stock purchase plan and fewer option exercises during the first six months of fiscal year 2008.

Cash is generated primarily from operating activities, employee stock activities, and investing activities. At May 2, 2008, we held in our investment portfolio approximately $35,680,000 of short-term and long-term municipal securities. Substantially all of our investments in the municipal securities are with A-1/SP-1/AAA (Standard & Poor’s), P-1/MIG-1/Aaa (Moody’s), and F-1/AA/AAA (Fitch) rated issuers.

Our investment policy prohibits our investment in auction rate securities, mortgage-backed securities, and asset-backed securities. Insured municipal notes or bonds are also prohibited, with the exception of daily and weekly variable rate demand notes that contain a hard put feature.

Based on our ability to liquidate our investment portfolio and our expected operating cash flows, we do not anticipate any liquidity constraints as a result of the current credit environment.

We believe the primary risk to liquidity is the potential decrease in demand for our products and services. Historically, this demand has been influenced by the ISR needs of the United States Government.

We believe that the funds generated from operations, existing working capital, and the amount available under our existing line of credit will be sufficient to meet our cash needs for the next twelve months.

### Borrowing Arrangements

***Revolving line of credit***. At May 2, 2008, we had a revolving line of credit (Line of Credit) under which Wells Fargo Bank (Wells Fargo), could advance funds to us, up to a maximum principal amount of $3 million. The Line of Credit was renewed on February 21, 2008, and it will expire on March 1, 2009.

At May 2, 2008, we had two standby letters of credit under the Line of Credit totaling approximately $1,370,000. One letter of credit, related to our Sunnyvale, California facilities lease, had a committed balance of approximately $1,221,000 at May 2, 2008. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at May 2, 2008. We do not pay interest on the amount associated with the standby letters of credit.

As a result of the committed but unused funds associated the two letters of credit, the total amount under the Line of Credit available for borrowing was approximately $1,629,000. No fees or interest were associated with this unused portion. Borrowings under the Line of Credit bear interest at Wells Fargo’s reference rate (5% at May 2, 2008), and interest on those borrowings are payable monthly. As security for our indebtedness under the Line of Credit, we have granted to Wells Fargo a security interest in our cash and marketable securities maintained with an affiliate of Wells Fargo.

***Term loan and interest rate swap***. Effective July 1, 2005, and in connection with the acquisition of DTI, we entered into a Term Loan with Wells Fargo, in the principal amount of $10 million, plus interest, the proceeds of which were used for acquisition financing (the Term Loan). The Term Loan bears interest at a fixed rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) (2.72% at May 2, 2008). Our Term Loan is for a seven-year term ending on July 1, 2012, with monthly payments of principal and interest.

As security for our indebtedness under the Term Loan, we have granted to Wells Fargo a security interest in our accounts receivable, general intangibles, inventory, and equipment.

We are required to maintain certain financial covenants setting forth minimum ratios for quick ratio and fixed charge coverage and maximum ratios for total liabilities to tangible net worth. As of May 2, 2008, we were in compliance with these covenants.

We are exposed to market risk from changes in interest rates on the Term Loan, and manage this exposure through the use of an interest rate swap agreement with Wells Fargo. By locking in a fixed rate for the entire term of the loan, this strategy decreases the variability of earnings and cash flows resulting from interest rate fluctuations and lowers the overall borrowing costs should interest rates rise. The interest rate swap is designated as a cash flow hedge and is accounted for under SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). No losses on the agreement due to counterparty credit issues are anticipated. Under this swap, we pay an interest rate of 4.33%, per annum, over the seven-year term of the loan and receive an average floating rate of LIBOR on the notional amount of the loan. Thus, we exchanged a variable rate obligation for a fixed interest obligation, resulting in an effective interest rate of 6.08%.

The effective portion of the cash flow hedge is reported as other comprehensive income and reclassified into earnings in the same period during which the hedged transaction affects earnings. At May 2, 2008, the effective portion of the cash flow hedge was a deferred net loss of approximately $71,000, net of taxes. Over the next twelve months, we expect to reclassify approximately $87,000 of the loss to interest expense as principal on the Term Loan is repaid and the related swap-instrument notional amount is reduced.

We assess effectiveness of the hedge instrument regularly. The ineffective portion of the gain or loss, if there is one, would impact earnings as it occurs. There is no ineffective portion of the outstanding swap as of May 2, 2008.

### Contractual Obligations

The following table sets forth our contractual obligations as of May 2, 2008 (in thousands).

| | | Payments Due by Period | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 Year | 1–3 Years | 3–5 Years | More than 5 Years |
| Operating lease obligations | $40,530 | $7,553 | $14,783 | $9,872 | $8,322 |
| Loan obligations – principal | 5,953 | 1,429 | 2,857 | 1,667 | — |
| Loan obligations – interest | 781 | 327 | 390 | 64 | — |
| Purchase obligations | 5,636<br>----------- | 5,636<br>----------- | —<br>----------- | —<br>----------- | —<br>----------- |
| Total | $52,900<br>======= | $14,945<br>======= | $18,030<br>======= | $11,603<br>======= | $8,322<br>======= |

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2009 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses. During the first quarter of fiscal year 2008, approximately $998,000 of the cost for our leasehold improvements was funded by the landlord of our new facility in Torrance, California. This was determined to be a lease incentive. This lease incentive reduces our rent expense and will be amortized on a straight-line basis over the remaining period of our operating lease that ends in fiscal year 2015. This reduction to rent expense is generally equal to the increased amortization expense of the associated leasehold improvements.

We do not have any off-balance sheet arrangements with unconsolidated entities or related parties, and, accordingly, our liquidity and capital resources are not subject to off-balance sheet risks from unconsolidated entities.

### Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS 157, *Fair Value Measurement*. SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances disclosures about fair value measurements. The statement will be effective for our fiscal year beginning November 1, 2008. We are evaluating the impact adopting SFAS 157 will have on our financial statements.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities.* SFAS 159 provides companies with an option to report selected financial assets and liabilities at fair value. It also establishes presentation and disclosure requirements to facilitate comparisons between companies using different measurement attributes for similar types of assets and liabilities. The statement will be effective for our fiscal year beginning November 1, 2008. We are evaluating the impact on the adoption of SFAS 159 will have on our financial statements.

In June 2007, the FASB ratified Emerging Issues Task Force (EITF) Issue No. 07-3, Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities (EITF 07-3). EITF 07-3 requires non-refundable advance payments for goods and services to be used in future research and development activities to be recorded as an asset, with the payments expensed when the research and development activities are performed. EITF 07-3 applies to new contractual arrangements entered into in fiscal years beginning after December 15, 2007. We currently record a prepaid asset for any non-refundable advance payments and recognize the expense when the activities are performed. We believe that adoption of EITF 07-3 will not have a material effect on our financial position, results of operations, or cash flows.

In December 2007, the FASB issued SFAS 141R, *Business Combinations*. SFAS 141R replaces SFAS 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. The statement will apply prospectively to business combinations occurring in our fiscal year beginning November 1, 2009. We are evaluating the impact adopting SFAS 141R will have on our financial statements.

In March 2008, the FASB issued SFAS 161*, Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. SFAS 161 requires enhanced disclosures about derivatives on a quarterly basis, including qualitative disclosures about objectives and strategies for using derivatives, and quantitative disclosures about the fair value of derivatives, as well as gains and losses on derivative instruments. It also requires disclosures about the volume of derivative activity and credit-risk-related contingent features in derivative agreements. SFAS 161 does not change the accounting treatment for derivative instruments, and therefore, the adoption will not have any impact on our financial position, results of operations, or cash flows. SFAS 161 is effective for fiscal years and interim periods beginning after November 15, 2008.

## Item 3: Quantitative and Qualitative Disclosures about Market Risk

***Interest rate risk***. Our interest income is sensitive to changes in the general level of United States interest rates. At May 2, 2008, our short-term and long-term securities consisted of municipal securities. Substantially all of our investments in the municipal securities are with A-1/SP-1/AAA (Standard & Poor's), P-1/MIG-1/Aaa (Moody's), and F-1/AA/AAA (Fitch) rated issuers. Our investment policy prohibits our investment in auction rate securities, mortgage-backed securities, and asset-backed securities. Insured municipal notes or bonds are also prohibited, with the exception of daily and weekly variable rate demand notes that contain a hard put feature.

The average days to maturity of our investment portfolio is 173 days as of May 2, 2008. Due to the short-term nature of these cash investments and the ability to liquidate our investment portfolio, we do not believe that there is a material interest rate risk associated with the current credit environment. As of May 2, 2008, our total cash and investments balance that was sensitive to interest rate risk was approximately $ 42,809,000. As a measurement of the sensitivity of our portfolio, if yields were to fluctuate by 100 basis points, the total effect to the investment portfolio balance would be approximately $178,000.

The following table summarizes our cash, cash equivalents, and short-term securities, at fair value, that are sensitive to interest rate risk (in thousands).

| | May 2, 2008 | October 31, 2007 |
|---|---|---|
| Cash and cash equivalents | $7,129 | $5,250 |
| Available-for-sale securities: | | |
| Short-term tax exempt | 27,719 | 29,683 |
| Long-term tax exempt | 7,961<br>----------- | 4,114<br>----------- |
| | $42,809<br>======= | $39,047<br>======= |

***Term loan and interest rate swap***. Effective July 1, 2005, and in connection with the acquisition of DTI, we entered into a Term Loan agreement in the principal amount of $10 million with Wells Fargo Bank, the proceeds of which were used for acquisition financing. The Term Loan bears interest at an annual rate of 1.75% above LIBOR ( 2.72% at May 2, 2008).

We manage potential market risk from changes in interest rates on the Term Loan through the use of an interest rate swap agreement designated as a cash flow hedge. By locking in a fixed rate for the entire term of the loan, this strategy decreases the variability of earnings and cash flows resulting from interest rate fluctuations and lowers our overall borrowing costs should interest rates rise.

Coincident with the Term Loan transaction, we also entered into an interest rate swap agreement with Wells Fargo whereby we pay interest to Wells Fargo at a fixed rate of 4.33% and Wells Fargo pays interest to us at a floating rate tied to the LIBOR index. The combined interest amounts on the Term Loan and the swap reflect our total monthly interest obligation, which is locked in at 6.08%.

### Item 4: Controls and Procedures

***Conclusions regarding disclosure controls and procedure***. Under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report.

***Changes in internal control over financial reporting***. T here have been no changes in our internal control over financial reporting during the quarter ended May 2, 2008, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

***Limitations of the effectiveness of internal control***. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the internal control system are met. Because of the inherent limitations of any internal control system, no evaluation of controls can provide absolute assurance that all control issues, if any, within a company have been detected. Notwithstanding these limitations, our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives. Our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures are, in fact, effective at the “reasonable assurance” level.

## Part II. Other Information

### Item 1: Legal Proceedings

We are subject to litigation, from time to time, in the ordinary course of business including, but not limited to, allegations of wrongful termination or discrimination, or governmental agency investigations. As a government contractor, we may also be subject to investigations by the United States Government for alleged violations of procurement or other federal laws. Under present government procurement regulations, if judged in violation of procurement or other federal civil laws, we could be suspended or barred from eligibility for awards of new government contracts.

On March 11 and July 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California. The cases were considered as *In re Applied Signal Technology Inc. Securities Litigation*, Master File No. 4:05-cv-1027 (SBA). The amended consolidated complaint is brought on behalf of a putative class of persons who purchased our Company’s securities during a class period of August 24, 2004, through February 22, 2005. The complaints name us, our former Chief Executive Officer, and our Chief Financial Officer as defendants, and allege that false and misleading statements regarding us were issued during the class period. On February 8, 2006, the Court dismissed the case with prejudice. On June 5, 2008, the Ninth Circuit reversed the dismissal and remanded to the District Court. We intend to contest this litigation vigorously. Any future unfavorable outcome of the litigation could have an adverse impact on our business, financial condition, and results of operation. At this time, we cannot estimate the amount of possible loss or range of loss that might be incurred as a result of this proceeding ..

### Item 1A: Risk Factors

Our future performance is subject to a variety of risks. If any of the following risks actually occurs, our business could be harmed and the trading price of our common stock could decline. In addition to the following disclosures, please refer to the other information contained in this report, including consolidated financial statements and the related notes.

***We may not be successful in our expansion of our products and markets, and may not realize the benefits of our investments in these new markets***. Over the last several years, we have made investments in other areas complementary to our historic COMINT offerings. As a result of these investments, including our acquisition of Dynamics Technology, Inc. (DTI) in July 2005, and our research and development into the ELINT market, we have expanded our product offerings, approached new customers, and entered into new markets for advanced digital signal processing products, systems, and services in support of intelligence, surveillance, and reconnaissance (ISR) for global security. Our operations during fiscal year 2008 have been, and are expected to continue to be, substantially influenced by the operations of the businesses we acquired from DTI as well as from our continued investment in products and markets complementary to our existing and new businesses. Our entry into new markets, and introduction of new products, subjects us to a number of risks and uncertainties, including the following:

We are entering markets in which we have no or limited prior experience, and are marketing to new customers in addition to our historic customer relationships. We may not be successful in these markets, and we may be unable to successfully enter into contracts with new or existing customers for these new business lines. We may not achieve the strategic objectives and other anticipated potential benefits of the acquisition of DTI or the investment in other products and complementary technologies. Our failure to achieve these strategic objectives could have a material, adverse effect on our ability to grow our business.

As a result of the acquisition of DTI, we incurred debt in the amount of $10 million, of which $6 million remains outstanding as of May 2, 2008. Our failure to repay this debt when due would materially, adversely affect our financial condition and results of operations.

Our diversification into ELINT, and into new signal processing capabilities, requires us to invest additional capital, open new facilities, and incur additional R&D expenditures. In addition, diversification results in diversion of management's attention from our historic business. Although we believe that entering into these new business areas will be important to remaining competitive in the defense electronics marketplace, there can be no assurance that we will derive benefits from this diversification, our core business could suffer, and we could incur significant unanticipated costs, which could have a material impact on our results of operations.

***Any decrease in expected product sales during a period could adversely impact our revenues, results of operations, and financial condition***. From time to time, we have derived a significant portion of our revenue from product sales. In recent periods, however, we have been focusing on sales of systems and software, and targeting larger programs. In addition, we have experienced some seasonality in product sales to the United States Government, with more product sales occurring in the second half of the fiscal year than in the first. The amount and timing of Government purchases of products is unpredictable, and fluctuates significantly from period to period, making it difficult for us to predict the amount of revenue we will generate from product sales in any particular period, and causing our revenues to fluctuate from period to period. If we are not able to generate revenues from product sales as expected in a particular period, we may fail to meet our revenue expectations and the expectations of industry analysts and investors, which could cause our stock price to decline.

***If we are unable to recruit, train, and retain key personnel with required security clearances, our ability to develop, introduce, and sell our products may be adversely impacted***. Our ability to execute our business plan is contingent upon successfully attracting and retaining qualified employees who obtain, or are able to obtain and retain, necessary government security clearances. If we fail to attract and retain qualified employees who can obtain the necessary security clearances, our business could be significantly harmed. The loss of the services of our qualified employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel could negatively impact our ability to develop, introduce, and sell our products. In addition, employees may leave us and subsequently compete against us.

Many of the personnel we hire will need United States Government security clearances in order to perform tasks required on our government contracts, and without such clearances, employees cannot work on the majority of our projects. We have found that there is a shortage of qualified personnel possessing the necessary clearances, and new security clearances are taking longer to be granted. If we are not able to obtain security clearances for our personnel where required, they will be unable to perform tasks requiring clearances, and we may be unable to satisfy the terms of our contracts, resulting in customer dissatisfaction and possible loss of current or future contracts.

***Stop-work orders could negatively impact our operating results and financial condition***. Almost all of our contracts contain stop-work clauses that permit the Government or other contracting party, at any time, by written order, to stop work on all or any part of the work called for by the contract for a period of ninety days. Within the ninety-day period, the other contracting party may cancel the stop-work order and resume work or terminate all or part of the work covered by the stop-work order. There can be no assurance that stop-work orders will not be received in future periods. If we receive stop work orders, our orders and backlog may be reduced, and we may fail to achieve anticipated revenues.

***Any reduction in government spending on ISR could materially adversely impact our revenues, results of operations, and financial condition***. Historically, defense and intelligence agencies of the United States Government have accounted for almost all of our revenues. There are risks associated with programs that are subject to appropriation by Congress, which could be potential targets for reductions in funding to pay for other programs. Future reductions in United States Government spending on global security or future changes in the kind of products or services required by the United States Government agencies could limit demand for our products and services, which could result in failure to achieve anticipated revenues, resulting in a materially adverse effect on our operating results and financial condition.

In the event there are shifts in responsibilities and functions among the government agencies responsible for United States defense and intelligence, it could result in a reduction of orders for global security by the defense and intelligence agencies that have historically been our major customers. Our relationships with other Government agencies to which responsibilities and functions for our contracts have shifted may not be as strong as our relationships with current customer agencies. Accordingly, a reduction in contracts from our customer agencies may not be offset by contracts from other United States Government agencies. Even if other agencies increase spending for global security, we may not secure the same amount of work from these agencies. As a result, demand for our products and services could decline, resulting in a decrease in revenues, and could adversely affect our operating results and financial condition materially.

***If we are unable to comply with complex government regulations governing security and contracting practices, we could be disqualified as a supplier to the United States Government***. As a supplier to United States Government defense and intelligence agencies, we must comply with numerous regulations, including those governing security and contracting practices. Failure to comply with these procurement regulations and practices could result in fines being imposed against us or our suspension for a period of time from eligibility for bidding on, or for award of, new government contracts. If we are disqualified as a supplier to government agencies, we will lose most, if not all, of our customers, revenues from sales of our products would decline significantly, and our ability to continue operations would be seriously jeopardized. Among the causes for disqualification are violations of various statutes, including those related to procurement integrity, export control, United States Government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign corruption.

***The government may investigate and make inquiries of our business practices and conduct audits of contract performance and cost accounting.*** The government audits and investigations can take several years to complete. Depending on the results of these audits and investigations, the government may make claims against us or take exception to certain costs we determined to be recoverable. In the period management determines recoverability is not likely, operating income would be reduced.

***We depend on revenues from a few significant contracts, and any loss, cancellation, reduction, or delay in these contracts could harm our business***. From time to time, including recent periods, we have derived a material portion of our revenue from one or more individual contracts that could be terminated by the customer in full or in part at the customer's discretion. We have in the past experienced a significant reduction of, and stop work order on, one of our largest contracts. We expect that in future periods we may again enter into individual contracts with significant revenue concentrations. In addition, the majority of our contracts are with a limited number of government agencies. If our individually large contracts were terminated or substantially reduced, we could fail to achieve expected revenues and net income.

United States Government contracts are generally not fully funded at inception and funding may be terminated or reduced at any time. We act as a prime contractor or subcontractor for many different United States Government programs. Department of Defense and intelligence contracts typically involve long lead times for design and development and are subject to significant changes in contract scheduling. Programs can be partially funded initially, and additional funds may or may not be allocated. The termination or reduction of funding for a government program would result in a loss of anticipated future revenues attributable to that program.

Our backlog as of May 2, 2008, was approximately $113.7 million and includes orders under awards that in some cases extend several years. The actual receipt of revenues on awards included in backlog may never occur or may change because a program schedule could change or the program could be canceled, or a contract could be reduced, modified, or terminated early.

***Our business depends upon our relationships with, and the performance of, our prime contractors***. We expect to continue to depend on relationships with other contractors for a substantial portion of our revenues in the foreseeable future. Our business, prospects, financial condition, or operating results could be adversely affected if other contractors terminate or reduce their subcontracts or relationships with us, either because they choose to establish relationships with our competitors or because they choose to directly offer services that compete with our business. Our business also suffers if the prime contractor fails to win the contract, or if the Government terminates or reduces these other contractors' programs or does not award them new or additional contracts.

In addition, on those contracts for which we are not the prime contractor, the United States Government could terminate a prime contract under which we are subcontractor, regardless of the quality of our performance as a subcontractor. A prime contractor's performance deficiencies could adversely affect our status as a subcontractor on the program, jeopardize our ability to collect award or incentive fees, cause customers to delay payments, and result in contract terminations.

***We depend on revenues from a few significant customers; the loss of any significant customer could have an adverse effect on our business***. Our success will depend on our continued ability to develop and manage relationships with significant customers. The markets in which we sell our products are dominated by a relatively small number of governmental agencies and allies of the United States Government, thereby limiting the number of potential customers. Our dependence on large orders from a relatively small number of customers makes our relationship with each customer critical to our business. We cannot be sure that we will be able to retain our largest customers, that we will be able to attract additional customers, or that our customers will continue to buy our products and services in the same amounts as in prior years. The loss of one or more of our largest customers, any reduction or delay in sales to these customers, our inability to successfully develop relationships with additional customers, or future price concessions that we may have to make could significantly harm our business.

***Continued competition in ISR may lead to a reduction in our revenues and market share***. The global security market is highly competitive and we expect that competition will continue to increase in the future. Our current competitors have significantly greater technical, manufacturing, financial, and marketing resources than we do. We expect that more companies will enter the market for global security, possibly resulting in pricing pressures on our products and services. We may not be able to compete successfully against either current or future competitors. Increased competition could result in reduced revenue, lower margins, or loss of market share, any of which could significantly harm our business. Our competitors may introduce improved products with lower prices, and we would have to do the same to remain competitive.

Unexpected increases in the cost to develop or manufacture our products under fixed-price contracts may cause us to experience unreimbursed cost overruns resulting in reduced profit margins or increased loss provisions. A significant portion of our revenue is derived from fixed-price contracts. Under fixed-price contracts, unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in materials costs, unfavorable indirect rate variances, inefficiencies, or other factors, are borne by us. We have experienced cost overruns in the past that have resulted in losses on certain contracts, and may experience additional cost overruns in the future. Such cost overruns would increase our operating expenses, reduce our net income and earnings per share, and could have a material, adverse effect on our future results of operations and financial condition.

Fixed price contracts use percentage-of-completion accounting to determine profit margins. Under generally accepted accounting principles unexpected cost over-runs can change the percentage completion estimates and result in reduced profit margins and the reversal of previously recognized profits in addition to reducing future period profits. Although we believe that our profit margins are fairly stated and that adequate provisions for losses for our fixed-price contracts are recorded in our financial statements as required under accounting principles generally accepted within the United States, there can be no assurance that our contract profit margins will not decrease or our loss provision will not increase in the future.

***Unexpected contract terminations could negatively impact our operating results and financial condition***. Almost all of our contracts contain termination clauses that permit contract termination upon our default or for the convenience of the other contracting party. In either case, termination could adversely affect our operating results and financial condition; however, we received no such terminations in fiscal years 2008 or 2007.

***Our future revenues are inherently unpredictable, our operating results are likely to fluctuate from period to period, and if we fail to meet the expectations of securities analysts or investors, our stock price could decline significantly***. Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate significantly in the future due to a variety of factors, some of which are outside our control. Accordingly, we believe that period-to-period comparisons of our results of operations are not meaningful and should not be relied upon as indications of future performance. Some of the factors that could cause our quarterly or annual operating results to fluctuate include conditions inherent in government contracting and our business such as the timing of cost and expense recognition for contracts, the United States Government contracting and budget cycles, and contract closeouts. Because we base our operating expenses on anticipated revenue trends and a high percentage of our expenses are fixed in the short term, any delay in generating or recognizing forecasted revenues could significantly harm our business. Fluctuations in quarterly results, competition, or announcements of extraordinary events such as acquisitions or litigation may cause earnings to fall below the expectations of securities analysts and investors. In this event, the trading price of our common stock could significantly decline. In addition, there can be no assurance that an active trading market will be sustained for our common stock. The stock market in recent years has experienced extreme price and volume fluctuations that have particularly affected the market prices of many technology companies. These fluctuations, as well as general economic and market conditions, may adversely affect the future market price of our common stock.

***Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new signal processing solutions that achieve market acceptance***. The market for our products is characterized by rapidly changing technology, frequent new product introductions, changes in customer requirements, and evolving industry standards. We believe that we have been successful to date in identifying certain global security needs early, investing in research and development to meet these needs, and delivering products before our competitors. We believe that our future success will depend upon continued development and timely introduction of products capable of satisfying emerging global security needs. However, we expect that new requirements will continue to emerge. Our future performance will depend on the successful development, introduction, and market acceptance of new and enhanced products that address these new requirements. The introduction of new and enhanced products may cause our customers to defer or cancel orders for existing products. There can be no assurance that we will be able to develop and market new products successfully in the future or respond effectively to new requirements, or that new products introduced by others will not render our products or technologies noncompetitive or obsolete.

We also may not be able to develop the underlying core technologies necessary to create new products and enhancements or to license these technologies from third parties. Product development delays may result from numerous factors, including:

- Changing product specifications and customer requirements
- Difficulties in hiring and retaining necessary technical personnel
- Difficulties in reallocating engineering resources and overcoming resource limitations
- Difficulties with contract manufacturers
- Changing market or competitive product requirements
- Unanticipated engineering complexities

The development of new, technologically advanced products is a complex and uncertain process requiring high levels of innovation and highly skilled engineering and development personnel, as well as the accurate anticipation of technological and market trends. We cannot ensure that we will be able to identify, develop, manufacture, market, or support new or enhanced products successfully, or on a timely basis, if at all. Further, we cannot ensure that our new products will gain market acceptance or that we will be able to respond effectively to product announcements by competitors, technological changes, or emerging industry standards. Any failure to respond to technological change would significantly harm our business.

***Our results of operations could be negatively impacted if we are required to write off inventory deemed not saleable or usable***. Some of our products or raw materials may become obsolete or unusable while in inventory. This could be due to changing customer specifications, decreases in demand for existing products, or changes in government spending on signal intelligence. Work in process deemed not saleable is written off to contract costs in our statement of operations, while unusable raw materials are written off to general and administrative expenses.

***We may lose sales if our suppliers fail to meet our needs***. Although we procure most of our parts and components from multiple sources or believe that these components are readily available from numerous sources, certain components are available only from sole sources or from a limited number of sources. While we believe that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require us to re-engineer our products, or both, which could delay shipment of our products and could have a materially adverse effect on our operating results and financial condition.

***Delays in the receipt of contracts could negatively impact our business***. During our history, the receipt of certain final contracts has periodically been delayed to periods later than originally expected. Delays in the receipt of such orders could result in revenues falling short of estimates. On some of these contracts, we will make expenditures in advance of receipt of the final contract in anticipation of meeting the expected timetables, and will from time to time hire personnel in anticipation of receipt of the contract. If the contract is delayed, these costs are not covered. In addition, gross margins and net income will decrease if we elect to hold our cost structure in place while awaiting the award of delayed contracts.

***Our failure to protect our intellectual property may significantly harm our business***. Our success and ability to compete is dependent in part on our proprietary technology. We rely on a combination of patent, copyright, trademark, and trade secret laws, as well as confidentiality agreements to establish and protect our proprietary rights. We license certain of our proprietary technology to customers, and we rely largely on provisions of our licensing agreements to protect our intellectual property rights in this technology. To date, we have relied primarily on proprietary processes and know-how to protect our intellectual property. Although we have filed applications for several patents, five of which we currently hold, we cannot ensure that any patents will be issued as a result of pending patent applications or that our issued patents will be upheld. Any infringement of our proprietary rights could result in significant litigation costs, and any failure to adequately protect our proprietary rights could result in our competitors offering similar products, potentially resulting in loss of a competitive advantage and decreased revenues. Despite our efforts to protect our proprietary rights, existing patent, copyright, trademark, and trade secret laws afford only limited protection. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States. Attempts may be made to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Accordingly, we may not be able to prevent misappropriation of our technology or deter others from developing similar technology. Furthermore, policing the unauthorized use of our products is difficult. Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of resources, and could significantly harm our business.

***The United States Government has rights to our technology that limits our intellectual property rights***. Although we seek to protect the competitive benefits we derive from our patents, proprietary information, and other intellectual property, we do not have the right to prohibit the United States Government from using certain technologies developed or acquired by us or to prohibit third party companies, including our competitors, from using those technologies in providing products and services to the United States Government. The United States Government has the right to royalty-free use of technologies that we have developed under United States Government contracts. We may commercially exploit those government-funded technologies and may assert our intellectual property rights against other non-government users of technology developed by us, but we may not be successful in our efforts to do so.

***Claims that we infringe third-party intellectual property rights could result in significant expenses or restrictions on our ability to sell our products***. It is possible that from time to time, other parties may assert patent, copyright, trademark, and other intellectual property rights to technologies and in various jurisdictions that are important to our business. Any claims asserting that our products infringe or may infringe proprietary rights of third parties, if determined adverse to us, could significantly harm our business. Any claims, with or without merit, could result in costly litigation, divert the efforts of our technical and management personnel, cause product shipment delays, or require us to enter into royalty or licensing agreements, any of which could significantly harm our business. Royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all. In addition, our agreements with our customers typically require us to indemnify our customers from any expense or liability resulting from claimed infringement of third-party intellectual property rights. In the event a claim against us was successful and we could not obtain a license to the relevant technology on acceptable terms, license a substitute technology, or redesign our products to avoid infringement, our business would be significantly harmed.

***We derive revenue from royalty payments, the timing of receipt of which can be difficult to predict and which may be difficult to expand***. We derive royalty income from the sale of products licensed to other third parties for sale, and expect to continue to derive royalty income in the future. Revenue derived from royalty payments provides greater profitability to us than revenue from sale of our products and services, accordingly, our operating income and earnings per share will be impacted by the comparative mix of revenue from our digital signal processing products, systems, and services and revenue derived from royalty income. Although we have licensed one of our products for sale by a third party, and expect to increase our efforts in future periods, we have not historically devoted significant resources to licensing our technologies. Our future ability to generate royalty income depends upon:

- Our ability to secure patent coverage for our technologies and enter into license agreements with potential licensees
- The ability of our licensees to develop and commercialize successful products that incorporate our technologies
- The rate of adoption of our technologies by, and the incorporation of our technologies into products of, other parties

In addition, royalty-based income is subject to the willingness and ability of licensees to design and assemble products using our technology, the pricing and demand for products incorporating our technology, and our ability to negotiate and enforce agreements for the determination and payment of royalties. It is difficult to predict when we will enter into additional license agreements, if at all. The timing of our receipt of royalty payments, including payments from our existing royalty-based arrangement, is also difficult to predict, and may fluctuate from period to period, causing our revenues to fluctuate from period to period, which may significantly impact our quarterly or annual operating results. If we are not able to generate royalty income as expected in a particular period, we may fail to meet our revenue expectations, our operating income may decline disproportionately, and we may fail to meet the expectations of industry analysts and investors, which could cause our stock price to decline.

***The operation of our business could be adversely affected by the transition of key personnel as we rebuild our executive leadership team***. Our former Chief Executive Officer terminated his employment with us effective May 30, 2008. Our Chief Operating Officer is now our Acting Chief Executive Officer. A committee of our Board of Directors is conducting a search for a permanent Chief Executive Officer, and will review candidates including our Acting Chief Executive Officer. It is important to our success that we appoint a permanent Chief Executive Officer promptly, to continue to build an effective management team and allow us to remain focused on providing high-quality technical solutions and expert delivery on our existing programs, while also addressing our overall operational efficiency. It may take some time to finalize the search for a permanent Chief Executive Officer, and if such successor is new to our organization, it may take time for such person to become fully integrated into our business. Our failure to manage these transitions, or to find and retain experienced management personnel, could adversely affect our ability to compete effectively and could adversely affect our operating results.

## Item 2: Unregistered Sales of Equity Securities and Use of Proceeds

None.

## Item 3: Defaults Upon Senior Securities

None.

## Item 4: Submission of Matters to a Vote of Security Holders

At the annual meeting of our shareholders held on March 14, 2008, the following matters were considered and voted upon.

The following nominees were elected as Class II directors to serve on our Board of Directors for a two-year term expiring at the 2010 annual meeting of shareholders or until their successors are duly elected and qualified. The number of shares voted and withheld for such nominees were as follows:

| Name | For | Withheld |
|---|---|---|
| Milton E. Cooper | 8,922,656 | 2,524,230 |
| Dr. John R Treichler | 9,691,211 | 1,755,675 |
| Marie S. Minton | 9,365,015 | 2,081,871 |

The appointment of Ernst & Young, LLP as our independent registered public accounting firm for the fiscal year ending October 31, 2008, was approved and ratified. The number of shares voted for and against the appointment was as follows:

| For | Against | Abstain |
|---|---|---|
| 10,737,466 | 697,657 | 11,763 |

A proposal to amend the Company’s 2004 Stock Incentive Plan to increase by 500,000 shares the maximum number of shares of common stock that may be issued under this plan was approved. The number of shares voted for and against the amendment were as follows:

| For | Against | Abstain | Broker Non-Votes |
|---|---|---|---|
| 7,211,726 | 2,290,938 | 7,969 | 1,936,253 |

### Item 5: Other Information

None.

### Item 6: Exhibits

***Exhibits***. See Index to Exhibits.

## Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

| | |
|---|---|
| Applied Signal Technology, Inc. | |
| /James E. Doyle/ | June 9, 2008 |
| --------------------------------------------------- | ------------------------- |
| James E. Doyle<br>Vice President and Chief Financial Officer<br>(Principal Financial and Accounting Officer) | |

## Applied Signal Technology, Inc.
## Index to Exhibits

| Exhibit Number | Description of Document |
|---|---|
| 3.1 | Second Amended and Restated Articles of Incorporation |
| 3.2 | Amended and Restated Bylaws |
| 4.1 | Specimen Common Stock Certificate |
| 10.61(1) | Severance Agreement and General Release of Claims between Applied Signal Technology, Inc. and Gary L. Yancey |
| 31.1 | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(1) Incorporated by reference to corresponding Exhibit filed with the Registrant’s Form 8-K dated May 23, 2008.