

APPLIED SIGNAL TECHNOLOGY INC  
Form 10-Q  
September 17, 2001

United States  
Securities and Exchange Commission  
Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the Period Ended August 3, 2001

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)

<u>California</u>	<u>77-0015491</u>
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

400 West California Avenue, Sunnyvale, CA 94086

(408) 749-1888

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by a check 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.

Applicable Only to Corporate Issuers

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date.

Common Stock, no par value, 9,592,308 shares outstanding as of September 7, 2001.

This Quarterly Report on Form 10-Q consists of 28 pages.

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Index  
Applied Signal Technology, Inc.

Part I Financial Information

Item 1. Financial Statements (Unaudited)

Balance Sheets August 3, 2001 and October 31, 2000

Statements of Operations Three months ended August 3, 2001 and July 28, 2000, and  
nine months ended August 3, 2001 and July 28, 2000

Statements of Cash Flows Three months ended August 3, 2001 and July 28, 2000, and  
nine months ended August 3, 2001 and July 28, 2000

Notes to Financial Statements August 3, 2001

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

Part II Other Information

Item 1. Legal Proceedings

Item 5. Other Information

Item 6. Exhibits and Reports on Form 8-K

Signatures

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Part I Financial Information

Item 1. Financial Statements

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

Assets	August 3, 2001 (Unaudited)	October 31, 2000 (Note)
Current assets:		
Cash and cash equivalents	\$ 5,385	\$ 14,478

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Short-term investments		2,029
Accounts receivable:		
	12,748	14,165
Billed		
	11,693	18,058
Unbilled		
	24,441	32,223
Total accounts receivable		
Inventory	10,476	10,376
Refundable income taxes	2,472	
Prepaid and other current assets	3,618	3,474
	46,392	62,580
Total current assets		
Property and equipment, at cost:		
	40,950	40,406
Machinery and equipment		
	4,892	4,600
Furniture and fixtures		
	12,324	8,755
Leasehold improvements		
	72	624
Construction in process		
	58,238	54,385
Accumulated depreciation and amortization	(37,623)	(33,871)
	20,615	20,514
Net property and equipment		
Long-term investments		1,997
Other assets	298	58
Total assets	\$ 67,305	\$ 85,149

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

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Liabilities and Shareholders Equity	August 3, 2001 (Unaudited)	October 31, 2000 (Note)
Current liabilities:		
	\$ 2,055	\$ 2,253
Accounts payable		
	3,839	7,099
Accrued payroll and related benefits		
	2,368	2,464
Other accrued liabilities		
		2,506
Income taxes payable		
	8,262	14,322
Total current liabilities		
Deferred income taxes	70	70
Shareholders equity:		
Common stock, no par value: 20,000,000 shares authorized; issued and outstanding: 9,592,308 at August 3, 2001 and 9,060,113 at October 31, 2000	24,880	22,789
Retained earnings	34,093	47,971
Accumulated other comprehensive loss		(3)
Total shareholders equity	58,973	70,757
	\$ 67,305	\$ 85,149
Total liabilities and shareholders equity		

Note: The balance sheet at October 31, 2000 has been derived from the audited financial statements at that date but does not include all of the information and features required by generally accepted accounting principles for complete financial statements.

See Notes to Financial Statements.

**Applied Signal Technology, Inc.**  
**Consolidated Statements of Operations**  
**(Unaudited)**

(In thousands, except per share data)

	Three Months Ended		Nine Months Ended	
	August 3, 2001	July 28, 2000	August 3, 2001	July 28, 2000
Revenues from contracts	\$ 15,396	\$ 25,173	\$ 54,683	\$ 78,988
Operating expenses:				
	16,234	19,290	43,810	52,493
Contract costs				
	3,426	4,133	12,741	9,688
Research and development				
	3,618	4,212	13,855	12,684
General and administrative				
Restructuring costs	1,584		2,261	
	24,862	27,635	72,667	74,865
Total operating expenses				
Operating income (loss)	(9,466)	(2,462)	(17,984)	4,123
Interest income (expense), net	71	233	330	775
Income (loss) before provision (benefit) for income taxes	(9,395)	(2,229)	(17,654)	4,898
Provision (benefit) for income taxes	(2,631)	(1,680)	(4,943)	1,028
Net income (loss)	\$ (6,764)	\$ (549)	\$ (12,711)	\$ 3,870
Net income (loss) per common share:				
Basic	\$ (0.71)	\$ (0.06)	\$ (1.36)	\$ 0.44
Diluted	\$ (0.71)	\$ (0.06)	\$ (1.36)	\$ 0.43

Number of shares used in  
calculating net income (loss)  
per common share:

	9,520	8,889	9,359	8,730
Basic				
	9,520	8,889	9,359	9,028
Diluted				

See Notes to Financial Statements.

**Applied Signal Technology, Inc.**  
**Consolidated Statements of Cash Flows**  
**Increase (decrease) in cash and cash equivalents**  
**(Unaudited)**  
(In thousands)

	Nine Months Ended	
	August 3, 2001	July 28, 2000
Operating Activities:		
Net income (loss)	\$ (12,711)	\$ 3,870
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,752	3,236
Changes in:		
Accounts receivable	7,782	4,697
Inventory, prepaids and other assets	(2,956)	(3,537)
Accounts payable, income taxes payable and accrued liabilities	(5,494)	(3,988)
	(9,627)	4,278

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Net cash provided by (used in)  
operating activities

Investing Activities:

		(15,058)
Purchases of available-for-sale securities		
	4,029	9,029
Maturities of available-for-sale securities		
	(3,853)	(3,162)
Additions to property and equipment		
	176	(9,191)
Net cash provided by (used in) investing activities		

Financing Activities:

	2,091	3,826
Issuance of common stock		
	(1,733)	(1,625)
Dividends paid		
	358	2,201
Net cash provided by financing activities		
	(9,093)	(2,712)
Net decrease in cash and cash equivalents		
	14,478	16,680
Cash and cash equivalents, beginning of period		
	\$ 5,385	\$ 13,968
Cash and cash equivalents, end of period		
Supplemental disclosures of cash flow information:		
	\$ 17	\$ 19
Interest paid		1,783
Income taxes paid		

See Notes to Financial Statements.

**Applied Signal Technology, Inc.**  
**Notes to Consolidated Financial Statements**  
**(unaudited)**  
August 3, 2001

Note 1 Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

Applied Signal Technology, Inc. ("Applied Signal Technology" or "the Company") designs, develops, and manufactures signal processing equipment to collect and process a wide range of telecommunication signals. This equipment is used for reconnaissance of foreign telecommunications, predominantly by the United States Government and allied foreign governments. In the second quarter of fiscal 2000, the Company formed two new wholly owned subsidiaries: Transcendent Technologies, Inc. ("Transcendent"), a provider of sophisticated network management and spectrum monitoring systems, and eNetSecure, Inc. ("eNetSecure"), a developer and provider of network monitoring services for both intrusion detection and policy enforcement.

On February 27, 2001, the Company's Board of Directors accepted the recommendation of eNetSecure to reintegrate eNetSecure into Applied Signal Technology. The primary reason for the reintegration was eNetSecure's inability to obtain adequate financing to satisfy its projected operational requirements. In addition to its \$5 million investment in eNetSecure, the Company incurred additional expenses and liabilities as a result of the eNetSecure reintegration. For information regarding the restructuring costs, please refer to "Note 4 Restructuring Costs."

The accompanying unaudited consolidated financial statements have been prepared in accordance with generally accepted accounting principles 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 generally accepted accounting principles for complete financial statements. 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 nine month period ending August 3, 2001 are not necessarily indicative of the results that may be expected for the year ending October 31, 2001. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended October 31, 2000.

Principles of Consolidation

The consolidated financial statements of Applied Signal Technology, Inc. include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

Investments

The Company's investment securities, which consist primarily of U.S. Treasury Securities, are classified as available-for-sale and are carried at fair market value. Unrealized gains and losses, net of tax, are reported as a separate component of shareholders' equity. Realized gains and losses on available-for-sale securities are included in interest income (expense), net. The cost of securities sold is based on the specific identification method. Interest on securities classified as available-for-sale is included in interest income (expense), net.

Revenues from Contracts



Applied Signal Technology accounts for fixed price contracts using the percentage-of-completion method of accounting. Under this method, all contract costs are charged to operations as incurred. 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 and estimated costs, is recognized as revenue each period. The Company accounts for cost reimbursement contracts by charging contract costs to operations as incurred and recognizing contract revenues and profits by applying an estimated fee rate to actual costs on an individual contract basis. Management reviews contract performance, costs incurred and estimated completion costs regularly and adjusts revenues and profits on contracts in the month in which changes become determinable.

To date, the Company's subsidiary, Transcendent Technologies has not generated significant revenues. Prior to its reintegration into the Company, eNetSecure did not generate significant revenues.

#### Per Share Data

Basic per share data is based on the weighted effect of all common shares issued and outstanding, and is calculated by dividing net income (loss) available to common shareholders by the weighted average shares outstanding during the period. Diluted per share data is calculated by dividing net income available to common shareholders 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 using the treasury stock method. When a net loss occurs, diluted per share data is the same as basic.

A reconciliation of shares used in the calculation of basic and diluted per share data follows (in thousands, except per share data; unaudited):

	Three Months Ended		Nine Months Ended	
	August 3, 2001	July 28, 2000	August 3, 2001	July 28, 2000
<b>Numerator:</b>				
Net income (loss)	\$ (6,764)	\$ (549)	(12,711)	\$ 3,870
<b>Denominator:</b>				
Shares used to compute net income per common share-basic	9,520	8,889	9,359	8,730
Effect of dilutive stock options				298
Shares used to compute net income per common share-diluted	9,520	8,889	9,359	9,028
Net income (loss) per common share-basic	\$ (0.71)	\$ (0.06)	\$ (1.36)	\$ 0.44

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Net income (loss) per common share-diluted                      \$ (0.71)            \$ (0.06\$ (1.36)            \$ 0.43

Approximately 63,000 and 93,000 stock options were excluded from the number of shares used to compute diluted net loss per common share for the three and nine months ended August 3, 2001, respectively, as their effect would be antidilutive.

Dividends

In the third quarter of fiscal 2000, the Board of Directors declared a \$0.25 per share dividend, payable over four quarters at the rate of \$0.0625 per share per quarter. Payments were made to shareholders of record at July 28, 2000; October 31, 2000; January 26, 2001; and April 27, 2001; during the month following the record date. In the three months ended August 3, 2001 and July 28, 2000 the Company paid dividends of \$585,000 and \$550,000, respectively. Dividends paid in the nine-month periods then ended totaled \$1,733,000 and \$1,625,000, respectively. In an effort to reduce future cash expenditures, the Board of Directors voted on May 17, 2001 to suspend the dividend payment.

Comprehensive Income

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

	Three Months Ended		Nine Months Ended	
	August 3, 2001	July 28, 2000	August 3, 2001	July 28, 2000
Net income (loss)	\$ (6,764)	\$ (549)	\$ (12,711)	\$ 3,870
Unrealized gain (loss) on securities		41	3	78
Comprehensive income (loss)	\$ (6,764)	\$ (508)	\$ (12,708)	\$ 3,948

Note 2 Inventory

The components of inventory consist of the following (in thousands):

	August 3, 2001 (unaudited)	October 31, 2000
Raw materials	\$ 1,534	\$ 1,354
Work in process	8,215	5,986

Finished goods	687	453
	10,436	7,793
Precontract costs	40	2,583
	\$ 10,476	\$ 10,376

The Company records contract revenues and costs for interim reporting purposes based on annual targeted indirect rates. At year-end, the revenues and costs are adjusted for actual indirect rates. During the interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. All timing-related indirect spending variances are inventoried as part of work in process during these interim reporting periods. These rates are reviewed regularly and any permanent variances are reflected in the statement of operations as they become known. At August 3, 2001 the inventoried variance was approximately \$867,000 (favorable). This amount included an actual unfavorable variance of approximately \$5,133,000 that was reduced by a management reserve of \$6,000,000. At July 28, 2000, the inventoried unfavorable variance was approximately \$1,978,000. The rate variance is included in work in process. At October 31, 2000 and 1999, the variance was zero since all revenues and costs were recorded at the actual indirect rates for each fiscal year end.

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### Note 3 Recent Accounting Pronouncements

In June 1998, the FASB issued Statement of Financial Accounting Standards No. 133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities," which was effective November 1, 2000. This statement establishes accounting and reporting standards requiring that every derivative instrument, including certain derivative instruments embedded in other contracts, be recorded in the balance sheet as either an asset or liability measured at its fair value. The statement also requires that changes in the derivative's fair value be recognized in earnings unless specific hedge accounting criteria are met. The adoption of SFAS 133 did not have a material effect on the financial statements, since the Company currently does not invest in derivative instruments and engage in hedging activities.

In December 1999, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 101, ("SAB 101"), "Revenue Recognition in Financial Statements." SAB 101 summarizes certain views of the SEC Staff in applying generally accepted accounting principles to revenue recognition in financial statements and is required to be adopted by the Company no later than the fourth quarter of fiscal 2001. The Company does not believe the adoption of SAB 101, if applicable, will be material to its operating results and financial position.

In July 2001, the Financial Accounting Standards Board issued Statements of Financial Accounting Standards (SFAS) No. 141, *Business Combinations*, and SFAS No. 142, *Goodwill and Other Intangible Assets*. The new standards require business combinations initiated after June 30, 2001, to be accounted for using the purchase method of accounting. Goodwill acquired after this date will no longer be amortized, but will be subject to annual impairment tests. Goodwill recorded prior to July 1, 2001 will cease to be amortized effective January 1, 2002 and will also be subject to annual impairment tests. All other intangible assets will continue to be amortized over their estimated useful lives. As the Company has not completed any business combinations through June 30, 2001, these standards will not have an impact on the Company's financial position or operating results.

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## Note 4 Restructuring Costs

As a result of the February 2001 reintegration of eNetSecure, 19 employees were terminated and the Company incurred and paid employee severance and benefits expenses of approximately \$219,000 and paid approximately \$58,000 in accrued vacation. Applied Signal Technology will continue to pursue opportunities related to eNetSecure's product.

In order to better align its operating expenses with anticipated revenues, Applied Signal Technology reduced its workforce by 69 employees in April 2001. During the third quarter, Applied Signal Technology's workforce was reduced by an additional 77 employees and Transcendent Technologies reduced its staff by 10 employees. As a result, Applied Signal Technology incurred and paid approximately \$951,000 in employee severance expenses and paid approximately \$492,000 in accrued vacation. Transcendent Technologies incurred approximately \$40,000 in employee severance expense and paid approximately \$42,000 in accrued vacation.

Through August 3, 2001, the consolidated company staff has been reduced by approximately 29% since April 18, 2001, which includes 102 technical employees and 54 administrative employees.

In addition, the Company has vacated one of its Sunnyvale, California buildings and will vacate a second Sunnyvale building by October 1, 2001. As a result, the Company incurred approximately \$1,105,000 in restructuring costs related to the leasehold improvements of these vacated facilities.

For nine months ended August 3, 2001, total consolidated restructuring costs were \$2,320,000. Approximately \$2,261,000 was included in operating expenses and approximately \$59,000 was included in inventory and construction in process. Management believes that the cost reduction actions being taken in fiscal year 2001 will position the Company to be able to return to profitability in fiscal year 2002.

## Note 5 Segment Reporting

The Company adopted SFAS 131, "Disclosure about Segments of an Enterprise and Related Information," at October 31, 1999. SFAS 131 establishes annual and interim reporting standards for an enterprise's operating segments and related disclosures about its products, services, geographic areas, and major customers. Operating segments are defined as components of an enterprise for which separate financial information is available and is evaluated regularly by the chief operating decision-maker in deciding the allocation of resources and assessment of performance.

As of May 4, 2001, the eNetSecure reintegration into Applied Signal Technology was complete. This means that the financial information relating to eNetSecure and Applied Signal Technology is reviewed and evaluated by the chief operating decision-maker as a whole, and not as individual reporting segments. As a result, there are two reportable segments at August 3, 2001.

Financial data by segment for the nine-month periods ended August 3, 2001 and July 28, 2000 is as follows:

	Applied Signal Technology		Transcendent Technologies		Consolidated Total	
	August 3, 2001	July 28, 2000	August 3, 2001	July 28, 2000	August 3, 2001	July 28, 2000
Revenues:	\$54,435	\$78,988	\$248		\$54,683	\$78,988

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Operating expenses:	\$68,743	\$74,230	\$3,924	\$ 635	\$72,667	\$74,865
Interest income:	\$377	\$827	\$18	\$5	\$395	\$832
Interest expense:	(\$51)	(\$57)	(\$14)		(\$65)	(\$57)
Net income (loss):	(\$9,039)	\$4,500	(\$3,672)	(\$630)	(\$12,711)	\$3,870
Total assets:	\$66,257	\$85,479	\$1,048	\$716	\$67,305	\$86,195

Note 6 Subsequent Event

Transcendent Reintegration

On August 28, 2001, Applied Signal Technology decided to reintegrate Transcendent Technologies into Applied Signal Technology. The primary reason for the reintegration was Transcendent's inability to obtain adequate financing to satisfy its projected operational requirements. Applied Signal Technology believes in the viability of Transcendent's products and plans to continue to develop, market, and manufacture Transcendent's current products. As a result of the August 2001 reintegration of Transcendent, 5 employees were terminated and the Company expects to incur employee severance and benefits expense of approximately \$17,000 and will pay approximately \$26,000 in accrued vacation. The employee severance and benefits expense will be recorded as restructuring costs in the fourth quarter of fiscal 2001.

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 financial statements and notes thereto.

Forward-looking statements in this report, including financial statements, are made pursuant to the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934. In this report, the words "anticipates," "believes," "expects," "future," "intends," and similar expressions identify forward-looking statements. Shareholders are cautioned that all forward-looking statements pertaining to the Company involve risks and uncertainties, including, without limitation, those contained under the caption, "Summary of Business Considerations and Certain Factors that May Affect Future Results of Operations and/or Stock Price," and other risks detailed from time to time in the Company's periodic reports and other information filed with the Securities and Exchange Commission. Actual events and results may differ materially from the Company's current expectations and beliefs.

Description of the Business

Applied Signal Technology, Inc. ("Applied Signal Technology" or "the Company") designs, develops and manufactures signal-processing equipment to collect and process a wide range of telecommunication signals. This equipment is used for reconnaissance of foreign telecommunications, predominantly by the United States Government and allied foreign governments. Signal reconnaissance systems are composed of collection equipment and processing equipment. Collection equipment consists of sophisticated receivers that scan the radio frequency (RF) spectrum (for example, cellular telephone, microwave, ship-to-shore, and military transmissions) to collect certain signals from, potentially, thousands of signals within the RF spectrum. Signal processing equipment, using sophisticated software

and hardware, evaluates the characteristics of the collected signals and selects signals that are likely to contain relevant information. Since inception, the Company has focused its efforts primarily on processing equipment, but also provides specialized collection equipment, as well as complete systems.

### Signal Reconnaissance

In recent years, accurate and comprehensive information regarding foreign affairs and developments has become increasingly important to the United States Government. The reduction of United States military tactical forces overseas, coupled with political instability in certain regions such as the Middle East, Eastern Europe, Africa, and Central and South America, has heightened the United States Government's need to be able to monitor overseas activities. In order to obtain information about activities within foreign countries, the United States Government gathers and analyzes telecommunication signals emanating from those countries.

Additionally, the use of established telecommunication technologies has increased throughout the world, and new telecommunication technologies, supplementing rather than replacing prior technologies, have been developed and commercialized. These trends have led to a significant increase in the overall volume of information communicated and an increase in the density of signals transmitted throughout the radio frequency spectrum. This increase can be seen in the proliferation of facsimile, cellular, and digital signal telecommunications equipment as well as the expansion of the global information network (that is, the Internet) in the last decade, resulting in a significant increase in the amount of information being communicated. These trends have required the development of signal reconnaissance equipment capable of collecting and processing an increased volume of signals as well as new types of signals.

Traditionally, organizations within the United States Government have satisfied their signal reconnaissance needs by first identifying their specific requirements and then contracting with government contractors to provide equipment. Contractors typically designed and built custom signal processing systems optimized to satisfy the particular needs of various agencies. Development of custom systems usually required many years of effort and involved great expense. The time required to develop these systems often meant that when a system was delivered, it did not address new telecommunication technologies that had evolved during the development process. These factors, combined with growing budgetary constraints, have caused many agencies to search for more flexible and cost-effective signal reconnaissance solutions that can be deployed promptly.

The Company devotes significant resources toward understanding the United States Government's signal reconnaissance goals, capabilities, and perceived future needs. The Company obtains information about these signal reconnaissance needs through frequent marketing contacts between its employees and technical and contracting officials of the United States Government. The Company believes that it has much more marketing contact with customers and potential customers than is customary among its competitors. In addition, the Company invests in research and development (R&D) which it anticipates will enable it to develop signal reconnaissance equipment that meets these needs. The Company believes that it invests a greater percentage of its revenues in R&D than is typical among its competitors. (See "Research and Development.")

The Company's signal reconnaissance products can be used, with or without further modification, to satisfy requirements of a variety of customers. The Company believes its products can be readily deployed in a wide variety of circumstances to meet current United States Government signal reconnaissance requirements. The Company designs its products to use advanced circuitry and highly integrated components. This enables the Company to offer products that are smaller, consume less power, and cost customers less when multiple units are built than equipment of similar functionality that use fewer advanced designs and materials.

### Subsidiaries

The Company believes that its products have commercial applications. Accordingly, in order to focus on the commercial sales of its products, Applied Signal Technology formed two new wholly owned subsidiary corporations, Transcendent Technologies, Inc. ("Transcendent") and eNetSecure, Inc. ("eNetSecure"), during the second quarter of fiscal year 2000.

#### Transcendent Technologies, Inc.

The volume of data transferred and made available to individuals is growing rapidly worldwide. Given the increasing constraints on satellite bandwidth and wireless spectrum availability, satellite service providers are confronted with the constant demands of finding more sophisticated ways to provide reliable signal quality to their customers while meeting increasing capacity demands. As wireless transport becomes an important part of the global information network by providing "last mile" connectivity, the need to provide bandwidth efficient communications techniques, as well as to manage these networks effectively, only becomes more critical to the service providers' success. This trend dictates maximum efficiency of frequency spectrum usage by the commercial telecommunications companies. The spectrum usage is especially critical in the band-limited radio frequency (RF) environment that communication satellite systems utilize. As these systems attempt to maximize this usage, there is an increasingly higher probability that data transfer will be impaired. This led Applied Signal Technology and Transcendent to believe that there will be a demand for sophisticated network management and spectrum monitoring systems designed to enhance the quality of satellite and terrestrial wireless communications.

On August 28, 2001, Applied Signal Technology decided to reintegrate Transcendent into Applied Signal Technology. The primary reason for the reintegration was Transcendent's inability to obtain adequate financing to satisfy its projected operational requirements. Applied Signal Technology believes in the viability of Transcendent's products and plans to continue to develop, market, and manufacture Transcendent's current products.

#### eNetSecure, Inc.

As the world becomes more reliant upon data transfer and data access for its day-to-day activities (that is, e-commerce), it also becomes more vulnerable to unauthorized data access or manipulation, as well as data handling policy violations. This creates a need for a high degree of information assurance. This information assurance must be performed without impact upon the data transfer. Applied Signal Technology believed that some of the intellectual property it developed for signal reconnaissance positioned it to develop and market intrusion detection technology. In particular, the voice-grade channel processor technology developed over the years directly lends itself to passive network monitoring for both intrusion detection and policy enforcement.

Following its creation in 2000, eNetSecure pursued the development of this technology and produced the ICEMON product to provide passive monitoring of data networks to detect unauthorized system entry for the purpose of altering or pirating data. In parallel, eNetSecure pursued the provision of comprehensive intrusion detection services as a managed security service provider.

On February 27, 2001, Applied Signal Technology's Board of Directors accepted the recommendation of eNetSecure to reintegrate eNetSecure into Applied Signal Technology. The primary reason for the reintegration was eNetSecure's inability to obtain adequate financing to satisfy its projected operational requirements. During the second quarter of fiscal 2001, Applied Signal Technology completed the reintegration of eNetSecure. Applied Signal Technology believes in the viability of eNetSecure's product and plans to continue to market and manufacture the product; however, Applied Signal Technology does not intend to act now as a managed security service provider.

#### Strategy

Applied Signal Technology's objective is to anticipate the needs of the signal reconnaissance marketplace and to invest in research and development in an effort to provide solutions before the Company's competitors. In some cases, this

involves the development of equipment to address new telecommunications technologies. In other cases, it involves the development of equipment that offers smaller size, lower power consumption, and lower cost than potentially competitive products. The Company's strategy is to aggressively pursue these objectives in its market area.

Three Months and Nine Months Ended August 3, 2001 Compared to Three Months and Nine Months Ended July 28, 2000

### Results of Operations

**Revenues and backlog.** Revenues for the third quarter of fiscal 2001 were approximately \$15,396,000, which represents a 39% decrease compared with the third quarter of fiscal 2000 revenues of approximately \$25,173,000. Revenues for the first nine months of fiscal 2001 were approximately \$54,683,000, down 31% from revenues of approximately \$78,988,000 recorded during the first nine months of fiscal 2000. The decline in revenues for the third quarter and the first nine months of fiscal year 2001 is due to a lower order flow during fiscal year 2000 and year-to-date 2001 when compared to the comparable periods in fiscal year 1999. This created a lower average backlog during the first nine months of fiscal year 2001 compared to the comparable period in fiscal 2000 from which to generate revenues. The net loss for the third quarter of fiscal 2001 is primarily due to absorbing approximately \$6,000,000 of anticipated unrecoverable indirect costs resulting from slower than anticipated revenue generation. The year-to-date net loss is primarily attributable to absorbing these anticipated unrecoverable indirect costs during the third quarter and to subsidiary losses of approximately \$6,500,000.

New orders received during third quarter of fiscal year 2001 were approximately \$9,522,000, down 50% from the approximately \$19,033,000 of orders received during the third quarter of fiscal year 2000. Order levels for the first nine months of fiscal year 2001 were approximately \$50,953,000 down 4% compared to the approximately \$53,010,000 reported for the same period of fiscal year 2000. Included in the third quarter and year-to-date order levels was the de-obligation of approximately \$5.2 million of orders on two major contracts. The decrease in new engineering orders during the third quarter is due, in part, to this de-obligation and, in part, to what the Company believes to be continued delays in the awarding of certain engineering efforts. The decrease in product orders is due to a decline in the demand for the Company's standard products.

The Company's backlog, which consists of anticipated revenues from new contracts and from the uncompleted portions of existing contracts (excluding unexercised options), was approximately \$30,631,000 at August 3, 2001, a decrease of 21% when compared to approximately \$38,963,000 at July 28, 2000. The decrease in backlog is primarily due to the impact of what the Company believes to be continued delays in the awarding of certain significant engineering development contracts and to a lower demand for the Company's standard products.

**Outlook.** The Company believes its anticipated revenues for fiscal year 2001 could be 25 to 35% lower than fiscal year 2000. The decline in anticipated revenues is due, in part, to what the Company believes to be continued delays in the awarding of certain significant engineering development contracts and, in part, to the unanticipated contract closeout of some significant engineering development contracts. In order to better align infrastructure costs with anticipated revenues; to date, the Company reduced its consolidated workforce by 161 employees or approximately 29% of the workforce since April 2001. As a result of the staff reductions, research and development spending, overhead spending and marketing expenditures will be reduced. In addition, the Company has vacated one of its Sunnyvale, CA. buildings and will vacate a second Sunnyvale building by October 1, 2001. Management believes that the cost reduction actions being taken during fiscal year 2001 will position the Company to return to profitability in fiscal year 2002.

**Contract costs.** Contract costs consist of direct costs on contract, including materials, labor, and manufacturing overhead costs. Contract costs as a percentage of revenues were 105.4% for the third quarter of fiscal year 2001 compared to 76.6% for the same period of fiscal 2000. Contract costs as a percentage of revenues for both the nine months ended August 3, 2001 and July 28, 2000 were 80.1% and 66.5%, respectively. Contract costs as a percentage of revenues increased for the third quarter of fiscal year 2001 and year-to-date due, in part, to absorbing approximately \$6,000,000 of anticipated unrecoverable indirect costs resulting from slower than anticipated revenue generation and, in part, to a higher manufacturing overhead rate applied during the first nine months of fiscal 2001 compared to the



same period of fiscal 2000.

**Research and Development (R&D).** Company-directed investment in research and development consists of expenditures recoverable from customers through the Company's billing rates and expenditures funded by the Company from earnings. It is the Company's accounting practice to record R&D expenses based on annual targeted indirect rates. (See "Notes to Financial Statements; Note 2 - Inventory.") Research and development expenses were approximately \$3,426,000 or 22.3% of revenues for the third quarter of fiscal year 2001 compared to approximately \$4,133,000 or 16.4% of revenues for the same period of fiscal year 2000. Research and development expenses for the first nine months of fiscal year 2001 were approximately \$12,741,000 or 23.3% of revenues compared to approximately \$9,688,000 or 12.3% of revenues for the same period of fiscal 2000. The decrease in R&D expenses during the third quarter of fiscal year 2001 compared to the same period of fiscal year 2000 is primarily due to reduced R&D spending because of lower than anticipated revenue generation. The increase in year-to-date R&D expenses is due, in part, to the Company investing in key R&D initiatives during the first two quarters of fiscal year 2001 while awaiting the award of certain engineering development contracts, and, in part, to approximately \$2,627,000 of research and development spending incurred by the Company's subsidiaries.

**General and administrative.** General and administrative expenses include administrative salaries, costs related to the Company's marketing and proposal activities, and other administrative costs. It is the Company's accounting practice to record general and administrative expenses based on annual targeted indirect rates. (See "Notes to Financial Statements; Note 2 - Inventory.") General and administrative expenses were approximately \$3,618,000 or 23.5% of revenues for the third quarter of fiscal year 2001 compared to approximately \$4,212,000 or 16.7% of revenues for the same period of fiscal year 2000. General and administrative expenses for the first nine months of fiscal year 2001 were approximately \$13,855,000 or 25.3% of revenues compared to approximately \$12,684,000 or 16.1% of revenues for the same period of fiscal year 2000. General and administrative expenses were lower during the third quarter of fiscal year 2001 compared to the same period of fiscal year 2000 primarily because of reduced G&A spending due to lower than anticipated revenue generation. The year-to-date increase in G&A expenses is due, in part, to a higher indirect rate application estimated for fiscal year 2001 compared to the rate application estimated for fiscal year 2000 (see "Notes to Financial Statements; Note 2 - Inventory.") and, in part, to approximately \$3,399,000 of general and administrative expenses incurred by the Company's subsidiaries during the first nine months of fiscal year 2001.

**Restructuring costs.** The Company recognized restructuring costs during the third quarter of fiscal year 2001 of approximately \$1,611,000 and year-to-date of approximately \$2,320,000. These restructuring costs consist primarily of severance payments of approximately \$1,215,000 and to the expensing of previously amortized leasehold improvements associated with vacated facilities of approximately \$1,105,000. Approximately \$2,261,000 was included in operating expenses and approximately \$59,000 was included in inventory and construction in process.

**Interest income/(expense), net.** Net interest income for the third quarter of fiscal year 2001 was approximately \$71,000, down 69.5% from net interest income of approximately \$233,000 for the third quarter of fiscal year 2000. Net interest income for the first nine months of fiscal year 2001 was approximately \$330,000, down 57.4% compared to approximately \$775,000 reported for the same period of fiscal year 2000. The decrease in net interest income for the third quarter of fiscal year 2001 and year-to-date is due to lower average cash balances in the current year period when compared to the same period of fiscal 2000.

**Provision for income taxes.** The Company's estimated annual effective tax rate for the quarter ended August 3, 2001 was a benefit rate of 28% compared to a 21% effective tax rate for the comparable period in fiscal year 2000. The Company's projected annual effective benefit tax rate for fiscal 2001 is calculated based on the projected losses for the year and reflects the benefit of potential carryback claims to recover previously paid taxes. The Company's estimated annual effective tax rate of 21% for fiscal year 2000 reflects benefits of federal and state income tax credits.

#### Analysis of Liquidity and Capital Resources

The Company's primary sources of liquidity during the third quarter of fiscal 2001 were the cash flows generated from accounts receivable and the issuance of common stock through its employee stock purchase plan. The year-to-date primary sources of liquidity were the cash flows generated from accounts receivable, the maturities of investments and the issuance of common stock through the Company's employee stock purchase plan. During the first nine months of fiscal year 2000, the Company's primary source of liquidity was the cash flow generated from operations as well as the issuance of common stock through its employee stock purchase plan.

The Company has a \$3,000,000 unsecured, revolving bank line of credit for short-term cash requirements bearing interest at the bank's reference rate (6.75% as of August 3, 2001). At both August 3, 2001 and October 31, 2000 this facility had not been utilized. As of August 3, 2001, the Company was not in compliance with the profitability covenant, although it was in compliance with the other covenants and restrictions. The bank has informed the Company that there will be no advances or loans made under the facility. The Company is currently working with the bank to try and develop an appropriate line of credit so it can borrow against it if necessary. The unsecured line of credit expires on March 15, 2002; the Company intends to seek renewal of some form of the line of credit at that time. The Company is also currently investigating alternative financing sources at this time. No assurance can be given that the line of credit will be renewed, that any advances can be obtained under the line of credit, or that an alternative financing source can be obtained.

**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 (loss), changes in the amount of investment in accounts receivable, and the change in inventories held by the Company. During the first nine months of fiscal 2001, approximately \$9,627,000 was used by operating activities compared to approximately \$4,278,000 provided during the same period of fiscal 2000. The net loss for the first nine months of fiscal 2001 used cash of approximately \$12,711,000 compared to cash provided from net income of approximately \$3,870,000 for the same period of fiscal 2000. Cash provided by accounts receivable during the first nine months of fiscal 2001 was approximately \$7,782,000 compared to cash provided of approximately \$4,697,000 during the same period of fiscal 2000. Cash provided by accounts receivable during the first nine months of fiscal 2001 was primarily due to collecting the first quarter fiscal 2001 billing of the higher than projected indirect rates for fiscal 2000. Cash used by inventory, prepaids and other assets during the first nine months of fiscal 2001 was approximately \$2,956,000 compared to cash used of approximately \$3,537,000 during the same period of fiscal 2000. The primary reason for the decrease in cash used was the lower inventoried indirect rate variance. Cash used by accounts payable, income taxes payable, and accrued liabilities during the first nine months of fiscal 2001 was approximately \$5,494,000 compared to cash used of approximately \$3,988,000 during the same period of fiscal 2000. The primary reason for the increase in cash used is the reduction of income taxes payable as a result of the fiscal 2001 net loss.

**Net cash from investing activities.** Cash provided by investing activities during the first nine months of fiscal year 2001 was approximately \$176,000 compared to approximately \$9,191,000 used by investing activities during the same period of fiscal 2000. During the first nine months of fiscal 2001, maturities of available-for-sale securities provided cash of approximately \$4,029,000, while the Company used cash of approximately \$15,058,000 to purchase such securities during the comparable period of fiscal 2000. Additions to property and equipment were approximately \$3,853,000 and approximately \$3,162,000 during the first nine months of fiscal 2001 and 2000, respectively. The fiscal 2001 increase was due to the addition of a new building in Sunnyvale, California and to the acquisition of property and equipment by the Company's two subsidiaries.

**Net cash from financing activities.** Cash provided by financing activities during the first nine months of fiscal 2001 was approximately \$358,000 as compared to cash provided by financing activities of approximately \$2,201,000 during the same period of fiscal 2000. The source of cash provided by financing activities in both periods was the issuance of common stock under the Company's employee stock purchase plan, which was partially offset by dividend payments. In an effort to reduce future cash expenditures, the Board of Directors voted on May 17, 2001 to suspend the dividend payment.

The Company believes that the funds generated from operations and existing working capital will be sufficient to meet its cash needs for at least the next twelve months.

Summary of Business Considerations and Certain Factors That May Affect Future Results of Operations and/or Stock Price

The Company's future operating results and stock price may be subject to volatility, particularly on a quarterly basis, or decline due to the following:

**Customer Concentration.** Historically, defense and intelligence agencies of the United States Government have accounted for almost all of Applied Signal Technology's revenues. Future reductions in United States Government spending on signal reconnaissance and communications equipment or future changes in the kind of signal reconnaissance and communications products or services required by the United States Government agencies, could limit demand for the Company's products, which would have a material adverse effect on the Company's operating results and financial condition.

Also, potential shifts in responsibilities and functions within the defense and intelligence communities could result in a reduction of spending on signal reconnaissance and communications equipment by the defense and intelligence agencies that have historically been the Company's major customers. The Company believes that the United States Government may compensate for reductions in spending by these agencies with increases in spending for signal reconnaissance and communications equipment by other Government agencies. However, the Company's contacts with other Government agencies are not as strong as they are with the agencies with which it has historically dealt. There is no assurance that any reduction in spending by the agencies with which the Company has historically dealt will be offset by other United States Government agencies, and even if other agencies increase spending for signal reconnaissance and communications equipment there is no assurance that the Company will secure the same amount of work from such other agencies. As a result, demand for the Company's products could decline, which would have a material adverse effect on the Company's operating results and financial condition.

In addition, as a supplier of these agencies, the Company must comply with numerous regulations, including regulations governing security and contracting practices. Failure to comply with these regulations could disqualify the Company as a supplier of these agencies, which would have a material adverse effect on the Company's operating results and financial condition.

**Revenue Concentration.** Due to the award of certain larger contracts, Applied Signal Technology has experienced a significant concentration of revenues from a single contract in recent periods. It is anticipated that this contract will complete by December 2001 and should decline as a percentage of fiscal 2001 revenues. This contract comprised 10% of revenues for the first nine months of fiscal 2001 compared to 13% for the first nine months of fiscal 2000. This contract may be terminated at the sole discretion of the United States Government. If this contract or other large contracts of the Company were terminated, this could have a material adverse effect on the Company's future operating results and financial condition.

**Competition.** The telecommunication signal processing market is highly competitive and Applied Signal Technology expects that competition will increase in the future. Some of the Company's current and potential competitors have significantly greater technical, manufacturing, financial, and marketing resources than the Company. Substantial competition could have a material adverse effect on the Company's future operating results and financial condition.

**Dependence Upon Personnel.** Applied Signal Technology's ability to execute its business plan is contingent upon successfully attracting and retaining qualified employees. During the last few years, the Company experienced difficulty in attracting new talent due to an increasingly competitive market for qualified personnel. In California, the Company must compete for new talent in the telecommunications sector, which employs a large number of the people the Company seeks to hire. Also, the Company has difficulty in recruiting new staff capable of obtaining the

necessary security clearance. (See "Employees.") The Company maintains offices in Annapolis Junction, Maryland; Herndon, Virginia; Hillsboro, Oregon; and Salt Lake City, Utah, providing it the ability to attract and retain qualified personnel in areas outside of California. The Company believes these offices, in addition to the increased investment made in the Company's engineering staff during fiscal 2000, should allow it to successfully attract and retain qualified employees. Failure to do so could have a material adverse effect on the Company's operating results and financial condition.

***Risk of Fixed Price and Contract Closures and Terminations.*** A significant portion of Applied Signal Technology's revenues are 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, inefficiencies, or other factors, are borne by the Company. The Company has experienced cost overruns in the past that have resulted in losses on certain contracts. There can be no assurance that the Company will not experience cost overruns in the future or that such overruns will not have a material adverse effect on the Company's future results of operations and financial condition.

The Company received three unanticipated early contract closure notices during the second quarter of fiscal 2001. These contract closures had a material adverse effect on the Company's ability to generate future revenues. There can be no assurances that such unanticipated early contract closures will not occur in the future.

In addition, almost all of the Company's contracts contain termination clauses, which permit contract termination upon the Company's default or for the convenience of the other contracting party. In either case, termination could adversely affect the Company's operating results. Although the Company has not experienced any material contract terminations to date, there can be no assurance that such terminations will not occur in the future.

***Potential Fluctuations in Quarterly Results and Market Volatility.*** Applied Signal Technology has experienced significant fluctuations in operating results from quarter to quarter and expects that it will continue to experience such fluctuations in the future. These fluctuations are caused by, among other factors, conditions inherent in government contracting and the Company's business, such as the timing of cost and expense recognition for contracts, the United States Government contracting and budget cycles, and the delays in contract awards. Fluctuations in quarterly results, shortfalls in revenues or earnings from levels forecast by securities analysts, changes in estimates by analysts, competition, or announcements of extraordinary events such as acquisitions or litigation may cause the price of the Company's common stock to fluctuate substantially. In addition, there can be no assurance that an active trading market will be sustained for the Company's 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 and that have been unrelated or disproportionately related to the operating performance of such companies. These fluctuations as well as general economic and market conditions may adversely affect the future market price of the Company's common stock.

***Rapid Technological Change.*** The market for Applied Signal Technology products is characterized by rapidly changing technology. The Company believes that it has been successful to date in identifying certain signal reconnaissance and industrial marketplace needs early, investing in research and development to meet these needs, and delivering products before the Company's competitors. The Company believes that its future success will depend upon continuing to develop and introduce, in a timely manner, products capable of collecting or processing new types of telecommunications signals. There can be no assurance that the Company will be able to develop and market new products successfully in the future or respond effectively to technological changes, such as data encryption technology and others, or that new products introduced by others will not render the Company's products or technologies noncompetitive or obsolete.

***Dependence Upon Certain Suppliers.*** Although Applied Signal Technology procures most of its parts and components from multiple sources or believes that these components are readily available from numerous other sources, certain components are available only from sole sources or from a limited number of sources. A number of

the Company's products contain critical components like single board computers available solely from Motorola and Force Computers, and field programmable gate arrays available solely from Xilinx, Inc. While the Company believes that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require the Company to re-engineer its products, or both, which could delay the Company's shipment of its products and could have a material adverse effect on the Company's operating results and financial condition.

**Business Disruption.** Applied Signal Technology's corporate headquarters, including most of its research and development operations and production facilities, are located in the Silicon Valley area of Northern California, a region known for seismic activity. A significant earthquake could materially affect operating results. The Company is not insured for most losses and business interruptions of this kind.

California's current energy crisis could present a risk to the Company if prolonged power outages or repeated power outages were to occur. Such power disruptions could have a material adverse impact on the Company's business operations. The Company is not insured against such power disruptions. To date, the Company has not experienced any prolonged or repeated power disruptions that have had a material impact on its business operations.

**Potential Impact of the Fiscal 2001 Indirect Rate Proposal.** At the beginning of each fiscal year, the Company submits a proposal to the Defense Contract Audit Agency (DCAA) to establish the indirect rates that will be applied to the Company's contracts with the United States Government during the fiscal year. The Company submitted its fiscal 2001 indirect rate proposal that includes a proposed maximum contribution by the Company to help reduce its fiscal 2001 indirect rates. The proposal was accepted by the Government. If the Company contributes the maximum proposed amount, and the Company believes it will, there will be a material impact to the Company's profitability and cash reserves. In the event the maximum contribution is made, the Company believes it will incur a material loss for fiscal 2001 but will still maintain adequate cash balances to continue operations.

Even though management will take what it believes to be the necessary actions to generate revenues and control costs, there can be no assurances that the Company will generate the revenues necessary to avoid further increases in its indirect rates. Failure to generate the necessary revenues or control costs could have a material adverse effect on the Company's future operating results and financial condition.

**Delays in the Receipt of Engineering Contracts.** The Company believes it has experienced continued delays in the receipt of certain engineering development contracts. While the Company is working closely with its customers to try and capture what it believes to be sole-source orders, continued delays in the receipt of such orders could have a material adverse impact on the Company's financial condition and operating results. There is no assurance that the Company is correct in its belief that these contracts are delayed. Rather, it may be the case that the contracts will not be awarded at all, or, if awarded, they may be awarded to persons other than the Company. The failure of the receipt of such contracts would have a material adverse impact on the Company's financial condition and operating results.

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## Part II. Other Information

### Item Legal Proceedings

1.

The Company, from time to time, is engaged in various legal actions including, but not limited to, wrongful termination allegations, governmental agency investigations and employee discrimination allegations. The Company believes that these legal actions will not, either individually or in aggregate, have a material adverse effect on the

operating results or financial condition of the Company.

**Item** Other Information  
**5.**

eNetSecure Reintegration

From its inception to February 27, 2001, the Company invested \$5 million in eNetSecure plus the necessary capital equipment and intellectual property. On February 27, 2001 Applied Signal Technology's Board of Directors accepted the recommendation of eNetSecure to reintegrate eNetSecure into Applied Signal Technology.

Transcendent Reintegration

From its inception to August 3, 2001, the Company invested \$5.4 million in Transcendent plus the necessary capital equipment and intellectual property. On August 28, 2001, Applied Signal Technology decided to reintegrate Transcendent.

Dividends

In an effort to reduce future cash expenditures, the Board of Directors voted on May 17, 2001 to suspend the dividend payment.

**Item** Exhibits and Reports on Form 8-K  
**6.**

Reports on Form 8-K

The Company filed one report on Form 8-K during the three months ended August 3, 2001. The report dealt with the Company's second quarter results and its near-term plans to reduce operating costs and was filed on May 31, 2001.

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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 therewith duly authorized.

Applied Signal Technology, Inc.

/James E. Doyle/      September 14, 2001

James E. Doyle  
Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)