APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
September 10, 2007

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 August 3, 2007

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 August 3, 2007, was 12,363,364.

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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		Nine Months Ended	
	August 3, 2007	**July 28, 2006**	**August 3, 2007**	**July 28, 2006**
Revenues from contracts	$39,542	$39,450	$124,140	$116,528
Operating expenses:				
Contract costs	27,062	27,258	84,505	78,579
Research and development	3,756	3,986	10,751	12,273
General and administrative	7,101	6,429	21,645	18,633
Total operating expenses	37,919	37,673	116,901	109,485
Operating income	1,623	1,777	7,239	7,043

Interest income, net	189 ----------	107 ----------	454 ----------	178 ----------
Income before provision for income taxes	1,812	1,884	7,693	7,221
Provision for income taxes	835 ----------	960 ----------	3,273 ----------	3,462 ----------
Net income	$977 ======	$924 ======	$4,420 ======	$3,759 ======
Net income per common share:				
Basic	$0.08	$0.08	$0.37	$0.32
Diluted	$0.08	$0.08	$0.36	$0.31
Number of shares used in calculating net income per common share:				
Basic	12,171	11,784	12,062	11,701
Diluted	12,381	12,019	12,283	11,976

See “Notes to Condensed Consolidated Financial Statements.”

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

Assets	August 3, 2007	October 31, 2006 †
Current assets:		
Cash and cash equivalents	$6,466	$4,194
Short term investments	28,408 -------------	25,651 -------------
Total cash and cash equivalents and short-term investments	34,874	29,845
Accounts receivable:		
Billed	23,293	20,766
Unbilled	15,882 -------------	19,813 -------------
Total accounts receivable	39,175	40,579
Inventory	12,464	6,078
Refundable income taxes	647	647
Prepaid and other current assets	8,531 -------------	12,306 -------------
Total current assets	95,691	89,455
Property and equipment, at cost:		
Machinery and equipment	40,306	39,224

Furniture and fixtures	4,650	4,614
Leasehold improvements	14,478	14,278
Construction in process	238 -------------	195 -------------
	59,672	58,311
Accumulated depreciation and amortization	(44,926) -------------	(41,496) -------------
Net property and equipment	14,746	16,815
Long-term investments	1,015	2,802
Goodwill	19,964	19,964
Intangible assets, net of accumulated amortization	777	1,260
Long-term deferred tax asset	6,273	5,455
Other assets	883 -------------	781 -------------
Total assets	$139,349 ========	$136,532 ========

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

Liabilities and Shareholders' Equity	August 3, 2007	October 31, 2006 †
Current liabilities:		
Accounts payable	$2,765	$5,253
Accrued payroll and related benefits	12,884	13,844
Note payable	1,429	1,429
Other accrued liabilities	1,731 -------------	1,741 -------------
Total current liabilities	18,809	22,267
Long-term note payable	5,595	6,786
Accrued rent	1,489	1,354
Other long-term liabilities	491	495
Shareholders' equity:		
Common stock and additional paid-in capital, no par value: 20,000,000 shares authorized; issued and outstanding shares: 12,363,364 at August 3, 2007 and 11,922,103 at October 31, 2006	60,803	53,295
Retained earnings	52,109	52,272
Accumulated other comprehensive income	53 -------------	63 -------------

Total shareholders' equity	112,965 -------------	105,630 -------------
Total liabilities and shareholders' equity	$139,349 ========	$136,532 ========

† The balance sheet at October 31, 2006, 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
Increase (Decrease) in Cash and Cash Equivalents (unaudited)
(in thousands)

	Nine Months Ended	
	August 3, 2007	**July 28, 2006**
Operating Activities		
Net income	$4,420	$3,759
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	4,214	3,840
Stock-based compensation	3,255	3,213
Tax benefit related to stock plan	55	325
Excess tax benefits from stock-based payment arrangements	(54)	(165)
Changes in:		
Accounts receivable	1,404	7,286
Inventory, prepaid expenses, and other assets	(3,537)	(9,727)
Accounts payable, taxes payable, and accrued liabilities	(3,440) ----------	(5,834) ----------
Net cash provided by operating activities	6,317	2,697
Investing Activities		
Purchases of available-for-sale securities	(56,902)	—
Maturities and sales of available-for-sale securities	55,790	8,600
Additions to property and equipment	(1,524) ----------	(4,565) ----------
Net cash (used for) provided by investing activities	(2,636)	4,035
Financing Activities		
Issuances of common stock	4,257	4,210

Excess tax benefits from stock-based payment arrangements	54	165
Term loan	(1,191)	(1,072)
Dividends paid	(4,529) ----------	(4,371) ----------
Net cash used for financing activities	(1,409)	(1,068)
Net increase in cash and cash equivalents	2,272	5,664
Cash and cash equivalents, beginning of period	4,194 ----------	18,920 ----------
Cash and cash equivalents, end of period	$6,466 ======	$24,584 ======
Supplemental disclosures of cash flow information:		
Interest paid	$515	$514
Income taxes paid	$3,007	$4,721

See "Notes to Condensed Consolidated Financial Statements."

Applied Signal Technology, Inc.
Notes to Condensed Consolidated Financial Statements (unaudited)
August 3, 2007

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 end 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 weapons manufacturing. Our sensor processing equipment provides automatic detection of physical abnormalities in both marine and terrestrial environments.

Substantially, all of our revenues were from contracts with the United States Government, its agencies, 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 of the rules and regulations of the Securities and Exchange Commission. 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, 2006. 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 nine-month periods ended August 3, 2007, are not necessarily indicative of the results that may be expected for the year ending October 31, 2007. The balance sheet at October 31, 2006, 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* (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).

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. 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. 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 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. 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		Nine Months Ended	
	August 3, 2007	July 28, 2006	August 3, 2007	July 28, 2006
Cost-reimbursement contracts	71%	83%	73%	80%
Fixed-price contracts	10%	11%	14%	15%
Time-and-materials contracts	19%	6%	13%	5%

Six contracts represented an aggregate of 56% and 57% of revenues for the respective three-month and nine-month periods ended August 3, 2007. Five contracts represented an aggregate of 51% and 41% of revenues for the three-month and nine-month periods ending July 28, 2006, respectively. One of the six significant contracts in fiscal year 2007 is a time-and-materials contract. All other contracts referenced in the paragraph are 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.

Pre-contract 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. Pre-contract costs for the periods ended August 3, 2007, and October 31, 2006, were approximately $2,530,000 and $5,667,000, respectively. Approximately $4,870,000 of the October 31, 2006, balance was recognized as revenue during the nine months ended August 3, 2007. At the end of fiscal year 2006, approximately $569,000 that was included in pre-contract costs was associated with an individual contract for which we had filed a formal claim against the U.S. Government. This was a formal request for reimbursement for work performed on this contract. During the second quarter of fiscal year 2007, the claim was rejected and we reduced pre-contract costs and operating income by $569,000.

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 determinable.

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 remainder of the fiscal 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 inventory. Fee percentages on fixed-price and cost-reimbursement contracts will generally decline as a result of any increase to indirect costs. If our rate variance is favorable, the modification of our billing rates will decrease revenue and operating expenses, and increase inventory. In this event, fee percentages on fixed-price 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 allocated to the program. 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 August 3, 2007, the unfavorable rate variance for the first nine months of fiscal year 2007 was approximately $5,445,000, and was reduced by a management reserve of $1,300,000, for a net unfavorable variance of approximately $4,145,000. We recorded $300,000 and $1,000,000 of the management reserve during the second and third quarters of fiscal year 2007, respectively. The reserve was recorded as an increase to operating expenses and a decrease to inventory, and represents the estimated amount of profit that is not expected to be recovered through contract activities during the remainder of the fiscal year. At July 28, 2006, the unfavorable rate variance was approximately $5,350,000, which was reduced by a management reserve of $1,000,000, for a net unfavorable balance of approximately $4,350,000.

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 either regularly progress bill 90% of incurred costs or 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.

There was no charge to bad debt expense during the first nine months of fiscal year 2007 or fiscal year 2006.

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 our products. 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 greater than full cost so there is limited decrement in valuation. If we determine that a product has reached the end of its life cycle or there is no longer a need for certain products, we dispose of the remaining inventory. Historically, we dispose of inventory at approximately the same time that the reduction to inventory is recorded and we do not hold inventory reserves.

Disposed items included units in various stages of completion. The charges associated with disposed work in process and finished goods are included in contract costs in our statement of operations. Amounts associated with disposed raw materials 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. Disposals of inventory were not significant during the first nine months of fiscal years 2007 or 2006.

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. This estimated tax rate is calculated based on the projected net income at the end of the fiscal year, and is reviewed at each reporting period. At the end of the fiscal year, income tax expense is adjusted for actual results. Our effective tax rate can differ from the statutory rate due to the non-tax-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 nine months of fiscal year 2007 or fiscal year 2006.

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 August 3, 2007, all of our short-term and long-term investments consist of tax-exempt securities. 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 nine months of fiscal year 2007 or fiscal year 2006.

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

		August 3, 2007	
	Amortized Cost	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	$6,466	$—	$6,466

Available-for-sale securities:			
Short-term, tax exempt	28,410	(2)	28,408
Long-term, tax exempt	1,016 ----------	(1) ----------	1,015 ----------
	$35,892 ======	$(3) ======	$35,889 ======

		October 31, 2006	
	Amortized Cost	Gross Unrealized Gains	Estimated Fair Market Value
Cash and cash equivalents	$4,194	$—	$4,194
Available-for-sale securities:			
Short-term, tax exempt	25,651	—	25,651
Long-term, tax exempt	2,801 ----------	1 ----------	2,802 ----------
	$32,646 ======	$1 ======	$32,647 ======

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

	August 3, 2007	October 31, 2006
Due in one year or less	$28,408	$25,651
Due in one to two years	1,015 ----------	2,802 ----------
	$29,423 ======	$28,453 ======

Restricted Cash

We had restricted cash balances of approximately $589,000 and $582,000 at August 3, 2007, and at October 31, 2006, 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 $189,000 and $177,000 of contributions to disability funds was included in prepaids and other current assets at August 3, 2007, and at October 31, 2006, respectively. Approximately $400,000 and $405,000 of contributions to disability funds was included in other assets at August 3, 2007, and at October 31, 2006, 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 test equipment and is not depreciated until placed in service.

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 existed at August 3, 2007.

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 existed at August 3, 2007.

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		Nine Months Ended	
	August 3, 2007	**July 28, 2006**	**August 3, 2007**	**July 28, 2006**
Numerator:				
Net income	$977 ======	$924 ======	$4,420 ======	$3,759 ======
Denominator:				
Shares used to compute net income per common share – basic	12,171	11,784	12,062	11,701
Effect of dilutive stock options and awards	210 ----------	235 ----------	221 ----------	275 ----------
Shares used to compute net income per common share – diluted	12,381 ======	12,019 ======	12,283 ======	11,976 ======
Net income per common share – basic	$0.08	$0.08	$0.37	$0.32
Net income per common share – diluted	$0.08	$0.08	$0.36	$0.31

The exercise prices of approximately 1,023,000 and 964,000 potential common shares for the three-month and nine-month periods ended August 3, 2007, were excluded from the diluted net income per common share computation for the respective periods, as their effect would be antidilutive. For the same periods in fiscal year 2006, we excluded 1,042,000 and 826,000 potential common shares from the diluted net income per common share computation.

Comprehensive Income

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

	Three Months Ended		Nine Months Ended	
	August 3, 2007	July 28, 2006	August 3, 2007	July 28, 2006
Net income	$977	$924	$4,420	$3,759
Unrealized gain (loss) on securities	3	1	(4)	5
Derivative gain (loss), net of tax	(4)	(10)	(6)	(21)
Comprehensive income	$976	$915	$4,410	$3,743

Accumulated other comprehensive income as of August 3, 2007, was approximately $53,000, and as of October 31, 2006, was approximately $63,000.

Dividends

The company pays dividends at the rate of $0.50 per share per annum, payable quarterly. In addition, the dividend is subject to approval by the Board of Directors, and is reviewed quarterly. Dividends were paid on February 16, 2007, May 18, 2007, and August 17, 2007, to shareholders of record on February 2, 2007, May 4, 2007, and August 3, 2007, and are expected to be paid on November 16, 2007, to shareholders of record on October 31, 2007.

We paid dividends of approximately $4,529,000 during the first nine months of fiscal year 2007 and approximately $4,371,000 during the first nine months of fiscal year 2006.

At August 3, 2007, and October 31, 2006, declared but unpaid dividends of approximately $1,545,000 and $1,491,000, 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 incentive and non-statutory stock options granted under various plans, and restricted stock awards. Stock options are generally time based, 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 of the employee.

Prior to fiscal year 2006, we used stock options as the primary component of our stock-based incentive plans for officers and directors. In fiscal year 2006, we began granting restricted stock to our officers and directors. During the first quarter of fiscal year 2007, we granted restricted stock to officers as part of their annual compensation review. In the first nine months of fiscal year 2007, we granted restricted stock to newly-hired and existing non-officer employees. The restrictions typically will lapse in equal annual installments, on each anniversary of 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 these offering periods. As a result of the modification to the ESPP, the December 1, 2006 offering period, ending November 30, 2008, is the final twenty-four-month offering.

As of August 3, 2007, there was a total of 1,163,182 shares reserved for future issuance under the plans.

In fiscal year 2006, we adopted the provisions of SFAS 123 (revised 2004), *Share-Based Payment* (SFAS 123R), requiring us to recognize expense related to the fair value of our stock-based compensation awards that are ultimately expected to vest. We elected to use the modified prospective transition method as permitted by SFAS 123R. Stock-based compensation expense for all stock-based compensation 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, using the Black-Scholes valuation model, 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 our ESPP included in our condensed consolidated statements of operations (in thousands, except share data).

	Three Months Ended		Nine Months Ended	
	August 3, 2007	**July 28, 2006**	**August 3, 2007**	**July 28, 2006**
Contract costs	$620	$542	$1,852	$1,884
Research and development	46	34	155	172
General and administrative	367	371	1,248	1,157
Stock-based compensation expense before income taxes	$1,033	$947	$3,255	$3,213
Income taxes	(223)	(209)	(682)	(571)
Stock-based compensation expense after income taxes	$810	$738	$2,573	$2,642
Reduction to basic net income per share	$0.07	$0.06	$0.21	$0.23
Reduction to diluted net income per share	$0.07	$0.06	$0.21	$0.22

The fair value of options granted and shares issued under the ESPP by the Company was estimated based on the Black-Scholes valuation model using the following weighted average assumptions:

	Employee Stock Options	Employee Stock Purchase Plan	
	Nine Months Ended July 28, 2006	**Nine Months Ended August 3, 2007**	**Nine Months Ended July 28, 2006**
Risk-free interest rate	5.0%	4.6%	4.9%
Expected life (years)	5.0	1.9	1.6
Expected volatility	44%	39%	39%
Expected dividends	2.8%	2.5%	2.2%
Weighted average fair value	$6.42	$5.59	$6.24

There were no options granted during the first nine months of fiscal year 2007.

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 complex and subjective variables. These factors include, but are not limited to, our expected stock price volatility, the projected life of the stock option, the expected dividend yield, and the risk-free interest rate. Changes in the subjective assumptions can materially affect the estimated value of the stock options 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 time of the option grant or ESPP offering date.

The expected life of the options represents the period that we expect the stock-based awards will be outstanding and is determined based on our historical experience of similar awards, considering contractual terms, exercise patterns, and vesting schedules. The expected life used for ESPP offering periods prior to June 1, 2007, was based on the six-month purchase periods within each twenty-four-month offering period.

Our computation of expected volatility for both stock options and ESPP purchases for the nine-month periods ended August 3, 2007, and July 28, 2006, 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 nine months of fiscal year 2007 and 2006 reflects estimated forfeitures, which are based on historical option forfeitures.

Net cash proceeds from the exercise of stock options were approximately $726,000 for the nine-month period ended August 3, 2007, and approximately $845,000 for the nine-month period ended July 28, 2006. The net cash proceeds associated with our ESPP were $3,531,000 for the nine-month period ended August 3, 2007, and $3,366,000 for the nine-month period ended July 28, 2006. The income tax benefit realized from stock option exercises during the first nine months of fiscal year 2007 was approximately $55,000 and $325,000 during the same period of fiscal year 2006. In accordance with SFAS 123R, we present excess tax benefits from the exercise of stock options, if any, as financing cash flows rather than operating cash flows.

The following table summarizes our stock option activity for the nine months ended August 3, 2007.

	Shares	Weighted Average Exercise Price
Outstanding at October 31, 2006	1,547,779	$17.83
Grants	—	—
Exercised	(78,096)	$9.30
Forfeitures or expirations	(39,142) ------------	$18.65
Outstanding at August 3, 2007	1,430,541	$18.26
Exercisable at August 3, 2007	951,637	$16.31

As of August 3, 2007, approximately $4,457,000 of total unrecognized compensation expense related to unvested stock options is expected to be recognized over a weighted average period of 2.8 years.

Unrecognized compensation expense associated with our ESPP as of August 3, 2007, is approximately $1,685,000 and is expected to be recognized over a weighted average period of 1.3 years.

The following table summarizes our restricted stock activity for the nine months ended August 3, 2007.

Nonvested Shares	Shares	Weighted Average Grant Date Fair Value Per Share
Nonvested at October 31, 2006	61,875	$19.58
Grants	104,750	$17.84
Vested	(15,472)	$19.58
Forfeitures	(950) ------------	$18.06
Nonvested at August 3, 2007	150,203	$17.75

The fair value of our restricted stock is based on our closing stock price on the date of grant. As of August 3, 2007, our unrecognized compensation cost related to nonvested (restricted) stock is $2,278,000, and is expected to be recognized over a weighted average period of 3.3 years.

Recent Accounting Pronouncements

In June 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20, *Accounting Changes*, and Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles were required to be recognized through a cumulative effect adjustment within net income of the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effect or the cumulative effect of the change. We adopted SFAS 154 at the beginning of fiscal year 2007. The adoption of SFAS 154 did not have a material impact on our financial statements.

In May 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Instruments*, which amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. We adopted SFAS 155 at the beginning of fiscal year 2007. The adoption of SFAS 155 did not have a material impact on our financial statements.

In September 2006, the SEC released Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on the SEC's views regarding quantifying the materiality of financial statement misstatements, including misstatements that were not material to prior years' financial statements. We adopted SAB 108 at the beginning of fiscal year 2007. The adoption of SAB 108 did not have a material impact on our financial statements.

In June 2006, the FASB issued FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109* (FIN 48). The interpretation clarifies the accounting for uncertainty in income taxes and utilizes a two-step approach. 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, with the presumption that the position will be examined. The second step is to measure the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The provisions are effective for us for our fiscal year beginning November 1, 2007. We are evaluating the impact this interpretation will have on our financial statements.

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 is effective as of the beginning of the first fiscal year beginning after November 15, 2007. Earlier application is permitted provided the company also applies the provisions of Statement 157. 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.

Note 2: Inventory

Inventories are stated at cost and consisted of the following (in thousands):

	August 3, 2007	October 31, 2006
Raw materials	$868	$768
Work in process	11,314	5,060
Finished goods	282 ----------	250 ----------
	$12,464	$6,078

At August 3, 2007, the unfavorable inventoried rate variance increased work in process by approximately $5,445,000, and was reduced by a management reserve of $1,300,000, for a net increase to work in process of approximately $4,145,000. We recorded $300,000 and $1,000,000 of the management reserve during the second and third quarters of fiscal year 2007, respectively. At July 28, 2006, the unfavorable inventoried indirect rate variance increased work in process by approximately $5,350,000, which was reduced by a management reserve of $1,000,000, for a net unfavorable balance of approximately $4,350,000.

Activity associated with actual production increased work in process by approximately $2,109,000 and $1,778,000 during the first nine months of fiscal years 2007 and 2006, respectively.

Disposal activities were not significant during the first nine months of fiscal years 2007 or 2006.

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 nine months of fiscal year 2007.

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

			August 3, 2007	
	Useful Life	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Identifiable intangible assets that are subject to amortization:				
Customer relationships	3 years	$1,720	$(1,194)	$526
Existing technology	5 years	340	(142)	198
Non-compete agreements	1 year	60	(60)	—
Patent	18 years	60	(7)	53
Trade name	1 year	90	(90)	—
Total		$2,270	$(1,493)	$777

All of our acquired identifiable intangible assets are subject to amortization and have originally estimated useful lives as noted in the table above.

As of August 3, 2007, the estimated future amortization expense for acquired identifiable intangible assets is as follows (in thousands):

Fiscal Years	
Remainder of 2007	$162
2008	453
2009	71
2010	49
2011–2023	42
Total	$777

The goodwill and identifiable intangible assets are related to our July 2005 acquisition of Dynamics Technology, Inc. (DTI) for a purchase price of approximately $31.4 million.

Note 4: Borrowing Arrangements

Revolving line of credit. At August 3, 2007, we had a revolving line of credit (Line of Credit) under which Wells Fargo Bank, National Association (the Bank), will advance funds to us from time to time up to and including March 1, 2008, not to exceed at any time the maximum principal amount of $3 million.

At August 3, 2007, 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 $1,220,000 at August 3, 2007. The second letter of credit is a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at August 3, 2007. 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 $1,630,000. No fees or interest were associated with this unused portion. Borrowings under the Line of Credit bear interest at the Bank's reference rate (8.25% at August 3, 2007), and interest on those borrowings are payable monthly. As security for our indebtedness under the Line of Credit, we have granted to the Bank a security interest in our cash and marketable securities maintained with an affiliate of the Bank.

Term loan and interest rate swap. Effective July 1, 2005, and in connection with the acquisition of Dynamics Technology, Inc. (DTI), we entered into a term loan with the Bank in the principal amount of $10 million the proceeds of which were used for acquisition financing (Term Loan). The Term Loan bears interest at a rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) (5.32% at August 3, 2007). Our Term Loan is for a seven-year term ending on July 1, 2012. Payment terms of the loan agreement include monthly payments of principal and interest.

As security for our indebtedness under the Term Loan, we have granted to the Bank 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 August 3, 2007, 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 derivatives. The derivative instrument employed, an interest rate swap, is considered a cash flow hedge and accounted for under FASB SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133). A derivative contract references an underlying variable, such as an interest rate index, a foreign currency exchange rate, or a commodity value. The payment, or settlement, obligation arising from a derivative is calculated by applying the terms of the contract to changes in the value of the reference variable during a calculation period. Derivatives may trade on exchanges, such as most common stock options, or may be private (over the counter) arrangements between two parties.

We entered into an over the counter interest rate swap contract with Wells Fargo Bank designed to operate as a cash flow hedge for our Term Loan. Effectively, the swap converts the floating interest rate of the Term Loan into a predicable fixed rate. The use of an interest rate swap in this situation locks the variable interest expense associated with the debt and results in a fixed interest expense that is typically immune from subsequent market rate fluctuations. Since there is a high correlation between the hedged instrument (the swap) and the underlying interest variable, gains and losses on the interest exposure are usually eliminated by offsetting changes in the swap, making it a highly effective instrument in hedging variability.

At August 3, 2007, we had one interest rate swap agreement outstanding with Wells Fargo Bank designated as a cash flow hedge under SFAS 133 related to our Term Loan. No losses on the agreement due to counterparty credit issues are anticipated. Under this swap, we pay a fixed interest rate of 4.33% 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 August 3, 2007, the effective portion of the hedge was a deferred gain of approximately $56,000, net of taxes**.** Over the next twelve months, we expect to reclassify approximately $43,000 of the gain 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 was no ineffective portion of the outstanding swap as of August 3, 2007.

Note 5: Contractual Obligations

The following table sets forth our contractual obligations as of August 3, 2007 (in thousands).

	Payments Due by Period

	Total	Less than 1 Year	1–3 Years	3–5 Years	More than 5 Years
Operating lease obligations	$46,188	$7,424	$15,114	$12,704	$10,946
Loan obligations – principal	7,024	1,429	2,857	2,738	—
Purchase obligations	3,462 ----------	3,462 ----------	— ----------	— ----------	— ----------
Total	$56,674 ======	$12,315 ======	$17,971 ======	$15,442 ======	$10,946 ======

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2007 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses. During the first nine months of fiscal year 2007, we entered into a new operating lease agreement with a total lease obligation of approximately $3,817,000 for our new facility in Torrance, California. In addition, we amended our operating lease agreements for our facilities in Anaheim, California and Salt Lake City, Utah. These amendments increased our total lease obligation by approximately $93,000 and $71,000, respectively.

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 U.S. 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

Our provision for income taxes for the third quarter and first nine months of fiscal year 2007 was approximately $835,000 and $3,273,000, respectively, with an estimated annual effective tax rate of 45%. Our provision for income taxes for the third quarter and first nine months of fiscal year 2006 was approximately $960,000 and $3,462,000, respectively, with an estimated annual effective tax rate of 48%. In addition, we recorded a reduction to income tax expense for discrete items of approximately $183,000 during the first nine months of fiscal year 2007, primarily associated with the benefit of our research and development tax refund from the state of California.

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 third quarter and first nine months of fiscal year 2007 were approximately $60,000 and $206,000, respectively. For the same periods of fiscal year 2006 warranty costs were approximately $63,000 and $204,000, 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 indemnification 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 August 3, 2007, or October 31, 2006.

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 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 and entered judgment in defendants’ favor. Plaintiffs appealed the judgment of dismissal on March 23, 2006; 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 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, 2006.

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 end 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 weapons manufacturing. Our sensor processing equipment provides automatic detection of physical abnormalities in both marine and terrestrial environments.

Substantially, all 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 with the United States Government, its agencies, or prime contractors with the United States Government 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).

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, which we began recognizing in fiscal year 2006, 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. 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.

Pre-contract 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. Pre-contract costs for the periods ended August 3, 2007, and October 31, 2006, were approximately $2,530,000 and $5,667,000, respectively. Approximately $4,870,000 of the October 31, 2006, balance was recognized as revenue during the first nine months of fiscal year 2007. At the end of fiscal year 2006, approximately $569,000 that was included in pre-contract costs was associated with an individual contract for which we had filed a formal claim against the U.S. Government. This was a formal request for reimbursement for work performed on this contract. During the second quarter of fiscal year 2007, the claim was rejected and we reduced pre-contract costs and operating income by $569,000.

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 determinable. We believe that this estimate is the preferred practice used within our industry. At year-end, the revenues and costs are adjusted 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, 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 reduce the variance: we can adjust some of our planned indirect spending during the remainder of the fiscal 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 inventory. Fee percentages on fixed-price and cost-reimbursement contracts will generally decline as a result of any increase to indirect costs. If our rate variance is favorable, the modification of our billing rates will decrease revenue and operating expenses, and increase inventory. In this event, fee percentages on fixed-price 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, depends on a number of other factors, including mix of contract types, contract terms, anticipated performance on specific contracts, and anticipated changes in inventory.

At August 3, 2007, the unfavorable rate variance for the first nine months of fiscal year 2007 was approximately $5,445,000, and was reduced by a management reserve of $1,300,000, for a net unfavorable variance of approximately $4,145,000. We recorded $300,000 and $1,000,000 of the management reserve during the second and third quarters of fiscal year 2007, respectively. The reserve was recorded as an increase to operating expenses and a decrease to inventory, and represents the estimated amount of profit that is not expected to be recovered through contract activities during the remainder of the fiscal year. At July 28, 2006, the unfavorable rate variance was approximately $5,350,000, which was reduced by a management reserve of $1,000,000, for a net unfavorable balance of approximately $4,350,000.

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 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.

There was no charge to bad debt expense during the first nine months of fiscal years 2007 or fiscal year 2006.

Inventory valuation and disposal. We provide advanced digital signal processing products and systems to the U.S. 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 greater than full cost, so there is limited decrement in valuation. If it is determined that a product has reached the end of its life cycle or there is no longer a need for certain equipment, the remaining inventory is disposed. Historically, we dispose of inventory at approximately the same time that the reduction to inventory is recorded and we do not hold inventory reserves.

Disposed items typically include units in various stages of completion. The charges associated with disposed work in process and finished goods are included in contract costs in our statement of operations. Amounts associated with disposed raw materials 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. Disposals of inventory were not significant during the first nine months of fiscal years 2007 or 2006.

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 nine months of fiscal years 2007 and 2006, 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 existed at August 3, 2007.

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 existed at August 3, 2007.

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 as permitted by SFAS 123R. Stock-based compensation expense for all stock-based compensation 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, using the Black-Scholes valuation model, 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.

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. For the first nine months of fiscal year 2007 and 2006, 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 stock options granted to non-officer employees in the first nine months of fiscal year 2006, we used a five-year expected life. We estimated the expected life of the options based on historical observations of our stock, considering the average years of options actually exercised, vested and cancelled options, and outstanding and exercisable options. At least once a year, we will assess the exercise behavior and determine if our current expected life assumptions need to change. For offering periods beginning prior to June 1, 2007, the expected life used for our ESPP 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 time of the option grant or ESPP offering date.The expected dividend yield for both stock options and purchases under the ESPP is calculated by taking the total expected annual dividend payout divided by the average stock price per share.

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 these new six-month offering periods. As a result of the modification to the ESPP, the December 1, 2006 offering period, ending November 30, 2008, is the final twenty-four-month offering and may be reset to a six-month offering period at December 1, 2007. Such a reset could potentially increase stock-based compensation in excess of $500,000 in fiscal year 2008.

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

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 2007.

At the beginning of fiscal year 2006, we adopted the provisions of SFAS 123R requiring us to recognize expense related to the fair value of our stock-based compensation awards that are ultimately expected to vest.

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		Nine Months Ended	
	August 3, 2007	**July 28, 2006**	**August 3, 2007**	**July 28, 2006**
Contract costs	$620	$542	1,852	$1,884
Research and development	46	34	155	172
General and administrative	367	371	1,248	1,157
Stock-based compensation expense before income taxes	$1,033	$947	$3,255	$3,213
Income taxes	(223)	(209)	(682)	(571)
Stock-based compensation expense after income taxes	$810	$738	$2,573	$2,642
Reduction to basic net income per share	$0.07	$0.06	$0.21	$0.23
Reduction to diluted net income per share	$0.07	$0.06	$0.21	$0.22

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

Three and Nine Months Ended August 3, 2007, Compared to Three and Nine Months Ended July 28, 2006

Revenues and backlog. Revenues for the third quarter of fiscal year 2007 were approximately $39,541,000, similar to revenues of approximately $39,450,000 recorded in the same period of fiscal year 2006. Revenues for the first nine months of fiscal year 2007 were approximately $124,140,000, a 6.5% increase from revenues of approximately $116,528,000 recognized during the same period of fiscal year 2006. The increase in revenues during the first nine months of fiscal year 2007 is primarily due to our ability to recognize approximately $4,870,000 of pre-contract costs incurred during the fourth quarter of fiscal 2006. The majority of the revenue associated with this pre-contract activity was recognized during the first quarter of fiscal year 2007.

New orders received during the third quarter of fiscal year 2007 were approximately $74,081,000, an increase of 145.3% from approximately $30,204,000 in new orders received during the same period of fiscal year 2006. New orders received during the first nine months of fiscal year 2007 were approximately $150,861,000, an increase of 72.5% from approximately $87,442,000 in new orders received during the same period of fiscal year 2006. Our backlog consists of the uncompleted portions of existing contracts (excluding unexercised contract options). At August 3, 2007, ending backlog was approximately $133,566,000, representing a 27.3% increase from ending backlog of approximately $104,952,000 at October 31, 2006. Reported backlog includes both funded and unfunded portions of contract values. There is no assurance or customer 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 by applying a negotiated billing rate to the level-of-effort. Historically, we have achieved greater profit margins from our fixed-price contracts than from our cost-reimbursement and time-and-materials contracts.

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

	Three Months Ended		Nine Months Ended	
	August 3, 2007	July 28, 2006	August 3, 2007	July 28, 2006
Cost-reimbursement contracts	71%	83%	73%	80%
Fixed-price contracts	10%	11%	14%	15%
Time-and-materials contracts	19%	6%	13%	5%

Six contracts represented an aggregate of 56% and 57% of revenues for the respective three-month and nine-month periods ended August 3, 2007. Five contracts represented an aggregate of 51% and 41% of revenues for the three-month and nine-month periods ended July 28, 2006, respectively. One of the six significant contracts in fiscal year 2007 is a time-and-materials contract. All other contracts referenced in this paragraph are 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 $27,062,000, or 68.4% of revenues, for the third quarter of fiscal year 2007 an immaterial difference between contract costs incurred during the same period of fiscal year 2006 of approximately $27,258,000, or 69.1% of revenues. Contract costs were approximately $84,505,000, or 68.1% of revenues, for the first nine months of fiscal year 2007 compared to approximately $78,579,000, or 67.4% of revenues, for the same period of fiscal year 2006. Contract costs increased during the first nine months of fiscal year 2007 primarily due to our ability to recognize pre-contract costs incurred during the fourth quarter of fiscal 2006.

Research and development (R&D). Company-directed investment in research and development consists of expenditures recoverable from customers through our billing rates. For interim reporting periods, R&D expenses include labor, materials, and estimated overhead costs. R&D expenses were approximately $3,756,000, or 9.5% of revenues, for the third quarter of fiscal year 2007 compared to approximately $3,986,000, or 10.1% of revenues , for the same period of fiscal year 2006. During the first nine months of fiscal year 2007, R&D expenses were approximately $10,751,000, or 8.7% of revenues, compared to approximately $12,273,000, or 10.5% of revenues, during the first nine months of fiscal year 2006. R&D expenses were lower in absolute dollars and as a percentage of revenues during the third quarter and first nine months of fiscal year 2007 due to a planned reduction in R&D activities. We manage the combination of company-directed R&D, proposal, and marketing expenditures as a total investment. As our proposal expenditures were high in the first nine months of fiscal year 2007 due to a large amount of proposal activity, we reduced R&D activities to balance our total investment.

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 $7,101,000, or 18.0% of revenues, for the third quarter of fiscal year 2007 compared to approximately $6,429,000, or 16.3% of revenues, for the same period of fiscal year 2006. G&A expenses incurred during the first nine months of fiscal year 2007 were approximately $21,645,000, or 17.4% of revenues, compared to approximately $18,633,000, or 16.0%, of revenues, incurred during the same period of fiscal year 2006. G&A expenses were higher in absolute dollars and as a percentage of revenues during the third quarter of fiscal year 2007 primarily due to an increase in expenses associated with estimated outstanding health insurance claims. G&A expenses were higher in absolute dollars and as a percentage of revenues during the first nine months of fiscal year 2007 compared to the first nine months of fiscal year 2006, due to an overall increase in contract and bid and proposal activities during the first nine months of fiscal year 2007.

Interest income. Interest income for the third quarter of fiscal year 2007 was approximately $347,000 compared to net interest income of approximately $299,000 for the same period of fiscal year 2006. Interest income recognized during the first nine months of fiscal year 2007 was approximately $969,000 compared to interest income of approximately $704,000 during the first nine months of fiscal year 2006. Interest income increased during the third quarter and first nine months of fiscal year 2007 due to higher yields within our investment portfolio and higher investment balances.

Interest expense. Interest expense for the third quarter of fiscal year 2007 was approximately $158,000 compared to approximately $192,000 for the same period of fiscal year 2006 . Interest expense incurred during the first nine months of fiscal year 2007 was approximately $515,000 compared to approximately $526,000 incurred during the first nine months of fiscal year 2006.

Provision for income taxes. Our provision for income taxes for the third quarter and first nine months of fiscal year 2007 was approximately $835,000 and $3,273,000, respectively, with an estimated annual effective tax rate of 45%. Our provision for income taxes for the third quarter and first nine months of fiscal year 2006 was approximately $960,000 and $3,462,000, respectively, with an estimated annual effective tax rate of 48%. The decline in our estimated annual effective tax rate at August 3, 2007, from our estimated effective tax rate at July 28, 2006, was primarily due to a projected decrease in our fiscal year 2007 non-deductible stock-based compensation expense as a percentage of our taxable income, as well as a projected increase to tax-exempt interest related to certain short-term and long-term investments. This decline was partially offset by an adjustment to our domestic production credit during the third quarter of fiscal year 2007. In addition, we recorded a reduction to income tax expense for discrete items of approximately $183,000 during the first nine months of fiscal year 2007, primarily associated with the benefit of our research and development tax refund from the state of California.

Analysis of Liquidity and Capital Resources

Our primary sources of liquidity during the first nine months of fiscal year 2007 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 $6,317,000 and approximately $2,697,000 during the first nine months of fiscal years 2007 and 2006, respectively. Net income for the first nine months of fiscal year 2007 was approximately $4,420,000 compared to net income of approximately $3,759,000 for the comparable period of fiscal year 2006.

Accounts receivable provided cash of approximately $1,404,000 during the first nine months of fiscal year 2007, and approximately $7,286,000 during the same period in fiscal year 2006. During the first nine months of fiscal year 2007, we generated revenues of approximately $124,140,000 and collected approximately $125,544,000. During the first nine months of fiscal year 2006, we generated revenues of approximately $116,528,000 and collected approximately $123,814,000.

Cash used for inventory, prepaid expenses, and other assets during the first nine months of fiscal year 2007 was approximately $3,537,000 and approximately $9,727,000 during the first nine months of fiscal year 2006. During the first nine months of fiscal year 2007, cash used for inventory was approximately $6,386,000, which included approximately $4,145,000, associated with our net inventoried indirect rate variance. The inventory activity was offset by a decrease in pre-contract costs of approximately $3,137,000. During the first nine months of fiscal year 2006, cash used for inventory was approximately $6,451,000, which included approximately $4,322,000, associated with our net inventoried indirect rate variance. Cash used for prepaid expenses during the first nine months of fiscal year 2006 was approximately $2,531,000, which included payments associated with our annual insurance renewals, equipment repair and maintenance contracts, and prepaid income taxes.

The change in accounts payable, taxes payable, and accrued liabilities balances resulted in a net decrease of approximately $3,440,000 and approximately $5,834,000 during the first nine months of fiscal years 2007 and 2006, respectively. Accounts payable and other accrued liabilities decreased approximately $2,480,000 during the first nine months of fiscal year 2007 and decreased approximately $2,376,000 during the same period in fiscal year 2006.

Accrued payroll liabilities decreased by approximately $960,000 during the first nine months of fiscal year 2007, and decreased by approximately $3,309,000 during the same period in fiscal year 2006. The difference in payroll activities was due to the timing of our bi-weekly payroll.

Net cash from investing activities. Investing activities used cash of approximately $2,636,000 and provided cash of approximately $4,035,000 during the first nine months of fiscal years 2007 and 2006, respectively. The primary difference between investing activities is that during fiscal year 2007, we increased our investment in securities that were classified as short-term or long-term investments. During the same period of fiscal year 2006, the majority of our investments were classified as cash equivalents. In addition, property and equipment purchases declined by approximately $3,041,000 during the first nine months of fiscal year 2007 compared to the same period of fiscal year 2006.

Net cash from financing activities. Financing activities used cash of approximately $1,409,000 during the first nine months of fiscal year 2007 and approximately $1,068,000 during the same period in fiscal year 2006. The increase in cash used is due to one additional payment of principal on our term loan and the amount of dividends paid.

Cash is generated primarily from operating activities, employee stock activities, and investing activities. Our investment portfolio includes a variety of low-risk investments. 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 U.S. 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 August 3, 2007, we had a revolving line of credit (Line of Credit) under which Wells Fargo Bank, National Association (the Bank), will advance funds to us from time to time up to and including March 1, 2008, not to exceed at any time the maximum principal amount of $3 million.

At August 3, 2007, 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 $1,220,000 at August 3, 2007. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at August 3, 2007. 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 $1,630,000. No fees or interest were associated with this unused portion. Borrowings under the Line of Credit bear interest at the Bank's reference rate (8.25% at August 3, 2007), and interest on those borrowings are payable monthly. As security for our indebtedness under the Line of Credit, we have granted to the Bank a security interest in our cash and marketable securities maintained with an affiliate of the Bank.

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 the Bank, in the principal amount of $10 million, the proceeds of which were used for acquisition financing (Term Loan). The Term Loan bears interest at a rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) (5.32% at August 3, 2007). Our Term Loan is for a seven-year term ending on July 1, 2012. Payment terms of the loan agreement include monthly payments of principal and interest.

As security for our indebtedness under the Term Loan, we have granted to the Bank 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 August 3, 2007, 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 the Bank. 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 considered a cash flow hedge and is accounted for under by SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133).

At August 3, 2007, we had one interest rate swap agreement outstanding with the Bank related to our $10 million Term Loan. No losses on the agreement due to counterparty credit issues are anticipated. Under this swap, we pay a fixed interest rate of 4.33% over the seven-year term of the loan and receive an average floating rate of LIBOR on the notional amount of the loan. The combined interest amounts on the Term Loan and the swap reflect our total monthly interest obligation, which is fixed at 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 August 3, 2007, the effective portion of the cash flow hedge was a deferred gain of approximately $56,000, net of taxes. Over the next twelve months, we expect to reclassify approximately $43,000 of the gain to interest expense as principle on the Term Loan is repaid and the related swap-instrument notional amount is reduced.

The ineffective portion of the gain or loss, if there is one, impacts earnings as it occurs. There is no ineffective portion of the outstanding swap as of August 3, 2007.

Contractual Obligations

The following table sets forth our contractual obligations as of August 3, 2007 (in thousands).

		Payments Due by Period			
	Total	Less than 1 Year	1–3 Years	3–5 Years	More than 5 Years
Operating lease obligations	$46,188	$7,424	$15,114	$12,704	$10,946
Loan obligations – principal	7,024	1,429	2,857	2,738	—
Loan obligations – interest	1,084	394	522	168	—
Purchase obligations	3,462	3,462	—	—	—
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Total	$57,758 ======	$12,709 ======	$18,493 ======	$15,610 ======	$10,946 ======

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2007 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses. During the first nine months of fiscal year 2007, we entered into a new operating lease agreement with a total lease obligation of approximately $3,817,000 for our new facility in Torrance, California. In addition, we amended our operating lease agreement for our facilities in Anaheim, California and Salt Lake City, Utah. These amendments increased our lease obligation by approximately $93,000 and $71,000, respectively.

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 June 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20, *Accounting Changes*, and Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles were required to be recognized through a cumulative effect adjustment within net income of the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effect or the cumulative effect of the change. We adopted SFAS 154 at the beginning of fiscal year 2007. The adoption of SFAS 154 did not have a material impact on our financial statements.

In May 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Instruments*, which amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*, and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. We adopted SFAS 155 at the beginning of fiscal year 2007. The adoption of SFAS 155 did not have a material impact on our financial statements.

In September 2006, the SEC released Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on the SEC's views regarding quantifying the materiality of financial statement misstatements, including misstatements that were not material to prior years' financial statements. We adopted SAB 108 at the beginning of fiscal year 2007. The adoption of SAB 108 did not have a material impact on our financial statements.

In June 2006, the FASB issued FASB Interpretation Number 48, *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109* (FIN 48). The interpretation clarifies the accounting for uncertainty in income taxes and utilizes a two-step approach. 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, with the presumption that the position will be examined. The second step is to measure the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The provisions are effective for us for our fiscal year beginning November 1, 2007. We are evaluating the impact this interpretation will have on our financial statements.

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.

On February 15, 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 is effective as of the beginning of the first fiscal year beginning after November 15, 2007. Earlier application is permitted provided the company also applies the provisions of Statement 157. 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.

Item 3: Quantitative and Qualitative Disclosures about Market Risk

Interest rate risk. Our interest income is sensitive to changes in the general level of U.S. interest rates. The average maturity of our investment portfolio is 146 days as of August 3, 2007. Due to the short-term nature of our cash equivalents and investments, we do not believe that there is a material interest rate risk. As of August 3, 2007, our total cash and investments balance that was sensitive to interest rate risk was approximately $35,889,000. The sensitivity of our portfolio is: if yields were to fluctuate by 100 basis points, the total effect to the investment portfolio balance would be approximately $126,000.

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

	August 3, 2007	October 31, 2006
Cash and cash equivalents	$6,466	$4,194
Available-for-sale securities:		
Short-term, tax exempt	28,408	25,651
Long-term, tax exempt	1,015 ----------	2,802 ----------
	$35,889 ======	$32,647 ======

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, National Association (the Bank), the proceeds of which were used for acquisition financing. The Term Loan bears interest at an annual rate of 1.75% above LIBOR (5.32% at August 3, 2007).

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 the Bank whereby we pay interest to the Bank at a fixed rate of 4.33% and the Bank pays interest to the Company 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 August 3, 2007, 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.

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 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 and entered judgment in defendants' favor. Plaintiffs appealed the judgment of dismissal on March 23, 2006; 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. There have been no material changes in our risk factors from those disclosed in Part I, Item 1A to our Annual Report on Form 10-K for the fiscal year ended October 31, 2006, which are set forth below. In addition to the following disclosures, please refer to the other information contained in this report, including the financial statements and 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. We are subject to a number of special risks as a result of our acquisition of Dynamics Technology, Inc. (DTI). On July 1, 2005, we acquired DTI for approximately $30.1 million, plus estimated transaction costs. As a result of this acquisition, together with investments we are making in other areas complementary to our historic COMINT offerings, we are expanding our products, approaching new customers, and entering 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 2007 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. This expansion subjects us to a number of risks and uncertainties, including:

- We are entering markets in which we have no or limited prior experience. We may not be successful in these markets, and we may be unable to enter into new contracts for these new business lines or grow the combined business. We may not achieve the strategic objectives and other anticipated potential benefits of the acquisition of DTI or the investment in other products. Our failure to achieve these strategic objectives could have a material, adverse effect on our revenues, expenses, and operating results.
- As a result of the acquisition of DTI, we incurred debt in the amount of $10 million, of which $7.0 million remains outstanding as of August 3, 2007, and our failure to repay this debt when due would materially, adversely affect our financial condition and results of operations.
- We may have assumed unknown liabilities, which risk the incurrence of expenses related to the future impairment of goodwill, or the incurrence of other large write-offs immediately or in the future.

We may not achieve the anticipated benefits of our investments in new business opportunities and any such investments could have a negative, material impact on our operating results and financial condition. We have expanded our historical COMINT business into ELINT, and have expanded our signal processing capabilities as a result of our acquisition of DTI. This diversification 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 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 additional 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. Depending on the results of these audits and investigations, the government may make claims against us, and if it prevails, certain incurred costs would not be recoverable.

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 August 3, 2007, was approximately $133.6 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 notifications in fiscal years 2007 or 2006.

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.

Our headquarters and most of our operations are located in California where natural disasters may occur, resulting in disruption to our business. Our corporate headquarters, including most of our research and development operations and production facilities, are located in the Silicon Valley area of Northern California, a region known for being vulnerable to natural disasters and other risks, such as earthquakes, fires, and floods, which at times have disrupted the local economy and posed physical risks to our property. A significant earthquake could materially affect operating results. We are not insured for most losses and business interruptions of this kind, and do not presently have redundant, multiple site capacity in the event of a natural disaster. In the event of such disaster, our business would suffer.

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, four 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.

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.

Continued compliance with new regulatory and accounting requirements will be challenging and may cause our general and administrative expenses to increase and impact our future financial position and results of operations. As a result of compliance with the Sarbanes-Oxley Act of 2002, as well as changes to listing standards adopted by the Nasdaq Stock Market, and the attestation and accounting changes required by the SEC, we are required to implement additional internal controls, to improve our existing internal controls, and to comprehensively document and test our internal controls. Although we successfully met our compliance with internal control evaluation and attestation at the end of fiscal year 2006, we continue to remain subject to these requirements, and as a result, expect to continue to obtain outside legal, accounting, and advisory services, all of which may add to our general and administrative costs. In addition, changes in the accounting rules, including legislative and other requirements to account for employee stock options as a compensation expense among others, could materially increase the expenses that we report under generally accepted accounting principles, which may adversely affect our operating results.

Changes in stock option accounting rules have adversely impacted our operating results prepared in accordance with generally accepted accounting principles. We have historically used broad-based employee stock option programs to hire, incentivize, and retain our workforce in a competitive marketplace. In December 2004, the FASB issued SFAS 123R, *Share-Based Payment*, which requires all companies to measure compensation cost for all share-based payments, including employee stock options, at fair value. We adopted Statement 123R beginning with the first quarter of our 2006 fiscal year, and implemented the new standard on a prospective basis. We have incurred approximately $3,255,000 in stock compensation expense during the first nine months of fiscal year 2007. We expect to continue to incur compensation expense in the future. Please refer to “Notes to Consolidated Financial Statements, Note 1: Summary of Significant Accounting Policies, Stock-Based Compensation.”

We face litigation risks as a result of our stock option review and restatement of our financial statements. In our annual report on Form 10-K for the year ended October 31, 2006, we restated the consolidated balance sheet as of October 31, 2005, and the statements of operations, shareholders’ equity, and cash flows for fiscal year 2004, as well as the statements of shareholder’s equity for fiscal year 2005 and our statements of operations, shareholders’ equity, and cash flows for the year ended October 31, 2004, and the changes to the financial statements for the years ended October 31, 2000, October 31, 2001, October 31, 2002, October 31, 2003, and October 31, 2004. This restatement was the result of our review of our historic stock option grant practices and procedures and related accounting. As a result of our review, we concluded that we had not properly measured compensation cost for an annual option grant to non-officer employees on November 18, 1999, because the number of shares certain non-officer individual employees were entitled to receive was not determined until after the original measurement date. We also concluded that we used improper measurement dates for certain grants to newly hired non-officer employees because the measurement date utilized predated the actual commencement of employment. This restatement of our prior financial statements could impose upon us additional risks, including the risk that derivative actions are filed against us or certain current and former directors and officers based on allegations relating to our historical stock option practices. Litigation may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any lawsuit could have a material adverse effect on our business, financial condition and results of operations. We cannot assure that any future litigation relating to our historical stock option practices will result in the same conclusions reached by us. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us, which could adversely affect our business, results of operations, or financial condition.

We may in the future be subject to regulatory proceedings or actions arising in relation to our historical stock option practices and the restatement of our prior period financial statements. Any potential regulatory proceeding or action may be time consuming, expensive and distracting for management from the conduct of our business. The adverse resolution of any potential regulatory proceeding or action could adversely affect our business, results of operations, or financial condition. We cannot assure that any future regulatory action relating to our historical stock option practices will result in the same conclusions reached by us. Furthermore, if we are subject to adverse findings in any of these matters, we could be required to pay damages or penalties or have other remedies imposed upon us, including criminal penalties, which could adversely affect our business, results of operations, or financial condition.

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

None.

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/ --	September 10, 2007 ---------------------------------
James E. Doyle Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	

Applied Signal Technology, Inc.
Index to Exhibits

Exhibit Number	Description of Document
3.1[1]	Second Amended and Restated Articles of Incorporation
3.2[1]	Amended and Restated Bylaws
4.1[1]	Specimen Common Stock Certificate
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 as an Exhibit to Registrant's Registration Statement on Form S-1 filed January 28, 1993 (File No. 33-58168).