APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
June 07, 2010

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 April 30, 2010

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 twelve 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 has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes	**No**

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

Large accelerated	ü **Accelerated filer**	**Non-accelerated filer**	**Smaller reporting**

filer **company**

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

	ü
Yes	**No**

The number of shares of the Registrant's common stock outstanding as of April 30, 2010, was 13,349,454.

Index
Applied Signal Technology, Inc.

Part I. Financial Information

Item 1: Condensed Consolidated Financial Statements

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

	Three Months Ended		Six Months Ended	
	April 30, 2010	**May 1, 2009**	**April 30, 2010**	**May 1, 2009**
Revenues from contracts	$56,219	$51,618	$102,832	$95,305
Revenues from royalty agreements	1,944 ----------	1,882 ----------	3,411 ----------	3,579 ----------
Total revenues	58,163 =======	53,500 =======	106,243 =======	98,884 =======
Operating expenses:				
Contract costs	40,850	37,489	74,850	69,020
Research and development	4,046	3,797	7,093	6,872
General and administrative	7,809	5,759	13,648	10,889
Total operating expenses	52,705	47,045	95,591	86,781
Operating income	5,458	6,455	10,652	12,103
Interest income, net	(34) ----------	69 ----------	(37) ----------	181 ----------
Income before provision for income taxes	5,424	6,524	10,615	12,284
Provision for income taxes	2,128 ----------	2,450 ----------	4,180 ----------	4,695 ----------
Net income	$3,296 =======	$4,074 =======	$6,435 =======	$7,589 =======
Net income per common share:				
Basic	$0.25	$0.31	$0.48	$0.58
Diluted	$0.24	$0.31	$0.48	$0.58
Number of shares used in calculating net				

income per common share:				
Basic	13,091	12,852	13,079	12,803
Diluted	13,230	13,033	13,222	12,978

See accompanying notes

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

Assets	April 30, 2010 (unaudited)	October 31, 2009†
Current assets:		
Cash and cash equivalents	$9,738	$4,102
Short-term investments	10,010 ----------	43,454 ----------
Total cash, cash equivalents, and short-term investments	19,748	47,556
Accounts receivable:		
Billed	32,575	26,630
Unbilled	17,164 ----------	20,433 ----------
Total accounts receivable	49,739	47,063
Inventory	11,698	8,378
Prepaid and other current assets	11,218 ----------	10,517 ----------
Total current assets	92,403	113,514
Property and equipment, at cost:		
Machinery and equipment	47,284	46,517
Furniture and fixtures	4,813	4,756
Leasehold improvements	20,048	18,480
Construction in process	763 ----------	647 ----------
	72,908	70,400
Accumulated depreciation and amortization	(57,738) ----------	(55,405) ----------

Property and equipment, net	15,170	14,995
Long-term investments	1,062	2,129
Goodwill	54,682	33,158
Intangible assets, net of accumulated amortization	5,349	1,904
Long-term deferred tax asset	4,308	4,196
Other assets	1,593 ----------	1,104 ----------
Total assets	$174,567 =======	$171,000 =======

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

Liabilities and Shareholders' Equity	April 30, 2010 (unaudited)	October 31, 2009†
Current liabilities:		
Accounts payable	$4,598	$6,807
Accrued payroll and related benefits	13,369	15,351
Note payable	1,429	1,429
Income taxes payable	2,135	444
Other accrued liabilities	4,343 ----------	2,298 ----------
Total current liabilities	25,874	26,329
Long-term note payable	1,786	2,500
Accrued rent	2,036	2,103
Other long-term liabilities	1,042	1,043
Shareholders' equity:		
Common stock and additional paid-in capital, no par value: 35,000,000 shares authorized; issued and outstanding shares: 13,349,454 at April 30, 2010, and 13,211,462 at October 31, 2009	78,205	76,492
Retained earnings	65,703	62,600

Accumulated other comprehensive income	(79) ----------	(67) ----------
Total shareholders' equity	143,829 ----------	139,025 ----------
Total liabilities and shareholders' equity	$174,567 =======	$171,000 =======

†The balance sheet at October 31, 2009, 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 accompanying notes

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

	Six Months Ended	
	April 30, 2010	**May 1, 2009**
Operating Activities		
Net income	$6,435	$7,589
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	3,541	3,056
Stock-based compensation	1,049	1,068
Excess tax benefits from stock-based payment arrangements	(74)	(251)
Changes in:		
Accounts receivable	735	(4,486)
Inventory, prepaid expenses, and other assets	(5,517)	(2,281)
Accounts payable, taxes payable, and accrued liabilities	(3,450) ----------	(2,413) ----------
Net cash provided by operating activities	2,719	2,282
Investing Activities		
Cash paid for business acquired, net	(24,327)	—
Cash from Pyxis escrow account, net	673	—

Purchases of available-for-sale securities	(39,134)	(28,801)
Maturities and sales of available-for-sale securities	73,108	31,285
Additions to property and equipment	(2,812) ----------	(2,684) ----------
Net cash provided by (used in) investing activities	7,508	(200)
Financing Activities		
Issuances of common stock	772	2,331
Shares repurchased for tax withholding of vested restricted stock awards	(168)	(127)
Excess tax benefits from stock-based payment arrangements	74	251
Term loans	(1,954)	(834)
Dividends paid	(3,315) ----------	(3,227) ----------
Net cash used in financing activities	(4,591)	(1,606)
Net increase in cash and cash equivalents	5,636	476
Cash and cash equivalents at beginning of period	4,102 ----------	4,668 ----------
Cash and cash equivalents at end of period	$9,738 =======	$5,144 =======
Supplemental disclosures of cash flow information:		
Interest paid	$108	$149
Income taxes paid	$2,265	$4,733

See accompanying notes

Applied Signal Technology, Inc.
Notes to Condensed Consolidated Financial Statements (unaudited)
April 30, 2010

Note 1: Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

Applied Signal Technology, Inc. (AST) provides advanced intelligence, surveillance, and reconnaissance (ISR) solutions to enhance global security. We provide systems, products, and services in the areas of communications, signals intelligence (SIGINT), cyber intelligence, and sensor signature processing. Our communication capabilities include the development and production of communication support products, bandwidth compression software, and network management software. Our SIGINT competencies include communications intelligence (COMINT) and electronic intelligence (ELINT). Our cyber intelligence capabilities include high-speed network monitoring, deep packet inspection, and high-end software engineering services. Our sensor signature expertise includes processing information from electro-optic, sonar, radar, magnetic, and chemical sensors to detect changes in the environment. We develop and manufacture sophisticated sensors and digital signal processing equipment that use advanced software.

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

The accompanying unaudited, condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements, and should be read in conjunction with the financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended October 31, 2009. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three-month and six-month periods ended April 30, 2010, are not necessarily indicative of the results that may be expected for the year ending October 31, 2010. The balance sheet at October 31, 2009, 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 subsidiaries, Dynamics Technology, Inc. (DTI), Pyxis Engineering, LLC (Pyxis) (from the acquisition date on September 1, 2009), and Seismic, LLC (from the acquisition date on April 28, 2010). All significant intercompany transactions have been eliminated.

Revenues and Contract Accounting

Revenues and cost recognition. Our contracts are executed through 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. The majority of our contracts are accounted for following the authoritative guidance for construction-type and production-type contracts. We recognize revenue on a limited number of standalone software contracts following the guidance for software revenue. For these software contracts, we defer revenue that is related to billings and customer payments in advance of the completion of the performance requirements set forth in the contracts.

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

We account for cost-reimbursement contracts by charging actual labor, materials, and other direct costs, plus estimated indirect costs of operations as incurred, including overhead, research and development (R&D), and general and administrative expenses (incurred costs). Stock compensation expense is not reimbursable under these contracts. Beginning in the first quarter of fiscal year 2009, we apply indirect costs to all subcontract costs.

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

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

Our time-and-materials contracts are performed 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.

We have one licensing agreement for which we accrue royalties on sales of our licensed product by a third party. Since there are essentially no costs associated with this agreement, operating income will increase by the same amount of revenue that we recognize. Royalties contributed approximately $1,944,000 and $3,411,000 to revenues and operating income for the three-month and six-month periods ended April 30, 2010, respectively, and $1,882,000 and $3,579,000 for the three-month and six-month periods ended May 1, 2009, respectively.

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

	Three Months Ended		Six Months Ended	
	April 30, 2010	May 1, 2009	April 30, 2010	May 1, 2009
Cost-reimbursement contracts	78%	61%	76%	61%
Time-and-materials contracts	10%	21%	11%	20%
Fixed-price contracts	9%	15%	10%	15%

Royalty contracts	3%	3%	3%	4%
	100%	100%	100%	100%

The following table represents the revenue concentration from significant contracts during the respective periods. Due to security requirements of the United States Government, we are unable to disclose the actual contract names. Therefore, for the ease of the reader, we have renamed these contracts for reporting purposes in the table below.

	Three Months Ended		Six Months Ended	
	April 30, 2010	May 1, 2009	April 30, 2010	May 1, 2009
Next Generation ASA	20%	—	20%	—
Thunderdome	11%	—	12%	—
Tiffany	11%	19%	11%	19%
ASA	—	17%	—	17%
High Beam	—	9%	—	11%
Stone Face II	—	5%	5%	6%
Specter	—	5%	—	—
Raider	—	—	—	5%
	42%	55%	48%	58%

a dash (—) designates less than 5% revenue concentration

The following contracts were indefinite-delivery-indefinite-quantity (IDIQ) contracts: Next Generation ASA, Tiffany, ASA, and Stone Face II. Under the terms of this type of contract, the Government may issue individual delivery orders (DOs) for goods or services that they require. Each DO is treated as a separate contract, which may be awarded on a cost-reimbursable, fixed-price, or time-and-materials basis. We typically aggregate the DOs under each IDIQ contract for purposes of distinguishing significant revenue concentrations. However, Thunderdome is a significant, individual DO within an IDIQ contract.

ASA is a time-and-materials contracts and Raider is a fixed-price contract. All of the other contracts referenced 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.

Project 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 estimable or determinable.

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and costs incurred in connection with ongoing contracts for which contract modifications have not been defined or completed at the end of the reporting period. These costs are included in other current assets on the balance sheet. Precontract costs incurred at April 30, 2010, and October 31, 2009, were approximately $1,964,000 and $1,139,000, respectively. Approximately $1,106,000 of the October 31, 2009, balance was recognized as revenue during the six months ended April 30, 2010.

Indirect rate variance adjustments to operations. We record contract revenues and costs of operations for interim reporting purposes based on annual targeted indirect rates. During our interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. Timing-related indirect spending variances are removed from contract costs, research and development, and general and administrative expenses, and are included in inventory as part of work in process during these interim reporting periods. These rates are reviewed regularly, and we record adjustments for any material, permanent variances in the period they become estimable. At the beginning of fiscal year 2009, we implemented a new rate structure, which changed the application of certain general and administrative expenses to contracts that created a one-time increase to operating income of approximately $450,000 from fixed-price contracts.

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, we record unfavorable rate variances as reductions to operating expenses and increases to work in process inventory. Favorable rate variances are recorded as increases to operating expenses and decreases to work in process inventory.

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

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

At April 30, 2010, the unfavorable rate variance was approximately $98,000, and at May 1, 2009, the unfavorable rate variance was approximately $115,000.

Accounts receivable and allowance for bad debt. Accounts receivable are segregated between billed and unbilled accounts. For cost-reimbursement contracts, we bill incurred costs and a portion of our fees on a regular basis. Under fixed-price contracts, we bill contract costs on a milestone or unit-of-delivery basis. Unbilled amounts result from our recognition of contract revenue in advance of contractual billing 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. Charges to bad debt expense were not significant during the first six months of fiscal years 2010 and 2009.

Inventory valuation and disposal. Typical life cycles of our products are eight to ten years or more. In addition, we maintain spare parts in order to repair the equipment. We evaluate our inventory quarterly at interim reporting periods, and assess our ability to sell our products, which include raw materials. Historically, we have sold our inventory at or above cost, so there was typically no decrement in valuation. When we determine a product has reached the end of its life cycle or there is no longer a need for a certain product, typically, we will dispose of any remaining inventory and record the associated reduction to inventory. Historically, any disposals of raw materials represent a minor amount. These disposals are included in general and administrative expenses on the statement of operations because we use raw materials in a variety of situations other than contract costs, including R&D. Disposals of other obsolete inventory and raw materials were not significant during the first six months of fiscal years 2010 and 2009.

If we determine that the estimated market value of certain inventory is below cost, we will write down the inventory to the estimated market value. We did not write down any inventory during the first six months of fiscal year 2010. During the three-month and six-month period ended May 1, 2009, we recorded an inventory write-down of approximately $422,000 to reflect the estimated market value of one inventoried product. Subsequent sale of inventory that has been subject to a write-down has not been significant to date.

Income Taxes

We estimate our income taxes in each of the taxing jurisdictions in which we operate. Our effective tax rate can differ from the statutory rate primarily due to research and development credits and tax exempt interest, offset by the non-tax-deductible nature of meals and entertainment expense and certain types of stock-based compensation expense. In addition, our process involves estimating our current tax expense together with assessing any temporary differences resulting from the different treatment of certain items, such as the timing for recognizing certain expenses, for tax and accounting purposes. These differences may result in deferred tax assets and liabilities, which are included in our consolidated balance sheet. We are required to assess the likelihood that our deferred tax assets, which included our net operating loss carryforwards and temporary differences that are expected to be deductible in future years, will be recoverable from future taxable income or other tax planning strategies. If recovery is not likely, we have to provide a valuation allowance based on our estimates of future taxable income in the various taxing jurisdictions, and the amount of deferred taxes that are ultimately realizable. The provision for current and deferred taxes involves evaluations and judgments of uncertainties in the interpretation of complex tax regulations by various taxing authorities. Actual results could differ from our estimates.

We also recognize the impact of an uncertain income tax position on the income tax return at the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than 50% likelihood of being sustained.

We record interest or penalties related to income taxes as a component of income tax expense in our financial statements.

Please refer to "Notes to Consolidated Financial Statements, Note 8: Provision for Income Taxes" for further information.

Price Redetermination

As a Government contractor, we are subject to price redetermination on certain fixed-price contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. We did not incur any price redeterminations on any of our contracts during the first six months of fiscal years 2010 and 2009.

Cash, Cash Equivalents, and Investments

Cash and cash equivalents balances include cash held in banks to support daily cash needs and were approximately $9,738,000 on April 30, 2010, and approximately $4,102,000 on October 31, 2009. We consider all highly liquid debt instruments purchased with an original maturity date of three months or less to be cash equivalents. Cash equivalents include money market funds and municipal securities.

Our remaining securities are classified as available for sale and are carried at fair value in short-term and long-term investments. At April 30, 2010, all of our short-term and long-term investments consist of municipal 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. Proceeds from the sale of available-for-sale securities were approximately $6,577,000 for the first six months of fiscal years 2010. We did not have any sales of available-for-sale securities during the first six months of fiscal year 2009. Realized gains and losses on sales of available-for-sale securities were not material for the first six months of fiscal years 2010 and 2009.

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

	April 30, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash equivalents:				
Money market funds	$1,803	—	—	$1,803
Available-for-sale securities:				
Short-term municipal	10,008	3	(1)	10,010
Long-term municipal	1,061	1	—	1,062
	$12,872	$4	$(1)	$12,875

	October 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash equivalents:				
Money market funds	2,028	—	—	2,028

Available-for-sale securities:				
Short-term municipal	43,403	51	—	43,454
Long-term municipal	2,131 ----------	— ----------	(2) ----------	2,129 ----------
	$47,562 =======	$51 =======	$(2) =======	$47,611 =======

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

	April 30, 2010	October 31, 2009
Due in one year or less	$10,010	$43,454
Due in one to two years	1,062 ----------	2,129 ----------
	$11,072 =======	$45,583 =======

The decline in the balance of our investment portfolio is primarily due to the acquisition of Seismic at the end of the second quarter of fiscal year 2010 and what we believe to be short-term delays in the government payment process for our billed accounts receivable.

Fair Value

The fair value accounting standard defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. It also establishes a framework for measuring fair value. We adopted the requirements of the fair value standard as they relate to certain non-financial assets and liabilities on November 1, 2009. This adoption did not have a material impact on our results of operations, financial position, or cash flows. The standard on fair value measurement establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

- ***Level 1***. Quoted (unadjusted) prices in active markets for identical assets or liabilities
- ***Level 2***. Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; or other inputs that are observable or can be corroborated by observable market data
- ***Level 3***. Unobservable inputs that are supported by little or no market activity and are significant to the measurement of the fair value of the assets or liabilities

The following table presents information about the Company's financial assets and liabilities measured at fair value on a recurring basis (in thousands).

	April 30, 2010			
	Quoted Prices in Active Markets for Identical Instruments (Level	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs	Total Fair Value

	1)		(Level 3)	
Assets				
Cash equivalents				
Money market funds	$1,803	$—	$—	$1,803
Available-for-sale securities:				
Short-term municipal	—	10,010	—	10,010
Long-term municipal	— ----------	1,062 ----------	— ----------	1,062 ----------
Total assets	$1,803 =======	$11,072 =======	$— =======	$12,875 =======
Liabilities				
Contingent consideration	—	—	$2,047	$2,047
Interest rate swap	— ----------	82 ----------	— ----------	82 ----------
Total liabilities	$— =======	$82 =======	$2,047 =======	$2,129 =======

	October 31, 2009		
	Quoted Prices in Active Markets for Identical Instruments (Level 1)	Significant Other Observable Inputs (Level 2)	Total Fair Value
Assets			
Cash equivalents			
Money market funds	$2,028	$—	$2,028
Available-for-sale securities:			
Short-term municipal	—	43,454	43,454
Long-term municipal	— ----------	2,129 ----------	2,129 ----------
Total assets	$2,028 =======	$45,583 =======	$47,611 =======

Liabilities			
Interest rate swap	$— ----------	$116 ----------	$116 ----------
Total liabilities	$— =======	$116 =======	$116 =======

As of April 30, 2010, our investment portfolio did not include investments in assets valued using Level 3 inputs.

Our money market funds are priced by using unadjusted prices in active markets for identical assets.

We determine the fair values of our municipal securities by using pricing models with inputs that are observable in the market or can be derived principally from or corroborated by observable market data, such as municipal yield curves and credit ratings.

We have a contingent consideration liability that is payable to the former members of Seismic. We recorded $2.0 million in other accrued liabilities in our consolidated balance sheet based on future revenues projected over a one-year period from the date of acquisition of April 28, 2010. We estimated the fair value of this liability by using the expected cash flow approach with revenue inputs being probability-weighted. Please refer to "Notes to Consolidated Financial Statements, Note 3: Business Combinations" for further information on the terms of the agreement as it pertains to the contingent consideration.

The inputs used to value the interest rate swap liability are based on observable market data such as the London Inter-Bank Offered Rate (LIBOR) swap rate (floating interest rate), a fixed rate (term loan interest rate), a discount factor, and a calculation of a present value of the interest paid/received based on the expected loan principal. Please refer to " Notes to Consolidated Financial Statements, Note 5: Borrowing Arrangements" for further information.

The following table presents the changes in our liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) at April 30, 2010 (in thousands).

	Significant Unobservable Inputs (Level 3)
Balance at October 31, 2009	$—
Contingent consideration	2,047 ----------
Balance at April 30, 2010	$2,047 =======

Restricted Cash

We had restricted cash balances of approximately $679,000 and $663,000 at April 30, 2010, and at October 31, 2009, respectively. These balances primarily 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 $152,000 was included in prepaids and other current assets at both April 30, 2010, and October 31, 2009. Approximately $527,000 and $511,000 was included in other assets at April 30, 2010, and at October 31, 2009, 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 remaining lease term. Construction in process includes costs incurred to build leasehold improvements and test equipment that have not yet been placed into service.

Business Combinations, Goodwill, and Long-Lived Asset Valuation

Effective at the beginning of our fiscal year on November 1, 2009, we adopted the revised accounting standard, *Business Combinations* (ASC Topic 805). The revised standard retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It requires that contingent consideration be recognized at fair value at the date of the acquisition, and requires the capitalization of in-process research and development at fair value, and the expensing of acquisition-related transaction costs as incurred.

We allocated the purchase prices of Pyxis and Seismic to the tangible and intangible assets acquired and liabilities assumed based on their estimated fair values. We engaged a third-party appraisal firm to assist management in determining the fair values of certain assets acquired and liabilities assumed, and the fair value of the contingent consideration payable to the former shareholders of Seismic (the Seismic Earn-Out). The valuations required management to make significant estimates and assumptions, especially with respect to intangible assets and the Seismic Earn-Out.

Management made estimates of fair value based upon assumptions believed to be reasonable. These estimates were based on historical experience and information obtained from the management of the acquired companies and are inherently uncertain. Critical estimates in valuing certain of the intangible assets included, but were not limited to, future expected cash flows from funded backlog, unfunded backlog, future contracts, and non-compete agreements.

Critical estimates in valuing the contingent consideration for Seismic included the probability of achieving target levels of revenues for the acquired business. In accordance with the revised standard for business combinations, the fair value of the Seismic Earn-Out was included as part of the initial purchase price, and will be remeasured at each subsequent balance sheet date. The subsequent adjustments to fair value will be recorded to operating expense.

Unanticipated events and circumstances may occur that may affect the accuracy or validity of such assumptions, estimates, or actual results. Please refer to “Notes to Consolidated Financial Statements, Note 3: Business Combination” for further information.

Goodwill valuation. We test goodwill for possible impairment on an annual basis, as of the first day of the fourth quarter, 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, taking a write-down to the extent the carrying amount exceeds the implied fair value. If the fair value of AST exceeds the carrying value of our net assets under step one, then no impairment is indicated and the test is complete.

There were no indicators of impairment as of April 30, 2010.

Long-lived asset valuation (property, plant and equipment, and intangible assets). We 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.

There were no indicators of impairment as of April 30, 2010.

Net Income Per-Share Data

In the first quarter of fiscal year 2010, we adopted new guidance issued by the staff of the Financial Accounting Standards Board (included in ASC Topic 260-10-45) on determining whether instruments granted in share-based payment transactions are participating securities. This guidance requires us to include our unvested restricted stock awards, which have rights to receive dividends, as participating securities in the calculation of net income per share using the two-class method. We are required to apply this method retrospectively, and we have adjusted prior period calculations. For the three months and six months ended May 1, 2009, the adoption of this guidance decreased our previously reported basic net income per share by $0.01 and $0.01, respectively, and had no impact on the diluted net income per share.

Under the two-class method, we allocate a portion of net income to the participating securities and exclude that income from the net income allocated to common stock. Basic net income per share is determined by dividing the net income allocated to common stock by the weighted average number of common shares outstanding during the period. Diluted net income per share is determined by dividing the net income allocated to common stock by the weighted average number of common shares used in the basic calculation plus the number of common shares issuable for dilutive stock options under the treasury stock method. The result of this method is more dilutive than if we had used the treasury stock method to calculate the dilutive impact of the restricted stock.

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

	Three Months Ended		Six Months Ended	
	April 30, 2010	**May 1, 2009**	**April 30, 2010**	**May 1, 2009**
Numerator:				
Net income	$3,296	$4,074	$6,435	$7,589
Less income allocated to participating securities (restricted stock awards)	(59) ----------	(56) ----------	(107) ----------	(105) ----------

Net income allocated to common stock	$3,237 =======	$4,018 =======	$6,328 =======	$7,484 =======
Denominator:				
Shares used to compute net income per common share – basic	13,091	12,852	13,079	12,803
Effect of dilutive stock options	139 ----------	181 ----------	143 ----------	175 ----------
Shares used to compute net income per common share – diluted	13,230 =======	13,033 =======	13,222 =======	12,978 =======
Net income per common share – basic	$0.25	$0.31	$0.48	$0.58
Net income per common share – diluted	$0.24	$0.31	$0.48	$0.58

We excluded approximately 461,000 and 464,000 potential common shares for the three-month and six-month periods ended April 30, 2010, respectively, from the diluted net income per common share computation, as their effect would be anti-dilutive. For the same periods in fiscal year 2009, we excluded 468,000 and 735,000 potential common shares, respectively, from the diluted net income per common share computation for the same reason.

Comprehensive Income

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

	Three Months Ended		Six Months Ended	
	April 30, 2010	**May 1, 2009**	**April 30, 2010**	**May 1, 2009**
Net income	$3,296	$4,074	$6,435	$7,589
Unrealized gain (loss) on securities	(22)	(45)	(46)	74
Derivative gain (loss)	17 ----------	3 ----------	34 ----------	(69) ----------
Comprehensive income	$3,291 =======	$4,032 =======	$6,423 =======	$7,594 =======

The balance of accumulated comprehensive income on securities as of April 30, 2010, and October 31, 2009, was approximately $3,000 and $49,000, respectively. The derivative-related accumulated comprehensive loss balance was approximately $82,000 and $116,000 as of April 30, 2010, and October 31, 2009, respectively.

Dividends

We have paid dividends at the rate of $0.50 per share per annum, payable quarterly. Continued payment of the dividend is subject to approval by the Board of Directors and is reviewed quarterly. We paid dividends on November 13, 2009, February 12, 2010, and May 14, 2010, to shareholders of record at October 31, 2009, January 29, 2010, and April 30, 2010, respectively.

We paid dividends of approximately $3,315,000 during the first six months of fiscal year 2010 and approximately $3,227,000 during the first six months of fiscal year 2009.

At April 30, 2010, and October 31, 2009, accrued dividends of approximately $1,669,000 and $1,651,000, respectively, were included in other accrued liabilities on the accompanying balance sheet.

Stock-Based Compensation

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

Additionally, we have an Employee Stock Purchase Plan (ESPP). For offering periods beginning prior to December 1, 2008, the ESPP allowed employees to purchase shares of common stock at 85% of the closing stock price at the lower of either the date of enrollment or the date of purchase. For offering periods subsequent to December 1, 2008, the purchase price is 95% of the closing stock price on the date of purchase, and therefore, is non-compensatory under the authoritative guidance for stock-based compensation. The remaining expense related to the final compensatory award under the ESPP was recognized in the first quarter of fiscal year 2009.

As of April 30, 2010, 522,483 shares were reserved for future issuance under the equity incentive plans and 698,979 shares were reserved for future issuance under the ESPP plan.

We recognize 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 the ESPP included in our condensed consolidated statements of operations (in thousands, except share data).

	Three Months Ended		Six Months Ended	
	April 30, 2010	May 1, 2009	April 30, 2010	May 1, 2009
Contract costs	$298	$260	$616	$663
Research and development	12	15	24	36
General and administrative	192	176	409	369
Stock-based compensation expense before income taxes	$502	$451	$1,049	$1,068
Income taxes				

	(185) ----------	(149) ----------	(377) ----------	(328) ----------
Stock-based compensation expense after income taxes	$317 =======	$302 =======	$672 =======	$740 =======

Stock-based compensation expense recognized in the consolidated statement of operations reflects estimated forfeitures that are based on historical option forfeitures.

The net cash proceeds associated with our ESPP were $635,000 for the six-month period ended April 30, 2010, and $1,473,000 for the six-month period ended May 1, 2009.

Stock option activity for the six months ended April 30, 2010, is as follows.

	Shares	**Weighted Average Exercise Price**
Outstanding at October 31, 2009	947,147	$19.57
Grants	—	—
Exercised	(15,550)	$8.87
Forfeitures or expirations	(29,929) ----------	$19.37 ----------
Outstanding at April 30, 2010	901,668	$19.77
Exercisable at April 30, 2010	812,188	$19.94

Net cash proceeds from the exercise of stock options were approximately $138,000 and $858,000 for the six-month periods ended April 30, 2010, and May 1, 2009, respectively. Unrecognized compensation cost associated with unvested stock options as of April 30, 2010, is approximately $280,000, and is expected to be recognized over a weighted average period of approximately 0.75 years.

The following table summarizes our restricted stock grant activity for the six months ended April 30, 2010.

Nonvested Shares	**Shares**	**Weighted Average Grant Date Fair Value Per Share**
Nonvested at October 31, 2009	181,733	$17.69
Grants	108,500	$19.31
Vested	(36,745)	$16.06
Forfeitures	(9,521) ----------	$17.09 ----------
Nonvested at April 30, 2010	243,967	$18.73

The fair value of our restricted stock is based on our closing stock price on the date of grant. Our unrecognized compensation cost related to nonvested (restricted) stock is $3,574,000, and is expected to be recognized over a weighted average period of 2.82 years.

We realized a net income tax benefit of approximately $61,000 from stock options exercised or forfeited and restricted stock vested during the first six months of fiscal year 2010. For the same period of fiscal year 2009, we experienced a net income tax benefit of $241,000. As required, we present excess tax benefits from the exercise of stock options and the vesting of restricted stock, if any, as financing cash flows rather than operating cash flows.

Recent Accounting Pronouncements

In October 2009, the FASB issued ASC Update No. 2009-13, updating ASC Topic 605, *Revenue Recognition*. This update provides new standards for revenue recognition for arrangements with multiple deliverables. These new standards affect the determination of when the individual deliverables may be treated as separate units of accounting. Additionally, these new standards modify the method of allocating consideration to the deliverables. The relative fair value method based on selling prices will be required and the residual method of allocating arrangement consideration will no longer be permitted. This new standard is effective for our fiscal year beginning November 1, 2010. Although the majority of our contracts are accounted for under the guidance for construction-type and production-type contracts, we are currently evaluating the potential impact, if any, on our financial position, results of operations, or cash flows as a result of adopting this new standard.

In October 2009, the FASB issued ASC Update No. 2009-14, updating ASC Topic 985, *Software*. This update provides new standards that amend the scope of previous software revenue guidance by excluding non-software components of tangible products and certain software components of tangible products. This new standard is effective for our fiscal year beginning November 1, 2010. Although the majority of our contracts are accounted for under the guidance for construction-type and production-type contracts, we are currently evaluating the potential impact, if any, on our financial position, results of operations, or cash flows as a result of adopting this new standard.

In January 2010, the FASB issued ASU No. 2010-06, *Improving Disclosures about Fair Value Measurements* (ASU 2010-06). ASU 2010-06 requires new disclosures for (i) transfers of assets and liabilities in and out of Levels 1 and 2 fair value measurements, including a description of the reasons for such transfers and (ii) additional information in the reconciliation for fair value measurements using significant unobservable inputs (Level 3). This guidance also clarifies existing disclosure requirements including (i) the level of disaggregation used when providing fair value measurement disclosures for each class of assets and liabilities and (ii) the requirement to provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for Level 2 and 3 assets and liabilities. ASU 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about activity in the roll forward for Level 3 fair value measurements, which is effective for fiscal years beginning after December 15, 2010. The adoption of this guidance has not had a material impact on our financial position and results of operations.

Note 2: Inventory

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

	April 30, 2010	October 31, 2009
Raw materials	$747	$767
Work in process	9,621	7,070
Finished goods	1,330 ----------	541 ----------
	$11,698 =======	$8,378 =======

At April 30, 2010, the unfavorable indirect rate variance included in work in process was approximately $98,000.

We did not write-down any inventory during the first six months of fiscal year 2010. During the three-month and six-month periods ended May 1, 2009, we recorded an inventory write-down of approximately $422,000 to reflect the estimated market value of one inventoried product.

Note 3: Business Combinations

On April 28, 2010, we acquired all of the outstanding membership interests in Seismic, LLC, and accounted for this purchase in accordance with the revised accounting standard for business combinations. Seismic has been engaged in cyber security solutions, software engineering, data management, and systems engineering and integration services for the Department of Defense and Intelligence Community. In September of our fiscal year 2009, we acquired all of the outstanding membership interests in Pyxis Engineering, LLC, and this purchase was accounted for under the prior accounting standard. Both companies were Maryland limited liability companies. We believe these acquisitions complement our existing software and network services business in the defense and intelligence communities. These acquisitions allow us the opportunity to expand our software and network services business into the emerging cyber security market.

We funded both acquisitions from our available cash and current investments. The fair values assigned to the intangible assets acquired were based on estimates, assumptions, and other information compiled by management, including independent valuations that utilize established valuation techniques. Intangible assets related to the acquisitions, excluding goodwill, are amortized to expense on a straight-line basis over their estimated useful lives, ranging from one to eight years. The results of operations for each acquisition are included in the accompanying statement of operations since the respective acquisition dates.

Acquisition of Seismic. The amount of goodwill recorded for the Seismic acquisition at April 30, 2010, was approximately $21.5 million and reflected the value of the future engineering services revenue opportunities associated with the cyber security marketplace.

The preliminary purchase price as of April 30, 2010, was approximately $26.7 million, which includes cash consideration of $24.7 million and contingent consideration of approximately $2.0 million. Approximately $4.9 million that would otherwise be distributed to the sellers at the closing was deposited into an escrow account to provide a fund against which we may make claims for damages, if any, based on the breaches of the representations made by Seismic in the purchase agreement. Fifty percent of the escrow account will be released on the one-year anniversary of the closing date and the remainder in 18 months from the closing date, net of any claims made by us against Seismic or the sellers under the terms of the purchase agreement.

The sellers are entitled to additional, contingent consideration (the Seismic Earn-Out) based upon the performance of the business acquired from Seismic during the six-month period ending October 31, 2010 (the Initial Earn-Out Period), and the following six-month period ending April 30, 2011 (the Subsequent Earn-Out Period). The Seismic Earn-Out is based on several key factors, including the revenue recorded during both the Initial and Subsequent Earn-Out Periods, program fees earned during the Initial Earn-Out Period, and the backlog measured on the last day of the Initial Earn-Out Period.

If total revenues that we generate from the acquired Seismic business, as defined in the purchase agreement, are in excess of $23 million during the Earn-Out Period, we will pay the sellers 51.5% of such excess up to a maximum of $2.58 million for revenues of $28 million or more.

If program profits exceed 12% during the Initial Earn-Out Period, there will be no reduction to the payout (based on revenue recorded). If program profits are less than 9% during the Initial Earn-Out Period, no Earn-Out Distribution Amount shall be paid. If Seismic program profits are between 9% and 12%, the payout will be reduced, in accordance with the terms in the purchase agreement.

If backlog measured on the last day of the Initial Earn-Out Period is greater than $10 million, there will be no reduction to the payout (based on revenue recorded). If backlog measured on the last day of the Initial Earn-Out Period is less than $5 million, no Earn-Out Distribution Amount will be paid. If Seismic backlog is between $5 million and $10 million, the payout will be reduced in accordance with the terms in the purchase agreement.

We recorded a liability of $2.0 million reflecting the fair value of the anticipated Seismic Earn-Out. The fair value was estimated by using the expected cash flow approach with revenue inputs being probability-weighted by using a discount rate of 5.6%. Changes in the fair value of the contingent liability will be recognized in earnings in the period of the change through the settlement of the liability on April 30, 2011.

Certain employees of Seismic are eligible to receive bonus payments up to a maximum total of $2.4 million upon achievement of performance targets. The performance targets include the achievement of the Seismic Earn-Out, as well as individual goals related to employee retention, minimum hiring levels, and new customer relationships. These bonus payments also include a two-year service requirement from the recipients, with fifty percent of the bonus to be paid after one year of service and the remaining portion to be paid at the end of the service period.

In addition, substantially all of the Seismic employees are eligible to receive retention bonus payments if they remain employees of Applied Signal Technology, Inc. through the one-year anniversary of the acquisition. The aggregate amount that could be paid is approximately $1.1 million.

We incurred approximately $901,000 and $911,000 of transaction costs during the second quarter and first six months of fiscal year 2010, respectively. These costs are included in general and administrative expenses within our statement of operations.

Seismic did not make a significant contribution to our revenues or operating income during the three and six-month periods ending on April 30, 2010, due to the fact that the acquisition occurred on April 28, 2010.

We allocated the aggregate preliminary purchase price for the acquisition to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition as follows (in thousands).

Cash and cash equivalents	$363
Accounts receivable and other current assets	3,603
Property and equipment and other assets	100
Accounts payable, accrued payroll and other current liabilities	(1,373)
Notes payable	(1,240)
Seismic Earn-Out	(2,047) ----------
Estimated net tangible assets acquired	(594)
Amortizable intangible assets:	
Future contracts	1,460

Unfunded backlog	1,440
Funded backlog	620
Non-compete agreements	310 ----------
Total amortizable intangible assets	3,830
Goodwill	21,454 ----------
Total cash consideration	$24,690 =======

The purchase price allocation is subject to agreement on the final closing working capital. The fair value and gross contractual amount of accounts receivable acquired was approximately $3,411,000. As of April 30, 2010, we expect that no amount will be uncollectible.

Pro forma information. The following unaudited pro forma financial information reflects the combined results of AST and Seismic as if the acquisition of Seismic had taken place as of the beginning of the periods presented. The unaudited pro forma financial information is not intended to represent or be indicative of the results of operations or financial condition of AST that would have been reported had the acquisition been completed as of the dates presented, and should not be taken as representative of the future results of operations or financial condition of AST.

	Three Months Ended		Six Months Ended	
	April 30, 2010	May 1, 2009	April 30, 2010	May 1, 2009
Revenue	$63,086	$56,854	$115,473	$105,140
Net income	$3,182	$3,796	$5,944	$6,687
Basic net income per share	$0.24	$0.29	$0.45	$0.52
Diluted net income per share	$0.24	$0.29	$0.44	$0.51

The unaudited pro forma financial information for the second quarter of both fiscal years 2010 and 2009 includes charges to operating expense for performance bonuses of approximately $322,000, retention bonuses of approximately $270,000, and amortization of intangibles of approximately $252,000. The unaudited pro forma financial information for the first six months of both fiscal years 2010 and 2009 includes charges to operating expense for performance bonuses of approximately $644,000, retention bonuses of approximately $541,000, and amortization of intangibles of approximately $504,000.

Acquisition of Pyxis Engineering. The amount of goodwill recorded for the Pyxis acquisition at October 31, 2009, was approximately $13.2 million and reflected the value of the future engineering services revenue opportunities associated with the cyber security marketplace. During the first six months of fiscal year 2010, we increased the amount of the purchase price allocated to goodwill by $70,000 due to increases in transaction costs. We allocated the aggregate purchase price for the acquisition to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition as follows (in thousands).

Cash and cash equivalents	$1,382
Accounts receivable and other current assets	4,047
Property and equipment	19
Accrued payroll and other current liabilities	(3,365)
Notes payable	(625)
Net tangible assets acquired	1,458
Amortizable intangible assets:	
Future contracts	880
Unfunded backlog	610
Funded backlog	300
Non-compete agreements	140
Total amortizable intangible assets	1,930
Goodwill	13,264
Total purchase price	$16,652

The sellers are also entitled to additional consideration (the Pyxis Earn-Out) based upon the performance of the business acquired from Pyxis during the 12-month period ending October 31, 2010 (Pyxis Earn-Out Period). If total revenue that we generate from the acquired Pyxis contracts plus new contracts in our cyber intelligence business is in excess of $13.25 million during the Earn-Out Period, we will pay the sellers all of such excess up to a maximum of $3.75 million for revenues of $17 million or more. Any payment of the Pyxis Earn-Out to sellers will result in an increase to goodwill, in the period the contingency is resolved.

In addition, substantially all of the Pyxis employees are eligible to receive retention bonus payments if they remain employees of Applied Signal Technology, Inc. through the end of fiscal year 2010. The aggregate amount that could be paid is approximately $0.6 million.

Note 4: Goodwill and Intangible Assets

The goodwill and identifiable intangible assets are related to our acquisitions of Seismic and Pyxis and the 2005 acquisition of DTI.

Goodwill. Goodwill is not subject to amortization. Rather, we evaluate goodwill for impairment at least annually or more frequently if events and changes in circumstances suggest that the carrying amount may not be recoverable. No impairment was recognized in the first six months of fiscal year 2010.

The activity of our goodwill balance during the first six months of fiscal year 2010 is as follows (in thousands).

Goodwill balance at October 31, 2009	$33,158
Additional transaction costs (Pyxis acquisition)	70
Acquisition of Seismic	21,454 ----------
Goodwill balance at April 30, 2010	$54,682 =======

Intangible assets. The tables below present information on our identifiable intangible assets that are subject to amortization (in thousands).

			April 30, 2010	
	Useful Life	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Future contracts	7–8 years	$2,340	$(84)	$2,256
Unfunded backlog	3–4 years	2,050	(135)	1,915
Funded backlog	1–2 years	920	(200)	720
Non-compete agreements	2 years	450	(47)	403
Existing technology	5 years	340	(329)	11
Patent	18 years	60 ----------	(16) ----------	44 ----------
Total		$6,160 =======	$(811) =======	$5,349 =======

			October 31, 2009	
	Useful Life	**Gross Carrying Amount**	**Accumulated Amortization**	**Net Carrying Amount**
Future contracts	7 years	$880	$(21)	$859
Unfunded backlog	3 years	610	(34)	576
Funded backlog	1 year	300	(50)	250
Non-compete agreements	2 years	140	(12)	128

Existing technology	5 years	340	(295)	45
Patent	18 years	60 ----------	(14) ----------	46 ----------
Total		$2,330 =======	$(426) =======	$1,904 =======

All of our acquired identifiable intangible assets are subject to amortization and have approximate original estimated useful lives as noted in the table above. Amortization expense associated with our intangible assets was approximately $193,000 and $385,000 for the second quarter and first six months of fiscal year 2010, respectively, and $18,000 and $36,000 for the same periods in fiscal year 2009, respectively.

As of April 30, 2010, the estimated future amortization expense for acquired identifiable intangible assets is as follows (in thousands).

Fiscal Years	
Remainder of 2010	$816
2011	1,398
2012	1,073
2013	672
2014	492
Thereafter	898 ----------
Total	$5,349

Note 5: Borrowing Arrangements

Revolving line of credit. We entered into a new revolving line of credit (Line of Credit) on February 22, 2010, under which Wells Fargo Bank (Wells Fargo) could advance funds to us, up to a maximum principal amount of $35.0 million. For borrowings under the new Line of Credit we will have the option to bear interest at either Wells Fargo’s reference rate or at a fixed rate per annum equal to 2.5% above the London Inter-Bank Offered Rate (LIBOR), and interest on those borrowings is payable monthly. The Line of Credit will expire on February 12, 2012.

As a subfeature under the Line of Credit, Wells Fargo may issue standby letters of credit for us, provided that the aggregate amount of all outstanding letters of credit shall not at any time exceed $3,000,000. At April 30, 2010, we had three standby letters of credit under the Line of Credit, totaling approximately $1,407,000. The first letter of credit, related to our Sunnyvale, California, facilities lease, had a committed balance of approximately $1,221,000 at April 30, 2010. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at April 30, 2010. The third letter of credit, a requirement of one of our customers, had a committed balance of $36,000 at April 30, 2010. 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 three letters of credit, the total amount under the Line of Credit available for future letters of credit was $1,593,000 and the total amount available for borrowing was approximately $33.6 million at April 30, 2010. No fees or interest were associated with this unused portion.

As security for our indebtedness under the Line of Credit, we have granted to Wells Fargo a security interest in our inventory, equipment, and accounts receivable.

Term loan and interest rate swap. In connection with the 2005 acquisition of DTI, we entered into a term loan with Wells Fargo in the original principal amount of $10 million, plus interest, the proceeds of which were used for acquisition financing (the Term Loan).

The Term Loan bears interest at a fixed rate per annum equal to 1.750% above the LIBOR (0.25% at April 30, 2010). Our Term Loan is for a seven-year term ending on July 1, 2012. The loan terms require us to make monthly payments of principal and interest.

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

Under the Line of Credit and the Term Loan, 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 April 30, 2010, we were in compliance with these covenants.

We are exposed to market risk from changes in interest rates on the Term Loan, and manage this exposure through the use of an interest rate swap agreement with Wells Fargo. By locking in a fixed rate for the entire term of the loan, this strategy decreases the variability of earnings and cash flows resulting from interest rate fluctuations and lowers the overall borrowing costs should interest rates rise. The interest rate swap is accounted for under the authoritative guidance for derivative instruments, and it is designated as a cash flow hedge. We do not anticipate losses on the agreement due to counterparty credit issues. Under this swap, we pay an interest rate of 4.33%, per annum, over the seven-year term of the loan and receive an average floating rate of LIBOR on the notional amount of the loan. Thus, we exchanged a variable rate obligation for a fixed interest obligation, resulting in an effective interest rate of 6.08%.

The effective portion of the cash flow hedge is reported as other comprehensive income and is reclassified into earnings in the same period during which the hedged transaction affects earnings. At April 30, 2010, the effective portion of the cash flow hedge was a deferred loss of approximately $135,000 on a gross basis. The deferred loss net of taxes was approximately $82,000 and was included in other comprehensive income and long-term liabilities on our balance sheet. During the three months and six months ended April 30, 2010, we recognized losses related to the hedge of approximately $6,000 and $19,000 in other comprehensive income, respectively. During the same periods for fiscal year 2009, we recognized losses related to the hedge of approximately $32,000 and $176,000 in other comprehensive income, respectively. During the three months and six months ended April 30, 2010, we recognized interest expense of approximately $35,000 and $73,000, respectively, reclassified from other comprehensive income. During the same periods for fiscal year 2009, we recognized interest expense of $45,000 and $81,000, respectively, reclassified from other comprehensive income. Over the next twelve months, we expect to reclassify approximately $100,000 of the loss to interest expense as principal on the Term Loan is repaid and the related swap-instrument notional amount is reduced.

We assess effectiveness of the hedge instrument regularly. The ineffective portion of the gain or loss, if there is one, would impact earnings as it occurs. There is no ineffective portion of the outstanding swap as of April 30, 2010.

Note 6: Contractual Obligations

The following table sets forth our contractual obligations as of April 30, 2010 (in thousands).

	Payments due by period

Fiscal Year	Total	1 Year	2 Years	3 Years	4 Years	5 Years or More
Operating lease obligations	$28,867	$7,618	$6,959	$4,038	$3,847	$6,405
Loan obligations – principal	3,214	1,429	1,429	356	—	—
Pyxis Earn-Out	3,750 ----------	3,750 ----------	— ----------	— ----------	— ----------	— ----------
Seismic Earn-Out	2,047 ----------	2,047 ----------	— ----------	— ----------	— ----------	— ----------
Purchase obligations	3,835 ----------	3,835 ----------	— ----------	— ----------	— ----------	— ----------
Total	$41,713 =======	$18,679 =======	$8,388 =======	$4,394 =======	$3,847 =======	$6,405 =======

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2010 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses.

The Seismic Earn-Out represents the fair value of the contingent liability recorded as part of the acquisition of Seismic on April 28, 2010. If achieved, the maximum undiscounted payment of $2.5 million will be paid in cash.

The Pyxis Earn-Out represents the maximum contingent consideration that could be paid to the former shareholders of Pyxis, based upon the achievement of the targets identified in the purchase agreement dated September 1, 2009. The Pyxis Earn-Out will be recognized in the period that the contingency is resolved. Eighty-four percent of the Pyxis Earn-Out, if achieved, will be paid in AST stock and the remaining portion will be paid in cash.

We do not have any off-balance sheet arran