APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
September 09, 2009

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 July 31, 2009

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 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):

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

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 July 31, 2009, was 13,169,310.

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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	
	July 31, 2009	August 1, 2008	July 31, 2009	August 1, 2008
Revenues from contracts	$47,845	$48,695	$143,150	$134,193
Revenues from royalty agreements	1,655	1,253	5,234	3,764
Total revenues	49,500	49,948	148,384	137,957
Operating expenses:				
Contract costs	35,347	34,572	104,367	95,435
Research and development	3,757	3,953	10,629	10,486
General and administrative	5,552	8,205	16,441	23,603
Total operating expenses	44,656	46,730	131,437	129,524
Operating income	4,844	3,218	16,947	8,433
Interest income, net	41	158	222	538
Income before provision for income taxes	4,885	3,376	17,169	8,971
Provision for income taxes	1,555	1,411	6,250	3,503
Net income	$3,330	$1,965	$10,919	$5,468
Net income per common share:				
Basic	$0.26	$0.16	$0.85	$0.44
Diluted	$0.25	$0.15	$0.83	$0.43
Number of shares used in calculating net income per common share:				
Basic	12,947	12,538	12,851	12,427
Diluted	13,226	12,741	13,101	12,616

See accompanying notes

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

Assets	July 31, 2009 (unaudited)	October 31, 2008 †
Current assets:		
Cash and cash equivalents	$5,893	$4,668
Short term investments	55,559 ---------	45,045 ---------
Total cash, cash equivalents, and short-term investments	61,452	49,713
Accounts receivable:		
Billed	24,862	22,224
Unbilled	14,944 ---------	17,891 ---------
Total accounts receivable	39,806	40,115
Inventory	9,558	8,141
Prepaid and other current assets	9,766 ---------	10,155 ---------
Total current assets	120,582	108,124
Property and equipment, at cost:		
Machinery and equipment	44,997	43,146
Furniture and fixtures	4,757	4,737
Leasehold improvements	18,625	17,537
Construction in process	666 ---------	353 ---------
	69,045	65,773
Accumulated depreciation and amortization	(54,530) ---------	(50,660) ---------
Property and equipment, net	14,515	15,113
Long-term investments	4,740	9,381
Goodwill	19,964	19,964
Intangible assets, net of accumulated amortization	109	162
Long-term deferred tax asset	3,889	4,410
Other assets		

	978	865
	---------	---------
Total assets	$164,777	$158,019
	=======	=======

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

Liabilities and Shareholders' Equity	July 31, 2009 (unaudited)	October 31, 2008 †
Current liabilities:		
Accounts payable	$4,240	$5,687
Accrued payroll and related benefits	14,966	14,383
Note payable	1,429	1,429
Income taxes payable	—	498
Other accrued liabilities	2,296	3,513
	---------	---------
Total current liabilities	22,931	25,510
Long-term note payable	2,857	3,929
Accrued rent	2,169	2,396
Other long-term liabilities	1,027	1,451
Shareholders' equity:		
Common stock and additional paid-in capital, no par value: 20,000,000 shares authorized; issued and outstanding shares: 13,169,310 at July 31, 2009, and 12,822,323 at October 31, 2008	75,202	70,145
Retained earnings	60,641	54,626
Accumulated other comprehensive income	(50)	(38)
	---------	---------
Total shareholders' equity	135,793	124,733
	---------	---------
Total liabilities and shareholders' equity	$164,777	$158,019
	=======	=======

† The balance sheet at October 31, 2008, 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)

	Nine Months Ended	
	July 31, 2009	**August 1, 2008**
Operating Activities		
Net income	$10,919	$5,468
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	4,658	4,635
Stock-based compensation	1,516	4,037
Excess tax benefits from stock-based payment arrangements	(287)	(24)
Changes in:		
Accounts receivable	309	2,189
Refundable income taxes	—	752
Inventory, prepaid expenses, and other assets	(619)	(1,741)
Accrued lease incentives	—	877
Accounts payable, taxes payable, and accrued liabilities	(2,975)	3,502
Net cash provided by operating activities	13,521	19,695
Investing Activities		
Purchases of available-for-sale securities	(52,112)	(80,236)
Maturities of available-for-sale securities	45,725	67,565
Additions to property and equipment	(3,557)	(3,030)
Net cash used in investing activities	(9,944)	(15,701)
Financing Activities		
Issuances of common stock	3,534	3,497
Shares repurchased for tax withholding of vested restricted stock awards	(240)	(279)
Excess tax benefits from stock-based		

payment arrangements	287	24
Term loan	(1,072)	(1,190)
Dividends paid	(4,861) ---------	(4,695) ---------
Net cash used in financing activities	(2,352)	(2,643)
Net increase in cash and cash equivalents	1,225	1,351
Cash and cash equivalents, beginning of period	4,668 ---------	5,250 ---------
Cash and cash equivalents, end of period	$5,893 ======	$6,601 ======
Supplemental disclosures of cash flow information:		
Interest paid	$219	$295
Income taxes paid	$6,785	$5,700

See accompanying notes

Applied Signal Technology, Inc.
Notes to Condensed Consolidated Financial Statements (unaudited)
July 31, 2009

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 products and services for both signals intelligence (SIGINT) and sensor signature processing. Our SIGINT competencies include communications intelligence (COMINT) focusing on broadband tactical wireless networks, and electronic intelligence (ELINT). 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 are 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, 2008. 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 July 31, 2009, are not necessarily indicative of the results that may be expected for the year ending October 31, 2009. The balance sheet at October 31, 2008, 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. We have evaluated subsequent events through September 8, 2009, which is the date that these financial statements have been filed with the Securities and Exchange Commission (SEC). No material subsequent events have occurred since July 31, 2009, that required recognition or disclosure in these financial statements, other than as described in Note 9, "Subsequent Event."

Estimates

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

Principles of Consolidation

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

Revenues and Contract Accounting

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

As a supplier to 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 the suspension are violations of various statutes, including those related to procurement integrity, export control, United States Government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign 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 generally not reimbursable under these contracts. Beginning in the first quarter of fiscal year 2009, we apply indirect costs to all subcontract costs. During fiscal year 2008, we did not apply indirect costs to subcontract costs that were in excess of $250,000 and that met certain other predetermined criteria.

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

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

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 $1,655,000 and $5,234,000 for the three-month and nine-month periods ended July 31, 2009, respectively, and $1,253,000 and $3,764,000, respectively, for the three-month and nine-month periods ended August 1, 2008.

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

	—— Three Months Ended ——		—— Nine Months Ended ——	
	July 31, 2009	**August 1, 2008**	**July 31, 2009**	**August 1, 2008**
Cost-reimbursement contracts	58%	68%	60%	70%
Time-and-materials contracts	24%	18%	21%	19%
Fixed-price contracts	15%	11%	15%	8%
Royalty contracts	3%	3%	4%	3%
	---------	---------	---------	---------
	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 ——		—— Nine Months Ended ——	
	July 31, 2009	**August 1, 2008**	**July 31, 2009**	**August 1, 2008**

Tiffany	21%	14%	20%	12%
ASA	20%	16%	18%	15%
High Beam	5%	18%	9%	15%
Stone Face II	5%	11%	6%	13%
Specter	— ---------	— ---------	— ---------	6% ---------
	51% ======	59% ======	53% ======	61% ======
a dash (—) designates less than 5% revenue concentration				

The following contracts are indefinite-delivery-indefinite-quantity (IDIQ) contracts: 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 aggregate the DOs under each IDIQ contract for purposes of determining significant revenue concentrations.

ASA is a time-and-materials contract. All of the other contracts referenced in the table above 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. We adjust revenues and profits on all contracts in the period in which changes, including anticipated losses, become determinable.

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and costs incurred in connection with ongoing contracts for which contract modifications have not been defined or completed at the end of the reporting period. These costs are included in other current assets on the balance sheet. Precontract costs incurred at July 31, 2009, and October 31, 2008, were approximately $976,000 and $1,283,000, respectively. Approximately $853,000 of the October 31, 2008, balance was recognized as revenue during the first nine months of fiscal year 2009.

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 indirect rate structure, which changed the application of certain indirect expenses to contracts. We implemented this new structure in accordance with the Federal Acquisition Regulations. Through this new rate structure, we changed the allocation of certain indirect costs from general and administrative expenses to contract costs. In addition, this structure changed the application of certain general and administrative expenses to contracts, which 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 the 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, the modification of our billing rates will decrease revenue and operating expenses, and decrease the favorable indirect rate variance accumulated in inventory. In this event, fee percentages on fixed-price and time-and-materials contracts will generally increase. Fee percentages on cost-reimbursable contracts will generally be unaffected as a result of any reduction to indirect costs due to the fact that programs will typically expend all of the funds available. Any impact on operating income, however, will depend on a number of other factors, including mix of contract types, contract terms, anticipated performance on specific contracts, and anticipated changes in inventory.

The favorable rate variance at July 31, 2009, was approximately $199,000. At August 1, 2008, the unfavorable rate variance was approximately $2,177,000, and included approximately $1,180,000 of unanticipated severance costs that were payable to our former Chief Executive Officer and were not included in our target rates for general and administrative expenses.

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. Charges to bad debt expense were not significant during the first nine months of fiscal years 2009 and 2008.

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 that a product has reached the end of its life cycle or there is no longer a need for a certain product, typically, we will dispose of any remaining inventory, and record the associated reduction to inventory.

We did not record inventory write-downs during the third quarter of fiscal year 2009. During the nine-month period ended July 31, 2009, we recorded inventory write-downs of approximately $422,000 and approximately $394,000 and $1,329,000, respectively, during the three-month and nine-month periods ended August 1, 2008. We recorded these write-downs to reflect the estimated market value of one inventoried product. Disposals of obsolete products were not significant during the three-month and nine-month periods of fiscal years 2009 and 2008.

Disposals associated with our raw materials represent a minor amount, and are included in general and administrative expenses on the statement of operations due to the fact that raw materials could be used in a variety of situations other than contract costs, including R&D. Disposals of raw material inventory were not significant during the first nine months of fiscal years 2009 and 2008.

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 the non-tax-deductible nature of 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 according to Financial Interpretation No. 48, *Accounting for Income Taxes – an interpretation of FASB Statement No. 109.* 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 6: 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 nine months of fiscal year 2009 or the full fiscal year of 2008.

Cash, Cash Equivalents, and Investments

Cash balances include cash held in banks to support daily cash needs and were approximately $5,893,000 on July 31, 2009, and approximately $4,668,000 on October 31, 2008. 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 July 31, 2009, 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. Realized gains and losses on sales of available-for-sale securities were not material for the first nine months of fiscal years 2009 and 2008.

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

	July 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash equivalents:				
Money market funds	2,054	—	—	2,054
Available-for-sale securities:				
Short-term municipal	55,491	69	(1)	55,559
Long-term municipal	4,732	8	—	4,740
	$62,277	$77	$(1)	$62,353

	October 31, 2008			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash equivalents:				
Money market funds	2,068	—	—	2,068
Municipal securities	—	—	—	—
Available-for-sale securities:				
Short-term municipal	45,006	39	—	45,045
Long-term municipal	9,380	10	(9)	9,381
	$56,454	$49	$(9)	$56,494

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

	July 31, 2009	October 31, 2008
Due in one year or less	$55,559	$45,045
Due in one to two years	4,740	9,381

	$60,299	$54,426
	======	======

Fair Value Measurements

As of November 1, 2008, we adopted Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements*. SFAS 157 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 and enhances disclosures about fair value measurements. The adoption of SFAS 157 did not have a material impact on our results of operations, financial position, or cash flows. The requirements of SFAS 157 regarding certain non-financial assets and liabilities have been deferred until the first quarter of our fiscal year 2010 as allowed under Financial Accounting Standards Board (FASB) Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. We currently do not expect that the adoption of SFAS 157 as it relates to certain non-financial assets and liabilities will have a material impact on our results of operations, financial position, or cash flows. In October 2008, the FASB issued FSP FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP 157-3), which clarifies the application of SFAS 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The adoption of this standard as of January 30, 2009, did not have a material impact on our results of operations, financial position, or cash flows.

SFAS 157 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. SFAS 157 describes 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 as of July 31, 2009 (in thousands).

	Fair Value Measurement Using		
	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	$2,054	$—	$2,054
Available-for-sale securities:			
Short-term municipal	—	55,559	55,559
Long-term municipal	—	4,740	4,740

	---------	---------	---------
Total assets	$2,054	$60,299	$62,353
Liabilities			
Interest rate swap	$— ---------	$126 ---------	$126 ---------
Total liabilities	$— ======	$126 ======	$126 ======

As of July 31, 2009, our investment portfolio did not include investments in assets 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.

The inputs used to value the interest rate swap 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 4: Borrowing Arrangements" for further information.

As of November 1, 2008, we also adopted SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities – including an Amendment of FASB Statement No. 115*, which allows an entity to choose to measure certain financial instruments and liabilities at fair value on a contract-by-contract basis. Subsequent fair value measurement for the financial instruments and liabilities an entity chooses to measure will be recognized in earnings. As of July 31, 2009, we did not elect such option for any of our financial instruments or liabilities.

Restricted Cash

We had restricted cash balances of approximately $689,000 and $605,000 at July 31, 2009, and at October 31, 2008, 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 $107,000 and $161,000 was included in prepaids and other current assets at July 31, 2009, and at October 31, 2008, respectively. Approximately $582,000 and $444,000 was included in other assets at July 31, 2009, and at October 31, 2008, 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 leasehold improvements and test equipment that has not yet been placed into service.

Goodwill and Long-Lived Asset Valuation

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

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

No indicators of impairment were identified at July 31, 2009.

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

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

No indicators of impairment were identified at July 31, 2009.

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	
	July 31, 2009	August 1, 2008	July 31, 2009	August 1, 2008
Numerator:				
Net income	$3,330	$1,965	$10,919	$5,468
Denominator:				
Shares used to compute net income per common share – basic	12,947	12,538	12,851	12,427
Effect of dilutive stock options and nonvested stock	279	203	250	189

Shares used to compute net income per common share – diluted	13,226 ======	12,741 ======	13,101 ======	12,616 ======
Net income per common share – basic	$0.26	$0.16	$0.85	$0.44
Net income per common share – diluted	$0.25	$0.15	$0.83	$0.43

We excluded approximately 331,000 and 471,000 potential common shares for the three-month and nine-month periods ended July 31, 2009, from the diluted net income per common share computation, as their effect would be antidilutive. For the same periods in fiscal year 2008, we excluded 882,000 and 926,000 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		Nine Months Ended	
	July 31, 2009	August 1, 2008	July 31, 2009	August 1, 2008
Net income	$3,330	$1,965	$10,919	$5,468
Unrealized gain (loss) on securities	(38)	3	36	48
Derivative gain (loss)	21 ---------	17 ---------	(48) ---------	(70) ---------
Comprehensive income	$3,313 ======	$1,985 ======	$10,907 ======	$5,446 ======

The balance of accumulated comprehensive income on securities as of July 31, 2009, and October 31, 2008, was approximately $76,000 and $40,000, respectively. The derivative-related accumulated comprehensive loss balance was approximately $126,000 and $78,000 as of July 31, 2009, and October 31, 2008, respectively.

Dividends

We have paid dividends at the rate of $0.50 per share per annum, payable quarterly. However, the dividend is subject to approval by the Board of Directors and is reviewed quarterly. We paid dividends on November 14, 2008, February 13, 2009, May 15, 2009, and August 14, 2009 to shareholders of record at October 31, 2008, January 30, 2009, May 1, 2009, and July 31, 2009, respectively.

We paid dividends of approximately $4,861,000 during the first nine months of fiscal year 2009 and approximately $4,695,000 during the first nine months of fiscal year 2008.

At July 31, 2009, and October 31, 2008, accrued dividends of approximately $1,646,000 and $1,603,000, respectively, were included in other accrued liabilities on the accompanying balance sheet.

Stock-Based Compensation

We have stock-based compensation programs that enable our Board of Directors to award employee equity incentives. These programs include restricted stock awards and incentive and non-statutory stock options granted under various plans. Restrictions on the restricted stock awards typically lapse in four equal annual installments, on each anniversary of the grant date, conditioned on continued employment. The restrictions on the majority of the fiscal year 2007 awards to non-employee directors will lapse in three equal annual installments. The vesting provisions of our 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 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. On August 20, 2008, the Board of Directors increased the purchase price and eliminated the look-back provision for offering periods beginning on or after December 1, 2008. The purchase price for participants is now 95% of the fair market value on the date of purchase, and therefore, is non-compensatory under the provisions of SFAS 123 (revised 2004), *Share-Based Payment* (SFAS 123R). The remaining expense related to the final compensatory award under the ESPP was recognized in the first quarter of fiscal year 2009.

Our closing stock price on the November 30, 2007, ESPP purchase date was lower than the closing stock price on the December 1, 2006, offering date. Therefore, 361 participants were re-enrolled into a new six-month offering period, beginning December 1, 2007, and ending May 31, 2008. Due to the May 2007 modification of the ESPP, this re-enrollment effectively canceled the final six-month purchase period of the original twenty-four-month offering. Therefore, the remaining unamortized compensation amount associated with this final purchase period, approximately $382,000, was recognized in the first quarter of fiscal year 2008. In addition, as a result of the modification, approximately $89,000 of incremental compensation cost was generated at December 1, 2007, of which we recognized $13,000 during the third quarter and $89,000 during the first nine months of fiscal year 2008.

As of July 31, 2009, 1,347,806 shares were reserved for future issuance under the equity incentive and ESPP plans.

We recognize stock compensation expense, based on the provisions of SFAS 123R, 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).

	Three Months Ended		Nine Months Ended	
	July 31, 2009	August 1, 2008	July 31, 2009	August 1, 2008
Contract costs	$268	$557	$932	$2,242
Research and development	13	41	49	153
General and administrative	166	633	535	1,642
Stock-based compensation expense before income taxes	$447	$1,231	$1,516	$4,037
Income taxes	(148)	(368)	(477)	(860)

Stock-based compensation expense after income taxes	$299 ======	$863 ======	$1,039 ======	$3,177 ======

We estimated the fair value of options granted and shares issued under our ESPP for fiscal year 2008 by using the Black-Scholes valuation model using the following weighted average assumptions:

	Nine Months Ended August 1, 2008
Risk-free interest rate	2.0%
Expected life (years)	0.50
Expected volatility	39%
Expected dividends	3.9%
Weighted average fair value	$3.79

Due to the non-compensatory nature of our ESPP Plan beginning December 1, 2008, we did not value any new ESPP grants during the first nine months of fiscal year 2009.

For grants in fiscal year 2008, the risk-free interest rate was based on the Federal Reserve Bank's constant maturities daily interest rate in effect at the ESPP offering date. Our computation of expected volatility reflected 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 was 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 years 2009 and 2008 reflects estimated forfeitures, which are based on historical option forfeitures.

The net cash proceeds associated with our ESPP were $2,137,000 for the nine-month period ended July 31, 2009, and $3,195,000 for the nine-month period ended August 1, 2008. There is no unrecognized compensation cost associated with our ESPP as of July 31, 2009.

Stock option activity for the nine months ended July 31, 2009, is as follows:

	Shares	Weighted Average Exercise Price
Outstanding at October 31, 2008	1,209,318	$18.05
Grants	—	
Exercised	(156,331)	$8.93
Forfeitures or expirations	(65,930) ---------	$21.32 ---------
Outstanding at July 31, 2009	987,057	$19.28
Exercisable at July 31, 2009	865,637	$19.15

Net cash proceeds from the exercise of stock options were approximately $1,396,000 for the nine-month period ended July 31, 2009, and approximately $301,000 for the nine-month period ended August 1, 2008. Unrecognized compensation cost associated with unvested stock options as of July 31, 2009, is approximately $864,000, and is expected to be recognized over a weighted average period of 1.34 years.

The following table summarizes our restricted stock grant activity for the nine months ended July 31, 2009.

Nonvested Shares	Shares	Weighted Average Grant Date Fair Value Per Share
Nonvested at October 31, 2008	175,402	$16.11
Grants	61,300	$24.31
Vested	(47,826)	$16.61
Forfeitures	(5,333) ---------	$17.16 ---------
Nonvested at July 31, 2009	183,543	$17.25

The fair value of our restricted stock is based on our closing stock price on the date of grant. Our unrecognized compensation cost related to nonvested (restricted) stock is $2,500,000, and is expected to be recognized over a weighted average period of 2.56 years.

During the third quarter of fiscal year 2008, all outstanding but unvested stock option and restricted stock awards held by our former Chairman and Chief Executive Officer were vested in full in connection with his severance agreement. We also extended the period of exercisability of his stock options for up to two years from the date of termination of employment. As a result of these modifications, we recognized stock-based compensation expense of approximately $304,000 during the third quarter of fiscal year 2008.

We realized a net tax benefit from stock options exercised and restricted stock vested of approximately $247,000 during the first nine months of fiscal year 2009. We realized a net tax deficiency of approximately $59,000 during the same period of fiscal year 2008. In accordance with SFAS 123R, we present excess tax benefits from the exercise of stock options and the vesting of restricted stock, if any, as financing cash flows rather than operating cash flows.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS 141R, *Business Combinations*. SFAS 141R replaces SFAS 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. In April 2009, the FASB issued FSP FAS 141R-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, which amends and clarifies the accounting for assets and liabilities arising from contingencies in business combinations under SFAS 141R. The revised statement and the FSP will apply prospectively to business combinations occurring in our fiscal year beginning November 1, 2009. The effects on future periods will depend on the nature and significance of business combinations subject to the new rules.

In March 2008, the FASB issued SFAS 161*, Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*. SFAS 161 requires enhanced disclosures about derivatives on a quarterly basis, including qualitative disclosures about objectives and strategies for using derivatives, and quantitative disclosures about the fair value of derivatives, as well as gains and losses on derivative instruments. It also requires disclosures about the volume of derivative activity and credit-risk-related contingent features in derivative agreements. We adopted SFAS 161 in the second quarter of fiscal year 2009. The adoption did not affect our financial position, results of operations, or cash flows due to the disclosure-only nature of the statement.

In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. This FSP affects the calculation of Basic EPS when a company has unvested share-based payment awards with non-forfeitable rights to dividends. The two-class method of calculation would be required, which means that dividends and undistributed earnings must be allocated between common shares and the unvested awards in calculating Basic EPS. The FSP will be effective for our fiscal year beginning November 1, 2009. We are evaluating the impact adopting FSP EITF 03-6-1 will have on our financial statements.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. The FSP establishes a new method of recognizing and reporting other-than-temporary impairments of debt securities and requires additional disclosures. We adopted this FSP in the third quarter of fiscal year 2009. The adoption did not affect our financial position, results of operations, or cash flows.

In May 2009, the FASB issued SFAS 165, *Subsequent Events*. This standard sets forth: 1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, 2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and 3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. We began applying the provisions of SFAS 165 in the third quarter of 2009 and its adoption did not affect our financial statements, other than the disclosures required by SFAS No. 165, which can be found in Note 1 under "Description of Business and Basis of Presentation."

In June 2009, the FASB issued SFAS 168, *The FASB Accounting Standards Codification TM and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162* (the Codification). The Codification, which was launched on July 1, 2009, became the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF), and related literature. The Codification eliminates the GAAP hierarchy contained in SFAS 162 and establishes one level of authoritative GAAP. All other literature is considered non-authoritative. The Codification is effective for financial statements for interim or annual reporting periods ending after September 15, 2009. We will adopt this Statement for our fourth quarter and fiscal year ending October 31, 2009. The adoption of this statement will have no impact on our financial position, results of operations or cash flows.

Note 2: Inventory

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

	July 31, 2009	October 31, 2008
Raw materials	$790	$799
Work in process	8,292	6,911
Finished goods	476 ---------	431 ---------
	$9,558	$8,141

At July 31, 2009, the favorable indirect rate variance included in work in process was approximately $199,000.

We did not record inventory write-downs during the third quarter of fiscal year 2009. During the nine-month period ended July 31, 2009, we recorded inventory write-downs of approximately $422,000 and approximately $394,000 and $1,329,000, respectively, during the three-month and nine-month periods ended August 1, 2008. We recorded these write-downs to reflect the estimated market value of one inventoried product.

Note 3: Goodwill and Intangible Assets

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

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 2009.

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

				July 31, 2009
	Useful Life	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Existing technology	5 years	$340	$(278)	$62
Patent	18 years	60	(13)	47
Total		$400	$(291)	$109

All of our acquired identifiable intangible assets are subject to amortization and have approximately original estimated useful lives as noted in the table above. Amortization expense associated with our intangible assets was approximately $18,000 and $54,000 for the third quarter and first nine months of fiscal years 2009, respectively, and $113,000 and $436,000, for the same periods in fiscal year 2008, respectively.

Note 4: Borrowing Arrangements

Revolving line of credit. At July 31, 2009, we had a revolving line of credit (Line of Credit) under which Wells Fargo Bank (Wells Fargo), could advance funds to us, up to a maximum principal amount of $3 million. The Line of Credit will expire on March 1, 2010.

At July 31, 2009, 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 July 31, 2009. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at July 31, 2009. The third letter of credit, a requirement of one of our customers, had a committed balance of $36,000. 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 borrowing was approximately $1,593,000. No fees or interest were associated with this unused portion. Borrowings under the Line of Credit bear interest at Wells Fargo's reference rate (3.25% at July 31, 2009), and interest on those borrowings is payable monthly. As security for our indebtedness under the Line of Credit, we have granted to Wells Fargo a security interest in our cash and marketable securities maintained with an affiliate of Wells Fargo.

Term loan and interest rate swap. Effective July 1, 2005, and in connection with the acquisition of DTI, we entered into a term loan with Wells Fargo in the principal amount of $10 million, plus interest, the proceeds of which were used for acquisition financing (the Term Loan). The Term Loan bears interest at a fixed rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) (0.28% at July 31, 2009). Our Term Loan is for a seven-year term ending on July 1, 2012, with monthly payments of principal and interest.

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

We are required to maintain certain financial covenants setting forth minimum ratios for quick ratio and fixed charge coverage and maximum ratios for total liabilities to tangible net worth. As of July 31, 2009, we were in compliance with these covenants.

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

The effective portion of the cash flow hedge is reported as other comprehensive income, and is reclassified into earnings in the same period during which the hedged transaction affects earnings. At July 31, 2009, the effective portion of the cash flow hedge was a deferred loss of approximately $205,000 on a gross basis. The deferred loss net of taxes was approximately $126,000, and was included in other comprehensive income and long-term liabilities on our balance sheet. During the three months and nine months ended July 31, 2009, we recognized losses related to the hedge of $10,000 and $186,000, respectively, in other comprehensive income. During the same periods of fiscal year 2009, we recognized in interest expense approximately $46,000 and $126,000, respectively, reclassified from other comprehensive income. Over the next twelve months, we expect to reclassify approximately $140,000 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 July 31, 2009.

Note 5: Contractual Obligations

The following table sets forth our contractual obligations as of July 31, 2009 (in thousands).

		Payments due by period			
Fiscal Year	**Total**	**Less than 1 year**	**1–3 years**	**3–5 years**	**More than 5 years**
Operating lease obligations	$32,291	$7,600	$13,120	$7,035	$4,536
Loan obligations – principal	4,286	1,429	2,857	—	—
Purchase obligations	5,599 ---------	5,599 ---------	— ---------	— ---------	— ---------
Total					

	$42,176 ======	$14,628 ======	$15,977 ======	$7,035 ======	$4,536 ======

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2009 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses.

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.

Note 6: Segment Reporting

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

Note 7: Provision for Income Taxes

Our provision for income taxes for the third quarter and first nine months of fiscal year 2009 was approximately $1,555,000 and $6,250,000, respectively, with an estimated annual effective tax rate of 38.5%. Our provision for income taxes for the third quarter and first nine months of fiscal year 2008 was approximately $1,411,000 and $3,503,000, respectively, with an estimated annual effective tax rate of approximately 45.9%.

In general, our income tax returns are subject to examination by United States federal tax authorities for tax years 2005 onward and by various United States state tax authorities for tax years 2004 onward. The Internal Revenue Service audit for the year ended October 31, 2007, has been completed and did not result in any adjustment. The results of our examination have been considered in estimating our future obligations for unrecognized tax benefits. As a result, we recorded a net decrease of approximately $1,303,000 in gross unrecognized tax benefits and reduced our accrual for interest and penalties by approximately $278,000 during the third quarter of fiscal year 2009.

The balance of our liability associated with unrecognized tax benefits and accrued interest was approximately $152,000 at July 31, 2009, and approximately $1,620,000 at October 31, 2008.

If our estimates of the federal and state income tax liabilities are less than the ultimate assessment, a further charge to expense would result. As of July 31, 2009, we do not expect any unrecognized tax benefits to be paid in the next twelve months.

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 2009 were approximately $46,000 and $80,000, respectively. For the same periods of fiscal year 2008, warranty costs were approximately $44,000 and $157,000, respectively.

Guarantees. From time to time, we enter into certain types of contracts that contingently require us to indemnify parties against third-party claims. These contracts primarily relate to (i) certain real estate leases, under which we may be required to indemnify property owners for environmental and other liabilities, and other claims arising from our use of the applicable premises; and (ii) certain agreements with our officers, directors, and employees under which we may be required to indemnify such persons for liabilities arising out of their employment relationship. The terms of such obligations vary. Generally, a maximum obligation is not explicitly stated. Because the obligated amounts of these types of agreements often are not explicitly stated, the overall maximum amount of the obligations cannot be reasonably estimated. Historically, we have not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these obligations on the balance sheets as of July 31, 2009, or October 31, 2008.

Legal proceedings. On March 11, and July 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California. The cases were considered as *In re Applied Signal Technology Inc. Securities Litigation*, Master File No. 4:05-cv-1027 (SBA). The amended consolidated complaint is brought on behalf of a putative class of persons who purchased our Company's securities during a class period of August 24, 2004, through February 22, 2005. The complaints name us, our former Chief Executive Officer, and our Chief Financial Officer as defendants, and allege that false and misleading statements regarding us were issued during the class period. The parties have agreed to a settlement, which will be paid by our insurers. On August 3, 2009, the District Court gave final approval to a settlement of this case. A purported appeal of a ruling denying a motion to intervene has been filed.

On August 12, 2008, a purported shareholder derivative action was filed in the Superior Court, State of California. *Shoemaker v. Devine et al.*, No. 1:08-CV-119810. It is brought on purported behalf of the Company, against current and former members of the Board of Directors, our Chief Financial Officer, and our former Chief Executive Officer, asserting that these individuals breached their fiduciary duties, based on essentially the same allegations as the class action case. No damages are specified. As the case is brought on purported behalf of the Company, there is no possible loss that might be incurred as a result of this proceeding.

On May 18, 2009, we filed a complaint for patent infringement in the United States District Court for the Northern District of California, Case Number 3:09-cv-2180-SBA, against Emerging Market Communications, Paradise Datacom LLC, and Viasat, Inc. On June 12, 2009, we filed an amended complaint adding EMC Satcom Technologies, Inc. as a defendant. All of the defendants have been served with the complaint, and none of the defendants has yet filed an answer. The Court has set an initial case management conference for November 19, 2009. If we are unable to come to a resolution of the patent infringement claims with the defendants, we expect to vigorously pursue our claims against the defendants.

Note 9: Subsequent Event

On September 1, 2009, we entered into a Membership Interest Purchase Agreement (the "Purchase Company Agreement") with Pyxis Engineering LLC, a Maryland limited liability company ("Pyxis"), and Eric Bennett as the initial seller ("Bennett"), and each additional member of Pyxis (the "Additional Sellers" and, together with Bennett, the "Sellers"), to acquire all of the outstanding membership interests in Pyxis (the "Acquisition"). The Purchase Agreement and the transactions contemplated therein have been approved by the Board of Directors of the Company, and by Pyxis and all of its members. We completed the acquisition on September 1, 2009 (the "Closing"), at which time Pyxis will became a wholly-owned subsidiary of Applied Signal Technology, Inc.

We believe the Pyxis acquisition will complement AST's existing software and network services business in the defense and intelligence communities. The acquisition allows AST the opportunity to expand its software and network services business into the emerging cyber-security market.

At closing, we paid from our cash and short-term investments on hand the closing purchase price of $16,250,000. In addition, we paid to Sellers an additional $623,000 as a result of excess working capital delivered by Sellers at Closing over the required minimum $2 million; this adjustment may be further adjusted up (to a maximum of $1 million) or down, upon audit of the estimated closing working capital.

In addition, the Sellers shall be entitled to additional amounts (the "Earn-Out") based upon the performance of the business acquired from Pyxis during the twelve months following the Closing (the "Earn-Out Period"), of up to $3,750,000, payable in stock to Bennett and cash to the other Additional Sellers. The Earn-Out shall be payable to the

Sellers if target revenues from contracts entered into by Pyxis before or after the Closing, together with target revenues generated from new contracts entered into by Applied Signal Technology, Inc. from contracts for business that is substantially similar to the Pyxis business, over the Earn-Out Period, are in excess of $13,250,000 (the "Threshold Target Revenues"). If the Threshold Target Revenues are achieved, the Earn-Out payable to the Sellers shall equal every dollar of target revenues that exceed the Threshold Target Revenues, up to a maximum Earn-Out of $3,750,000, payable if target revenues are $17 million or more.

We expect to retain substantially all of the employees of Pyxis, representing approximately 75 additional employees. Pyxis has been engaged in software engineering, system and database administration, systems engineering, information assurance, and project management services for the Department of Defense and Intelligence Community, including cleared system software development, systems architecture, application performance management, web portal development, data management, and data mining.

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, 2008.

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 Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended October 31, 2008. 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) is a leading provider of advanced intelligence, surveillance, and reconnaissance (ISR) solutions to enhance global security. We provide domain knowledge in the areas of signals intelligence (SIGINT) and sensor signature processing. Our SIGINT competencies include communications intelligence (COMINT) focusing on broadband and tactical wireless networks, and electronic intelligence (ELINT). Our sensor signature expertise includes processing information from electro-optic, sonar, radar, magnetic, and chemical sensors to detect changes in the environment and provide real-time alerts of potential threats. We specialize in the collection, processing, and understanding of signals for ISR missions with low size, weight, and power configurations to enable increased deployment on unmanned platforms. Our primary customers are the United States Government and defense industry prime contractors for the United States Government.

Our sophisticated products, systems, and services help resolve our customers' most critical national security and signal collection issues. We provide advanced ISR solutions that allow our nation to prepare for, prevent, evaluate, and respond to foreign and domestic threats. Our specific capabilities include:

- ***Tactical COMINT***. Our tactical COMINT solutions include deployment of ground-based and airborne payloads for the detection, identification, location, and tracking of mobile communications and weapon systems. The AST product portfolio includes man-portable, airborne, remote/unattended, and system-level solutions for both strategic and tactical missions. Our systems are wideband digital systems that utilize signal processing technology to deliver superior performance against conventional and modern signals, even in the most challenging signal environments.

- ***Electronic Warfare***. Our Electronic Warfare (EW) solutions detect, identify, and counter adversary weapon and sensor systems by collecting signals from electronic emitters. We have developed a suite of ELINT and electronic support measures (ESM) to derive intelligence from signals associated with weapons systems. This equipment is 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. Our ELINT offering is new, and to date, we have derived a small amount of revenue from the sale of products.
- ***Broadband Network Communications***. Our broadband communication network monitoring systems automatically scan and process tens of thousands of modern communications signals and produce actionable intelligence. These complex systems locate signals of interest and provide the analysis and visualization tools necessary to produce meaningful results in time to make a difference. We are developing a suite of high capacity network monitoring products to protect against the threat of cyber attacks. We also provide bandwidth compression technology to maximize performance for satellite communications.
- ***Sensor Surveillance***. Our specialized sensors and signature processing observes changes in the environment that can provide an indication of activities of concern to global security. Sensor signatures addressed by AST include the use of sound, such as in sonar or radar, to detect mines or submarines; detection of chemicals to expose explosive devices; and detection of magnetic materials that might indicate the presence of buried mines or underground weapons facilities. Our sensor processing equipment provides automatic detection and classification of threatening objects in both marine and terrestrial environments.
- ***Mission Planning and Support***. We provide software-based management systems that provide the tasking and planning of deployed sensors and collection systems to conduct operations, training, and sustainment. We also provide mission management of deployed systems.
- ***Professional Services***. We perform high-end engineering services for government product development and operationally deployed systems. Examples of these services are evaluation of current performance, engineering improvements for performance enhancement, evaluation of signals being processed to develop system operation techniques that can improve intelligence gathering, and customer training in the use of our standard products. Our services are typically offered on a time-and-materials basis. The prices of our services may vary based upon the skill level of technical talent required by our customers.

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

Critical Accounting Policies and Estimates

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

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

As a supplier to 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 the suspension are violations of various statutes, including those related to procurement integrity, export control, United States Government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign 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, operating income would be reduced.

We account for cost-reimbursement contracts by charging actual labor, materials, and other direct costs, plus estimated indirect costs of operations as incurred, including overhead, research and development, and general and administrative expenses (incurred costs). Stock compensation expense is generally not reimbursable under these contracts. Beginning in the first quarter of fiscal year 2009, we apply indirect costs to all subcontract costs. During fiscal year 2008, we did not apply indirect costs to subcontract costs that were in excess of $250,000 and that met 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 position 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.

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

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

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

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and costs incurred in connection with ongoing contracts for which contract modifications have not been defined or completed at the end of the reporting period. These costs are included in other current assets on the balance sheet. Precontract costs incurred at July 31, 2009, and October 31, 2008, were approximately $976,000 and $1,283,000, respectively. Approximately $853,000 of the October 31, 2008, balance was recognized as revenue during the first nine months of fiscal year 2009.

We have one royalty licensing agreement for which we accrue royalties upon 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. For the three-month and nine-month periods ended July 31, 2009, our royalties contributed approximately $1,655,000 and $5,234,000, respectively, to revenues and operating income, and $1,253,000 and $3,764,000, respectively during the three-month and nine-month periods ended August 1, 2008.

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

At the beginning of fiscal year 2009, we implemented a new indirect rate structure, which changed the application of certain indirect expenses to contracts. We implemented this new structure in accordance with the Federal Acquisition Regulations. We believe this structure has been accepted by our customers. Through this new rate structure, we changed the allocation of certain indirect costs from general and administrative expenses to contract costs. In addition, this structure changed the application of certain general and administrative expenses to contracts, which created a one-time increase to operating income of approximately $450,000 from fixed-price contracts. We do not anticipate any further change to our operating income as a result of changes to our rate structure, as our operating income levels tend to be driven by contract type. In addition, during fiscal year 2009 we believe that contract costs will be higher as a percentage of revenues and general and administrative expenses will be lower as a percentage of revenues compared to historical levels.

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. We record favorable rate variances as increases to operating expenses and decreases to work-in-process inventory.

If we anticipate that actual contract activities will be different than planned levels, there are alternatives we can utilize to reduce the variance: we can adjust some of our planned indirect spending during the year; we can request a modification of our billing rates to our customers through the Defense Contract Audit Agency any time during the year, in accordance with the 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, the modification of our billing rates will decrease revenue and operating expenses, and decrease the favorable indirect rate variance accumulated in inventory. In this event, fee percentages on fixed-price and time-and-materials contracts will generally increase. Fee percentages on cost-reimbursable contracts will generally be unaffected as a result of any reduction to indirect costs, due to the fact that programs will typically expend all of the funds available. Any impact on operating income, however, will depend on a number of other factors, including mix of contract types, contract terms, anticipated performance on specific contracts, and anticipated changes in inventory.

At July 31, 2009, the favorable inventoried indirect variance was approximately $199,000. At August 1, 2008, the unfavorable inventoried indirect rate variance was approximately $2,177,000, and included approximately $1,180,000 of unanticipated severance costs that were payable to our former Chief Executive Officer and were not included in our target rates for general and administrative expenses.

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 includes raw materials. Historically, we have sold our inventory at or above cost, so there was typically no decrement in valuation. When we determine that a product has reached the end of its life cycle or there is no longer a need for a certain product, typically, we will dispose of any remaining inventory, and record the associated reduction to inventory.

We did not record inventory write-downs during the third quarter of fiscal year 2009. During the nine-month period ended July 31, 2009, we recorded inventory write-downs of approximately $422,000 and approximately $394,000 and $1,329,000, respectively, during the three-month and nine-month periods ended August 1, 2008. We recorded these write-downs to reflect the estimated market value of one inventoried product. Disposals of obsolete products were not significant during the three-month and nine-month periods of fiscal years 2009 and 2008.

Disposals associated with our raw materials represent a minor amount and are included in general and administrative expenses on the statement of operations due to the fact that raw materials could be used in a variety of situations other than contract costs, including R&D. Disposal activities were not significant during the first nine months of fiscal years 2009 and 2008.

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 the non-tax-deductible nature of 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 according to Financial Interpretation No. 48, *Accounting for Income Taxes – an interpretation of FASB Statement No. 109.* 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 6: 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. During the first nine months of 2009 and the full fiscal year 2008, we did not incur any price redeterminations on any of our contracts.

Goodwill valuation. We test goodwill for possible impairment on an annual basis in the fourth quarter of our fiscal year 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 future performance as well as the estimation of discount rates.

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

No indicators of impairment were identified at July 31, 2009.

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

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

No indicators of impairment were identified at July 31, 2009.

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

We have an Employee Stock Purchase Plan (ESPP). For offering periods beginning prior to December 1, 2008, the ESPP allowed 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. On August 20, 2008, the Board of Directors increased the purchase price and eliminated the look-back provision for offering periods beginning on or after December 1, 2008. The purchase price for participants is now 95% of the fair market value on the date of purchase, and therefore, is non-compensatory under the provisions of SFAS 123R. The remaining expense related to the final compensatory award under the ESPP was recognized in the first quarter of fiscal year 2009.

Our closing stock price on the November 30, 2007, ESPP purchase date was lower than the closing stock price on the December 1, 2006, offering date. Therefore, 361 participants were re-enrolled into a new six-month offering period, beginning December 1, 2007, and ending May 31, 2008. Due to the May 2007 modification of the ESPP, this re-enrollment effectively canceled the final six-month purchase period of the original twenty-four-month offering. Therefore, the remaining unamortized compensation amount associated with this final purchase period, approximately $382,000, was recognized in the first quarter of fiscal year 2008. In addition, as a result of the modification, approximately $89,000 of incremental compensation expense was generated at December 1, 2007, of which we recognized $13,000 during the third quarter and $89,000 during the first nine months of fiscal year 2008.

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		Nine Months Ended	
	July 31, 2009	**August 1, 2008**	**July 31, 2009**	**August 1, 2008**
Contract costs	$268	$557	$932	$2,242
Research and development	13	41	49	153
General and administrative	166	633	535	1,642
Stock-based compensation expense before income taxes	$447	$1,231	$1,516	$4,037
Income taxes	(148)	(368)	(477)	(860)
Stock-based compensation expense after income taxes	$299	$863	$1,039	$3,177

The decrease to our stock-based compensation expense is primarily due to the non-compensatory nature of our ESPP Plan, effective December 1, 2008. In addition, during the third quarter of fiscal year 2008, all outstanding but unvested stock option and restricted stock awards held by our former Chairman and Chief Executive Officer were vested in full in connection with his severance agreement. We also extended the period of exercisability of his stock options for up to two years from the date of termination of employment. As a result of these modifications, we recognized stock-based compensation expense of approximately $304,000 during the third quarter of fiscal year 2008.

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

Fair Value Measurements

As of November 1, 2008, we adopted SFAS 157, *Fair Value Measurements*. SFAS 157 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 and enhances disclosures about fair value measurements. The adoption of SFAS 157 did not have a material impact on our results of operations, financial position or cash flows. The requirements of SFAS 157 regarding certain non-financial assets and liabilities have been deferred until the first quarter of our fiscal year 2010 in accordance with Financial Accounting Standards Board (FASB) Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. We currently do not expect that the adoption of SFAS 157 as it relates to certain non-financial assets and liabilities will have a material impact on our results of operations, financial position or cash flows.

SFAS 157 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. SFAS 157 describes 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 as of July 31, 2009 (in thousands):

	Fair Value Measurement Using		
	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	$2,054	$—	$2,054
Available-for-sale securities:			
Short-term municipal	—	55,559	55,559
Long-term municipal	—	4,740	4,740
Total assets	$2,054	$60,299	$62,353

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Liabilities			
Interest rate swap	$— ---------	$126 ---------	$126 ---------
Total liabilities	$— ======	$126 ======	$126 ======

As of July 31, 2009, our investment portfolio did not include investments in assets using Level 3 inputs, and we do not intend to purchase such investments in future periods.

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.

The inputs used to value the interest rate swap liability are based on observable market data such as the 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 4: Borrowing Arrangements" for further information.

As of November 1, 2008, we also adopted SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities – including an Amendment of FASB Statement No. 115*, which allows an entity to choose to measure certain financial instruments and liabilities at fair value on a contract-by-contract basis. Subsequent fair value measurement for the financial instruments and liabilities an entity chooses to measure will be recognized in earnings. As of July 31, 2009, we did not elect such option for any of our financial instruments or liabilities.

Overview

We believe top-line defense community funding is slowing relative to the prior five-year period as a result of anticipated decreases in supplemental budgets and impacts from financial market stimulus packages. We also believe that large defense infrastructure and platform programs will have the largest declines in funding. Despite potential declines in overall defense spending, we believe that interest in intelligence, surveillance, and reconnaissance (ISR) by the United States Government will remain strong to respond to the continuing threat of terrorist activities and irregular war campaigns.

As we look ahead, we believe that spending levels in our high-demand niche categories of procurement will remain strong, even if total defense spending declines. We are a full-service provider of ISR products, systems, and services, serving the defense, intelligence, and homeland security markets. We believe these core markets have strong growth potential and that we are well positioned to benefit from defense spending in these areas. Since the beginning of fiscal year 2009, we have strengthened our product development pipeline and debuted three new products: a broadband network analysis product for cyber surveillance, a tactical wireless reconnaissance product capable of addressing 3G communication networks, and a towed synthetic aperture sonar system for port and harbor surveillance.

We continue to focus our operations on delivering strong program performance, meeting staffing requirements, maintaining a competitive cost structure, and expanding 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 through fiscal year 2009.

We have a firm foundation in broadband communications and tactical SIGINT solutions. We believe that we will continue to have solid growth potential in these areas through the remainder of fiscal year 2009. Over the next several years, we anticipate that the Government will recapitalize a significant portion of its existing SIGINT equipment with new technology. As a result, we anticipate continued strong contract activity in our core markets.

We have implemented a new multi-rate structure in fiscal year 2009 that we believe should have several positive effects on our business. This rate structure has reduced the cost of our product offerings. We believe this allows us to compete for product sales in highly competitive markets where price is a significant factor. We believe that this new structure could also allow us to compete more effectively on system integration efforts and to be more competitive in our emerging professional services business. However, there can be no assurances that the United States Government will agree with this new rate structure approach. If the United States Government does not agree, our revenues and operating income could be reduced.

Our diluted earnings per share for the third quarter of fiscal year 2009 was $0.25, compared to $0.15 in the same quarter of fiscal year 2008. Our diluted earnings per share for the first nine months of fiscal year 2009 was $0.83, compared to $0.43 in the same period of fiscal year 2008.

Our product sales have increased operating income by approximately $2.8 million during the first nine months of fiscal year 2009, compared to the same period of fiscal year 2008. This increase also included $0.5 million associated with the one-time change in the method of allocating indirect expenses to fixed-price contracts, recorded during the first quarter of fiscal year 2009. Revenues and operating income from royalty contracts during the first nine months of fiscal year 2009 increased by approximately $1.5 million compared to the first nine months of fiscal year 2008. Stock compensation expense declined by approximately $2.5 million during the first nine months of fiscal year 2009, compared to the first nine months of fiscal year 2008. The decline is primarily due to the modification to our ESPP at the end of fiscal year 2008 and to modifications to the equity awards of our former Chief Executive Officer during the third quarter of fiscal year 2008. Our contract costs related to inventory write-downs have decreased by approximately $0.9 million, compared to the first nine months of fiscal year 2008.

Acquisition of Pyxis. On September 1, 2009, we entered into a Membership Interest Purchase Agreement (the "Purchase Company Agreement") with Pyxis Engineering LLC, a Maryland limited liability company ("Pyxis"), and Eric Bennett as the initial seller ("Bennett"), and each additional member of Pyxis (the "Additional Sellers" and, together with Bennett, the "Sellers"), to acquire all of the outstanding membership interests in Pyxis (the "Acquisition"). The Purchase Agreement and the transactions contemplated therein have been approved by the Board of Directors of the Company, and by Pyxis and all of its members. We completed the acquisition on September 1, 2009 (the "Closing"), at which time Pyxis will became a wholly-owned subsidiary of Applied Signal Technology, Inc.

We believe the Pyxis acquisition will complement AST's existing software and network services business in the defense and intelligence communities. The acquisition allows AST the opportunity to expand its software and network services business into the emerging cyber-security market.

At closing, we paid from our cash and short-term investments on hand $16,250,000, the closing purchase price of $16,250,000. In addition, we paid to Sellers an additional $623,000 as a result of excess working capital delivered by Sellers at Closing over the required minimum $2 million; this adjustment may be further adjusted up (to a maximum of $1 million) or down, upon audit of the estimated closing working capital.

In addition, the Sellers shall be entitled to additional amounts (the "Earn-Out") based upon the performance of the business acquired from Pyxis during the twelve months following the Closing (the "Earn-Out Period"), of up to $3,750,000, payable in stock to Bennett and cash to the other Additional Sellers. The Earn-Out shall be payable to the Sellers if target revenues from contracts entered into by Pyxis before or after the Closing, together with target revenues generated from new contracts entered into by Applied Signal Technology, Inc. from contracts for business that is substantially similar to the Pyxis business, over the Earn-Out Period, are in excess of $13,250,000 (the

"Threshold Target Revenues"). If the Threshold Target Revenues are achieved, the Earn-Out payable to the Sellers shall equal every dollar of target revenues that exceed the Threshold Target Revenues, up to a maximum Earn-Out of $3,750,000, payable if target revenues are $17,000,000 or more.

We expect to retain substantially all of the employees of Pyxis, representing approximately 75 additional employees. Pyxis has been engaged in software engineering, system and database administration, systems engineering, information assurance, and project management services for the Department of Defense and Intelligence Community, including cleared system software development, systems architecture, application performance management, web portal development, data management, and data mining.

Three and Nine Months Ended July 31, 2009, Compared to Three Months and Nine Months Ended August 1, 2008

Revenues and backlog. Revenues for the third quarter of fiscal year 2009 were approximately $49,500,000, a 0.9% decrease from revenues of approximately $49,948,000 recorded in the third quarter of fiscal year 2008. Revenues for the first nine months of fiscal year 2009 were approximately $148,384,000, a 7.6% increase from revenues of approximately $137,957,000 recognized during the same period of fiscal year 2008. Product sales increased by approximately $960,000 during the third quarter of fiscal year 2009 and increased by $9,784,000 during first nine months of fiscal year 2009, compared to the same periods of fiscal year 2008. The increase was primarily due to sales related to our Model 680 Raider product and continued demand for our core broadband communication products. Revenues generated by our development programs decreased by approximately $1,810,000 and $827,000 during the third quarter and first nine months of fiscal year 2009, compared to the same periods in fiscal year 2008 primarily due to the decline in revenues related to our Stone Face II and Specter contracts.

We have one licensing agreement for which we accrue royalties upon 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. We recorded royalty income of approximately $1,655,000 during the third quarter of fiscal year 2009, compared to approximately $1,253,000 during the same period of fiscal year 2008. During the first nine months of fiscal year 2009, our royalty income was approximately $5,234,000, compared to approximately $3,764,000 during the same period of fiscal year 2008. We believe that our fiscal year 2009 royalty income will increase, compared to fiscal year 2008. However, there can be no assurance that our royalty income will continue at the same level.

New orders received during the third quarter of fiscal year 2009 were $51,235,000, representing a 27.1% decrease when compared to new orders of $70,275,000 received during the third quarter of fiscal year 2008. New orders for the first nine months of fiscal year 2009 were $140,810,000, representing a 3.1% decrease when compared to new orders of $145,314,000 for the same period of fiscal year 2008.

Our backlog consists of the uncompleted portions of existing contracts (excluding unexercised contract options). At July 31, 2009, ending backlog was approximately $114,794,000, representing an 8.0% decrease from ending backlog of approximately $124,784,000 at October 31, 2008. Reported backlog includes both funded and unfunded portions of contract values. There is no assurance or obligation that contracts will be fully funded. To the extent that contracts are not fully funded, there will be a reduction to backlog in a future period. During fiscal year 2008, we received a termination for the convenience of the government related to several delivery orders. New orders and backlog are expected to be reduced by approximately $4 million to $5 million when we complete settlement of the terminated efforts related to our Stone Face II contract. During the third quarter, we reduced backlog by approximately $2.6 million as a result of the settlement of a portion of these terminated efforts. We anticipate the remaining balance of approximately $2.0 million will be settled in future periods.

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

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

	Three Months Ended		Nine Months Ended	
	July 31, 2009	August 1, 2008	July 31, 2009	August 1, 2008
Cost-reimbursement contracts	58%	68%	60%	70%
Time-and-materials contracts	24%	18%	21%	19%
Fixed-price contracts	15%	11%	15%	8%
Royalty contracts	3%	3%	4%	3%
	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		Nine Months Ended	
	July 31, 2009	August 1, 2008	July 31, 2009	August 1, 2008
Tiffany	21%	14%	20%	12%
ASA	20%	16%	18%	15%
High Beam	5%	18%	9%	15%
Stone Face II	5%	11%	6%	13%
Specter	—	—	—	6%
	51%	59%	53%	61%

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

The following contracts were indefinite-delivery-indefinite-quantity (IDIQ) contracts: 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 aggregate the DOs under each IDIQ contract for purposes of determining significant revenue concentrations.

ASA is a time-and-materials contract. All of the other contracts referenced in the table above were cost-reimbursement contracts.

Contract costs. Contract costs consist of direct costs incurred in the performance of the contract, including labor, materials, and estimated overhead costs. Contract costs were approximately $35,347,000, or 71.4 % of revenues, for the third quarter of fiscal year 2009 compared to approximately $34,572,000, or 69.2 % of revenues, for the same period of fiscal year 2008. Contract costs were approximately $104,367,000, or 70.3% of revenues, for the first nine months of fiscal year 2009 compared to approximately $95,435,000, or 69.2% of revenues, for the same period of fiscal year 2008.Contract costs increased in absolute dollars and as a percentage of revenues during the third quarter and first nine months of fiscal year 2009, compared to the same periods of fiscal year 2008 primarily due to overall increased activity associated with product sales and to the change in our indirect rate structure for fiscal year 2009. The increase was partially offset by a decline in stock-based compensation expense of approximately $289,000 and $1,310,000 during the third quarter and first nine months of fiscal year 2009 compared to the same periods of fiscal year 2008.

Research and development. Company-directed investment in research and development (R&D) consists of expenditures recoverable from customers through our billing rates and expenditures funded by us from operations. For interim reporting periods, R&D expenses include labor, materials, and estimated overhead costs. R&D expenses were approximately $3,757,000, or 7.6 % of revenues, for the third quarter of fiscal year 2009 compared to approximately $3,953,000, or 7.9% of revenues, for the same period of fiscal year 2008. During the first nine months of fiscal year 2009, R&D expenses were approximately $10,629,000, or 7.2% of revenues, compared to approximately $10,486,000, or 7.6% of revenues, during the first nine months of fiscal year 2008. R&D expenses for 2009 were not significantly different from the first nine months of fiscal year 2008.

General and administrative. General and administrative (G&A) 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 $5,552,000, or 11.2 % of revenues, for the third quarter of fiscal year 2009, compared to approximately $8,205,000, or 16.4% of revenues, for the same period of fiscal year 2008. During the first nine months of fiscal year 2009, G&A expenses were approximately $16,441,000, or 11.1 % of revenues, compared to approximately $23,603,000, or 17.1% of revenues, during the first nine months of 2008. G&A expenses decreased in absolute dollars and as a percentage of revenue during the third quarter and first nine months of fiscal year 2009, primarily due the change in our indirect rate structure for fiscal year 2009. In addition, stock-based compensation declined by approximately $467,000 and $1,107, 000 during the third quarter and first nine months of fiscal year 2009, compared to the same periods of fiscal year 2008.

Interest income and other, net. Net interest income for the third quarter of fiscal year 2009 was approximately $147,000 compared to approximately $285,000 for the third quarter of fiscal year 2008. Interest income recognized during the first nine months of fiscal year 2009 was approximately $565,000 compared to interest income of approximately $950,000 during the first nine months of 2008. Interest income decreased during the third quarter and first nine months of fiscal year 2009 primarily due to lower average yields within our investment portfolio.

Interest expense. Interest expense for the third quarter of fiscal year 2009 was approximately $106,000 compared to approximately $127,000 of interest expense in the third quarter of fiscal year 2008. Interest expense incurred during the first nine months of fiscal year 2009 was approximately $343,000 compared to interest expense of approximately $412,000 during the first nine months of fiscal year 2008. Interest expense decreased during the third quarter and first nine months of fiscal 2009 due to the lower average balance of our term loan.

Provision for income taxes. Our provision for income taxes for the third quarter and first nine months of fiscal year 2009 was approximately $1,555,000 and $6,250,000, respectively, representing an estimated 38.5% annual effective tax rate. Our provision for income taxes for the third quarter and first nine months of fiscal year 2008 was approximately $1,411,000 and $3,503,000, respectively, representing an estimated 45.9% annual effective tax rate. The difference in our estimated annual effective tax rate at July 31, 2009, from our effective tax rate at August 1, 2008, was primarily due to a reduction in non-deductible stock compensation expense from our ESPP related to changes in the plan that make it non-compensatory under SFAS 123R for offering periods beginning in fiscal year 2009, and an increase to estimated R&D credits for fiscal year 2009.

In addition, we reduced our income tax expense by approximately $356,000 during the first nine months of fiscal year 2009, primarily due to the reduction of our liability for unrecognized tax benefits. During the first nine months of fiscal year 2008, we reduced our income tax expense by approximately $616,000, primarily due to the filing of an Application for Change in Accounting Method with the Internal Revenue Service (IRS) under the automatic-consent provisions, during the second quarter of fiscal year 2008. Based upon the change in method filed with the IRS, we re-measured our deferred tax asset balance related to the determination of tax basis depreciation on certain property and equipment assets as of October 31, 2006. This led to a tax benefit of approximately $333,000, which was recorded as a discrete item during the second quarter of fiscal year 2008. During the third quarter of fiscal year 2008, we recorded additional discrete tax benefit items, which led to a net reduction to income tax expense of approximately $176,000. These additional discrete items included a reduction to income tax expense of approximately $303,000, associated with research and development credits; offset by an increase to tax expense of approximately $108,000 associated with a reduction to tax-exempt interest taken on our income tax returns for fiscal year 2007.

Analysis of Liquidity and Capital Resources

Our primary sources of liquidity during the first nine months of fiscal year 2009 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. We have reduced option grants in favor of restricted stock awards and have modified our ESPP. Subsequent to the modification of our ESPP, participation has significantly declined. Cash received from the issuance of common stock under our ESPP in fiscal year 2009 declined by approximately by $1,058,000 as compared to fiscal year 2008.

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 $13,521,000 and $19,695,000 during the first nine months of fiscal years 2009 and 2008, respectively. Net income for the first nine months of fiscal year 2009 was approximately $10,919,000 compared to net income of approximately $5,468,000 for the comparable period of fiscal year 2008.

Accounts receivable balances decreased during the first nine months of fiscal year 2009 by approximately $309,000 and by approximately $2,189,000 during the same period in fiscal year 2008. During the first nine months of fiscal year 2009, we generated revenues of approximately $148,384,000 and collected approximately $148,717,000. During the first nine months of fiscal year 2008, we generated revenues of approximately $137,957,000 and collected approximately $140,146,000.

Inventory, prepaid expenses, and other assets increased during the first nine months of fiscal year 2009 by approximately $619,000 and during the first nine months of fiscal year 2008 by approximately $1,741,000. During the first nine months of fiscal year 2009, inventory balances increased by approximately $1,417,000 due to an increase in our work-in-process inventory of approximately $2,002,000 partially offset by a reduction due to an inventory write-down of approximately $422,000 during the second quarter of fiscal year 2009. Prepaid expenses increased by approximately $1,418,000 and consisted of approximately $578,000 primarily associated with normal renewal activities for insurance and computer repair and maintenance contracts, and an increase of approximately $829,000 to prepaid income taxes.

The increase to inventory and prepaid expenses was partially offset by a decrease to deferred tax assets of approximately $2,023,000. The decrease is primarily associated with adjustments related to our unrecognized tax benefits.

During the first nine months of fiscal year 2008, the increase in inventory included an increase to the indirect rate variance of approximately $2,177,000, an increase to work-in-process inventory of approximately $1,431,000, and a reduction due to an inventory write-down of approximately $1,329,000. Prepaid expenses increased by approximately $1,849,000 during the first nine months of fiscal year 2008 primarily due to an increase in prepaid income taxes of approximately $1,398,000. During the first nine months of fiscal year 2008, precontract costs decreased other current assets by approximately $3,220,000 primarily due to our ability to obtain funding for our ASA and Simple Edge contracts.

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

Accounts payable, taxes payable, accrued payroll liabilities, and other accrued liabilities balances decreased by approximately $2,975,000 during the first nine months of fiscal year 2009 and increased by approximately $3,502,000 during the first nine months of fiscal year 2008. Accounts payable balances decreased by approximately $1,448,000 primarily due to the payments for our subcontract efforts, accrued at the end of fiscal year 2008. Other accrued liabilities declined by approximately $1,613,000 primarily due to reductions to our liabilities for unrecognized tax benefits of approximately $1,468,000.

Accrued payroll liabilities increased by approximately $583,000. This increase consisted of an increase to accrued salaries and payroll taxes of approximately $2,073,000 due to the timing of our bi-weekly payroll and an increase to accrued bonus of approximately $3,169,000 for our fiscal year 2009 bonus plans. The increase to accrued salaries was partially offset by bonus payments of approximately $2,751,000, accrued at the end of fiscal year 2008, and payments for accrued vacation of approximately $1,181,000 due to a change in our vacation policy.

The increase during the first nine months of fiscal year 2008 included a severance accrual for our former Chief Executive officer of approximately $1,135,000. In addition, accounts payable and other accrued liabilities increased by approximately $1,998,000 during the first nine months of fiscal year 2008.

Net cash from investing activities. Investing activities used cash of approximately $9,944,000 during the first nine months of fiscal year 2009. During the same period of fiscal year 2008, investing activities used cash of approximately $15,701,000. During the first nine months of fiscal year 2009, we purchased approximately $52,112,000 of investment securities and approximately $45,725,000 matured. During the same period of fiscal year 2008, we purchased approximately $80,236,000 of investment securities and approximately $67,565,000 matured.

Net cash from financing activities. Financing activities used cash of approximately $2,352,000 during the first nine months of fiscal year 2009 and used cash of approximately $2,643,000 during the same period in fiscal year 2008. The difference in financing activities between the first nine months of fiscal years 2009 and 2008 is primarily due to increased tax benefits from stock option exercises during the first nine months of fiscal year 2009.

Cash is generated primarily from operating activities, employee stock activities, and investing activities. At July 31, 2009, we held in our investment portfolio approximately $60,299,000 of short-term and long-term municipal securities. Substantially all of our investments in the municipal securities are with AA/AAA/SP-1/ (Standard & Poor’s), Aa/Aaa/MIG-1 (Moody’s), and AA/AAA /F-1 (Fitch) rated issuers.

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

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

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

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

Borrowing Arrangements

Revolving line of credit. At July 31, 2009, we had a revolving line of credit (Line of Credit) under which Wells Fargo Bank (Wells Fargo), could advance funds to us, up to a maximum principal amount of $3 million. The Line of Credit will expire on March 1, 2010.

At July 31, 2009, 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 July 31, 2009. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at July 31, 2009. The third letter of credit, a requirement of one of our customers, had a committed balance of $36,000.We do not pay interest on the amount associated with the standby letters of credit.

As a result of the committed but unused funds associated with the three letters of credit, the total amount under the Line of Credit available for borrowing was approximately $1,593,000. No fees or interest were associated with this unused portion. Borrowings under the Line of Credit bear interest at Wells Fargo's reference rate (3.25% at July 31, 2009), and interest on those borrowings are payable monthly. As security for our indebtedness under the Line of Credit, we have granted to Wells Fargo a security interest in our cash and marketable securities maintained with an affiliate of Wells Fargo.

Term loan and interest rate swap. Effective July 1, 2005, and in connection with the acquisition of DTI, we entered into a Term Loan with Wells Fargo, in the principal amount of $10 million, plus interest, the proceeds of which were used for acquisition financing (the Term Loan). The Term Loan bears interest at a fixed rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) (0.28% at July 31, 2009). The 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.

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 July 31, 2009, we were in compliance with these covenants.

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

The effective portion of the cash flow hedge is reported as other comprehensive income and reclassified into earnings in the same period during which the hedged transaction affects earnings. At July 31, 2009, the effective portion of the cash flow hedge was a deferred loss of approximately $205,000 on a gross basis. The deferred net loss net of taxes was approximately $126,000, and was included in other comprehensive income and long-term liabilities on our balance sheet. During the three months and nine months ended July 31, 2009, we recognized losses related to the hedge of $10,000 and $186,000, respectively, in other comprehensive income. During the same periods of fiscal year 2009, we recognized in interest expense approximately $46,000 and $126,000, respectively, reclassified from other comprehensive income. Over the next twelve months, we expect to reclassify approximately $140,000 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 July 31, 2009.

Contractual Obligations

The following table sets forth our contractual obligations as of July 31, 2009 (in thousands).

		Payments due by period			
Fiscal Year	**Total**	**Less than 1 year**	**1–3 years**	**3–5 years**	**More than 5 years**
Operating lease obligations	$32,291	$7,600	$13,120	$7,035	$4,536
Loan obligations – principal	4,286	1,429	2,857	—	—
Loan obligations – interest	384	215	169	—	—
Purchase obligations	5,599	5,599	—	—	—
Total	$42,560	$14,843	$16,146	$7,035	$4,536

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2009 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses.

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 December 2007, the FASB issued SFAS 141R, *Business Combinations*. SFAS 141R replaces SFAS 141. The statement retains the purchase method of accounting for acquisitions, but requires a number of changes, including changes in the way assets and liabilities are recognized in the purchase accounting. It changes the recognition of assets acquired and liabilities assumed arising from contingencies, requires the capitalization of in-process research and development at fair value, and requires the expensing of acquisition-related costs as incurred. In April 2009, the FASB issued FSP FAS 141R-1, *Accounting for Assets Acquired and Liabilities Assumed in a Business Combination That Arise from Contingencies*, which amends and clarifies the accounting for assets and liabilities arising from contingencies in business combinations under SFAS 141R. The revised statement and the FSP will apply prospectively to business combinations occurring in our fiscal year beginning November 1, 2009. The effects on future periods will depend on the nature and significance of business combinations subject to the new rules.

In March 2008, the FASB issued SFAS 161*, Disclosures about Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133*. SFAS 161 requires enhanced disclosures about derivatives on a quarterly basis, including qualitative disclosures about objectives and strategies for using derivatives, and quantitative disclosures about the fair value of derivatives, as well as gains and losses on derivative instruments. It also requires disclosures about the volume of derivative activity and credit-risk-related contingent features in derivative agreements. We adopted SFAS 161 in the second quarter of fiscal year 2009. The adoption did not affect our financial position, results of operations or cash flows due to the disclosure-only nature of the statement.

In June 2008, the FASB issued FSP EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*. This FSP affects the calculation of Basic EPS when a company has unvested share-based payment awards with non-forfeitable rights to dividends. The two-class method of calculation would be required, which means that dividends and undistributed earnings must be allocated between common shares and the unvested awards in calculating Basic EPS. The FSP will be effective for our fiscal year beginning November 1, 2009. We are evaluating the impact adopting FSP EITF 03-6-1 will have on our financial statements.

In April 2009, the FASB issued FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*. The FSP establishes a new method of recognizing and reporting other-than-temporary impairments of debt securities and requires additional disclosures. We adopted this FSP in the third quarter of fiscal year 2009. The adoption did not affect our financial position, results of operations, or cash flows.

In May 2009, the FASB issued SFAS 165, *Subsequent Events*. This standard sets forth: 1) the period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, 2) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and 3) the disclosures that an entity should make about events or transactions that occurred after the balance sheet date. We began applying the provisions of SFAS 165 in the third quarter of 2009 and its adoption did not affect our financial statements, other than the disclosures required by SFAS No. 165, which can be found in Note 1 under "Description of Business and Basis of Presentation."

In June 2009, the FASB issued SFAS 168, *The FASB Accounting Standards Codification TM and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162* (the Codification). The Codification, which was launched on July 1, 2009, became the single source of authoritative nongovernmental U.S. GAAP, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Force (EITF) and related literature. The Codification eliminates the GAAP hierarchy contained in SFAS 162 and establishes one level of authoritative GAAP. All other literature is considered non-authoritative. The Codification is effective for financial statements for interim or annual reporting periods ending after September 15, 2009. We will adopt this Statement for our fourth quarter and fiscal year ending October 31, 2009. The adoption of this statement will have no impact 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 United States interest rates. At July 31, 2009, our short-term and long-term securities consisted of municipal securities. Substantially all of our investments in the municipal securities are with AA/AAA/SP-1/ (Standard & Poor's), Aa/Aaa/MIG-1 (Moody's), and AA/AAA /F-1 (Fitch) rated issuers.

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

The average days to maturity of our investment portfolio is 99 days as of July 31, 2009. Due to the short-term nature of these cash investments and the ability to liquidate our investment portfolio, we do not believe that there is a material interest rate risk associated with the current credit environment.

As of July 31, 2009, our total cash and investments balance that was sensitive to interest rate risk was approximately $ 62,353,000. As a measurement of the sensitivity of our portfolio, if yields were to fluctuate by 100 basis points, the total effect to the investment portfolio balance would be approximately $165,000.

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

	July 31, 2009	October 31, 2008
Cash equivalents:		
Money market funds	$2,054	$2,068
Available-for-sale securities:		
Short-term municipal	55,559	45,045
Long-term municipal	4,740 ---------	9,381 ---------
	$62,353 ======	$56,494 ======

Term loan and interest rate swap. Effective July 1, 2005, and in connection with the acquisition of DTI, we entered into a Term Loan agreement in the principal amount of $10 million with Wells Fargo Bank, the proceeds of which were used for acquisition financing. The Term Loan bears interest at an annual rate of 1.75% above LIBOR (0.28% at July 31, 2009).

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

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

Item 4: Controls and Procedures

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

Changes in internal control over financial reporting. T here have been no changes in our internal control over financial reporting during the quarter-ended July 31, 2009, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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

Part II. Other Information

Item 1: Legal Proceedings

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

On March 11, and July 19, 2005, purported securities class action complaints were filed in the United States District Court, Northern District of California. The cases were considered as *In re Applied Signal Technology Inc. Securities Litigation*, Master File No. 4:05-cv-1027 (SBA). The amended consolidated complaint is brought on behalf of a putative class of persons who purchased our Company's securities during a class period of August 24, 2004, through February 22, 2005. The complaints name us, our former Chief Executive Officer, and our Chief Financial Officer as defendants, and allege that false and misleading statements regarding us were issued during the class period. The parties have agreed to a settlement, which will be paid by our insurers. On August 3, 2009, the District Court gave final approval to a settlement of this case. A purported appeal of a ruling denying a motion to intervene has been filed.

On August 12, 2008, a purported shareholder derivative action was filed in the Superior Court, State of California. *Shoemaker v. Devine et al.*, No. 1:08-CV-119810. It is brought on purported behalf of the Company, against current and former members of the Board of Directors, our Chief Financial Officer, and our former Chief Executive Officer, asserting that these individuals breached their fiduciary duties, based on essentially the same allegations as the class action case. No damages are specified. As the case is brought on purported behalf of the Company, there is no possible loss that might be incurred as a result of this proceeding.

On May 18, 2009, we filed a complaint for patent infringement in the United States District Court for the Northern District of California, Case Number 3:09-cv-2180-SBA, against Emerging Market Communications, Paradise Datacom LLC, and Viasat, Inc. On June 12, 2009, we filed an amended complaint adding EMC Satcom Technologies, Inc. as a defendant. All of the defendants have been served with the complaint, and none of the defendants has yet filed an answer. The Court has set an initial case management conference for November 19, 2009. If we are unable to come to a resolution of the patent infringement claims with the defendants, we expect to vigorously pursue our claims against the defendants.

Item 1A: Risk Factors

Our future performance is subject to a variety of risks. In addition to the other information set forth in this report, including the information included in the discussion in Part I, Item 2, above, under "Management's Discussion and

Analysis of Financial Condition and Results of Operations," you should carefully consider the risk factors discussed in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended October 31, 2008, as well as the additional risk factors described below, which could materially affect our business, financial condition, or future results. There were no other material changes from the risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended October 31, 2008, filed on January 12, 2009.

Risk Factors relating to the acquisition of Pyxis

We may be unable to successfully integrate the businesses of Pyxis with our existing businesses. As a result of the acquisition of Pyxis Engineering LLC on September 1, 2009, we will have to integrate the Pyxis operations into our combined operations. The integration will require significant efforts, including the coordination of future development and sales and marketing efforts. We may find it difficult to integrate these operations. Former customers of Pyxis may decline to do business with us. The challenges involved in the integration of the acquisition include, but are not limited to, the following:

- Retaining Pyxis customers and strategic partners and enhancing the relationship of the combined company with current and future Pyxis customers and strategic partners
- Integrating and retaining the key employees acquired from Pyxis, as well as retaining key employees of ours performing similar services to those offered by Pyxis prior to the acquisition
- Coordinating development activities to enhance the services offered by Pyxis and us, and to expand our software engineering, system and database administration, systems engineering, information assurance, and project management services for the Department of Defense and Intelligence Community
- Expanding the services offered by the combined company following the acquisition relating to cleared system software development, systems architecture, application performance management, web portal development, data management, and data mining, especially in light of rapidly evolving markets for those products and technologies
- Effectively managing the diversion of management's attention from business matters to integration issues
- Combining development, sales, and marketing activities effectively and quickly
- Combining our business culture with the business culture previously operated by Pyxis
- Enhancing the internal controls of the operations acquired in the acquisition

The merger may fail to achieve the anticipated benefits. We have completed the acquisition with the expectation that the acquisition of Pyxis will result in benefits to us, including expansion of our services business, entry into new markets and access to new customers and expansion of relationships with existing customers, resulting in an increase in our revenues. Achieving these anticipated synergies and the potential benefits underlying our reasons for completing the acquisition will depend in part on the success of integrating the acquisition into our business. It is not certain that any of the anticipated benefits will be realized. Risks from an unsuccessful integration of the purchase include:

- The potential disruption of our existing business and the distraction of our management
- The risk that we are unable to expand our software engineering, system and database administration, systems engineering, information assurance, and project management services for the Department of Defense and Intelligence Community; enhance and expand our relationships with customers in this industry; and add additional services to the solutions we offer to our customers
- The risk that we are unable to retain key employees of Pyxis, causing disruption to our ability to continue to offer the services offered by Pyxis to its customers, generate revenues, and expand this business
- The risk that the costs and expenditures for retaining personnel, enhancing the internal controls and infrastructure required to integrate the Pyxis business with our operations, and integrating the businesses are greater than anticipated.

Even if we are able to integrate the acquisition with our operations, there can be no assurance that the anticipated benefits will be achieved. The failure to achieve such benefits could adversely affect our business, results of operations, and financial condition.

We must retain and motivate key employees, and failure to do so could seriously harm our financial results and operations. We expect to retain substantially all of the Pyxis employees in connection with the acquisition; however, these personnel may decline to join our company, and even if they join, we may be unable to retain key employees following the acquisition. To be successful, we must also retain and motivate existing executives and other key employees. Our employees and former employees of Pyxis may experience uncertainty about their future role with us until or after strategies with regard to the acquisition have been executed. This potential uncertainty may adversely affect our ability to attract and retain key personnel. As the business acquired from Pyxis is entirely dependent on the continued retention of employees able to perform the services offered by Pyxis, any failure to retain key employees will cause us to fail to achieve the revenues expected from the acquisition, and to achieve the benefits of the acquisition.

We expect to incur significant costs associated with the acquisition. Pyxis is a small company, operating without a large infrastructure or robust internal controls. We will need to integrate the Pyxis operations with our own operations, and ensure the development of appropriate controls and procedures commensurate with the controls and procedures that we operate all of our other operations. We expect that we will incur direct transaction costs associated with the acquisition, including direct costs of the acquisition as well as liabilities to be accrued in connection with the acquisition. In addition, we may incur charges to operations, which are not currently reasonably estimable, in the quarter in which the acquisition is completed or the following quarters, to reflect costs associated with integrating the acquisition. There is no assurance that we will not incur additional material charges in subsequent quarters to reflect additional costs associated with the acquisition. If the benefits of the acquisition do not exceed the costs of the acquisition, our financial results may be adversely affected.

We expect to incur significant amounts of goodwill associated with the acquisition of Pyxis. We will account for the acquisition of Pyxis by using the purchase method of accounting. A portion of the purchase price for this business will be allocated to identifiable tangible and intangible assets and assumed liabilities based on estimated fair values at the date of consummation of the acquisition. Any excess purchase price, which is likely to constitute a significant portion of the purchase price, will be allocated to goodwill. In accordance with the Financial Accounting Standards Board's Statement No. 142, Goodwill and Other Intangible Assets, goodwill and certain other intangible assets with indefinite useful lives are not amortized but are reviewed at least annually for impairment, or more frequently if there are indications of impairment. All other intangible assets are subject to periodic amortization. We evaluate the remaining useful lives of other intangibles each quarter to determine whether events and circumstances warrant a revision to the remaining period of amortization. When the combined company performs future impairment tests, it is possible that the carrying value of goodwill or other intangible assets could exceed their implied fair value and therefore would require adjustment. Such adjustment would result in a charge to operating income in that period. Once adjusted, there can be no assurance that there will not be further adjustments for impairment in future periods.

The acquisition of Pyxis results in a new lines of business for us that could be difficult to integrate, disrupt our business, dilute stockholder value, or harm our results of operations. Although we offer some services to customers similar to those offered by Pyxis, the acquisition substantially enhances our presence in this line of business. We may acquire or make additional investments in complementary businesses, technologies, services, or products and enter into new lines of business if appropriate opportunities arise. The process of integrating any acquired business, technology, service, or product into our business and operations or entry into a new line of business in which we are inexperienced may result in unforeseen operating difficulties and expenditures. Integration of an acquired company also may consume much of our management’s time and attention that would otherwise be available for ongoing development of our business. In developing and marketing the new line of business acquired from Pyxis, we will invest significant time and resources. External factors, such as competitive alternatives, and shifting customer preferences, may also impact the successful implementation of this new line of business. Therefore, we may be unable to take full advantage of business opportunities for the software engineering, system and database administration, systems engineering, information assurance, and project management services for the Department of Defense and Intelligence Community, and we may encounter difficulties in meeting our expectations or the expectations of investors for the operating results of this business. Failure to successfully manage these risks in the development and implementation of new lines of business could have a material, adverse effect on the Company's business, financial condition, and results of operations.

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. /s/ James E. Doyle --	September 8, 2009 ----------------------
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	Third Amended and Restated Articles of Incorporation

3.2	Amended and Restated Bylaws
4.1	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