# FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **1999-09-10** | Period of Report: **1999-07-31**
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## FILER

**APPLIED SIGNAL TECHNOLOGY INC**

CIK:**741696**| IRS No.: **770015491** | State of Incorp.:**CA** | Fiscal Year End: **1031**
Type: **10-Q** | Act: **34** | File No.: **000-21236** | Film No.: **99709933**
SIC: **3663** Radio & tv broadcasting & communications equipment

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UNITED STATES
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, 1999

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

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Indicate by a check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days YES [X] NO [ ]

Applicable Only to Corporate Issuers

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

Common Stock, no par value, 8,454,139 shares outstanding as of September 8, 1999.

Part 1. Financial Information
Item 1. Financial Statements

APPLIED SIGNAL TECHNOLOGY, INC.
BALANCE SHEETS
(In thousands, except share data)

<TABLE>
<CAPTION>

| <S> | July 30, 1999 (Unaudited) <C> | October 31 1998 (Note) <C> |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $16,655 | $14,085 |
| Short-term investments | -- | 1,029 |
| Accounts receivable: | | |
| Billed | 13,636 | 14,298 |
| Unbilled | 16,860 | 16,282 |
| Total accounts receivable | 30,496 | 30,580 |
| Inventory | 9,682 | 5,551 |
| Prepaid and other current assets | 3,004 | 3,035 |
| Total current assets | 59,837 | 54,280 |
| Property and equipment, at cost: | | |
| Machinery and equipment | 36,506 | 31,654 |
| Furniture and fixtures | 4,356 | 4,011 |
| Leasehold improvements | 6,921 | 5,813 |
| Construction in process | 570 | 1,438 |
| | 48,353 | 42,916 |
| Accumulated depreciation and amortization | (28,329) | (24,775) |
| Net property and equipment | 20,024 | 18,141 |
| Other assets | 21 | 42 |
| Total assets | $79,882 | $72,463 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $3,359 | $3,842 |
| Accrued payroll and related benefits | 7,113 | 6,331 |
| Other accrued liabilities | 2,908 | 2,092 |
| Income taxes payable | 3,803 | 2,300 |
| Total current liabilities | 17,183 | 14,565 |
| Deferred income taxes | 1,033 | 1,033 |
| Shareholders' equity: | | |
| Preferred stock, no par value: 2,000,000 shares authorized; none issued and outstanding | -- | -- |
| Common stock, no par value: 20,000,000 shares authorized; issued and outstanding -- 8,484,429 shares at July 30, 1999 and 8,393,526 shares at October 31, 1998 | 18,323 | 19,154 |
| Retained earnings | 43,343 | 37,711 |
| Total shareholders' equity | 61,666 | 56,865 |

| | | |
|---|---|---|
| Total liabilities and shareholders' equity | $79,882 | $72,463 |

</TABLE>

Note: The balance sheet at October 31, 1998 has been derived from the audited balance sheet at that date but does not include all of the information required by generally accepted accounting principles for complete financial statements.

See notes to financial statements.

APPLIED SIGNAL TECHNOLOGY, INC.
STATEMENTS OF OPERATIONS
(UNAUDITED)
(In thousands, except per share data)

<TABLE>
<CAPTION>

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | July 30, 1999 | July 31, 1998 | July 30, 1999 | July 31, 1998 |
| <S> | <C> | <C> | | |
| Revenues from contracts | $27,555 | $27,373 | $77,993 | $79,466 |
| Operating expenses: | | | | |
| Contract costs | 17,410 | 16,695 | 48,538 | 49,117 |
| Research and development | 2,554 | 3,050 | 8,759 | 8,301 |
| General and administrative | 4,535 | 3,296 | 11,183 | 10,190 |
| Total operating expenses | 24,499 | 23,041 | 68,480 | 67,608 |
| Operating income | 3,056 | 4,332 | 9,513 | 11,858 |
| Interest income(expense), net | 152 | 140 | 477 | 432 |
| Income before provision for income taxes | 3,208 | 4,472 | 9,990 | 12,290 |
| Provision for income taxes | 1,219 | 1,621 | 3,796 | 4,670 |
| Net income | $1,989 | $2,851 | $6,194 | $7,620 |
| Net income per common share: | | | | |
| Basic | $0.24 | $0.34 | $0.74 | $0.90 |
| Diluted | $0.23 | $0.32 | $0.71 | $0.86 |
| Number of shares used in calculating net income per common share: | | | | |
| Basic | 8,446 | 8,429 | 8,424 | 8,495 |
| Diluted | 8,707 | 8,776 | 8,689 | 8,909 |

</TABLE>

See notes to financial statements.

APPLIED SIGNAL TECHNOLOGY, INC.
STATEMENTS OF CASH FLOW
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS
(UNAUDITED)
(In thousands)

<TABLE>
<CAPTION>

| | NINE MONTHS ENDED | |
|---|---|---|
| | July 30, 1999 | July 31, 1998 |
| <S> | <C> | <C> |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | $6,194 | $7,620 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 3,554 | 3,107 |
| Changes in: | | |
| Accounts receivable | 84 | 2,201 |
| Inventory, prepaids and other current assets | (4,079) | (2,396) |
| Accounts payable, income taxes payable and accrued | 2,085 | (640) |
| Net cash provided by operating activities | 7,838 | 9,892 |
| INVESTING ACTIVITIES: | | |
| Purchase of available-for-sale securities | -- | (5,000) |
| Maturity of available-for-sale securities | 1,000 | 4,300 |
| Additions to property and equipment | (5,437) | (5,099) |
| Net cash used in investing activities | (4,437) | (5,799) |
| FINANCING ACTIVITIES: | | |
| Issuances of common stock | 2,380 | 2,707 |
| Repurchases of common stock | (3,211) | (5,971) |
| Net cash provided by (used in) financing activities | (831) | (3,264) |
| Net increase in cash and cash equivalents | 2,570 | 829 |
| Cash and cash equivalents, beginning of period | 14,085 | 7,403 |
| Cash and cash equivalents, end of period | $16,655 | $8,232 |
| Supplemental disclosures of cash flow information: | | |
| Interest paid | $17 | $23 |
| Taxes paid | $2,293 | $2,084 |

</TABLE>

See notes to financial statements.

APPLIED SIGNAL TECHNOLOGY, INC.

NOTES TO FINANCIAL STATEMENTS
(UNAUDITED)
July 30, 1999

NOTE 1 -- SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION

The accompanying unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of the management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the nine-month period ending July 30, 1999 are not necessarily indicative of the results that may be expected for the year ending October 31, 1999. For further information, refer to the financial statements and footnotes thereto included in the Company's annual report on Form 10-K for the year ended October 31, 1998.

INVESTMENTS

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

REVENUES FROM CONTRACTS

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

PER SHARE DATA

Basic earnings per share is based on the weighted effect of all common shares issued and outstanding, and is calculated by dividing net income available to common shareholders by the weighted average shares outstanding during the period. Diluted earnings per share is calculated by dividing net income available to common shareholders, adjusted for the effect, if any, from assumed conversion of all potentially dilutive common shares outstanding, 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 common shares outstanding. All historical earnings per share amounts have been restated to conform to the provisions of this statement.

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

<TABLE>
<CAPTION>

| | Three Months Ended | | Nine Months Ended | |
|---|---|---|---|---|
| | July 30, 1999 | July 31, 1998 | July 30, 1999 | July 31, 1998 |
| <S> | <C> | <C> | <C> | <C> |
| Net income | $2,851 | $2,851 | $6,194 | $7,620 |
| Shares used to compute net income per common share - basic | 8,446 | 8,429 | 8,424 | 8,495 |
| Effect of dilutive stock options | 261 | 347 | 265 | 414 |
| Shares used to compute net income per common share - diluted | 8,707 | 8,776 | 8,689 | 8,909 |
| Net income per common share - basic | $0.24 | $0.34 | $0.74 | $0.90 |
| Net income per common share - diluted | $0.23 | $0.32 | $0.71 | $0.86 |

</TABLE>

RECLASSIFICATIONS

Certain prior year amounts have been reclassified to the current year presentation.

NOTE 2 -- INVENTORY

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

<TABLE>
<CAPTION>

| | JULY 30, 1999 | OCTOBER 31, 1998 |
|---|---|---|
| <S> | <C> | <C> |
| Raw Materials | $1,327 | $1,102 |
| Work in Process | 7,960 | 4,114 |
| Finished Goods | 392 | 245 |
| | 9,679 | 5,461 |
| Precontract Costs | 3 | 90 |
| | $9,682 | $5,551 |

</TABLE>

The Company records contract revenues and costs for interim reporting purposes based on annual targeted indirect rates. At year end, the revenues and costs are adjusted for actual indirect rates. During the interim reporting periods variances may accumulate between the actual indirect rates and the annual targeted rates. All timing-related indirect spending variances are inventoried as part of work in process during these interim reporting periods. These rates are reviewed regularly and any permanent variances are reflected in the statement of operations as they become known. At July 30, 1999, the unfavorable inventoried variance was approximately $1,932,000 while at July 31, 1998 the unfavorable inventoried variance was $337,000; each variance was included in work in process. At October 31, 1998 the variance was zero since all revenues and costs were recorded at the actual indirect rates for each fiscal year end.

## ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following information should be read in conjunction with the attached financial statements and notes thereto.

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

### BACKGROUND:

Applied Signal Technology, Inc. (Applied Signal Technology or the Company) designs, develops, and manufactures signal processing equipment to collect and process a wide range of telecommunication signals. This equipment is used for reconnaissance of foreign telecommunications predominantly by the United States Government and allied foreign governments, for certain industrial applications and for defense communications systems. Signal reconnaissance systems are composed of collection equipment and processing equipment. Collection equipment consists of sophisticated receivers that scan the radio frequency (RF) spectrum (cellular telephone, microwave, ship-to-shore, and military transmissions) to collect certain signals from, potentially, thousands of signals within the RF spectrum. Signal processing equipment, using sophisticated software and hardware, evaluates the characteristics of the collected signals and selects signals that are likely to contain relevant information. Industrial applications include commercial communication system quality monitoring and data network intrusion detection. Defense communication equipment provides reliable, high-speed data transfer for military applications. Since inception, the Company has focused its efforts primarily on processing equipment, but also provides specialized collection equipment, as well as complete systems.

### Signal Reconnaissance

In recent years, accurate and comprehensive information regarding foreign affairs and developments has become increasingly important to the United States Government. The reduction of United States military tactical forces overseas, coupled with political instability in certain regions such as the Middle East, Eastern Europe, Africa and Central and South

America, has heightened the United States Government's need to be able to monitor overseas activities. In order to obtain information about activities within foreign countries, the United States Government gathers and analyzes telecommunication signals emanating from those countries.

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

Budgetary constraints and critical time-to-deployment requirements have caused many United States Government agencies to search for more flexible and cost-effective signal reconnaissance solutions that can be deployed promptly. The Company's signal reconnaissance products can be used, with or without further modification, to satisfy requirements of a variety of customers. The Company believes its products can be readily deployed in a wide variety of circumstances to meet current United States Government signal reconnaissance requirements. The Company designs its products to use advanced circuitry and highly integrated components, including Company-designed application-specific integrated circuits (ASICs). This enables the Company to offer products that are smaller, consume less power, and cost customers less when multiple units are built than equipment of similar functionality that use fewer advanced designs and materials.

Industrial Applications

The volume of data transferred and made available to individuals is growing exponentially worldwide. This trend dictates maximum efficiency of frequency spectrum usage by the commercial telecommunication companies. Spectrum usage is especially critical in the band-limited radio frequency (RF) environment that personal communication systems (e.g., cellular systems) and communication satellite systems (e.g., PanAmSat, Intelsat, InMarSat) utilize. As these systems attempt to maximize this spectrum usage, data transfer will be impaired. This creates demand for sophisticated data quality monitoring.

The Company believes that its signal processing prowess in non-intrusive signal reconnaissance, developed over the years, positions the Company to capitalize on this quality monitoring requirement. In addition, as the Company continues to stay abreast of the United States Government's future signal reconnaissance needs, it should stay abreast of trends in telecommunication technology. The Company believes its knowledge and experience will permit the Company to develop quality monitoring equipment.

As the world becomes more reliant upon data transfer and data access for its day-to-day activities (i.e., e-commerce), it also becomes more vulnerable to unauthorized data access or manipulation. This creates a requirement for data system intrusion detection. This intrusion detection must be performed without impact upon the data transfer.
The Company believes that the technological expertise it has developed for signal reconnaissance, positions the Company to develop and commercialize intrusion detection technology. In particular, the Company's signal processing prowess provides the fundamentals for the development of intrusion detection equipment.

Defense Communications

Just as the civilian world is becoming increasingly dependent upon data transfer and access, so is the military. The military branches utilize data transfer for guidance, computer-to-computer battlefield planning, high quality communications, and other applications. Many times this data transfer must occur under non-ideal transport modes. The transport invariably is in the radio frequency spectrum and must occur under sub-optimum conditions such as minimal frequency planning for interference mitigation, inaccurate antenna pointing, and moving platforms. These defense communication systems must be able to mitigate these data transfer anomalies in an automated or semi-automated manner in order to provide reliable, rapidly deployed communications.

The Company believes that the technological expertise it has developed for signal reconnaissance systems to adequately process data collected in non-ideal situations positions the Company to develop products satisfying these defense communication system requirements. In particular, the Company's experience in adaptive equalization/demodulation of sophisticated data telecommunication signals enable the Company to develop equipment that overcomes these data transport anomalies.

Strategy

Applied Signal Technology's objective is to anticipate the needs of the telecommunication processing marketplace and to invest in research and development in an effort to provide solutions before the Company's competitors. In some cases, this involves the development of equipment to address new telecommunications technologies. In other cases, it involves the development of equipment that offers smaller size, lower power consumption, and lower cost than potentially competitive products. The Company's strategy is to aggressively pursue these objectives in each of the market areas described above.

THREE MONTHS AND NINE MONTHS ENDED JULY 30, 1999 COMPARED TO THREE MONTHS AND NINE MONTHS ENDED JULY 31, 1998

RESULTS OF OPERATIONS:

REVENUES AND BACKLOG: Revenues for the third quarter of fiscal year 1999 were approximately $27,555,000, relatively unchanged from the third quarter of fiscal year 1998 revenues of approximately $27,373,000. Revenues for the nine months ended July 30, 1999 were approximately $77,993,000, down 2% of revenues from approximately $79,466,000 for the first nine months of fiscal 1998. While third quarter revenue is materially unchanged between the periods, the decrease in year-to-date revenues is attributable to a decrease in firm-fixed price contracts in Operations and is partially offset by an increase in engineering contract revenues.

New order levels for the third quarter of fiscal 1999 were approximately $32,305,000, up 29% from order levels of approximately $25,079,000 reported for the third quarter of fiscal 1998. New orders for the first nine months of fiscal 1999 were approximately $84,722,000, an increase of approximately 65% compared to new order levels of approximately $51,430,000 reported for the same period of fiscal 1998. Increases in new orders for the third quarter continue to be strong in both the strategic and the tactical signal reconnaissance markets. The increase in year-to-date new order levels is due in part to booking orders that the Company believes were delayed in the prior year, and, in part due to a higher volume of orders for off-the-shelf products when compared to the first nine months of the prior fiscal year.

The Company's backlog, which consists of anticipated revenues from new contracts and from the uncompleted portions of existing contracts (excluding unexercised options) was approximately $56,109,000 at July 30, 1999, an increase of 2% when compared to $55,106,000 at July 31, 1998. The increase in year to year backlog is primarily due to the higher ordering levels in the current fiscal year as compared to the ordering levels in fiscal 1998.

CONTRACT COSTS: Contract costs consist of direct costs on contracts, including labor, materials and manufacturing overhead costs. Contract costs for the third quarter of fiscal 1999 were approximately $17,410,000 or 63.2% of revenues; contract costs for the same period of fiscal 1998 were approximately $16,695,000 or 61.0% of revenues. The increase in contract costs for the current quarter is due to an increase in engineering development contracts which have lower margins compared to the volume of operation production contracts in the third quarter of fiscal year 1998. Year-to-date contract costs were approximately $48,538,000 or 62.2% of revenues for fiscal 1999 as compared to approximately $49,117,000 or 61.8% for the first nine months of fiscal 1998. Year-to-date contract costs as a percentage of revenue for both fiscal years 1999 and 1998 are consistent with the Company's business model.

RESEARCH AND DEVELOPMENT (R&D): Company-directed investment in research and development consists of expenditures recoverable from customers through the Company's billing rates and expenditures funded by the Company from earnings. It is the Company's accounting practice to record R&D expenses based on annual targeted indirect rates. Research and development expenses were approximately $2,554,000 or 9.3% of revenues and approximately $3,050,000 or 11.1% of revenues for the third quarter of fiscal years 1999 and 1998, respectively. For the first nine months of fiscal years 1999 and 1998 research and development were approximately $8,759,000 or 11.2% of revenues and approximately $8,301,000 or 10.4% of revenues, respectively. R&D as a percentage of revenues for the third quarter and year-to-date are currently in line with the Company's business model and reflect the Company's strategy of funding future products in an effort to meet customers' needs before its competitors.

GENERAL AND ADMINISTRATIVE: General and administrative expenses include administrative salaries, related costs for the Company's marketing and proposal activities and other administrative costs. It is the Company's accounting practice to record general and administrative expenses based on annual targeted indirect rates. General and administrative expenses were approximately $4,535,000 or 16.5% of revenues for the third quarter of fiscal 1999 and were 37.6% higher when compared to approximately $3,296,000 or 12.0% of revenues for the same period of fiscal 1998. General and administrative expenses were approximately $11,183,000 or 14.3% of revenues for the nine months ended July 30, 1999 and were higher than the approximately $10,190,000 or 12.8% of revenues in general and administrative expenses for the same period ended July 31, 1998. Before applying the target G&A rate, general and administrative spending levels were comparable for the quarter and for the first nine months of fiscal 1999 when compared to the same periods of fiscal 1998. However, the applied target G&A rate for fiscal year 1999 is 3.6% greater than the rate used in fiscal year 1998, and, resulted in reporting higher G&A expenses.

Consistent with government contracting requirements, the Company considers both general and administrative expenses and research and development expenses part of its general and administrative indirect expense pool. Combined R&D and general and administrative expenses of approximately $19,942,000 were 25.6% of revenues for the first nine months of fiscal 1999 compared to approximately $18,491,000 or 23.3% of revenues for the same period of fiscal 1998.

INTEREST INCOME/(EXPENSE), NET: Net interest income in the three and nine month periods of fiscal year 1999 was relatively consistent with the same periods in fiscal year 1998. The increase in net interest income in both 1999 periods is primarily due to the higher average cash balances on hand.

PROVISION FOR INCOME TAXES: The provision for income taxes as a percentage of income before income taxes was 38% and 36% for the third quarter of fiscal years 1999 and 1998, respectively. The effective tax rate was 38% for the nine months ended July 31, 1999 and July 30, 1998. The lower tax rate for the third quarter of fiscal year 1998 was the result of a year-to-date adjustment made during the quarter to reflect a cumulative 38% effective tax rate projected for fiscal year 1998.

ANALYSIS OF LIQUIDITY AND CAPITAL RESOURCES:

At July 30, 1999 cash and short-term investments totaled approximately $16,655,000. Historically, the Company's primary source of liquidity has been the cash flow generated from operations as well as the issuances of common stock through its employee stock plans.

The Company has a $3,000,000 unsecured, revolving line of credit for short-term cash requirements bearing interest at the bank's reference rate (8% as of July 30, 1999). Outstanding amounts on the line of credit were zero at July 30, 1999 and October 31, 1998. The line expires on March 15, 2001.

CASH FROM OPERATING ACTIVITIES: Net cash from operating activities has varied significantly from quarter to quarter. These quarter-to-quarter fluctuations are primarily the result of changes in net income, changes in the rate of investment in accounts receivable and the changes in inventories held by the Company.

During the first nine months of fiscal 1999, approximately $7,838,000 was provided by operating activities versus approximately $9,892,000 provided during the comparable period of fiscal 1998. The year-to-year decline in cash from operating activities is primarily due to the decline in net income in fiscal 1999 compared to fiscal 1998 of approximately $1,426,000. During the first nine months of fiscal 1999, cash generated from accounts receivable decreased by approximately $2,117,000, when compared to the first nine months of fiscal 1998. This decrease is primarily due to the high collections received in the first nine months of fiscal 1998 resulting from a one-time billing modification allowed by the United States Government in the last quarter of fiscal 1997. During the first nine months of fiscal 1999, the Company increased its rate of investment in inventories, prepaids and other current assets by approximately $1,683,000 over the fiscal 1998 period. Actual inventory increased by approximately $4,131,000, due in part by building inventory for on-the-shelf products and in part by the unfavorable variance carried in inventory of approximately $1,900,000. In comparison, inventories increased approximately $2,165,000 during the same period for fiscal 1998 and the unfavorable variance was approximately $300,000. Cash generated by accounts payable and other accrued liabilities during the first nine months of fiscal 1999 was approximately $2,085,000, and was primarily due to the increase in income tax accruals as well as to the timing of quarter-end accruals. During the first nine months of fiscal 1998, cash used in accounts payable and other accrued liabilities was approximately $640,000.

CASH FROM INVESTING ACTIVITIES: Cash used in investing activities during the first nine months of fiscal 1999 and 1998 was $4,437,000 and $5,799,000, respectively. The $1,362,000 decrease in cash used in investing activities in fiscal 1999 is primarily the result of the sale of $1,000,000 in investments as compared to the net purchases of $700,000 of U.S. Treasury securities during fiscal 1998 partially offset by an increase in purchases of property and equipment.

CASH FROM FINANCING ACTIVITIES: Net cash used in financing activities during the first nine months of fiscal years 1999 and 1998 were approximately $831,000 and approximately $3,264,000, respectively. The decrease in cash used in financing activities for fiscal 1999 as compared to fiscal 1998 is primarily due to the result of fewer shares repurchased by the Company during fiscal 1999 less proceeds from the issuances of common stock to employees under the employee stock option and purchase plans.

SUMMARY OF BUSINESS CONSIDERATIONS AND CERTAIN FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS AND/OR STOCK PRICE:

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

Customer Concentration: Historically, defense and intelligence agencies of the United States Government have accounted for almost all of the Company's revenues. Future reductions in United States Government spending on signal reconnaissance and communications equipment or future changes in the kind of signal reconnaissance and communications products or services required by the United States Government agencies could limit demand for the Company's products which would have a material adverse effect on the Company's operating results and financial condition. In addition, as a supplier of these agencies, the Company must comply with numerous regulations, including regulations governing security and contracting practices. Failure to comply with these regulations could disqualify the Company as a supplier of these agencies, which would have a material adverse effect on the Company's future results of operations and financial condition.

Revenue Concentration: Due to the award of certain larger contracts, the Company has experienced a significant concentration of revenues from a single contract in recent periods. Revenue related to a single contract comprised 23% of revenue for the first nine months of fiscal 1999 compared to 20% attributable to the same contract in the first nine months of fiscal 1998. This contract may be terminated at the convenience of the United States Government. If this contract or other large contracts of the Company were terminated, this could have a material adverse effect on the Company's future results of operations and financial condition.

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

Dependence Upon Personnel: The Company's ability to execute its business plan is contingent upon successfully attracting and retaining qualified employees. During the last two years, the Company has experienced difficulty in attracting new talent in an increasingly competitive market for qualified personnel. Management believes this is, in part, attributable to the expanding U.S. economy and, in particular, to the local California economy where the Company competes for new talent in the rapidly expanding telecommunications sector and, in part, due to the difficulty in recruiting new staff capable of obtaining the necessary security clearance. While the Company believes progress in attracting and retaining sufficient personnel has been made recently, there can be no assurance that the Company will continue to be successful at attracting and retaining sufficient personnel. Failure to do so could have a material adverse effect on the Company's future operating results and financial condition.

Risk of Fixed Price and Contract Terminations: A significant portion of the Company's revenues are derived from fixed-price contracts. Under fixed-price contracts, unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in materials costs, inefficiencies or other factors, are borne by the Company. The Company has experienced cost overruns in the past that have resulted in losses on certain contracts. There can be no assurance that the Company will not experience cost overruns in the future or that such overruns will not have a material adverse effect on the Company's future operating results and financial condition.

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

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

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

Dependence Upon Certain Suppliers: Although the Company procures most of its parts and components from multiple sources or believes that these components are readily available from numerous other sources, certain components are available only from sole sources or from a limited number of sources. A number of the Company's products contain critical components like single board computers available solely from Motorola and Force Computers and digital signal processing integrated circuits available solely from Texas Instruments. While the Company believes that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require the Company to re-engineer its products, or both, which could delay the Company's shipment of its products and could have a material adverse effect on the Company's future operating results and financial condition.

Year 2000(Y2K) Risks: The Company has been implementing a program over the last two years to define and minimize risks related to transitioning into the Year 2000 and beyond. The program and associated risk assessment is segregated into the following three main areas: 1)Product Readiness Program, 2)Internal Infrastructure Readiness Program and 3)Business Partners Readiness Program. For each readiness area, the Company is systematically performing risk assessment and conducting tests and remediation as well as developing contingency plans to mitigate risk. Further, the Company is communicating with its employees, suppliers and customers regarding the Year 2000 issue in an effort to raise awareness and further mitigate risk by requesting compliance letters from its key business partners.

Product Readiness Program

Prior to January 1, 1997 (the "Certification Date"), the Company had no contractual obligation to provide Y2K compliant products/systems. As is the nature with most government contractors, the Company either developed or delivered a product to customer-defined acceptance criteria. As the United States Government became more concerned regarding the impact of Y2K on their systems, they began requiring contractors, as part of the contractual terms and conditions, to certify that all deliveries are Y2K compliant. The risk assessment for products and systems delivered prior to and after the Certification Date is as follows:

Products and Systems Delivered Prior to the Certification Date:

The Company will bring all products delivered under contracts entered into prior to the Certification Date into compliance upon the customer's request. The Company has performed a risk assessment for the United States Government so they have an understanding of what previously delivered products have Y2K exposure. Since the Company's products and systems met the original contract acceptance criteria, it is generally expected that the customers would pay for the necessary upgrades.

Products and Systems Delivered After to the Certification Date:

Company personnel have worked with customers to develop a comprehensive test plan and are now certifying that Company products meet a mutually agreed upon set of testing criteria for Y2K compliance.

Internal Infrastructure Readiness Program

The Company has embarked on a comprehensive inventory, evaluation, remediation and/or replacement of all internal applications and hardware used to run its business. The Company expects a fully compliant internal infrastructure by the end of the 1999 fiscal year. The compliance matrix the Company is using includes all network switches, hubs, routers, servers, critical business systems software and hardware, engineering support applications and tools, desktop systems, and telephone/voicemail systems.

Business Partners Readiness Program

The Company is working with its suppliers and service providers to minimize risk and provide uninterrupted service including unimpeded flow of materials to programs. Specific status is as follows:

Suppliers (Hardware and Software for Programs):

The Company has investigated all purchased items which may have an impact on its products resulting from the suppliers' hardware/software not being Y2K compliant. The risk in this area has been reduced to two areas: 1) key software providers and 2) providers of the single board computers.

Key software providers include Sun Microsystems and Wind River Systems. Wind River has provided a certification of their Y2K compliance. Sun Microsystems is implementing a Y2K compliance program.

The manufacturers of the Company's single board computers used in certain products include Force, Ariel, Actel and Motorola. All of these manufacturers have provided certification of Y2K compliance.

Suppliers (Operational Controls):

The Company's goal is to insure the unimpeded flow of materials to its programs. A review of all other components than those described above indicates that there are multiple sources available from which the Company could procure the items in the event one of the Company's suppliers has an internal control problem related to Y2K.

Other Business Partners:

The Company has been in contact with its other critical business partners (such as its 401(k) plan carrier and insurance provider) to insure there will be uninterrupted availability of services. All critical business partners have provided compliance letters to the Company.

Summary

The Company expects to implement successfully the systems and programming changes necessary to insure continued operations as a normal part of the Company's activities (upgrades, maintenance, normal communications, etc.). Additionally, since the programs described in this section are ongoing, all potential Year 2000 issues may have not been identified. Therefore, the potential impact of these issues on the Company's financial condition are not determinable at this time.

Costs related to the Year 2000 compliance program are either borne by certain contracts which are paid directly by the customer or administrative costs which are reimbursed indirectly through the Company's billing rates. While the Year 2000 administrative costs incurred to date have not been material, the Company anticipates incurring additional costs as the phases are completed. The Company expects to incur total costs of less than $150,000 for investigating and remedying issues directly related to Year 2000 compliance. The Company has not included Year 2000 costs activities which are accomplished as part of normal system upgrades and/or improvements since other factors are driving these requirements.

The Company does not believe that the cost of such actions will have a material effect on the Company's results of operations or financial condition. There can be no assurance, however, that there will not be a delay in, or increased costs associated with, the implementation of such changes, and the Company's inability to implement such changes could have an adverse effect on future results of operations.

The Company has not developed extensive formal contingency plans as backup to those discussed above. The Company expects the plans discussed above to be successful and not limit the ability of the Company to develop and sell its products and services.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

In April 1994, the Company was served with a subpoena by the Department of Defense Office of Inspector General (OIG) in connection with approximately six contracts, several of which had been audited by the Defense Contract Audit Agency (DCAA) the previous year. As is routine in such matters involving government contracts, the OIG referred the matter to another government agency which also had contracts with the Company. Shortly thereafter, this second agency issued a request for information related to nine additional contracts. To date, the Company has not received any allegations of wrong-doing from the OIG or the other agency. At the request of its Board of Directors, the Company initiated its own review of the contract in conjunction with its legal counsel.

Further review of the contracts in question and related contracts through April 1995 indicated the Company was not compliant with Public Law 87-653, Truth in Negotiations Act, which requires disclosure of all actual costs available on the date of cost certification on certain contracts performed during the 1989 and 1990 timeframe. These findings have resulted in a voluntary disclosure to the Government which is expected to result in a downward price adjustment on certain contracts. In June 1995, the Company announced it was taking a charge against the operating results in anticipation of a settlement with the government on the subject contracts. The charge resulted in a reduction for the fiscal 1995 operating income by $1.2 million.

In April 1996, the Company was served with a second subpoena by the OIG in connection with all contracts entered into between 1990 and the date of the subpoena related to three products: the Model 102P Voice Channel Demodulator, the Model 120 Multichannel Processor, and the Model 150 FAX Scanner.

In February 1998, the company was contacted by one of its primary customers to negotiate an administrative settlement regarding voluntary disclosure discussed above. The Company has provided the necessary information to the Government.

While management believes the fiscal year 1995 charge is adequate to cover all potential liabilities associated with this investigation by the United States Government, the United States Government has not concluded its investigation or agreed to a settlement with the Company. There can be no assurances the Company will not be required to take additional charges in connection with this matter in future periods. However, management believes that any such charges would not have a material effect on the operating results and financial condition of the Company.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

Exhibits - See Index to Exhibits

REPORTS ON FORM 8-K

The Company did not file any reports on Form 8-K during the three months ended July 30, 1999.

SIGNATURES

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

Applied Signal Technology, Inc.

| | |
|---|---|
| /s/ Brian M. Offi/ | September 14, 1999 |

Brian M. Offi
Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer), and
Coproate Secretary

APPLIED SIGNAL TECHNOLOGY

INDEX TO EXHIBITS

EXHIBIT

| NUMBER | DESCRIPTION OF DOCUMENT |
| --- | --- |
| 27.1 | Financial Data Schedule |

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<ARTICLE> 5

<LEGEND> THIS SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM THE CONSOLIDATED BALANCE SHEET AND CONSOLIDATED STATEMENT OF OPERATIONS INCLUDED IN THE COMPANY'S FORM 10-Q FOR THE PERIOD ENDED JULY 30, 1999 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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