APPLIED SIGNAL TECHNOLOGY INC
Form 10-K
January 13, 2011

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

Form 10-K

(Mark One)

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Fiscal Year Ended October 31, 2010

or

[ ] Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Transition Period from ____________________ to ____________________.

Commission file number 0-21236

Applied Signal Technology, Inc.
(Exact name of registrant as specified in its charter)

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

460 West California Ave., Sunnyvale, CA 94086
(Address of principal executive offices)

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

Securities registered pursuant to Section 12(b) of the Act: Common Stock, without par value Nasdaq Global Select Market.

Securities registered pursuant to Section 12(g) of the Act: none.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

	ü
Yes	**No**

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

	ü
Yes	**No**

Indicate by check mark 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).

ü	
Yes	**No**

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

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 definition 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**

Aggregate market value of the voting common stock held by non-affiliates of the registrant:

Common stock, without par value – $238,586,613 as of April 30, 2010, based on the closing price on such date for the registrant's common stock reported by the NASDAQ Global Market System. For purposes of this disclosure, shares of common stock held by persons who held more than 5% of the outstanding shares of common stock and shares held by officers and directors of the registrant have been excluded in that such persons may be deemed affiliates. The determination of affiliate status is not necessarily a conclusive determination for other purposes.

Number of shares of registrant's common stock outstanding:

Common stock, without par value – 13,825,568 shares as of October 31, 2010.

Documents Incorporated by Reference

The registrant has incorporated by reference into Part II, Item 5, and Part III of this Form10-K portions of its proxy statement expected to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K.

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Applied Signal Technology Inc.

Part I

Item 1: Business

This annual report on Form 10-K 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 "will," "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; 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 under "Item 1A: Risk Factors" and "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations." 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) after the date of the annual report. These SEC filings, as well as our latest annual report, can be obtained through our website at www.appsig.com. In addition, hard copies can be obtained free of charge through our investor relations department.

Description of the Business

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

- ***Broadband Network Communications***. Our broadband communication technology provides secure, high-speed communication networks to Government customers. Our solutions enable private networks to operate at the highest communication rates while simultaneously monitoring and scanning all channels to prevent disruptions to network quality of service. We also provide bandwidth compression technology to maximize performance for satellite communications.
- ***Cyber Intelligence***. Our specialized systems, software, and analytics address sophisticated cyber space threats by creating a unique blend of proprietary intelligence techniques and advanced computer network solutions. We are developing a suite of high capacity network monitoring products to provide deep packet inspection to protect against the threat of cyber attacks. These complex systems identify and localize illicit activity on communication networks and provide the analysis and visualization tools necessary to produce meaningful results in time to make a difference.
- ***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 weapons 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(EW)***. Our EW solutions detect, identify, and counter adversary weapons 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. To date, we have derived a limited amount of revenue from the sale of our ELINT products.
- ***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 include software engineering development of service-oriented architectures, system-level performance evaluation and modeling, system integration, field support, and customer training in the use of our standard products.

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

We are incorporated in California. Our headquarters are located at 460 West California Ave., Sunnyvale, CA, 94086, and our telephone number at that address is (408) 749-1888. Our website address is www.appsig.com. The information posted on our website is not incorporated into this annual report. However, investors can obtain a copy of this annual report on Form 10-K, our quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to such reports filed or furnished with the SEC, as well as a copy of our Code of Ethics, on our website free of charge. These filings are also available on the SEC's website at www.sec.gov. The public may read and copy any materials we file with the SEC at the SEC Public Reference Room at 100 F Street, NE, Washington, D.C. The public may obtain information from the Public Reference Room by calling the SEC at 1-800- SEC-0330.

Agreement and Plan of Merger. On December 18, 2010, we entered into an agreement and plan of merger (the "Merger Agreement"), with Raytheon Company, a Delaware corporation ("Raytheon"), and RN Acquisition Company, a California corporation and a wholly owned subsidiary of Raytheon ("Merger Sub"), pursuant to which, among other things, Merger Sub agreed to commence a cash tender offer (the "Tender Offer") to acquire all outstanding shares of our common stock, for $38.00 per share (the "Offer Price"), net to the seller in cash, without interest thereon and subject to applicable withholding taxes. The Merger Agreement also provides that following consummation of the Tender Offer, Merger Sub will be merged with and into us (the "Merger"), with our company surviving the Merger as an indirect wholly-owned subsidiary of Raytheon. At the effective time of the Merger, all remaining outstanding shares of common stock not tendered in the Tender Offer (other than shares of common stock owned by us, Raytheon, or any of Raytheon's subsidiaries) will be cancelled and converted into the right to receive the same Offer Price paid in the Tender Offer. All unvested stock options representing the right to purchase our common stock will vest and become exercisable on the date the Tender Offer is consummated. At the effective time of the Merger, each then outstanding option will be cancelled and will represent the right to receive an amount in cash equal to the excess, if any, of the Offer Price over the exercise price of such option.

The Tender Offer was commenced on December 30, 2010, and is scheduled to expire at 12:00 midnight, New York City time, on January 28, 2011, unless extended or earlier terminated. In the Tender Offer, each share of common stock accepted by Merger Sub in accordance with the terms and conditions of the Tender Offer will be exchanged for the right to receive the Offer Price. Raytheon shall cause Merger Sub to accept for payment, and Merger Sub shall accept for payment, all shares of common stock validly tendered and not validly withdrawn, pursuant to the terms and conditions of the Tender Offer, promptly following the Tender Offer's expiration date.

Merger Sub's obligation to accept for payment and pay for all shares of common stock validly tendered and not validly withdrawn pursuant to the Tender Offer is conditioned upon, among other things, the number of shares of our common stock tendered and not validly withdrawn prior to the end of a then-scheduled expiration date of the offer represents at least 76.3 percent of our common stock outstanding on such date (the "Minimum Condition"), the expiration of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and the satisfaction of certain other customary conditions as set forth in the Merger Agreement. In the event that the Minimum Condition is not met, and in certain other circumstances, the parties have agreed to complete the transaction through a one-step merger after receipt of shareholder approval.

We have also granted to Raytheon an irrevocable option (the "Top-Up Option"), which Raytheon may exercise immediately following consummation of the Tender Offer, to purchase from us the number of shares of common stock that, when added to the shares of common stock already owned by Raytheon or any of its subsidiaries following consummation of the Tender Offer, constitutes one share more than 90% of the shares then outstanding immediately after the issuance of the Top-Up Option shares, subject to applicable regulatory requirements and there being sufficient authorized shares available for issuance. If Raytheon, Merger Sub, and any of their respective affiliates acquire more than 90% of the outstanding shares of our common stock, including through exercise of the Top-Up Option, the Merger will be effected through the "short form" merger procedures available under California law.

The Merger Agreement contains certain termination rights for Raytheon and us including, with respect to our company, in the event that we receive a superior proposal (as defined in the Merger Agreement). In connection with the termination of the Merger Agreement under specified circumstances, including with respect to our entry into an agreement with respect to a superior proposal, we may be required to pay to Raytheon a termination fee equal to approximately $17.3 million and to reimburse Raytheon for up to $1 million of its out-of-pocket expenses.

The foregoing description of the Merger Agreement has been provided solely to inform investors of its terms. The representations, warranties, and covenants contained in the Merger Agreement were made only for the purposes of such agreement and as of specific dates, were made solely for the benefit of the parties to the Merger Agreement and may be intended not as statements of fact, but rather as a way of allocating risk to one of the parties if those statements prove to be inaccurate. In addition, such representations, warranties, and covenants may have been qualified by certain disclosures not reflected in the text of the Merger Agreement, and may apply standards of materiality in a way that is different from what may be viewed as material by shareholders of, or other investors in, AST. Our shareholders and other investors are not third-party beneficiaries under the Merger Agreement and should not rely on the representations, warranties, and covenants or any descriptions thereof as characterizations of the actual state of facts or conditions of AST, Raytheon, Merger Sub, or any of their respective subsidiaries or affiliates. We acknowledge that, notwithstanding the inclusion of the foregoing cautionary statements, we are responsible for considering whether additional specific disclosures of material information regarding material contractual provisions are required to make the statements in this Form 10-K not misleading.

Business Strategies

Our objective continues to be to grow our business as a leading provider of state-of-the-art ISR products, systems, and services. In order to accomplish this objective, we focus on three major strategies: solidifying our leadership in signal processing, improving our competitiveness, and expanding the business in our core ISR market. To do so, we anticipate the needs of the global security marketplace and invest in research and development to introduce new capabilities and products including offering high-end engineering services in support of major United States Government technology development initiatives.

Solidify our leadership position in signal processing with established customers by:

- ***Expanding our core competency in signal processing***. Since inception, we have focused our attention on developing signal processing equipment and services. We believe that there have been, and will continue to be, opportunities to develop specialized signal processing equipment and services to satisfy emerging technological requirements. We work closely with industry technology leaders to develop custom and off-the-shelf solutions by using in-house software to create new products and systems to address emerging global security needs.
- ***Anticipating marketplace needs***. We devote significant resources in order to anticipate future global security needs. We monitor technological and commercial advances in communications and sensors as well as trends in terrorist activities to identify potential solutions for our customers. We obtain information about marketplace needs through frequent contact with technical and contracting officials of pertinent Government agencies within the intelligence community.
- ***Investing in research and development***. We invest in independent research and development (R&D) that we believe will enable us to develop equipment and services that will satisfy the future global security needs of our customers before our competitors. An

important aspect of our R&D efforts is the understanding of information sources that could enhance global security in order to anticipate the future needs of our customers. Not only does this allow us to direct R&D engineering efforts to produce solutions promptly once a customer expresses a requirement, but it often allows us to educate the customer about potential requirements and simultaneously present a conceptual solution to those requirements.

Improve our competitiveness by:

- ***Strategic acquisitions***. We acquired Seismic LLC (Seismic) during fiscal year 2010 and Pyxis Engineering, LLC (Pyxis) during fiscal year 2009. The acquisitions incrementally increased our engineering services.
- ***Reducing internal costs***. When technical difficulty and specialized solutions determine the customer's need, our technological capabilities often provide the basis for sole-source awards. During fiscal year 2010, we continued to focus on reducing our indirect costs through organizational consolidation.
- ***Implementing a new, multi-rate strategy***. Historically, we have had success in capturing sole-source product development efforts. We intend to seek additional business opportunities as a specialized system integrator and by providing engineering services in order to enhance our competitiveness in these markets. In fiscal year 2010, we commenced implementation of a new multiple rate structure, which allows us to compete in these areas.
- ***Attract and develop a highly skilled workforce***. Our success depends on the continued contributions of our engineers, scientists, and managers. We intend to continue to hire and develop the highly skilled professionals needed for our work. We seek to recruit exceptional recent college graduates and former key personnel from the defense and intelligence communities. We believe we can continue to attract, develop, and retain employees by offering competitive compensation and benefits, challenging assignments, and opportunities for career growth.

Expand the business in our core ISR market by:

- ***Developing flexible products***. We believe a combination of our highly skilled staff and leading-edge technology offers opportunities into new programs and markets. We develop customized products that are tailored to meet the specific requirements of our customers. We use prior product development efforts to offer cost-effective solutions with a shortened time-to-market. We also see opportunity in implementing our next-generation signal processing in software product solutions, enabling customers to upgrade their signal collection capabilities without extensive hardware recapitalization costs.
- ***Migrating up the value chain from established product positions***. In many of our programs, we provide knowledge of the signal source and threat environment, which can be leveraged to expand our participation and provide end-to-end responsibility for a payload subsystem or fully integrated sensor system. We believe we can leverage our unique domain knowledge to expand our products and services and serve as a system integrator on select opportunities.
- ***Increasing our business with existing customers and broadening our customer base***. We intend to increase our services to meet the needs of the military and to increase our participation in emerging programs as the Department of Defense recapitalizes its inventory of ISR equipment. For example, we are developing a suite of miniaturized, low power products to address market expansion opportunities on unmanned vehicles. We believe the adaptability and flexibility of our SIGINT and sensor surveillance products make them attractive in joint or coalition warfare environments.
- ***Expanding our role in providing engineering and support services***. We plan to continue to expand our presence near customer facilities to provide high-quality engineering services in support of major community developments to meet the Government outsourcing of key technical support services. We also plan to offer operational and sustainment support in our products and systems as they are deployed.
- ***Investing in our long-term value proposition***. We plan to continue to seek opportunities to acquire companies of complementary technology, products, or businesses that accelerate our growth in our core ISR markets. We also expect to expand our suite of patents to protect the long-term opportunity associated with our current and future licensing efforts.

Operating Divisions and Products

Within our one operating segment, we have organized our operations into three market-facing divisions to optimize management span of control and ensure a strong customer focus. Our three market-facing divisions, Broadband Communication Systems, Surveillance Systems, and Network Intelligence sell predominantly to one customer, the United States Government. In addition to these divisions, we operate a single Operations division for manufacturing our products, purchasing materials, and providing sustaining engineering support. The prices of each of the products and systems within our market-facing divisions may vary based on the level of customization required by our customers. The specific focus of our three market-facing organizations is described below.

Broadband Communication Systems

The Broadband Communication Systems Division provides proprietary broadband communication technology and network solutions for high-speed communications, primarily to Government customers. Our network solutions include the full spectrum of communication support equipment and software for bandwidth compression, encrypting and decrypting traffic, multiplexing and demultiplexing traffic from multiple communication streams, conducting deep packet inspection for network traffic monitoring and management, and performing real-time network quality assessment. Many of these products and systems use an advanced selection architecture (ASA) that incorporates custom and commercially available hardware and software in configurations capable of being readily adapted or upgraded to accommodate future signal formats at a reduced cost. This design methodology allows us to adapt our products and systems to the challenging requirements presented by quick-reaction missions. The benefits of our design methodology include shorter implementation schedules, flexibility, improved interoperability with other systems, and reduced operational costs to our customers.

Surveillance Systems

At the end of fiscal year 2010, we consolidated our Intelligence and Electronic Warfare Systems division and our Sensor Systems division into one market-facing division. The consolidation of these two divisions allows for more effective penetration of the Department of Defense (DOD) market.

In the current counterterrorism campaign, the United States Government is expanding the collection of signature information to aid in the detection and location of potential terrorist activities.

The Surveillance Systems Division provides advanced sensor signal processing solutions for space-based, airborne, terrestrial, and undersea sensor technologies. Our sensor processing products consist of advanced digital signal processing hardware and software to automatically process the results of raw sensor data to detect abnormalities of interest. We provide remote sensing by processing and analyzing information from sound to light spectrum sources including radar, magnetic, infrared, electro-optical, hyperspectral, and visible light.

Our key sensor solutions include synthetic aperture sonar, radar, magnetic, and explosive detection products. These systems are designed to detect abnormalities in the marine environment such as the presence of a submarine, mines tethered to the ocean floor, and terrorist activities such as attempts to destruct a national infrastructure (such as pipelines or communication lines) on the ocean floor. Our solutions consist of active sensors, such as synthetic aperture sonar and radar detection of periscopes, and passive sensing, such as magnetic detection of submarines. We are also developing integrated sensor systems to detect explosive materials deployed in vehicles, luggage, and cargo containers.

Additionally, accurate and comprehensive information regarding foreign affairs and developments affecting international security has become increasingly important to the United States Government. We believe the political instability in certain regions around the world and ongoing counterterrorism campaigns have heightened the United States Government’s need to be able to monitor activities overseas. In order to obtain information about activities from foreign threats, the United States Government gathers and analyzes communication signals emanations. The Surveillance Systems Division now provides research and development for the collection and analysis of tactical wireless communications and electronic intelligence.

The ever-increasing commercial development of telecommunications equipment has led to a significant increase in the overall quantity of information communicated and an increase in the density of signals transmitted throughout the RF spectrum. This increase can be seen in the proliferation of radio, cellular, and digital signal telecommunications equipment and in the global information network (such as the Internet), resulting in a significant increase in the amount of information being communicated. Our tactical wireless COMINT systems automatically scan and process thousands of modern telecommunication signals to isolate and collect specific communications from targets of interest. Our products and systems are tailored for small tactical and hand-launched platforms and vehicles. Our miniature, low power systems can be used on a broad range of strategic and military platforms including aircraft, unmanned aerial vehicles (UAV), land-mobile vehicles, fixed-site installations, and relocatable land sites.

Our key COMINT products include wideband processors and collection products. These processors “groom” telecommunication signals for further processing by voice-grade channel (VGC) processors by adjusting for signal distortions that commonly occur during transmission. The two primary types of distortions that these processors correct are multipath interference (caused by the reception of a signal and its reflections) and co-channel interference (caused by the reception of multiple interfering signals). Our collection products include low-cost, small receivers that collect information in very complex signaling formats and optimize multiple antenna inputs to overcome co-channel interference and certain forms of multi-path interference.

Our ELINT and ESM products include a flexible product line developed to characterize enemy weapon systems and provide battlefield mapping and force protection by using unmanned aerial vehicles and smaller manned aircraft as standoff sensing platforms. Our equipment exploits the threat emitters in a small form factor to facilitate collection operations by using stealthy platforms.

Network Intelligence

At the beginning of fiscal year 2010, we formed a new market-facing division to address the emerging opportunities in cyber security, leveraging our legacy in communication signal processing. Our Network Intelligence Division brings an understanding of the global telecommunications network to the cyber domain. We leverage our knowledge of the network to provide systems, analytics, and services that enable our customers’ defensive and offensive cyber operations. We have solutions that provide dynamic, real-time characterization and monitoring of very high bandwidth cyber networks and cyber data streams. We believe that our solutions handle the traffic and demands of today's largest broadband networks with less size and power than is required by commercially available equipment. 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. In addition to the added staff and expertise acquired from Pyxis Engineering LLC (Pyxis) in fiscal year 2009, we acquired Seismic LLC during fiscal year 2010 to add to the capabilities of our Network Intelligence Division. Both of the companies that we acquired help us address emerging near-term opportunities by providing post-collection intelligence analysis tools such as human language technology, cloud computing, complex event processing, and advanced data operation. We utilize highly skilled software engineers to provide subcontract services to the U.S. intelligence community. These services protect sensitive networks and critical infrastructure as well as provide a range of capabilities applicable to both defensive and offensive network operations. Together, we provide technical experience from the signal source through to the analyst's report.

Segments

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. We have integrated the companies that we have acquired into our existing operating and financial reporting structure. Our CEO, who is the chief decision maker of our operations, reviews aggregate financial information for the Company as a whole. As the technologies and the operations of our market-facing divisions are highly integrated, he makes resource allocation decisions based on this aggregate financial information.

Customers

Since our inception, purchases by the United States Government have accounted for almost all of our revenues. These purchases occur in two ways: through contracts directly with the United States Government and subcontracts to prime contractors. Direct contracts with the United States Government accounted for approximately 66%, 65%, and 65% of revenues in fiscal years 2010, 2009, and 2008, respectively. The subcontracts to prime contractors with the United States Government accounted for approximately 30%, 30%, and 31% of revenues in fiscal years 2010, 2009, and 2008, respectively.

Our United States Government customers consist of military and intelligence agencies that have signal reconnaissance needs. Within our United States Government customers, we have contracts with approximately 40 different organizations, each with separate budgets and contracting authority.

The following table identifies the source of our revenues for fiscal years 2010, 2009, and 2008 by market.

	FY10	FY09	FY08
Intelligence	89%	83%	80%
Defense	8%	12%	16%
Commercial	3%	5%	4%
Foreign	— ---------	— ---------	— ---------
	100% ======	100% ======	100% ======
a dash (—) designates less than 1% revenue concentration			

Foreign revenues consist of contracts directly with foreign governments or foreign companies.

Within the customer types, contracts with two intelligence community customers and one defense customer represented a significant portion of revenues.

The table below identifies the revenue concentration (as a percentage of total revenues) from all contracts with each significant customer.

	FY10	FY09	FY08

Intelligence community customer 1	40%	33%	25%
Intelligence community customer 2	38%	43%	50%
Largest defense customer	6% ---------	9% ---------	12% ---------
	84% ======	85% ======	87% ======

Contracts

Most of our business is conducted under contracts that include United States Government security requirements. Our contracts with United States Government agencies are of two types, as described below.

Sole-source contracts are awarded by the United States Government when a single contractor is deemed to have an expertise or technology that is superior to that of competing contractors. Potential suppliers compete informally for sole-source contracts through R&D investment and marketing efforts. This competition requires a contractor to identify the United States Government's requirements early and invest in developing potential solutions so that the contractor can demonstrate a distinguishing expertise or technology promptly after the United States Government has identified a requirement. Sole-source contracts are awarded without a formal competition.

Competitive-bid contracts are awarded based on formal proposal evaluation criteria established by the procuring agency. Interested contractors prepare a bid and proposal in response to the agency's request. A bid and proposal is usually prepared in a short time period (for example, 45 days) in response to a deadline, and requires the extensive involvement of numerous technical and administrative personnel. Competitive-bid contracts are awarded after a formal bid and proposal competition among suppliers.

The following table identifies the allocation of revenues from all sources from which we generated revenue for fiscal years 2010, 2009, and 2008.

	FY10	FY09	FY08
Sole-source contracts	91%	89%	76%
Competitive-bid contracts	9% ---------	11% ---------	24% ---------
	100% ======	100% ======	100% ======

Sole-source and competitive-bid contracts can be fixed-price contracts, where we agree to deliver equipment for a fixed price and we assume the risk of cost overruns; cost-reimbursement contracts, where we are reimbursed for our direct and indirect costs and paid a negotiated profit; or time-and-materials contracts, where we recognize revenue by applying a negotiated billing rate to the level of effort. Historically, we achieve greater profit margins from our fixed-price contracts than from our cost-reimbursement and time-and-materials contracts. In recent years, our significant contracts have been cost-reimbursement contracts. In addition, we have two agreements for which we accrue royalties on sales of our licensed product by a third party. Since there are essentially no costs associated with these agreements, operating income will increase by the same amount of revenue that we recognize.

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

	FY10	FY09	FY08
Cost-reimbursement contracts	74%	59%	69%
Time-and-materials contracts	15%	22%	18%
Fixed-price contracts	8%	16%	10%
Royalty contracts	3% ---------	3% ---------	3% ---------

	100%	100%	100%
	======	======	======

Most of our fixed-price contracts are for the manufacture of multiple units of our established products, rather than the development of new products. We believe that the risk of cost overruns is much less in the case of fixed-price manufacturing contracts, where the product has already been developed and at least a prototype made, than in the case of fixed-price development contracts.

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.

	FY10	FY09	FY08
Next Generation ASA	20%	—	—
Tiffany	13%	21%	13%
Thunderdome	8%	—	—
ASA	—	18%	15%
High Beam	—	7%	15%
Stone Face II	—	6%	12%
Specter	— ---------	— ---------	5% ---------
	41% ======	52% ======	60% ======
a dash (—) designates less than 5% revenue concentration			

The following contracts were indefinite-delivery-indefinite-quantity (IDIQ) contracts: Next Generation ASA, ASA, Tiffany, and Stone Face II. Under the terms of this type of contract, the United States 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 distinguishing significant revenue concentrations. However, Thunderdome is a significant, individual DO within one of the IDIQ contracts listed above.

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

We are subject to price redetermination on certain fixed-price United States Government contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. During fiscal years 2010, 2009, and 2008, the United States Government made no material claims against us for noncompliance with these regulations.

Almost all of our contracts contain termination clauses that permit contract termination by the customer for cause upon our default or without cause for the convenience of the other contracting party. In either case, terminations could adversely affect our operating results. Under contracts terminable at the convenience of the United States Government, a contractor is generally entitled to receive payments for its allowable costs and, in general, the proportionate share of fees or earnings for the work done. Contracts that are terminable for default generally provide that the United States Government only pay for the work it has accepted and may require the contractor to pay for the incremental cost of reprocurement and may hold the contractor liable for damages incurred by the customer.

Backlog

Our backlog, which consists of anticipated revenues from the uncompleted portions of existing contracts and excludes unexercised contract options, was $152,171,000, $139,108,000, and $124,784,000, at October 31, 2010, 2009, and 2008, respectively. Anticipated revenues included in backlog may be realized over a multi-year period and include expected revenues from contracts that are fully funded as well as from contracts that are only partially funded. We include expected revenues from a contract in backlog when the contract is signed by us and by our customer. We believe the backlog figures are firm, subject only to the cancellation and modification provisions contained in our contracts. (See "Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations, New Orders, and Backlog.") Because of possible future changes in delivery schedules and cancellations of orders, backlog at any particular date is not necessarily representative of actual revenue to be expected for any succeeding period, and actual revenue for the year may not meet or exceed the backlog represented. We may experience significant cancellations of contracts that were previously booked and included in backlog.

Research and Development

We conduct R&D as part of our own R&D investment. We believe that our investment in R&D provides us with a significant competitive advantage. R&D expenses incurred by us were approximately $15,082,000, $14,482,000, and $13,116,000 in fiscal years 2010, 2009, and 2008, respectively. As a percent of revenue, R&D equated to 6.7%, 7.1%, and 7.0% in fiscal years 2010, 2009, and 2008, respectively.

Competition

The global security market is highly competitive and we expect that competition will continue to increase in the future. Some of our current and potential competitors have significantly greater technical, manufacturing, financial, and marketing resources than we do. Substantial competition could impose pricing pressure on sales of our products, could develop and introduce new products meeting market demand more quickly than we can, and could result in lower revenue and decreased sales, which would have a materially adverse effect on our financial condition and operating results.

The competition for competitive-bid contracts differs from the competition for sole-source contracts. Companies competing for competitive-bid contracts prepare bids and proposals in response to either commercial or Government requests and typically compete on price. Potential suppliers compete informally for sole-source contracts through R&D investment and marketing efforts. Companies competing for sole-source contracts attempt to identify the customer’s requirements early and invest in solutions so that they can demonstrate a distinguishing expertise or technology promptly after the customer has identified a signal processing requirement. The principal factors of competition for sole-source contracts include investments in R&D; the ability to respond promptly to Government needs; and product price relative to performance, quality, and customer support. We believe that we compete favorably on each of these factors.

Our current competitors include Argon ST, BAE Systems, The Boeing Company, General Dynamics, Harris Corporation, ITT Corporation, L-3 Communications, Lockheed Martin, Northrop Grumman, QinetiQ, Raytheon Company, Sierra Nevada Corporation, Science Applications International Corporation, and Thales

Proprietary Rights

The United States Government has rights to most of the technology that we have developed under Government contracts, including rights to permit other companies, including our competitors, to use this technology to develop products for the United States Government. To our knowledge, the United States Government has not exercised these rights related to our products.

As of October 31, 2010, we had six issued patents.We believe that, given the rapidly changing nature of signal collection and processing technology, our future success will depend primarily on the technical competence and creative skills of our personnel, rather than the legal protection afforded by patents. We attempt to protect our trade secrets and other proprietary information through agreements with customers, employees, and consultants, and through other security measures. To the extent we wish to assert our patent rights, we cannot be sure that any claims of our patents will be sufficiently broad to protect our technology. In addition, there can be no assurance that any patents issued to us will not be challenged, invalidated, or circumvented; that any rights granted under these patents will provide us adequate protection; or that there will be sufficient resources to protect and enforce our rights. For example, we have filed a patent infringement claim and countersuits related to the claim have been filed against us. For further details, please see “Item 3: Legal Proceedings.” In addition, the laws of some foreign countries may not protect our proprietary rights to the same extent as do the laws of the United States. Although we do not believe that we are infringing upon the intellectual property rights of others, it is possible that such a claim will be asserted against us in the future. In the event any third party makes a claim against us for infringement of patents or other intellectual property rights of a third party, such claims, with or without merit, could be time-consuming and result in costly litigation. In addition, we could experience loss or cancellation of customer orders, could experience product shipment delays, or could be subject to significant liabilities to third parties. If our products were found to infringe on a third party’s proprietary rights, we could be required to enter into royalty or licensing agreements to continue selling our products. Royalty or licensing agreements, if required, may not be available under acceptable terms or at all, which could seriously harm our business. Our involvement in any patent dispute or other intellectual property dispute or action to protect trade secrets and expertise could have a materially adverse effect on our business.

Government Regulations

We must comply with regulatory requirements of federal, state, and municipal authorities applicable to companies contracting with the United States Government and its agencies, including regulations concerning employment obligations and affirmative action, workplace safety, and protection of the environment. Most importantly, we must comply with detailed Government procurement and contracting regulations and with United States Government security regulations, certain of which carry substantial penalties for noncompliance or misrepresentation in the course of negotiations. Failure to comply with our Government procurement or contracting obligations or security obligations could result in penalties imposed on us or suspension from Government contracting, which would prevent us from selling our products to the United States Government, severely limiting our ability to operate our business and generate revenue, resulting in a materially adverse effect on our financial condition and operating results.

Additionally, all of our products and services are subject to United States export laws and regulations. Exports of commercial products, software, technology, and services are subject to controls under the Export Administration Regulations (EAR) and exports of military products, software, technical data, and services are subject to controls under the International Traffic in Arms Regulations (ITAR). Our ability to export is dependent upon our ability to obtain the appropriate export authorization from the United States Government. If we are unable to receive the appropriate export authorization, we may be prohibited from selling our products and services internationally, which may limit our sales and may have a material, adverse effect on growing this portion of our business.

While compliance with applicable regulations has not adversely affected our operations in the past, we cannot be sure that we will continue to be in compliance in the future or that these regulations will not change, resulting in increased operational costs.

Employees

Our success is dependent on the skills and dedication of our employees. Our staff includes a mix of experienced professionals and recent college graduates who, together, provide experienced thought leadership with the latest technical skills to meet the challenges presented by our customers. As of December 6, 2010, we had 856 employees. Our business requires the majority of our technical employees to obtain and retain security clearances from the United States Government, which limits the available pool of eligible candidates for such positions to those who can satisfy the prerequisites to obtaining these clearances. We have a United States Government-sanctioned security program that allows staff members to obtain appropriate clearances. Approximately 83% of our staff has security clearances. Our future success is dependent on attracting, retaining, and motivating qualified key management and technical personnel, whose loss could adversely affect our business materially. We offer a robust employee benefits program and challenging work environment to maintain high employee morale.

Item 1A: Risk Factors

Our future performance is subject to a variety of risks. If any of the following risks actually occurs, our business could be harmed and the trading price of our common stock could decline. In addition to the following disclosures, please refer to the other information contained in this report, including consolidated financial statements and the related notes.

If the Merger contemplated by the Merger Agreement with Raytheon and Merger Sub does not occur, it could have a material adverse effect on our business, results of operations, and financial condition. On December 18, 2010, we entered into a Merger Agreement with Raytheon and Merger Sub. Under the terms of the Merger Agreement, on December 30, 2010, Merger Sub commenced a Tender Offer to purchase all outstanding shares of our common stock for the Offer Price. The Tender Offer is scheduled to expire at 12:00 midnight, New York City time, on January 28, 2011, unless the Tender Offer is extended. The Tender Offer is conditioned upon, among other things, satisfaction of the Minimum Condition, the expiration of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and other customary closing conditions. Following the successful completion of the Tender Offer, Merger Sub will merge with and into us and any shares of our common stock not tendered in the Tender Offer (except for shares of common stock owned by us, Raytheon, or any of Raytheon's subsidiaries) will be cancelled and converted into the right to receive the same Offer Price paid in the Tender Offer. In the event that the minimum tender condition is not met, and in certain other circumstances, the parties have agreed to complete the transaction through a one-step merger after receipt of shareholder approval.

We cannot predict whether the closing conditions for the Tender Offer and the Merger set forth in the Merger Agreement will be satisfied, and the transactions contemplated by the Merger Agreement may be delayed or even abandoned before completion if certain events occur. The Merger Agreement may be terminated by us, on the one hand, or Raytheon, on the other hand, under certain circumstances, and termination of the Merger Agreement may require us to pay a termination fee of approximately $17.3 million to Raytheon and to reimburse Raytheon for up to $1 million of its out-of-pocket expenses. If the conditions to the transactions set forth in the Merger Agreement are not satisfied or waived pursuant to the Merger Agreement, or if the transactions are not completed for any other reason, (i) the market price of our common stock could significantly decline; (ii) we will remain liable for the significant expenses that we have incurred related to the transaction, including legal and financial advisor fees, and may be required to pay the approximately $17.3 million termination fee and $1 million expense reimbursement; (iii) we may experience substantial disruption in our sales, research and development, and operating activities, and the loss of key personnel, customers, suppliers, and other third-party relationships, any of which could materially and adversely affect us and our business, operating results, and financial condition; and (iv) we may have difficulty attracting and retaining key personnel.

Until the closing of the transactions, it is possible that the focus of our management team and employees may be diverted, and that there may be a negative reaction to the Tender Offer and the Merger on the part of our customers, employees, suppliers, or other third-party relationships. The Merger Agreement also contains certain limitations regarding our business operations prior to completion of the Merger.

Risks Related to our Business and Operations

Any reduction in Government spending on ISR could materially adversely impact our revenues, results of operations, and financial condition. Historically, defense and intelligence agencies of the United States Government have accounted for almost all of our revenues. There are risks associated with programs that are subject to appropriation by Congress, which could be potential targets for reductions in funding to pay for other programs. Future reductions in United States Government spending on global security or future changes in the kind of products or services required by the United States Government agencies could limit demand for our products and services, which could result in failure to achieve anticipated revenues, resulting in a materially adverse effect on our operating results and financial condition.

In the event there are shifts in responsibilities and functions among the Government agencies responsible for United States defense and intelligence, it could result in a reduction of orders for global security by the defense and intelligence agencies that have historically been our major customers. Our relationships with other Government agencies to which responsibilities and functions for our contracts have shifted may not be as strong as our relationships with current customer agencies. Accordingly, a reduction in contracts from our customer agencies may not be offset by contracts from other United States Government agencies. Even if other agencies increase spending for global security, we may not secure the same amount of work from these agencies. As a result, demand for our products and services could decline, resulting in a decrease in revenues, and could adversely affect our operating results and financial condition materially.

We depend on revenues from a few significant contracts, and any loss, cancellation, reduction, or delay in these contracts could harm our business. From time to time, including recent periods, we have derived a material portion of our revenue from one or more individual contracts that could be terminated by the customer in full or in part at the customer’s discretion. In the past, we have experienced a significant reduction of, and stop work order on, one of our largest contracts. We expect that in future periods we may again enter into individual contracts with significant revenue concentrations. In addition, the majority of our contracts are with a limited number of Government agencies. If our individually large contracts were terminated or substantially reduced, we could fail to achieve expected revenues and net income.

United States Government contracts are generally not fully funded at inception and funding may be terminated or reduced at any time. We act as a prime contractor or subcontractor for many different United States Government programs. Department of Defense and intelligence contracts typically involve long lead times for design and development and are subject to significant changes in contract scheduling. Programs can be partially funded initially, and additional funds may or may not be allocated. The termination or reduction of funding for a Government program would result in a loss of anticipated future revenues attributable to that program.

Our backlog as of October 31, 2010, was approximately $152.2 million and includes orders under awards that in some cases extend several years. The actual receipt of revenues on awards included in backlog may never occur or may change because a program schedule could change; the program could be canceled; or a contract could be reduced, modified, or terminated early.

We depend on revenues from a few significant customers; the loss of any significant customer could have an adverse effect on our business. Our success will depend on our continued ability to develop and manage relationships with significant customers. The markets in which we sell our products are dominated by a relatively small number of Governmental agencies and allies of the United States Government, thereby limiting the number of potential customers. Our dependence on large orders from a relatively small number of customers makes our relationship with each customer critical to our business. We cannot be sure that we will be able to retain our largest customers, that we will be able to attract additional customers, or that our customers will continue to buy our products and services in the same amounts as in prior years. The loss of one or more of our largest customers, any reduction or delay in sales to these customers, our inability to successfully develop relationships with additional customers, or future price concessions that we may have to make could significantly harm our business.

Any decrease in expected product sales during a period could adversely impact our revenues, results of operations, and financial condition. From time to time, we have derived a significant portion of our revenue from product sales. In recent periods, however, we have been focusing on sales of systems and software, and targeting larger programs. In addition, we have experienced some seasonality in product sales to the United States Government, with more product sales occurring in the second half of the fiscal year than in the first. The amount and timing of Government purchases of products is unpredictable, and fluctuates significantly from period to period, making it difficult for us to predict the amount of revenue we will generate from product sales in any particular period, and causing our revenues to fluctuate from period to period. If we are not able to generate revenues from product sales as expected in a particular period, we may fail to meet our revenue expectations and the expectations of industry analysts and investors, which could cause our stock price to decline.

If we are unable to recruit, train, and retain key personnel with required security clearances, our ability to develop, introduce, and sell our products may be adversely impacted. Our ability to execute our business plan is contingent upon successfully attracting and retaining qualified employees who obtain, or are able to obtain and retain, necessary Government security clearances. If we fail to attract and retain qualified employees who can obtain the necessary security clearances, our business could be significantly harmed. The loss of the services of our qualified employees, the inability to attract or retain qualified personnel in the future, or delays in hiring required personnel could negatively impact our ability to develop, introduce, and sell our products. In addition, employees may leave us and subsequently compete against us.

Many of the personnel we hire will need United States Government security clearances in order to perform tasks required on our Government contracts, and without such clearances, employees cannot work on the majority of our projects. We have found that there is a shortage of qualified personnel possessing the necessary clearances, and new security clearances are taking longer to be granted. If we are not able to obtain security clearances for our personnel where required, they will be unable to perform tasks requiring clearances, and we may be unable to satisfy the terms of our contracts, resulting in customer dissatisfaction and possible loss of current or future contracts.

Stop-work orders could negatively impact our operating results and financial condition. Almost all of our contracts contain stop-work clauses that permit the Government or other contracting party, at any time, by written order, to stop work on all or any part of the work called for by the contract for a period of ninety days. Within the ninety-day period, the other contracting party may cancel the stop-work order and resume work or terminate all or part of the work covered by the stop-work order. There can be no assurance that stop-work orders will not be received in future periods. If we receive stop-work orders, our orders and backlog may be reduced, and we may fail to achieve anticipated revenues.

Unexpected contract terminations could negatively impact our operating results and financial condition. Almost all of our contracts contain termination clauses that permit contract termination upon default or for the convenience of the other contracting party. In either case, termination could adversely affect our operating results and financial condition.

If we are unable to comply with complex Government regulations governing security and contracting practices, we could be disqualified as a supplier to the United States Government. As a supplier to United States Government defense and intelligence agencies, we must comply with numerous regulations, including those governing security and contracting practices. Failure to comply with these procurement regulations and practices could result in fines being imposed against us or our suspension for a period of time from eligibility for bidding on, or for award of, new Government contracts. If we are disqualified as a supplier to Government agencies, we will lose most, if not all, of our customers, revenues from sales of our products would decline significantly, and our ability to continue operations would be seriously jeopardized. Among the causes for fines or disqualification are violations of various statutes, including those related to procurement integrity, the Truth In Negotiations Act, export control, United States Government security regulations, employment practices, protection of the environment, accuracy of records in the recording of costs, and foreign corruption.

In addition, the programs we support and systems we develop, install, and maintain involve managing and protecting information involved in intelligence, national security, and other classified Government functions. A security breach by us or our employees in the course of our development, production, or service activities could cause serious harm to our business, damage our reputation, and prevent us from being eligible for further work on critical classified systems for United States Government customers.

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.

For example, during fiscal year 2008, the Defense Contract Audit Agency (DCAA) advised us that we are considered a major contractor and are subject to more audits and oversight. The results of these and future audits could result in sustained claims against us. In those cases where we believe that the Government is likely to prevail, we have reduced operating income by establishing appropriate reserves for the estimated loss.

We implemented a new multi-rate structure in fiscal year 2009 that we believe should have several positive effects on our business. The DCAA performed initial reviews of our new rate structure without taking exception. However, we believe this new rate structure is subject to further audit. If the United States Government does not agree with our approach, our revenues and operating income could be reduced.

Our business depends upon our relationships with, and the performance of, our prime contractors. We expect to continue to depend on relationships with other contractors for a substantial portion of our revenues in the foreseeable future. Our business, prospects, financial condition, or operating results could be adversely affected if other contractors terminate or reduce their subcontracts or relationships with us, either because they choose to establish relationships with our competitors or because they choose to directly offer services that compete with our business. Our business also suffers if the prime contractor fails to win the contract, or if the Government terminates or reduces these other contractors' programs or does not award them new or additional contracts.

In addition, on those contracts for which we are not the prime contractor, the United States Government could terminate a prime contract under which we are subcontractor, regardless of the quality of our performance as a subcontractor. A prime contractor's performance deficiencies could adversely affect our status as a subcontractor on the program, jeopardize our ability to collect award or incentive fees, cause customers to delay payments, and result in contract terminations.

Continued competition in ISR may lead to a reduction in our revenues and market share. The global security market is highly competitive and we expect that competition will continue to increase in the future. Our current competitors have significantly greater technical, manufacturing, financial, and marketing resources than we do. We expect that more companies will enter the market for global security, possibly resulting in pricing pressures on our products and services. We may not be able to compete successfully against either current or future competitors. Increased competition could result in reduced revenue, lower margins, or loss of market share, any of which could significantly harm our business. Our competitors may introduce improved products with lower prices, and we would have to do the same to remain competitive.

Unexpected increases in the cost to develop or manufacture our products under fixed-price contracts may cause us to experience unreimbursed cost overruns resulting in reduced profit margins or increased loss provisions. A significant portion of our revenue is derived from fixed-price contracts. Under fixed-price contracts, unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in materials costs, unfavorable indirect rate variances, inefficiencies, or other factors, are borne by us. We have experienced cost overruns in the past that have resulted in losses on certain contracts, and may experience additional cost overruns in the future. Such cost overruns would increase our operating expenses, reduce our net income and earnings per share, and could have a material, adverse effect on our future results of operations and financial condition.

Fixed-price contracts use percentage-of-completion accounting to determine profit margins. Under generally accepted accounting principles, unexpected cost over-runs can change the percentage completion estimates and result in reduced profit margins and the reversal of previously recognized profits in addition to reducing future period profits. Although we believe that our profit margins are fairly stated and that adequate provisions for losses for our fixed-price contracts are recorded in our financial statements as required under accounting principles generally accepted within the United States, there can be no assurance that our contract profit margins will not decrease or our loss provision will not increase in the future.

Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new signal processing solutions that achieve market acceptance. The market for our products is characterized by rapidly changing technology, frequent new product introductions, changes in customer requirements, and evolving industry standards. We believe that we have been successful to date in identifying certain global security needs early, investing in research and development to meet these needs, and delivering products before our competitors. We believe that our future success will depend upon continued development and timely introduction of products capable of satisfying emerging global security needs. However, we expect that new requirements will continue to emerge. Our future performance will depend on the successful development, introduction, and market acceptance of new and enhanced products that address these new requirements. The introduction of new and enhanced products may cause our customers to defer or cancel orders for existing products. There can be no assurance that we will be able to develop and market new products successfully in the future or respond effectively to new requirements, or that new products introduced by others will not render our products or technologies noncompetitive or obsolete.

We also may not be able to develop the underlying core technologies necessary to create new products and enhancements or to license these technologies from third parties. Product development delays may result from numerous factors, including:

- Changing product specifications and customer requirements
- Difficulties in hiring and retaining necessary technical personnel
- Difficulties in reallocating engineering resources and overcoming resource limitations
- Difficulties with contract manufacturers
- Changing market or competitive product requirements
- Unanticipated engineering complexities

The development of new, technologically advanced products is a complex and uncertain process requiring high levels of innovation and highly skilled engineering and development personnel, as well as the accurate anticipation of technological and market trends. We cannot ensure that we will be able to identify, develop, manufacture, market, or support new or enhanced products successfully, or on a timely basis, if at all. Further, we cannot ensure that our new products will gain market acceptance or that we will be able to respond effectively to product announcements by competitors, technological changes, or emerging industry standards. Any failure to respond to technological change would significantly harm our business.

We derive revenue from royalties, the timing of which can be difficult to predict and sustain. We derive royalty income from the sale of products licensed to other third parties for sale, and expect to continue to derive royalty income in the future. Revenue derived from royalties provides greater profitability to us than revenue from the sale of our products and services. Accordingly, our operating income and earnings per share will be impacted by the comparative mix of revenue from our digital signal processing products, systems, and services and revenue derived from royalty income. Although we have licensed one of our products for sale by a third party, and expect to increase our efforts in future periods, we have not historically devoted significant resources to licensing our technologies. We believe there is a life cycle to the technology upon which this royalty revenue is based. We anticipate that royalty revenues from this agreement could decline in future periods.

Our future ability to generate royalty income depends upon:

- Our ability to secure patent coverage for our technologies and enter into license agreements with potential licensees
- The ability of our licensees to develop and commercialize successful products that incorporate our technologies
- The rate of adoption of our technologies by, and the incorporation of our technologies into products of, other parties

In addition, royalty-based income is subject to the willingness and ability of licensees to design and assemble products using our technology, the pricing and demand for products incorporating our technology, and our ability to negotiate and enforce agreements for the determination and payment of royalties. It is difficult to predict when we will enter into additional license agreements, if at all. The timing of our receipt of royalty payments, including payments from our existing royalty-based arrangement, is also difficult to predict, and may fluctuate from period to period, causing our revenues to fluctuate from period to period, which may significantly impact our quarterly or annual operating results. If we are not able to generate royalty income as expected in a particular period, we may fail to meet our revenue expectations, our operating income may decline disproportionately, and we may fail to meet the expectations of industry analysts and investors, which could cause our stock price to decline.

Our future revenues are inherently unpredictable, our operating results are likely to fluctuate from period to period, and if we fail to meet the expectations of securities analysts or investors, our stock price could decline significantly. Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate significantly in the future due to a variety of factors, some of which are outside our control. Accordingly, we believe that period-to-period comparisons of our results of operations are not meaningful and should not be relied upon as indications of future performance. Some of the factors that could cause our quarterly or annual operating results to fluctuate include conditions inherent in Government contracting and our business such as the timing of cost and expense recognition for contracts, the United States Government contracting and budget cycles, and contract closeouts. Because we base our operating expenses on anticipated revenue trends and a high percentage of our expenses are fixed in the short term, any delay in generating or recognizing forecasted revenues could significantly harm our business. Fluctuations in quarterly results, competition, or announcements of extraordinary events such as acquisitions or litigation may cause earnings to fall below the expectations of securities analysts and investors. In this event, the trading price of our common stock could significantly decline. In addition, there can be no assurance that an active trading market will be sustained for our common stock. The stock market in recent years has experienced extreme price and volume fluctuations that have particularly affected the market prices of many technology companies. These fluctuations, as well as general economic and market conditions, may adversely affect the future market price of our common stock.

Delays in the receipt of contracts could negatively impact our business. During our history, the receipt of certain final contracts has periodically been delayed to periods later than originally expected. Delays in the receipt of such orders could result in revenues falling short of estimates. On some of these contracts, we will make expenditures in advance of receipt of the final contract in anticipation of meeting the expected timetables, and will from time to time hire personnel in anticipation of receipt of the contract. If the contract is delayed, these costs are not covered. In addition, gross margins and net income will decrease if we elect to hold our cost structure in place while awaiting the award of delayed contracts.

Our results of operations could be negatively impacted if we are required to write off inventory deemed not saleable or usable. Some of our products or raw materials may become obsolete or unusable while in inventory. This could be due to changing customer specifications, decreases in demand for existing products, or changes in Government spending on signal intelligence. Work in process deemed not saleable is written off to contract costs in our statement of operations, while unusable raw materials are written off to general and administrative expenses.

We may lose sales if our suppliers fail to meet our needs. Although we procure most of our parts and components from multiple sources or believe that these components are readily available from numerous sources, certain components are available only from sole sources or from a limited number of sources. While we believe that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require us to re-engineer our products, or both, which could delay shipment of our products and could have a materially adverse effect on our operating results and financial condition.

Our failure to protect our intellectual property may significantly harm our business. Our success and ability to compete is dependent in part on our proprietary technology. We rely on a combination of patent, copyright, trademark, and trade secret laws, as well as confidentiality agreements to establish and protect our proprietary rights. We license certain of our proprietary technology to customers, and we rely largely on provisions of our licensing agreements to protect our intellectual property rights in this technology. To date, we have relied primarily on proprietary processes and know-how to protect our intellectual property. Although we have filed applications for several patents, five of which we currently hold, we cannot ensure that any patents will be issued as a result of pending patent applications or that our issued patents will be upheld. Any infringement of our proprietary rights could result in significant litigation costs, and any failure to adequately protect our proprietary rights could result in our competitors offering similar products, potentially resulting in loss of a competitive advantage and decreased revenues. Despite our efforts to protect our proprietary rights, existing patent, copyright, trademark, and trade secret laws afford only limited protection. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States. Attempts may be made to copy or reverse engineer aspects of our products or to obtain and use information that we regard as proprietary. Accordingly, we may not be able to prevent misappropriation of our technology or deter others from developing similar technology. Furthermore, policing the unauthorized use of our products is difficult. Litigation may be necessary in the future to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of resources, and could significantly harm our business.

The United States Government has rights to our technology that limits our intellectual property rights. Although we seek to protect the competitive benefits we derive from our patents, proprietary information, and other intellectual property, we do not have the right to prohibit the United States Government from using certain technologies developed or acquired by us or to prohibit third party companies, including our competitors, from using those technologies in providing products and services to the United States Government. The United States Government has the right to royalty-free use of technologies that we have developed under United States Government contracts. We may commercially exploit those Government-funded technologies and may assert our intellectual property rights against other non-Government users of technology developed by us, but we may not be successful in our efforts to do so.

Claims that we infringe third-party intellectual property rights could result in significant expenses or restrictions on our ability to sell our products. It is possible that from time to time, other parties may assert patent, copyright, trademark, and other intellectual property rights to technologies and in various jurisdictions that are important to our business. Any claims asserting that our products infringe or may infringe proprietary rights of third parties, if determined adverse to us, could significantly harm our business. Any claims, with or without merit, could result in costly litigation, divert the efforts of our technical and management personnel, cause product shipment delays, or require us to enter into royalty or licensing agreements, any of which could significantly harm our business. For example, we have filed a patent infringement claim and countersuits related to the claim have been filed against us. For further details, please see “Item 3: Legal Proceedings.” Royalty or licensing agreements, if required, may not be available on terms acceptable to us, if at all. In addition, our agreements with our customers typically require us to indemnify our customers from any expense or liability resulting from claimed infringement of third-party intellectual property rights. In the event a claim against us was successful and we could not obtain a license to the relevant technology on acceptable terms, license a substitute technology, or redesign our products to avoid infringement, our business would be significantly harmed.

Risks Related to Acquisitions

We intend to continue to pursue selective acquisitions of businesses or complementary technologies, which could involve costs and other risks, and may not provide the expected benefits. Over the last several years, we have made acquisitions and investments in areas complementary to our historic COMINT offerings, such as our acquisition of Dynamics Technology, Inc., Pyxis Engineering LLC, and Seismic LLC and our research and development into the ELINT market. As a result, we have expanded our product offerings, approached new customers, and entered into new markets for advanced digital signal processing products, systems, and services in support of ISR for global security.

Although we intend to continue to grow by acquisition, expand into new markets, and invest in products and markets complementary to our existing and new businesses, we may be unable to realize the benefits of our investments. Acquisitions could require significant capital infusions and could involve many risks, including, but not limited to, the following:

- We may have to issue convertible debt or equity securities to complete an acquisition, which may dilute the interests of our stockholders and could adversely affect the market price of our common stock
- An acquisition may negatively impact our results of operations because it may require us to write down amounts related to goodwill and amortize other intangible assets, or incur or assume substantial debt or liabilities, or it may cause adverse tax consequences, substantial depreciation, or deferred compensation charges
- We may encounter difficulties in assimilating and integrating the business, products, technologies, personnel, or operations of companies that we acquire
- Certain acquisitions may impact our relationship with existing or potential partners who are competitive with the acquired business, products, or technologies
- Acquisitions may require significant capital infusions and the acquired businesses, products, or technologies may not generate sufficient value to justify acquisition costs
- An acquisition may disrupt our ongoing business, divert resources, increase our expenses, and distract our management
- Acquisitions may involve the entry into a market in which we have little or no prior experience
- Key personnel of an acquired company may decide not to work for us

If any of these risks occurred, it could adversely affect our business, financial condition, and operating results. In addition, we may be unable to identify potential future acquisition candidates, or reach agreement on acceptable terms with potential acquisition candidates, adversely impacting our ability to grow by acquisition. If we do pursue and complete any acquisitions, it is possible that we may not realize the anticipated benefits from such acquisitions or that the market will not view such acquisitions positively. We may not be successful in our expansion of our products and markets, and may not realize the benefits of our investments in new markets.

We may be unable to successfully integrate the businesses of acquired companies.We will have to integrate the operations of any acquired company, including Seismic LLC, into our combined operations. Integration may require significant efforts, including the coordination of future development, sales, marketing efforts. We may find it difficult to integrate operations. Former customers of the acquired company 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 the customers and strategic partners of the acquired company and enhancing the relationship of the combined company with current and future customers and strategic partners of the acquired company
- Integrating and retaining the key employees from the acquired company as well as retaining key employees of ours performing similar services to those offered by the acquired company prior to the acquisition
- Coordinating development activities to enhance the services offered by the acquired company 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 of the acquired company
- Enhancing the internal controls of the operations acquired in the acquisition

The merger with Seismic may fail to achieve the anticipated benefits. We have completed the acquisition of Seismic with the expectation that the acquisition 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 Seismic, or key employees acquired from our acquisition of Pyxis, causing disruption to our ability to continue to offer the services offered by Seismic or 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 acquired businesses with our operations, and integrating the businesses are greater than anticipate d

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.

Since we have surpassed the 750-employee size standard eligibility for new awards under the Small Business Innovative Research (SBIR) program, any "small business" company we acquire will likely lose its eligibility to bid on new SBIR contracts once it is acquired by us. In addition, the imposition of Small Business Administration rules requiring small businesses to recertify as to their small business status before award of options or extensions to existing contracts may limit our ability to meet our growth objectives from acquired small businesses. For these or other reasons, we may be unable to retain key customers of acquired companies or to retain or renew contracts of acquired companies. Moreover, any acquired business may fail to generate the revenue or net income we expected or produce the efficiencies or cost-savings that we anticipated. Any of these outcomes could materially, adversely affect our operating results.

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 Seismic 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 Seismic or 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 acquired businesses are each entirely dependent on the continued retention of employees able to perform the services offered by Seismic and 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 acquisitions. We expect that our acquisitions could be of smaller companies, such as our acquisitions of Seismic and Pyxis, operating without a large infrastructure or robust internal controls. We will need to integrate the operations of these acquired companies, including Seismic and Pyxis, with our own operations, and ensure the development of appropriate controls and procedures commensurate with the controls and procedures with which we operate all of our other operations. We expect that we will incur direct transaction costs associated with such acquisitions, 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 may incur significant amounts of goodwill associated with acquisitions. We expect that any acquisition we complete will be accounted for by using the purchase method of accounting, such as in our acquisitions of Seismic LLC and Pyxis Engineering LLC. A portion of the purchase price in such acquisitions will be allocated to identifiable tangible and intangible assets and assumed liabilities based on valuation analysis of fair values at the date of consummation of the acquisition. Any excess purchase price will be allocated to goodwill. 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 Seismic could be difficult to integrate, disrupt our business, dilute stockholder value, or harm our results of operations. 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, 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 1B: Unresolved Staff Comments

None.

Item 2: Properties

Our corporate offices, located in Sunnyvale, California, also serve as our primary research and development, engineering, production, marketing, and administrative center. In addition, we maintain eight additional offices within the United States. The following table lists the properties we lease, as of October 31, 2010.

City	State	Leased space (sq. ft.)	Lease Expiration Date
Sunnyvale	California	266,077	March 2012
Torrance	California	39,692	June 2015
Anaheim	California	15,000	October 2016
Torrance	California	2,008	October 2011
Annapolis Junction	Maryland	61,038	April 2016
Salt Lake City	Utah	46,699	October 2014
Allen	Texas	32,000	February 2011
Herndon	Virginia	15,250	March 2011
Arlington	Virginia	9,523	June 2013

Our business requires that we maintain a facility clearance, sponsored and approved by the United States Government, at most of our offices. This approval could be suspended or revoked if we are found not to have complied with security regulations applicable to such facilities. Any revocation or suspension of such approval that materially delayed delivery of our products to customers would have a material, adverse impact on our ability to manufacture and sell our products and operate our business. Although we have adopted policies directed at assuring our compliance with relevant regulations, there can be no assurance that the approved status of our facilities will continue without interruption.

Item 3: 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 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 have answered; each asserts standard patent case defenses. On October 15, 2009, ViaSat, Inc. filed a counterclaim against us for infringement of two patents. On November 9, 2009, we answered those counterclaims, denying infringement and alleging that the ViaSat patents are invalid. On May 14, 2010, ViaSat amended its counterclaims against us to assert a third patent and to add third-party claims for patent infringement against our licensee, Comtech EFData. A claim construction hearing is scheduled for January 2011. No trial date has been set. The Court referred the parties to participate in settlement conferences with a Magistrate Judge in the Northern District of California. As to ViaSat and Paradise, the parties were unable to come to a resolution. A settlement conference with Emerging Market Communications and EMC Satcom Technologies was conducted on July 22, 2010, which resulted in a settlement agreement in principle, which is being formalized. We do not anticipate a material impact on our financial condition or operations from the proposed settlement agreement if it is adopted in its current form.If we are unable to come to a resolution of the patent infringement claims with ViaSat and Paradise, we expect to continue to vigorously pursue our claims and defenses.

On January 11, 2011, the Company received a copy of an unfiled complaint and was informed that a putative shareholder class action lawsuit has been, or will be, filed in the Superior Court of the State of California, County of Santa Clara, captioned Jarackas v. Applied Signal Technology, Inc., et al. (Case No. 111CV191643) against the Company, the members of its board of directors, Raytheon Company and RN Acquisition Company (the "Complaint"). The Complaint alleges that the members of the Company's board of directors breached their fiduciary duties in connection with the board's recommendation to the Company's stockholders to accept the Offer, authorizing the Company to enter into the Merger Agreement and the disclosures regarding the Offer and the Merger. The Complaint seeks injunctive relief and does not seek an award of money damages. The Company believes the allegations are without merit and intends to defend vigorously the action.

Item 4: Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year.

Part II

Item 5: Market for Registrant's Common Equity, Related Shareholder Matters, and Issuer Purchases of Equity Securities

Selected Common Stock Data

Our common stock trades on the NASDAQ Global Select Market under the symbol "APSG." As of October 29, 2010, the closing price of our common stock, as reported on NASDAQ, was $33.56, and we had approximately 487 registered shareholders of record. The following table sets forth the high and low closing prices for our common stock over the eight quarters ending October 31, 2010.

Closing Prices, as Reported on NASDAQ	High	Low
Fiscal year ended October 31, 2009		
First quarter	$19.74	$13.65
Second quarter	$21.55	$16.93
Third quarter	$26.47	$17.81
Fourth quarter	$26.22	$20.49
Fiscal year ended October 31, 2010		
First quarter	$21.08	$17.79
Second quarter	$19.96	$17.53
Third quarter	$21.44	$17.17
Fourth quarter	$33.56	$18.99

The company has paid dividends at the rate of $0.50 per share per annum, payable quarterly, since fiscal year 2004. Pursuant to the Merger Agreement, we have agreed not to declare or pay dividends. If the Merger Agreement is terminated, continued payment of the dividend will be subject to approval by the Board of Directors, and will be reviewed quarterly.

The continued payment of dividends and the amount thereof in the future will depend on a number of factors, including our financial condition, capital requirements, results of operations, future business prospects, and other factors that our Board of Directors may deem relevant.

We did not repurchase any of our equity securities during the fourth quarter of fiscal year 2010 nor issue any securities that were not registered under the Securities Act of 1933.

Comparison of Shareholder Return

Set forth below is a line graph comparing the annual percentage in the cumulative total return on our common stock with the cumulative total return for the Standard & Poor’s MIDCAP 400 Index (S&P MIDCAP 400), the Standard and Poor’s Aerospace and Defense Index (S&P Aerospace and Defense), and the Russell 2000 Index (Russell 2000) for the five-year period commencing October 31, 2005, and ending on October 31, 2010.

	Cumulative Total Return					
	10/05	10/06	10/07	10/08	10/09	10/10
Applied Signal Technology, Inc.	100.00	89.07	89.14	115.28	134.99	225.41
S&P Midcap 400	100.00	113.43	132.73	84.33	99.67	127.21
S&P Aerospace & Defense	100.00	128.51	166.69	105.66	112.98	141.96
Russell 2000	100.00	119.98	131.10	86.32	91.89	116.31

** Assumes that $100.00 was invested on 10/31/05 in our common stock and in each index, and that all dividends have been reinvested. Shareholder returns over the indicated period should not be considered indicative of future shareholder returns.*

This stock performance graph does not constitute soliciting material, and should not be deemed filed or incorporated by reference into any other company filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent we specifically incorporate this stock performance graph by reference therein.

Item 6: Selected Financial Data

(In thousands, except per share data)

	Year Ended October 31,				
Summary of Operations:	**2010**	**2009**	**2008**	**2007**	**2006**
Revenues from contracts	$218,573	$196,371	$181,147	$168,845	$161,193
Revenues from royalty agreements	6,656	6,244	5,184	1,530	720
Total revenues	$225,229	$202,615	$186,331	$170,375	$161,913
Operating expenses:					
Contract costs	159,949	142,722	129,835	116,133	107,898
Research and development	15,082	14,482	13,116	14,204	19,165
General and administrative	28,046	22,541	30,593	28,734	25,978
Total operating expenses	203,077	179,745	173,544	159,071	153,041
Operating income	22,152	22,870	12,787	11,304	8,872
Interest income (expense), net	(116)	223	761	683	315
Income before provision for income taxes	22,036	23,093	13,548	11,987	9,187
Provision (benefit) for income taxes	8,813	8,564	5,531	5,175	4,860
Net income	$13,223	$14,529	$8,017	$6,812	$4,327

Cash dividends declared per common share	$0.50	$0.50	$0.50	$0.50	$0.50
Net income per common share:					
Basic	$0.99	$1.11	$0.63	$0.56	$0.37
Diluted	$0.98	$1.10	$0.63	$0.55	$0.36
Number of shares used in calculating net income per common share:					
Basic	13,130	12,890	12,475	12,100	11,739
Diluted	13,248	13,083	12,642	12,300	11,994

	Year Ended October 31,				
Financial Position at End of Fiscal Year:	**2010**	**2009**	**2008**	**2007**	**2006**
Working capital	$69,787	$87,185	$82,614	$75,337	$67,188
Total assets	188,546	171,000	158,019	142,733	136,532
Long term debt	1,071	2,500	3,929	5,357	6,786
Retained earnings	69,088	62,600	54,626	52,953	52,272
Shareholders' equity	149,463	139,025	124,733	114,836	105,630

Note: The financial results in fiscal year 2010 include the results of Seismic since its acquisition in April 2010. The financial results in fiscal year 2009 and thereafter include the results of Pyxis since its acquisition in September 2009.

In the first quarter of fiscal year 2010, we adopted new guidance issued by the staff of the Financial Accounting Standards Board (included in ASC Topic 260-10-45) on determining whether instruments granted in share-based payment transactions are participating securities. This guidance requires us to include our unvested restricted stock awards, which have rights to receive dividends, as participating securities in the calculation of net income per share using the two-class method. We are required to apply this method retrospectively, and we have adjusted prior period calculations. For the year ended October 31, 2009, the adoption of this guidance decreased our previously reported basic net income per share and diluted net income per share by $0.02 and $0.01, respectively For the year ended October 31, 2008, the adoption of this guidance decreased our previously reported net income per share by $0.01 and had no impact on diluted net income per share. The adoption of this guidance had no impact on the net income and diluted net income per share for the years ended October 31, 2007, and 2006.

Item 7: Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion contains forward-looking statements that involve risks and uncertainties, as discussed in the introduction to "Item 1: Business." Actual results could differ substantially from those anticipated in these forward-looking statements as a result of many factors, including those set forth under "Item 1A: Risk Factors."

We believe funding of the United States defense budget is slowing relative to the prior five-year period as a result of anticipated decreases in supplemental budgets and pressures from other Government spending priorities. Despite these 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 warfare campaigns.

As we look ahead, we believe that spending levels in our high-demand niche categories of procurement will remain strong. 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 exploiting modern communication signals, and a towed high definition sonar system for undersea port and harbor surveillance.

We have a firm foundation in broadband communications and anticipate continued strong activity in this core market. Over the next several years, we anticipate growth opportunities in tactical SIGINT and cyber intelligence as the Government recapitalizes its existing equipment with new technology and develops an integrated response to emerging cyber security threats. 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 development efforts. A significant portion of our revenue continues to be generated by cost-reimbursable contracts.

Recent Acquisitions. In September of our fiscal year 2009, we acquired all of the outstanding membership interests in Pyxis Engineering LLC. This acquisition was accounted under the original accounting standard for business combinations. As of October 31, 2010, the total purchase price was approximately $20.4 million and the amount of the purchase price allocated to goodwill was approximately $17.0 million.

The sellers are entitled to additional consideration (the Pyxis Earn Out) based upon the performance of the business acquired from Pyxis during the 12-month period ending October 31, 2010 (Pyxis Earn-Out Period). Under the accounting rules in effect at the time of this acquisition, the contingent consideration increases the purchase price and goodwill in the period when the contingency is resolved.

As of October 31, 2010, the maximum amount of the Pyxis Earn Out was achieved, and we recorded liability of $3.75 million and increased goodwill by the same amount. On December 21, 2010, we paid eighty-four percent of the Pyxis Earn Out in AST common stock and 118,197 shares were issued. We paid the remaining portion in cash on December 29, 2010.

In addition, on December 15, 2010, we paid retention bonuses of approximately $0.6 million to the Pyxis employees who remained employees of AST through November 15, 2010. During fiscal year 2010 and fiscal year 2009, we recognized approximately $0.5 million and $0.1 million in operating expenses related to the Pyxis bonuses, respectively.

On April 28, 2010, we acquired all of the outstanding membership interests in Seismic LLC, and accounted for this purchase in accordance with the revised accounting standard for business combinations. Seismic has been engaged in cyber security solutions, software engineering, data management, and systems engineering and integration services for the Department of Defense and the intelligence communities. We believe this acquisition will complement our existing software and network services business in the defense and intelligence communities. In addition, we believe this acquisition will allow us the opportunity to expand our software and network services business into the emerging cyber security market.

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

The preliminary purchase price was approximately $26.7 million, which includes cash consideration of $24.7 million and contingent consideration of approximately $2 million. Approximately $4.9 million that would otherwise be distributed to the sellers at closing was deposited into an escrow account to provide a fund against which we may make claims for damages, if any, based on the breaches of the representations made by Seismic in the purchase agreement. Fifty percent of the escrow account will be released on the one-year anniversary of the closing date and the remainder in 18 months from the closing date, net of any claims made by us against Seismic or the sellers under the terms of the purchase agreement.

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

During the Initial Earn-Out Period, program profits exceeded 12% of Seismic revenues and Seismic backlog was greater than $10 million on October 31, 2010. Therefore, the Earn-Out Distribution Amount will only be based on revenue recorded during both the Initial and Subsequent Earn-Out Periods.

We recorded a liability of $2 million reflecting the fair value of the anticipated Seismic Earn Out. This amount was also included in the preliminary purchase price. We estimated the fair value by using the expected cash flow approach with probability-weighted revenue inputs and using a discount rate of 5.6%. Changes in the fair value of the contingent liability are recognized in earnings in the period of the change through the settlement of the liability. In the second half of fiscal year 2010, we increased the liability for accretion due to the increased probability of achievement as well as the passage of time, and recognized $0.4 million in general and administrative expense, representing a total liability of $2.4 million.

On January 10, 2011, we paid the shareholders of Seismic an accelerated earn-out payment of approximately $2.5 million due to the Merger Agreement with Raytheon Company, as required by the terms of the agreement with Seismic.

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

In addition, substantially all of the Seismic employees are eligible to receive retention bonus payments if they remain employees of Applied Signal Technology, Inc. through the one-year anniversary of the acquisition. The aggregate amount that could be paid is approximately $1.0 million.

For fiscal year 2010, we recognized approximately $1.5 million of compensation expense for the retention and Earn-Out bonuses in our statement of operations.

We incurred approximately $1.1 million of transaction costs related to the Seismic acquisition during fiscal year 2010. These costs are included in general and administrative expenses within our statement of operations.

Subsequent events. On December 20, 2010, Raytheon and AST announced that the companies have signed a definitive merger agreement providing for the acquisition of AST by Raytheon for $38.00 per share in cash. The transaction was unanimously approved by the board of directors of both companies. Under the terms of the definitive merger agreement, Raytheon commenced a cash tender offer on December 30, 2010, to purchase all of our outstanding shares for $38.00 per share in cash. The closing of the tender offer is subject to customary terms and conditions, including the tender of a number of shares that, together with the number of shares already owned by Raytheon, constitutes at least 76.3% of our outstanding shares of common stock (on a fully diluted basis) and expiration or termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. In the event that the minimum tender condition is not met, and in certain other circumstances, the parties have agreed to complete the transaction through a one-step merger after receipt of shareholder approval.

As a result of the Merger Agreement, we expect to pay BofA Merrill Lynch a fee totaling approximately $8.8 million, of which $1 million was earned upon delivery of its opinion during the first quarter of fiscal year 2011, and the remaining portion of which will be payable upon the consummation of the merger. In addition, we also expect to incur approximately $1.5–2 million of additional transaction costs during the first quarter of fiscal year 2011.

On November 11, 2010, the Compensation Committee of the Board of Directors of AST approved a modification to Mr. Van Vleet’s stock agreement such that in the event of a Change in Control, as defined in the Company’s Executive Retention and Severance Plan (the “ERSP”), the vesting of forty percent (40%) of the number of unvested shares of restricted stock then held by Mr. Van Vleet shall accelerate (with such number coming first from the restricted stock grant made to Mr. Van Vleet in September 2010), with the remaining unvested shares subject to vesting in accordance with the original terms of grant and subject to acceleration in accordance with the terms of the ERSP.

On December 13, 2010, the Compensation Committee of the Board of Directors of AST approved certain amendments to the ERSP. The amendments (i) clarify the ERSP’s compliance with Section 409A of the Internal Revenue Code and the scope of the term “Good Reason” as defined in the ERSP, and (ii) extend the “Change in Control Period” as defined in the ERSP for unvested equity awards until the date occurring 24 months following a Change in Control (as defined by the ERSP). In addition, the Company’s 2004 Stock Incentive Plan (the “2004 Plan”) was amended to provide for accelerated vesting in full of restricted stock awards in the event such holder is terminated without Cause (as defined in the 2004 Plan) or resigns for Good Reason (as defined in the 2004 Plan) within 24 months following a Change in Control as defined in the 2004 Plan. These amendments became effective as a result of the Merger Agreement.

Critical Accounting Policies and Estimates

General. Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements. These 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 consolidated 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 consolidated financial statements and, therefore, consider these critical accounting policies. See “Notes to 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.

Revenues and cost recognition. Our contracts are executed through written contractual arrangements, most of which require us to design, develop, manufacture, and/or modify our complex products, and perform related services according to specifications provided by the customer. The majority of our contracts are accounted for following the authoritative guidance for construction-type and production-type contracts. We recognize revenue on a limited number of stand-alone software contracts following the guidance for software revenue. For these software contracts, we defer revenue that is related to billings and customer payments in advance of the completion of the performance requirements set forth in 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, R&D, and general and administrative expenses (incurred costs). Stock compensation expense is generally not reimbursable under these contracts. Beginning the first quarter of fiscal year 2009, we apply indirect costs to all subcontract costs.

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

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

Our time-and-materials contracts are performed on a level-of-effort basis. We recognize revenue for these contracts by applying a negotiated billing rate to the level of effort.

We account for fixed-price contracts by using the percentage-of-completion method. Under this method, we charge labor, materials, and other direct costs, plus estimated indirect costs of operations as they are incurred. Each period, we recognize as revenue a portion of the contract revenue, based on estimated profits and the degree of completion of the contract as measured by a comparison of the actual costs incurred and the estimated costs to complete. On fixed-price contracts, we bear the risk of any unexpected increases in the cost to develop or manufacture a product, whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies, or other factors; and these costs could have a materially adverse effect on our results of operations.

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

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

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and costs incurred in connection with ongoing contracts for which contract modifications have not been defined or completed at the end of the reporting period. These costs are included in other current assets on the balance sheet. Precontract costs for the periods ending October 31, 2010, and October 31, 2009, were approximately $1,454,000 and $1,139,000, respectively. Approximately $1,139,000 of the October 31, 2009, balance was recognized as revenues during fiscal year 2010.

We have two royalty licensing agreements for which we accrue royalties on sales of our licensed product by a third party. Since there are essentially no costs associated with these agreements, operating income will increase by the same amount of revenue that we recognize. Royalties contributed approximately $6,656,000, $6,244,000, and $5,184,000 to revenues and operating income during fiscal years 2010, 2009, and 2008, respectively.

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. At the beginning of fiscal year 2009, we implemented a new indirect rate structure that 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 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, in general, the modification of our billing rates will typically 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 the end of fiscal year 2010, we absorbed an unfavorable indirect rate variance that accumulated during the fiscal year by modifying our billing rates to our customers. Consequently, we increased revenues by approximately $1,047,000 and operating expenses by approximately $1,532,000, which represented a reduction to operating income of approximately $485,000.

At the end of fiscal year 2009, we absorbed a favorable indirect rate variance that accumulated during the fiscal year by modifying our billing rates to our customers, which created an insignificant adjustment to revenues and decreased operating expenses by approximately $329,000.

At the end of fiscal year 2008, we absorbed a favorable indirect rate variance that accumulated during the fiscal year by modifying our billing rates to our customers. Consequently, we decreased revenues by approximately $1,657,000 and operating expenses by approximately $1,243,000, which represented a reduction to operating income of approximately $414,000. The reduction to operating income included an increase to general and administrative (G&A) expense of approximately $1,241,000, primarily associated with inventory purchases related to one product during the fourth quarter.

Inventory valuation and disposal. We provide advanced digital signal processing products and systems to the United States Government. 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.

If we determine that the estimated market value of certain inventory is below cost, we will write down the inventory to the estimated market value. We did not record a write-down in fiscal year 2010. We recorded a write-down of approximately $422,000 during fiscal year 2009 to reflect the estimated market value of one inventoried product. This charge was included in contract costs in our statement of operations. Disposals associated with our raw materials are included in general and administrative expenses on the statement of operations. This is because we could use raw materials in a variety of situations other than contract costs, including R&D. Disposals of raw material inventory amounted to approximately $197,000 during fiscal year 2010 and were not significant during fiscal year 2009. Disposals of obsolete products amounted to approximately $155,000 during fiscal year 2010 and approximately $304,000 during fiscal year 2009.

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

Actual results could differ from our estimates.

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

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

Please refer to “Notes to Consolidated Financial Statements, Note 8: 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 fiscal years 2010, 2009, or 2008.

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

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

Management made estimates of fair value based upon assumptions believed to be reasonable. These estimates were based on historical experience and information obtained from the management of the acquired companies and are inherently uncertain. Critical estimates in valuing the contingent consideration for the Seismic Earn Out included the probability of achieving target levels of revenues for the acquired business. In accordance with the revised standard for business combinations, the fair value of the Seismic Earn Out was included as part of the initial purchase price, and is re-measured at each balance sheet date. The adjustments to fair value are recorded to operating expense.

Critical estimates in valuing certain of the intangible assets included, but were not limited to, future expected cash flows from funded backlog, unfunded backlog, future contracts, and non-compete agreements. Unanticipated events and circumstances may occur that may affect the accuracy or validity of such assumptions, estimates, or actual results.

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

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, as of the first day of the fourth quarter. We believe AST is one reporting unit, and therefore, we compare the fair value of AST to the total net asset value on our balance sheet. If our total net asset value were to exceed our fair value, we would perform the second step of the impairment test. In the second step, we would compare the implied fair value of our goodwill to our carrying amount, taking a write-down to the extent the carrying amount exceeds the implied fair value. If the fair value of AST exceeds the carrying value of our net assets under step one, then no impairment is indicated and the test is complete.

We passed the first step of our annual impairment test for fiscal year 2010. In addition, there were no indicators of impairment as of October 31, 2010.

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 considerations, 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 discarded 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 the fair value.

There were no indicators of impairment as of October 31, 2010.

Share-based payment. We adopted the current accounting standard related to share-based payment in fiscal year 2006. We elected to use the modified prospective transition method. 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 the new standard. 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 prior accounting standard. 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) with a six-month offering period. For offering periods beginning prior to December 1, 2008, the ESPP allowed employees to purchase shares of common stock at 85% of the closing stock price at the lower of either the date of enrollment or the date of purchase. In 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 closing stock price on the date of purchase, and therefore, the ESPP is non-compensatory. The remaining expense related to the final compensatory award under the ESPP was recognized in the first quarter of fiscal year 2009.

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).

	Year Ended October 31,		
	2010	**2009**	**2008**
Contract costs	$1,225	$1,397	$2,747
Research and development	51	76	177
General and administrative	779 ---------	763 ---------	1,855 ---------
Stock-based compensation expense before income taxes	$2,055	$2,236	$4,779
Income taxes	(775) ======	(727) ======	(1,029) ======
Stock-based compensation expense after income taxes	$1,280	$1,509	$3,750
Reduction to basic net income per share	$0.10	$0.12	$0.30
Reduction to diluted net income per share	$0.10	$0.12	$0.30

The decrease to our stock-based compensation expense in fiscal year 2009 is primarily due to the non-compensatory nature of our ESPP Plan, effective December 1, 2008. In addition, fiscal year 2008 includes additional compensation expense of approximately $304,000 related to the modification of certain equity awards held by our former Chairman and Chief Executive Officer in connection with his severance agreement.

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

Fair value measurements. The fair value accounting standard defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. It also establishes a framework for measuring fair value. We adopted the requirements of the fair value standard as they relate to certain non-financial assets and liabilities on November 1, 2009. This adoption did not have a material impact on our results of operations, financial position, or cash flows.

The standard on fair value measurement establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

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

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

	October 31, 2010 Fair Value Measurements			
	Level 1	**Level 2**	**Level 3**	**Total Fair Value**
Assets				
Cash equivalents:				
Money market funds	$531	$—	$—	$531
Available-for-sale securities:				
Short-term municipal	—	30,398	—	30,398
Total assets	$531	$30,398	$—	$30,929
Liabilities				
Contingent consideration	$—	$—	$2,374	$2,374
Interest rate swap	—	$56	—	$56
Total liabilities	$—	$56	$2,374	$2,430

	October 31, 2009 Fair Value Measurements		
	Level 1	**Level 2**	**Total Fair Value**
Assets			
Cash equivalents			
Money market funds	$2,028	$—	$2,028
Available-for-sale securities:			

Short-term municipal	—	43,454	43,454
Long-term municipal	— ---------	2,129 ---------	2,129 ---------
Total assets	$2,028 =====	$45,583 =====	$47,611 =====
Liabilities			
Interest rate swap	$— ---------	$116 ---------	$116 ---------
Total liabilities	$— =====	$116 =====	$116 =====

As of October 31, 2010, 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, such as municipal yield curves and credit ratings.

We have a contingent consideration liability that is payable to the shareholders of Seismic. We recorded $2 million in other accrued liabilities in our consolidated balance sheet based on future revenues projected over a one-year period from the date of acquisition of April 28, 2010. We estimated the fair value of this liability by using the expected cash flow approach with probability-weighted revenue inputs. In the second half of fiscal year 2010, we increased the liability for accretion due to the increased probability of achievement as well as the passage of time, and recognized $327,000 in general and administrative expense. The fair value of the Seismic Earn Out was also included in the preliminary purchase price. Please refer to “Notes to Consolidated Financial Statements, Note 4: Business Combinations” for further information on the terms of the agreement as it pertains to the contingent consideration.

The inputs used to value the interest rate swap liability are based on observable market data such as the London Inter-Bank Offered Rate (LIBOR) swap rate (floating interest rate), a fixed rate (term loan interest rate), a discount factor, and a calculation of a present value of the interest paid/received based on the expected loan principal. Please refer to “ Notes to Consolidated Financial Statements, Note 6: Borrowing Arrangements” for further information.

Allowance for bad debt. Since the majority of our revenues are generated from the United States Government, its agencies, or prime contractors for the United States Government, we regard the credit risk of our business to be minimal. We record allowances for bad debt as a reduction to accounts receivable and an increase to bad debt expense. These allowances are recorded in the period a specific collection problem is identified. Once the receivable is deemed uncollectible, the allowance is reversed and the receivable is written off to bad debt expense. Charges to bad debt expense were not significant during fiscal years 2010, 2009, and 2008.

Operating Results – Fiscal Years Comparison

The following table sets forth, for the periods indicated, statements of operations data as a percentage of revenues from contracts, and, at the end of each period indicated, our backlog.

	—— Year Ended October 31, ——		
	2010	**2009**	**2008**
Revenues	100.0%	100.0%	100.0%
Operating expenses:			

Contract costs	71.0%	70.4%	69.7%
Research and development	6.7%	7.2%	7.0%
General and administrative	12.4% ---------	11.1% ---------	16.4% ---------
Total operating expenses	90.1% ---------	88.7% ---------	93.1% ---------
Operating income	9.9%	11.3%	6.9%
Interest income (expense), net	(0.1)% ---------	0.1% ---------	0.4% ---------
Income before provision for income taxes	9.8%	11.4%	7.3%
Provision for income taxes	3.9% ---------	4.2% ---------	3.0% ---------
Net income	5.9% =====	7.2% =====	4.3% =====
Backlog (thousands of dollars)	$152,171	$139,108	$124,784

Revenues

Revenues were approximately $225,229,000, $202,615,000, and $186,331,000 for fiscal years 2010, 2009, and 2008, respectively. Revenues increased by 11.2% during fiscal year 2010 over fiscal year 2009 and increased by 8.7% during fiscal year 2009 over fiscal year 2008.

Revenues generated by our development programs increased by approximately $38,279,000 in fiscal year 2010 compared to the same period in fiscal year 2009. The increase was primarily due to an increase in our network intelligence business area that included revenues generated from Seismic of approximately $13,361,000 and Pyxis contracts of approximately $17,362,000. Revenues from development programs increased by approximately $3,735,000 during fiscal year 2009 compared to the same period in fiscal year 2008. This increase included revenues generated from Pyxis of approximately $2,246,000.

Product sales decreased by approximately $16,077,000 during fiscal year 2010 compared to the same period in fiscal year 2009. During fiscal year 2009, our product sales increased by approximately $11,488,000 compared to fiscal year 2008.

We have two royalty agreements for which we accrue royalties on sales of our licensed product by a third party. Since there are essentially no costs associated with these agreements, operating income will increase by the same amount of revenue that we recognize. Revenues from royalties increased by approximately $412,000 during fiscal year 2010 over fiscal year 2009, and increased by approximately $1,060,000 during fiscal year 2009 over fiscal year 2008.

The following table represents our revenue concentration (as a percentage of total revenues) during the respective periods by revenue type.

	FY10	FY09	FY08
Development revenues	92%	83%	88%
Product revenues	5%	14%	9%
Royalty revenues	3% ---------	3% ---------	3% ---------
	100% ======	100% ======	100% ======

Our contracts can be either 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 (as a percentage of total revenues) during the respective periods by contract type.

	FY10	FY09	FY08
Cost-reimbursement contracts	74%	59%	69%
Time-and-materials contracts	15%	22%	18%
Fixed-price contracts	8%	16%	10%
Royalty contracts	3%	3%	3%
	100%	100%	100%

The following table represents the revenue concentration of our 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.

	FY10	FY09	FY08
Next Generation ASA	20%	—	—
Tiffany	13%	21%	13%
Thunderdome	8%	—	—
ASA	—	18%	15%
High Beam	—	7%	15%
Stone Face II	—	6%	12%
Specter	—	—	5%
	41%	52%	60%
a dash (—) designates less than 5% revenue concentration			

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

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

The following table identifies the source of our revenues (as a percentage of total revenues) for fiscal years 2010, 2009, and 2008 by market.

	FY10	FY09	FY08
Intelligence	89%	83%	80%
Defense	8%	12%	16%

Commercial	3%	5%	4%
Foreign	— ---------	— ---------	— ---------
	100% ======	100% ======	100% ======
a dash (—) designates less than 1% revenue concentration			

Within the customer types, contracts with two intelligence community customers and one defense customer represented a significant portion of revenues.

The table below identifies the revenue concentration (as a percentage of total revenues) from all contracts with each significant customer.

	FY10	FY09	FY08
Intelligence community customer 1	40%	33%	25%
Intelligence community customer 2	38%	43%	50%
Largest defense customer	6% ---------	9% ---------	12% ---------
	84% ======	85% ======	87% ======

Revenues from the United States Government can also be categorized as direct purchases and subcontracts, where we are the supplier to another contractor. The following table distinguishes revenue (as a percentage of total revenues) between those two categories.

	FY10	FY09	FY08
Direct purchases	66%	65%	65%
Subcontracts	30% ---------	30% ---------	31% ---------
	96% ======	95% ======	96% ======

New Orders and Backlog

We received new orders of approximately $221,614,000, $210,285,000, and $185,139,000 during fiscal years 2010, 2009, and 2008, respectively. Our backlog consists of the uncompleted portions of existing contracts (excluding unexercised contract options). At the end of fiscal year 2010, ending backlog was approximately $152,171,000. 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. The fiscal year 2010 backlog represents a 9.4% increase to the backlog of $139,108,000 at the end of fiscal year 2009. The fiscal year 2009 backlog represents an 11.5% increase to the backlog of $124,784,000 at the end of fiscal year 2008, primarily due to the backlog acquired from Pyxis of $8,648,000.

Contract Costs

Contract costs consist of direct costs incurred in the performance of contracts, including labor, materials, and overhead costs. Contract costs were approximately $159,949,000, or 71.0% of revenues, in fiscal year 2010 compared to approximately $142,722,000, or 70.4% of revenues, in fiscal year 2009, and approximately $129,835,000, or 69.7% of revenues, in fiscal year 2008. Contract costs increased in absolute dollars due to the increase in revenues, and increased slightly as a percentage of revenues during fiscal years 2010, 2009, and 2008. The increase in costs during fiscal year 2010 compared to fiscal year 2009 was primarily due to contract activity related to our development contracts. In addition, compensation expense payable to the employees of Seismic and Pyxis increased contract costs by approximately $1,463,000 during fiscal year 2010. Contract costs increased in absolute dollars during fiscal year 2009, primarily due to increased contract activity related to our development contracts, offset by reductions to contract costs from pre-contract activity of approximately $2,356,000, inventory write-downs of approximately $907,000, and stock-based compensation expense of approximately $1,350,000.

Research and Development Expenses

We invest our R&D expenses based on an annual targeted percentage of revenues. Company-directed investment in R&D expenses were approximately $15,082,000, or 6.7% of revenues, in fiscal year 2010 compared to approximately $14,482,000, or 7.1% of revenues, in fiscal year 2009 and approximately $13,116,000, or 7.0% of revenues, in fiscal year 2008. R&D expenses declined as a percentage of revenues due to the increase in revenues associated with Seismic contracts.

General and Administrative Expenses

General and administrative (G&A) expenses include administrative salaries, costs related to marketing and proposal activities, costs related to product warranties, and other administrative costs. General and administrative expenses were approximately $28,046,000, or 12.4% of revenues, in fiscal year 2010 compared to approximately $22,541,000, or 11.1% of revenues, in fiscal year 2009 and approximately $30,593,000, or 16.4% of revenues, in fiscal year 2008. G&A expenses were higher in absolute dollars and as a percentage of revenue during fiscal year 2010 compared to fiscal year 2009 primarily due to an increase in acquisition-related expenses totaling approximately $2,567,000. G&A expenses decreased in absolute dollars and as a percentage of revenue during fiscal year 2009 compared to fiscal year 2008, primarily due to the change in our indirect rate structure for fiscal year 2009. In addition, stock-based compensation declined by approximately $1,092,000 during fiscal year 2009, compared to fiscal year 2008.

Interest Income and Other, Net

Interest income and other, net for fiscal year 2010, was approximately $197,000 compared to approximately $676,000 and $1,296,000 of interest income in fiscal years 2009 and 2008, respectively. Interest income has decreased in fiscal years 2010 and 2009 primarily due to lower average yields within our investment portfolio. In addition, we used cash to acquire Seismic, LLC in 2010 and Pyxis Engineering LLC in 2009, reducing our investment balance and corresponding interest income. Please refer to “Notes to Consolidated Financial Statement Note 4: Business Combination” for further information.

Interest Expense

Interest expense for fiscal year 2010 was approximately $313,000 compared to approximately $453,000 and $535,000 in fiscal years 2009 and 2008, respectively. Interest expense has declined in fiscal years 2010 and 2009 due to the reduction to our Term Loan with Wells Fargo through scheduled principal payments.

Provision for Income Taxes

Our provision for income taxes for fiscal years 2010, 2009, and 2008 resulted in income tax expense of approximately $8,813,000, $8,564,000, and $5,531,000, respectively. The effective tax rate for fiscal years 2010, 2009, and 2008 were approximately 40%, 37%, and 41%, respectively. The increase in our tax rate in fiscal year 2010, compared to fiscal year 2009 is primarily due to a reduction in research and development credits and a decline in tax-exempt interest.

The decline in our tax rate in fiscal year 2009, compared to fiscal year 2008 is primarily due to a reduction in non-deductible stock compensation expense from our ESPP related to changes in the plan and a decline in non-deductible meals and entertainment expense. In addition, the reduction of our liability for unrecognized tax benefits as a result of a favorable IRS audit created a reduction to income tax expense of approximately $245,000.

Analysis of Liquidity and Capital Resources

Our primary sources of liquidity during fiscal year 2010 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. As a result of the modification to our ESPP, participation has significantly declined and therefore cash received from the issuance of common stock under our ESPP has declined in 2010.

Cash from operating activities. Net cash from operating activities has fluctuated significantly from year to year. Net cash provided by operating activities was approximately $22,895,000, $17,169,000, and $28,163,000 in fiscal years 2010, 2009, and 2008, respectively. The year-to-year variances are primarily the result of changes in net income and operating assets and liabilities.

Net income for fiscal year 2010 was approximately $13,223,000, a $1,306,000 decrease from fiscal year 2009. Net income for fiscal year 2009 was approximately $14,529,000, an increase of $6,512,000 from fiscal year 2008.

Accounts receivable balances decreased by approximately $2,284,000 during fiscal year 2010, increased by approximately $2,914,000 during fiscal year 2009, and decreased by approximately $4,361,000 during fiscal year 2008. During fiscal year 2010, we generated revenues of approximately $225,229,000 and collected approximately $228,136,000. During fiscal year 2009, we generated revenues of approximately $196,371,000 and collected approximately $196,888,000. During fiscal year 2008, we generated revenues of approximately $186,331,000 and collected approximately $191,443,000. Our accounts receivable collections improved during fiscal year 2010 despite certain delays in the Government payment process during the second quarter of fiscal year 2010.

Inventories, prepaid expenses, and other assets increased by approximately $2,579,000 in fiscal year 2010, decreased by approximately $482,000 and increased by approximately $2,697,000 in fiscal years 2009 and 2008, respectively. During fiscal year 2010, inventory balances increased by approximately $1,844,000, due to a combined increase to our work-in-process and finished goods inventory of approximately $2,042,000, in anticipation of future contracts. During fiscal year 2009, inventory balances increased by approximately $237,000 due to an aggregate increase to our work-in-process and finished goods balance of approximately $691,000 partially offset by a reduction due to an inventory write-down of approximately $422,000. In addition, prepaid income taxes increased by approximately $576,000.

During fiscal year 2009, deferred tax assets decreased by approximately $1,539,000. The decrease is primarily associated with adjustments related to our unrecognized tax benefits. In addition, our pre-contract cost decreased by approximately $143,000. This decrease included a reduction associated with costs incurred during fiscal year 2008 of approximately $1,073,000. The decline was primarily offset by an increase to pre-contract costs from Pyxis efforts of approximately $582,000.

During fiscal year 2008, inventory balances increased by approximately $2,196,000. The increase in inventory included an increase to work-in-process inventory by approximately $3,642,000, primarily associated with two products, and a reduction due to an inventory write-down of approximately $1,329,000. Current deferred tax assets increased by approximately $3,643,000 primarily due to an increase of approximately $1,125,000 associated with unrecognized tax benefits recorded during fiscal year 2008, and a reclassification from long-term deferred tax assets of approximately $1,025,000 associated with our net operating loss carryforward. Our pre-contract costs decreased by approximately $3,182,000 primarily due to our ability to obtain funding for the ASA contract.

Accounts payable, taxes payable, accrued payroll liabilities, and other accrued liabilities balances increased by approximately $932,000 in fiscal year 2010, decreased in fiscal year 2009 by approximately $3,141,000, and increased in fiscal year 2008 by approximately $5,454,000. Accounts payable increased during fiscal year 2010 by approximately $1,470,000 due to normal timing of vendor payments. Accrued payroll liabilities decreased by approximately $205,000 primarily due to a decline in accrued salaries of approximately $540,000 and accrued severance of approximately $398,000. The decline was partially offset by an increase to accrued bonuses of approximately $804,000. Our fiscal year 2010 bonus accrual was approximately $5,028,000. In addition, we accrued approximately $1,660,000 associated with the retention and performance bonus plans for the former employees of Seismic and Pyxis. The bonus accruals were offset by bonus payments of approximately $4,397,000, accrued at the end of fiscal year 2009, and approximately $1,077,000 for the liability acquired from Pyxis.

Accounts payable increased during fiscal year 2009 by approximately $730,000 due to normal timing of vendor payments. Other accrued liabilities decreased by approximately $1,460,000 primarily due to reductions to our liabilities for unrecognized tax benefits of approximately $1,403,000. Accrued payroll liabilities declined by approximately $2,357,000 primarily due to payments for accrued vacation of approximately $2,365,000 due to a change in our vacation policy; bonus payments of approximately $2,751,000, accrued at the end of fiscal year 2008; and payments of payroll liabilities acquired from Pyxis of approximately $1,225,000 related to the tax withholding of the Pyxis stock compensation awarded prior to the closing of the acquisition. This decline was partially offset by an increase to accrued bonus of approximately $4,326,000 for our fiscal year 2009 bonus plans.

The increase during fiscal year 2008 included accrued severance for our former Chief Executive Officer of approximately $1,003,000. Accounts payable increased by approximately $1,839,000 due to the timing of our vendor payments. Other accrued liabilities increased by approximately $1,956,000 primarily due to recording unrecognized tax benefits and related interest of approximately $1,620,000.

Cash from investing activities. Net cash used in investing activities during fiscal years 2010, 2009, and 2008 was approximately $14,087,000, $13,269,000, and $24,829,000, respectively.

During fiscal year 2010, we paid approximately $24,691,000 related to the acquisition of Seismic. We acquired cash of approximately $1,068,000 from Seismic.

During fiscal year 2010, we purchased approximately $75,287,000 of investment securities, approximately $80,785,000 matured and $8,961,000 was sold. Fiscal year 2010 property and equipment purchases included approximately $2,704,000 for leasehold improvements primarily associated with our facilities in Anaheim, California and Salt Lake City, Utah. In addition, we purchased approximately $1,762,000 for computer equipment and approximately $1,019,000 for test equipment.

During the fourth quarter of fiscal year 2009, we paid approximately $17,325,000 related to the acquisition of Pyxis. We acquired cash of approximately $1,382,000 from Pyxis.

During fiscal year 2009, we purchased approximately $63,687,000 of investment securities, while $71,776,000 matured. Fiscal year 2009 property and equipment purchases included approximately $2,273,000 in computer equipment and approximately $1,098,000 in test equipment.

During fiscal year 2008, we increased our investment in tax-exempt securities that were classified as short-term or long-term investments. Fiscal year 2008 property and equipment purchases included approximately $1,339,000 in computer equipment and approximately $1,247,000 in test equipment.

Cash from financing activities. Net cash used in financing activities during fiscal years 2010, 2009, and 2008 were approximately $7,387,000, $4,466,000, and $3,916,000, respectively.

The sources of cash from financing activities for fiscal years 2010, 2009, and 2008 were from the purchase of common stock under our ESPP and the cash received from stock option exercises. During fiscal year 2010, cash from purchases under our ESPP declined by approximately $896,000 as compared to fiscal year 2009 due to less participation in our ESPP. During fiscal year 2010, cash from option exercises declined by approximately $871,000.

During fiscal years 2010, 2009, and 2008, loan payments totaled approximately $2,669,000, $2,054,000, and $1,428,000, respectively. Term loan payments during fiscal year 2010 included a payment of approximately $1,240,000 for the loan balance acquired from Seismic. Term loan payments during fiscal year 2009 included a payment of approximately $625,000 for the loan balance acquired from Pyxis.

Dividend payments in fiscal year 2010 were the same as for fiscal years 2009 and 2008, at $0.50 per share per annum. Dividend payments were approximately $6,658,000, $6,507,000, and $6,290,000 in fiscal years 2010, 2009, and 2008, respectively. The year-over-year increases are due to increases in common stock outstanding resulting from activities associated with our stock compensation plans.

Cash is generated primarily from operating activities, employee stock activities, and investing activities. At October 31, 2010, we held in our investment portfolio approximately $30,398,000 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. We entered into a new revolving line of credit (Line of Credit) on February 22, 2010, under which Wells Fargo Bank (Wells Fargo) could advance funds to us, up to a maximum principal amount of $35 million. For borrowings under the new Line of Credit we have the option to bear interest at either Wells Fargo’s reference rate or at a fixed rate per annum equal to 2.5% above the London Inter-Bank Offered Rate (LIBOR), and interest on those borrowings is payable monthly. The Line of Credit expires on February 12, 2012.

As a subfeature under the Line of Credit, Wells Fargo may issue standby letters of credit for us, provided that the aggregate amount of all outstanding letters of credit shall not at any time exceed $3,000,000. At October 31, 2010, we had three standby letters of credit under the Line of Credit, totaling approximately $1,407,000. The first letter of credit, related to our Sunnyvale, California, facilities lease, had a committed balance of approximately $1,221,000 at October 31, 2010. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at October 31, 2010. The third letter of credit, a requirement of one of our customers, had a committed balance of $36,000 at October 31, 2010. We do not pay interest on the amounts associated with the standby letters of credit.

As a result of the committed but unused funds associated with the three letters of credit, the total amount under the Line of Credit available for future letters of credit was $1,593,000 and the total amount available for borrowing was approximately $33.6 million at October 31, 2010. No fees or interest were associated with this unused portion.

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

Term loan and interest rate swap. Effective July 1, 2005, and in connection with the acquisition of Dynamics Technology, Inc. (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 (Term Loan). The Term Loan bears interest at a rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) (0.26% at October 31, 2010). Our Term Loan is for a seven-year term ending on July 1, 2012. The loan terms require us to make monthly payments of principal and interest.

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

Under the Line of Credit and Term Loan, we are required to maintain certain financial covenants setting forth minimum ratios for quick ratio and fixed charge coverage and maximum ratios for total liabilities to tangible net worth. As of October 31, 2010, we were in compliance with these covenants.

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

The effective portion of the cash flow hedge is reported as other comprehensive income and reclassified into earnings in the same period during which the hedged transaction affects earnings. At October 31, 2010, the effective portion of the cash flow hedge was a deferred loss of approximately $93,000 on a gross basis. The deferred loss net of taxes was approximately $56,000, and was included in other comprehensive income and long-term liabilities on our balance sheet. For the years 2010, 2009, and 2008, we recognized losses related to the hedge of $35,000, $210,000, and $232,000, respectively, in other comprehensive income. During fiscal years 2010, 2009, and 2008, we recognized interest expense of approximately $130,000, $168,000, and $58,000, respectively, reclassified from other comprehensive income. Over the next twelve months, we expect to reclassify approximately $76,000 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 October 31, 2010.

Contractual Obligations

The following table sets forth our contractual obligations as of October 31, 2010 (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	$25,088	$7,616	$9,167	$6,950	$1,355
Loan obligations – principal	2,500	1,429	1,071	—	—
Loan obligations – interest	141	113	28	—	—
Purchase obligations	7,799	7,799	—	—	—
Pyxis Earn Out	3,750	3,750	—	—	—
Seismic Earn Out	2,374	2,374	—	—	—
Total	$41,652	$23,081	$10,266	$6,950	$1,355

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2011 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses.

The Seismic Earn Out represents the fair value of the contingent liability related to the acquisition of Seismic as of October 31, 2010. On January 10, 2011, we paid the shareholders of Seismic an accelerated earn-out payment of approximately $2.5 million due to the Merger Agreement with Raytheon Company, as required by the terms of the agreement with Seismic.

The Pyxis Earn Out represents the contingent consideration that was paid during the first quarter of fiscal year 2011 to the former shareholders of Pyxis, based upon the achievement of the targets identified in the purchase agreement dated September 1, 2009.

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.

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 were approximately $346,000, $117,000, and $181,000 for fiscal years 2010, 2009, and 2008, respectively.

Recent Accounting Pronouncements

In October 2009, the FASB issued ASC Update No. 2009-13, updating ASC Topic 605, *Revenue Recognition*. This update provides new standards for revenue recognition for arrangements with multiple deliverables. These new standards affect the determination of when the individual deliverables may be treated as separate units of accounting. Additionally, these new standards modify the method of allocating consideration to the deliverables. The relative fair value method based on selling prices will be required and the residual method of allocating arrangement consideration will no longer be permitted. These new standards are effective for our fiscal year beginning November 1, 2010. We do not expect the adoption of these standards to have a material impact on our consolidated financial statements.

In October 2009, the FASB issued ASC Update No. 2009-14, updating ASC Topic 985, *Software*. This update provides new standards that amend the scope of previous software revenue guidance by excluding non-software components of tangible products and certain software components of tangible products. These new standards are effective for our fiscal year beginning November 1, 2010. We do not expect the adoption of these standards to have a material impact on our consolidated financial statements.

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

Quarterly Results

The following table sets forth certain unaudited quarterly consolidated financial data for the eight quarters ending October 31, 2010. In the opinion of management, the unaudited information set forth below has been prepared on the same basis as the audited information and includes all adjustments necessary to present fairly the information set forth herein. The operating results for any quarter are not indicative of results for any future period. All data is in thousands except for common share and per common share data.

	2009					2				
	Q1	Q2	Q3	Q4	Total	Q1	Q2	Q3	Q4	Total
Revenues from contracts	$43,687	$51,618	$47,845	$53,221	$196,371	$46,613	$56,219	$ 54,494	$61,247	$218,5
Revenues from royalty agreements	1,697 ---------	1,882 ---------	1,655 ---------	1,010 ---------	6,244 ---------	1,467 ---------	1,944 ---------	1,916 ---------	1,329 ---------	6,65 ---------
Total revenues	$45,384	$53,500	$49,500	$54,231	$202,615	$48,080	$58,163	$56,410	$62,576	$225,22

Operating expenses:										
Contract costs	31,531	37,489	35,347	38,355	142,722	34,000	40,850	40,078	45,021	159,94
Research and development	3,075	3,797	3,757	3,853	14,482	3,047	4,046	4,003	3,986	15,08
General and administrative	5,130	5,759	5,552	6,100	22,541	5,839	7,809	6,224	8,174	28,04
Total operating expenses	39,736	47,045	44,656	48,308	179,745	42,886	52,705	50,305	57,181	203,07
Operating income	5,648	6,455	4,844	5,923	22,870	5,194	5,458	6,105	5,395	22,15
Interest income (expense), net	112	69	41	1	223	(3)	(34)	(37)	(42)	(11
Income before provision (benefit) for income taxes	5,760	6,524	4,885	5,924	23,093	5,191	5,424	6,068	5,353	22,03
Provision (benefit) for income taxes	2,245	2,450	1,555	2,314	8,564	2,052	2,128	2,504	2,129	8,81
Net income	$3,515	$4,074	$3,330	$3,610	$14,529	$3,139	$3,296	$3,564	$3,224	$13,22
Net income, per common share										
Basic	$0.27	$0.31	$0.25	$0.27	$1.11	$0. 24	$0.25	$0.27	$0.24	$0
Diluted	$0.27	$0.31	$0.25	$0.27	$1.10	$0.23	$0.24	$0.26	$0.23	$0
Number of shares used in calculating net income per common share										
Basic	12,754	12,852	12,947	13,005	12,890	13,068	13,091	13,150	13,211	13,1
Diluted	12,932	13,033	13,170	13,213	13,083	13,216	13,230	13,282	13,350	13,2

In the first quarter of fiscal year 2010, we adopted new guidance issued by the staff of the Financial Accounting Standards Board (included in ASC Topic 260-10-45) on determining whether instruments granted in share-based payment transactions are participating securities. This guidance requires us to include our unvested restricted stock awards, which have rights to receive dividends, as participating securities in the calculation of net income per share using the two-class method. We are required to apply this method retrospectively, and we have adjusted prior period calculations. For each quarter of fiscal year 2009, the adoption of this guidance decreased our previously reported basic net income per share by $0.01 and had no impact on the diluted net income per share. For fiscal year 2009, the adoption of this guidance decreased our previously reported basic net income per share and diluted net income per share by $0.02 and $0.01, respectively.

At times, we have experienced fluctuations in our quarterly results. Management believes that these fluctuations are an inherent part of the business and could continue into the future. These have included costs associated with uneven flows of incoming material, the level of R&D spending during any given quarter, the use of target indirect rates at interim reporting periods, fee recognition on development contracts in the early phases of contract performance where the financial risk is not entirely known until the contract is further along in the development cycle, the United States Government contracting and budget cycles, the timing of contract awards, and changes in estimates that impact our effective tax rate.

Reconciliation of GAAP to Non-GAAP Financial Measures

To supplement the consolidated financial results prepared under GAAP, we use a non-GAAP conforming, or non-GAAP, measure that is GAAP net income and earnings per share adjusted to exclude certain costs related to acquisitions including the transaction costs, the amortization of intangibles, retention bonuses, and compensation expense related to a potential earn out. Non-GAAP net income and earnings per share gives an indication of the baseline performance before acquisition expenses that are considered by management to be outside the core operating results. These measures are not in accordance with, or an alternative for, GAAP and may be materially different from non-GAAP measures used by other companies. Non-GAAP net income is computed by adjusting GAAP net income for acquisition-related expenses. These non-GAAP results should be read only in conjunction with the consolidated financial statements prepared in accordance with GAAP. AST management regularly uses supplemental non-GAAP financial measures to internally understand, manage, evaluate the business, and make operating decisions. These non-GAAP measures are among the primary factors management uses in planning and forecasting future periods. Management believes that these non-GAAP financial measures reflect an additional way of viewing aspects of operations that, when viewed with GAAP results, provide a more complete understanding of factors and trends affecting the business. Management compensates for the limitations in the use of non-GAAP financial measures by relying on comparable GAAP financial measures and providing investors with a reconciliation of the non-GAAP financial measures to the most directly comparable GAAP financial measures. Below is the reconciliation between net income on a GAAP basis and non-GAAP net income for fiscal years 2010, 2009, and 2008.

		FY10	FY09	FY08
Contract Costs				
GAAP contract costs		$159,949	$142,722	$129,835
Non-GAAP acquisition expenses:				
Compensation expense	c	(1,463) ---------	— ---------	— ---------
Total non-GAAP acquisition expenses		(1,463) ---------	— ---------	— ---------
Non-GAAP contract costs		$158,486 ======	$142,722 ======	$129,835 ======
General and Administrative Expenses				
GAAP general and administrative expenses		$28,046	$22,541	$30,593
Non-GAAP acquisition expenses:				
Transaction costs	a	(1,305)	(186)	(13)
Amortization of intangibles	b	(1,218)	(188)	(454)
Compensation expense	c	(524) ---------	(106) ---------	— ---------
Total non-GAAP acquisition expenses		(3,047) ---------	(480) ---------	(467) ---------
Non-GAAP general and administrative expenses		$24,999 ======	$22,061 ======	$30,126 ======

Operating Expenses				
GAAP operating expenses		$203,077	$179,745	$173,544
Non-GAAP acquisition expenses:				
Transaction costs	a	(1,305)	(186)	(13)
Amortization of intangibles	b	(1,218)	(188)	(454)
Compensation expense	c	(1,987) ---------	(106) ---------	— ---------
Total non-GAAP acquisition expenses		(4,510) ---------	(480) ---------	(467) ---------
Non-GAAP operating expenses		$198,567 ======	$179,265 ======	$173,077 ======
Operating Income				
GAAP operating income		$22,152	$22,870	$12,787
Non-GAAP acquisition expenses:				
Transaction costs	a	1,305	186	13
Amortization of intangibles	b	1,218	188	454
Compensation expenses	c	1,987 ---------	106 ---------	— ---------
Total non-GAAP acquisition expenses		4,510 ---------	480 ---------	467 ---------
Non-GAAP operating income		$26,662 ======	$23,350 ======	$13,254 ======
Net Income				
GAAP net income		$13,223	$14,529	$8,017
Non-GAAP acquisition expenses:				
Transaction costs	a	1,305	186	13
Amortization of intangibles	b	1,218	188	454
Compensation expenses	c	1,987	106	—
Income tax effect on non-GAAP adjustments	d	(1,802) ---------	(183) ---------	(190) ---------
Total non-GAAP acquisition expenses		2,708 ---------	297 ---------	277 ---------
Non-GAAP net income				

	$15,931 ======	$14,826 ======	$8,294 ======
Non-GAAP net income per common share:			
Basic	$1.19	$1.13	$0.66
Diluted	$1.18	$1.12	$0.65
Number of shares used in calculating non-GAAP net income per common share:			
Basic	13,130	12,890	12,475
Diluted	13,248	13,083	12,642

a. Transaction Costs. Transaction costs are primarily legal, due diligence, and other consulting costs that are incurred directly as a result of the acquisition activities.

b. Amortization of intangibles. Amortization of intangibles arises from current and prior acquisitions and is non-cash in nature.

c. Compensation Expense. Compensation expense includes the retention and performance bonuses payable to the employees of the acquired Seismic and Pyxis businesses.

d. Income tax effect on non-GAAP adjustments. This amount adjusts the provision for income taxes to reflect the effect of the non-GAAP adjustments on non-GAAP net income.

Item 7A: 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 October 31, 2010, 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 48 days, as of October 31, 2010. 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 October 31, 2010, our total cash and investments balance that was sensitive to interest rate risk was approximately $30,929,000. 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 $41,000.

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

	2010	2009
Cash equivalents	$531	$2,028
Available-for-sale securities:		
Short-term municipals	30,398	43,454
Long-term municipals		

	—	2,129
	---------	---------
	$30,929	$47,611
	======	======

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 original principal amount of $10 million with Wells Fargo, the proceeds of which were used for acquisition financing. At October 31, 2010, the remaining unpaid balance of the Term Loan was $2,500,000. The Term Loan bears interest at an annual rate of 1.75% above LIBOR (0.26% at October 31, 2010).

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 8: Consolidated Financial Statements and Supplementary Data

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of
Applied Signal Technology, Inc.

We have audited the accompanying consolidated balance sheets of Applied Signal Technology, Inc. as of October 31, 2010, and 2009, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended October 31, 2010. These financial statements are the responsibility of Applied Signal Technology, Inc.'s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Applied Signal Technology, Inc. at October 31, 2010, and 2009, and the consolidated results of its operations and its cash flows for each of the three years in the period ended October 31, 2010, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Applied Signal Technology, Inc.'s internal control over financial reporting as of October 31, 2010, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 13, 2011, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Jose, California
January 13, 2011

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of
Applied Signal Technology, Inc.

We have audited Applied Signal Technology, Inc.'s internal control over financial reporting as of October 31, 2010, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Applied Signal Technology, Inc.'s management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting in Item 9A. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, Applied Signal Technology, Inc. maintained, in all material respects, effective internal control over financial reporting as of October 31, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Applied Signal Technology, Inc. as of October 31, 2010, and 2009, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the three years in the period ended October 31, 2010, and our report dated January 13, 2011, expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

San Jose, California
January 13, 2011

Consolidated Statements of Operations
(in thousands, except per share data)

	Year Ended October 31,		
	2010	**2009**	**2008**
Revenues from contracts	$218,573	$196,371	$181,147
Revenues from royalty agreements	6,656 ---------	6,244 ---------	5,184 ---------
Total revenues	225,229	202,615	186,331
Operating expenses:			

Contract costs	159,949	142,722	129,835
Research and development	15,082	14,482	13,116
General and administrative	28,046 ---------	22,541 ---------	30,593 ---------
Total operating expenses	203,077 ---------	179,745 ---------	173,544 ---------
Operating income	22,152	22,870	12,787
Interest income and other, net	197	676	1,296
Interest expense	(313) ---------	(453) ---------	(535) ---------
Income before provision for income taxes	22,036	23,093	13,548
Provision for income taxes	8,813 ---------	8,564 ---------	5,531 ---------
Net income	$13,223 ======	$14,529 ======	$8,017 ======
Net income per common share			
Basic	$0.99	$1.11	$0.63
Diluted	$0.98	$1.10	$0.63
Number of shares used in calculating net income per common share			
Basic	13,130	12,890	12,475
Diluted	13,248	13,083	12,642
See accompanying notes.			

Consolidated Balance Sheets
(in thousands except share information)

	October 31,	
	2010	**2009**
Assets		
Current assets:		
Cash and cash equivalents	$5,523	$4,102
Short-term investments	30,398 ---------	43,454 ---------
Total cash, cash equivalents, and short-term investments	35,921	47,556
Accounts receivable:		

Billed	35,299	26,630
Unbilled	12,755 ---------	20,433 ---------
Total accounts receivable	48,054	47,063
Inventory	10,222	8,378
Prepaid and other current assets	10,859 ---------	10,517 ---------
Total current assets	105,056	113,514
Property and equipment, at cost:		
Machinery and equipment	49,098	46,517
Furniture and fixtures	4,714	4,756
Leasehold improvements	21,144	18,480
Construction in process	187 ---------	647 ---------
	75,143	70,400
Accumulated depreciation and amortization	(59,813) ---------	(55,405) ---------
Property and equipment, net	15,330	14,995
Long-term investment	—	2,129
Goodwill	58,470	33,158
Intangible assets, net of accumulated amortization	4,646	1,904
Long-term deferred tax asset	3,908	4,196
Other assets	1,136 ---------	1,104 ---------
Total assets	$188,546 ======	$171,000 ======

Consolidated Balance Sheets (continued)
(in thousands except share information)

	October 31,	
	2010	**2009**
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable	$8,433	$6,807

Accrued payroll and related benefits	16,693	15,351
Note payable	1,429	1,429
Income taxes payable	—	444
Contingent consideration	6,124	—
Other accrued liabilities	2,590 ---------	2,298 ---------
Total current liabilities	35,269	26,329
Long-term note payable	1,071	2,500
Accrued rent	1,900	2,103
Other long-term liabilities	843	1,043
Shareholders' equity:		
Preferred stock, no par value: 2,000,000 shares authorized; none issued and outstanding	—	—
Common stock, no par value: 35,000,000 shares authorized; issued and outstanding shares – 13,825,568 at October 31, 2010, and 13,211,462 at October 31, 2009	80,431	76,492
Retained earnings	69,088	62,600
Accumulated comprehensive income	(56) ---------	(67) ---------
Total shareholders' equity	149,463 ---------	139,025 ---------
Total liabilities and shareholders' equity	$188,546 ======	$171,000 ======
See accompanying notes.		

Consolidated Statements of Cash Flows
(in thousands)

	Year Ended October 31,		
	2010	**2009**	**2008**
Operating activities:			
Net income	$13,223	$14,529	$8,017
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	7,080	6,361	6,138
Stock-based compensation	2,055	2,236	4,779

Excess tax benefits from stock-based payment arrangements	(100)	(384)	(37)
Changes in:			
Accounts receivable	2,284	(2,914)	4,361
Income tax receivable	—	—	752
Inventory, prepaid expenses and other current assets	(2,834)	507	(2,697)
Other assets	255	(25)	519
Accrued lease incentives	—	—	877
Accounts payable and accrued liabilities	932 ---------	(3,141) ---------	5,454 ---------
Net cash provided by operating activities	22,895	17,169	28,163
Investing activities:			
Cash paid for business acquired, net	(23,623)	(15,943)	—
Cash from Pyxis escrow account, net	670	—	—
Purchases of available-for-sale securities	(75,287)	(63,687)	(109,964)
Maturities of available-for-sale securities	80,785	71,776	88,935
Sales of available-for-sale securities	8,961	—	—
Additions to property and equipment	(5,593) ---------	(5,415) ---------	(3,800) ---------
Net cash used in investing activities	(14,087)	(13,269)	(24,829)
Financing activities:			
Issuances of common stock	2,227	3,995	4,044
Shares repurchased for tax withholding of vested restricted stock awards	(387)	(284)	(279)
Excess tax benefits from stock-based payment arrangements	100	384	37
Term loans	(2,669)	(2,054)	(1,428)
Dividends paid	(6,658) ---------	(6,507) ---------	(6,290) ---------
Net cash (used in) financing activities	(7,387) ---------	(4,466) ---------	(3,916) ---------
Net increase (decrease) in cash and cash equivalents	1,421	(566)	(582)
Cash and cash equivalents at beginning of year	4,102 ---------	4,668 ---------	5,250 ---------
Cash and cash equivalents at end of year	$5,523 ======	$4,102 ======	$4,668 ======
Supplemental disclosure of cash flow information:			

Interest paid	$194	$281	$382
Income taxes paid	$8,976	$8,668	$7,005
See accompanying notes.			

Consolidated Statement of Shareholders' Equity
(in thousands, except share data)

	Number of Outstanding Shares	Common Stock	Retained Earnings	Accumulated Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at October 31, 2007 (as reported)	12,388,422	$61,849	$52,953	$34	$114,836
Issuance of common shares to employees under stock compensation plans	433,901	3,765	—	—	3,765
Stock-based compensation expense	—	4,779	—	—	4,779
Dividends declared	—	—	(6,344)	—	(6,344)
Tax benefit related to stock plans	—	(248)	—	—	(248)
Other comprehensive income	—	—	—	(72)	(72)
Net income	—	—	8,017	—	8,017
Balance at October 31, 2008 (as reported)	12,822,323	$70,145	$54,626	$(38)	$124,733
Issuance of common shares to employees under stock compensation plans, net of repurchases	389,139	3,711	—	—	3,711
Stock-based compensation expense	—	2,236	—	—	2,236
Dividends declared	—	—	(6,555)	—	(6,555)
Tax deficiency related to stock plans	—	400	—	—	400
Other comprehensive income	—	—	—	(29)	(29)
Net income	—	—	14,529	—	14,529
Balance at October 31, 2009 (as reported)	13,211,462	$76,492	$62,600	$(67)	$139,025
Issuance of common shares to employees under stock compensation plans, net of repurchases	614,106	1,840	—	—	1,840

Stock-based compensation expense	—	2,055	—	—	2,055
Dividends declared	—	—	(6,735)	—	(6,735)
Tax benefit related to stock plans	—	44	—	—	44
Other comprehensive income	—	—	—	11	11
Net income	— ---------	— ---------	13,223 ---------	— ---------	13,223 ---------
Balance at October 31, 2010	13,825,568 ---------	$80,431 ---------	$69,088 ---------	$(56) ---------	$149,463 ---------
See accompanying notes.					

Notes to Consolidated Financial Statements, October 31, 2010

Note 1: Organization and Summary of Significant Accounting Policies

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

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

Estimates

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

Principles of Consolidation

The financial statements include the accounts of AST and its wholly owned subsidiaries, Dynamics Technology, Inc. (DTI), Pyxis Engineering LLC (Pyxis) (from the acquisition date on September 1, 2009), and Seismic LLC (Seismic) (from the acquisition date on April 28, 2010). All significant intercompany transactions have been eliminated.

Revenues and Contract Accounting

Revenues and cost recognition. Our contracts are executed through written contractual arrangements, most of which require us to design, develop, manufacture, and/or modify our complex products and perform related services according to specifications provided by the customer. The majority of our contracts are accounted for following the authoritative guidance for construction-type and production-type contracts. We recognize revenue on a limited number of stand-alone software contracts following the guidance for software revenue. For these software contracts, we defer revenue that is related to billings and customer payments in advance of the completion of the performance requirements set forth in the contracts.

As a supplier to the United States Government, we are required to comply with numerous regulations, including those governing security and contracting practices. Failure to comply with these procurement regulations and practices could result in fines being imposed against us or our suspension for a period of time from eligibility for bidding on, or for award of, new Government contracts. Among the causes for 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 affect on our results of operations.

We have two royalty licensing agreements for which we accrue royalties on sales of our licensed product by a third party. Since there are essentially no costs associated with these agreements, operating income will increase by the same amount of revenue that we recognize. Royalties contributed approximately $6,656,000, $6,244,000, and $5,184,000 to revenues and operating income during fiscal years 2010, 2009, and 2008, respectively.

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

	FY10	FY09	FY08
Cost-reimbursement contracts	74%	59%	69%
Time-and-materials contracts	15%	22%	18%
Fixed-price contracts	8%	16%	10%
Royalty contracts	3% ---------	3% ---------	3% ---------
	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.

	FY10	FY09	FY08
Next Generation ASA	20%	—	—
Tiffany	13%	21%	13%
Thunderdome	8%	—	—
ASA	—	18%	15%
High Beam	—	7%	15%
Stone Face II	—	6%	12%
Specter	— ---------	— ---------	5% ---------
	41% ======	52% ======	60% ======
a dash (—) designates less than 5% revenue concentration			

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

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

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

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

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and costs incurred in connection with ongoing contracts for which contract modifications have not been defined or completed at the end of the reporting period. These costs are included in other current assets on the balance sheet. Precontract costs for the periods ending October 31, 2010, and October 31, 2009, were approximately $1,454,000 and $1,139,000, respectively. Approximately $1,139,000 of the October 31, 2009, balance was recognized as revenues during fiscal year 2010.

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

Our accounting policy for recording indirect rate variances is based on management's belief that variances accumulated during interim reporting periods will be absorbed by expected contract activities during the remainder of the year. We consider the rate variance to be unfavorable when our actual indirect rates are greater than our annual targeted rates. In contrast, a favorable rate variance occurs when our actual indirect rates are lower than our annual targeted rates. During interim reporting periods, we record unfavorable rate variances as reductions to operating expenses and increases to work-in-process inventory. Favorable rate variances are recorded as increases to operating expenses and decreases to work-in-process inventory.

If we anticipate that actual contract activities will be different than planned levels, there are alternatives we can utilize to 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, in general, the modification of our billing rates will typically 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 the end of fiscal year 2010, we absorbed an unfavorable indirect rate variance that accumulated during the fiscal year by modifying our billing rates to our customers. Consequently, we increased revenues by approximately $1,047,000 and operating expenses by approximately $1,532,000.

At the end of fiscal year 2009, we absorbed a favorable indirect rate variance that accumulated during the fiscal year by modifying our billing rates to our customers. Consequently, we created an insignificant adjustment to revenues and decreased operating expenses by approximately $329,000.

During fiscal year 2008, we absorbed a favorable indirect rate variance that accumulated during the fiscal year by modifying our billing rates to our customers. Consequently, we decreased revenues by approximately $1,657,000 and operating expenses by approximately $1,243,000.

Accounts receivable and allowance for bad debt. Accounts receivable are segregated between billed and unbilled accounts. For cost-reimbursement contracts, we bill incurred costs and a portion of our fees on a regular basis. Under fixed-price contracts, we bill contract costs on a milestone or unit of delivery basis. Unbilled amounts result from our recognition of contract revenue in advance of contractual billing terms.

When evaluating our need for a bad debt allowance, we consider our customer base and their payment history. The majority of our revenues are generated from the United States Government, and therefore credit risk is minimal. We record allowances for bad debt as a reduction to accounts receivable and an increase to bad debt expense. These allowances are recorded in the period a specific collection problem is identified. Once the receivable is deemed uncollectible, the allowance is reversed and the receivable is written off to bad debt expense. Charges to bad debt expense were not significant during fiscal years 2010, 2009, and 2008.

Inventory valuation and disposal. We provide advanced digital signal processing products and systems to the United States Government. 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.

If we determine that the estimated market value of certain inventory is below cost, we will write down the inventory to the estimated market value. We did not record a write-down in fiscal year 2010. We recorded a write-down of approximately $422,000 during fiscal year 2009 to reflect the estimated market value of one inventoried product. This charge was included in contract costs in our statement of operations. Disposals associated with our raw material are included in general and administrative expenses on the statement of operations. This is because we could use raw materials in a variety of situations other than contract costs, including R&D. Disposals of raw material inventory amounted to approximately $197,000 during fiscal year 2010 and were not significant during fiscal year 2009. During fiscal year 2010, disposals of obsolete products amounted to approximately $155,000 and $304,000 during fiscal year 2009.

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

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

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

Please refer to "Notes to Consolidated Financial Statements, Note 8: 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 fiscal years 2010, 2009, or 2008.

Cash, Cash Equivalents, and Investments

Cash and cash equivalents balances include cash held in banks to support daily cash needs and were approximately $5,523,000 and $4,102,000 on October 31, 2010, and October 31, 2009, respectively. 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.

Our remaining securities are classified as available for sale and are carried at fair value in short-term and long-term investments. At October 31, 2010, all of our available-for-sale investments are short term and consist of tax-exempt securities. At the time of purchase, management determines the appropriate classification of these securities and re-evaluates such designation as of each balance sheet date. Unrealized gains and losses, net of tax, are reported in shareholders' equity as part of comprehensive income. The cost of securities sold is based on the specific identification method. Realized gains and losses on sales of available-for-sale securities were not material for fiscal years 2010, 2009, and 2008.

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

	October 31, 2010			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash equivalents:				
Money market funds	$531	$—	$—	$531
Available-for-sale securities:				
Short-term municipal	30,398	3	(3)	30,398
Long-term municipal	—	—	—	—
	$30,929	$3	$(3)	$30,929

	October 31, 2009			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Cash equivalents:				

Money market funds	$2,028	$—	$—	$2,028
Available-for-sale securities:				
Short-term municipal	43,403	51	—	43,454
Long-term municipal	2,131	—	(2)	2,129
	$47,562	$51	$(2)	$47,611

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

	October 31, 2010
Due in one year or less	$30,398
Due in one to two years	—
	$30,398

Fair Value Measurements

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

The standard on fair value measurement establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. There are three levels of inputs that may be used to measure fair value:

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

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

	October 31, 2010 Fair Value Measurements			
	Level 1	Level 2	Level 3	Total Fair Value
Assets				
Cash equivalents:				
Money market funds	$531	$—	$—	$531
Available-for-sale securities:				
Short-term municipal	—	30,398	—	30,398

Total assets	$531	$30,398	$—	$30,929
Liabilities				
Contingent consideration	$—	$—	$2,374	$2,374
Interest rate swap	—	$56	—	$56
Total liabilities	$—	$56	$2,374	$2,430

	October 31, 2009 Fair Value Measurements		
	Level 1	**Level 2**	**Total Fair Value**
Assets			
Cash equivalents			
Money market funds	$2,028	$—	$2,028
Available-for-sale securities:			
Short-term municipal	—	43,454	43,454
Long-term municipal	—	2,129	2,129
Total assets	$2,028	$45,583	$47,611
Liabilities			
Interest rate swap	$—	$116	$116
Total liabilities	$—	$116	$116

As of October 31, 2010, our investment portfolio did not include investments in assets valued using Level 3 inputs.

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

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

We have a contingent consideration liability that is payable to the shareholders of Seismic. We recorded $2,047,000 million in other accrued liabilities in our consolidated balance sheet based on future revenues projected over a one-year period from the date of acquisition of April 28, 2010. In the second half of fiscal year 2010, we increased the liability for accretion due to the increased probability of achievement as well as the passage of time, and recognized $327,000 in general and administrative expense, representing a total liability of $2,374,000. The fair value of the Seismic Earn Out was also included in the preliminary purchase price. We estimated the fair value of this liability by using the expected cash flow approach with probability-weighted revenue inputs. Please refer to “Notes to Consolidated Financial Statements, Note 4: Business

Combinations" for further information on the terms of the agreement as it pertains to the contingent consideration.

The inputs used to value the interest rate swap liability are based on observable market data such as the London Inter-Bank Offered Rate (LIBOR) swap rate (floating interest rate), a fixed rate (term loan interest rate), a discount factor, and a calculation of a present value of the interest paid/received based on the expected loan principal. Please refer to " Notes to Consolidated Financial Statements, Note 6: Borrowing Arrangements" for further information.

The following table presents the changes in our liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) at October 31, 2010 (in thousands).

	Measurements Using Level 3 Inputs
Balance at October 31, 2009	$—
Contingent consideration	2,047
Increase in contingent consideration	327 ---------
Balance at October 31, 2010	$2,374 ======

Restricted Cash

We had restricted cash balances of approximately $423,000 and $663,000 at October 31, 2010, and October 31, 2009, 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 $152,000 of the restricted cash balance was included in prepaids and other current assets on both October 31, 2010, and October 31, 2009. Approximately $271,000 and $511,000 was included in other assets on October 31, 2010, and October 31, 2009, respectively.

Property and Equipment

Machinery and equipment as well as furniture and fixtures are depreciated by using the straight-line method over the estimated useful lives of the assets, ranging up to five years. Leasehold improvements are amortized by using the straight-line method over the lesser of the useful life of the assets or the remaining lease term. Construction in process includes costs incurred to build leasehold improvements and test equipment that has not yet been placed into service.

Business Combinations, Goodwill, and Long-Lived Asset Valuation

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

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

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

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

Unanticipated events and circumstances may occur that may affect the accuracy or validity of such assumptions, estimates, or actual results. Please refer to "Notes to Consolidated Financial Statements, Note 4: Business Combination" for further information.

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

To perform the goodwill impairment test, we determine the fair value of the reporting unit and compare the fair value to the reporting unit's carrying value. We believe AST is one reporting unit, and therefore, we compare the fair value of AST to the total net asset value on our balance sheet. If our total net asset value were to exceed our fair value, we would perform the second step of the impairment test. In the second step, we would compare the implied fair value of our goodwill to our carrying amount, taking a write-down to the extent the carrying amount exceeds the implied fair value. If the fair value of AST exceeds the carrying value of our net assets under step one, then no impairment is indicated and the test is complete.

We passed the first step of our annual impairment test for fiscal year 2010. In addition, there were no indicators of impairment as of October 31, 2010.

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

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

There were no indicators of impairment as of October 31, 2010.

Net Income Per Share Data

In the first quarter of fiscal year 2010, we adopted new guidance issued by the staff of the Financial Accounting Standards Board (included in ASC Topic 260-10-45) on determining whether instruments granted in share-based payment transactions are participating securities. This guidance requires us to include our unvested restricted stock awards, which have rights to receive dividends, as participating securities in the calculation of net income per share using the two-class method. We are required to apply this method retrospectively, and we have adjusted prior period calculations. For the year ended October 31, 2009, the adoption of this guidance decreased our previously reported basic net income per share and diluted net income per share by $0.02 and $0.01, respectively For the year ended October 31, 2008 the adoption of this guidance decreased our previously reported net income per share by $0.01 and had no impact on diluted net income per share.

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

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

	Year Ended October 31,		
	2010	2009	2008
Numerator			

Net income	$13,223	$14,529	$8,017
Less income allocated to participating securities (restricted stock awards)	(264) ======	(193) ======	(111) ======
Net income allocated to common stock	$12,959	$14,336	$7,906
Denominator			
Shares used to compute net income per common share – basic	13,130	12,890	12,475
Effect of dilutive stock options	118 ---------	193 ---------	167 ---------
Shares used to compute net income per common share – diluted	13,248 ======	13,083 ======	12,642 ======
Net income per common share – basic	$0.99 ======	$1.11 ======	$0.63 ======
Net income per common share – diluted	$0.98 ======	$1.10 ======	$0.63 ======

We excluded approximately 392,000, 463,000, and 886,000 potential common shares for fiscal years 2010, 2009, and 2008 from the diluted net income per common share computation for the respective periods, as their effect would be antidilutive.

Comprehensive Income

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

	Year Ended October 31,		
	2010	**2009**	**2008**
Net income	$13,223	$14,529	$8,017
Unrealized gain (loss) on securities	(48)	9	22
Derivative gain (loss)	59 ---------	(38) ---------	(94) ---------
Comprehensive income	$13,234 ======	$14,500 ======	$7,945 ======

The derivative-related accumulated comprehensive loss balance, as of October 31, 2010, and October 31, 2009, was approximately $56,000, and $116,000, respectively. The balance of accumulated comprehensive income on securities as of October 31, 2010, and October 31, 2009, was approximately $0 and $49,000, respectively.

Dividends

We have paid dividends at the rate of $0.50 per share per annum, payable quarterly. Pursuant to the Merger Agreement with Raytheon, we have agreed not to declare or pay dividends. If the Merger Agreement is terminated, continued payment of the dividend will be subject to approval by the Board of Directors and will be reviewed quarterly.

Total dividends paid during fiscal years 2010, 2009, and 2008 were approximately $6,658,000, $6,507,000, and $6,290,000, respectively.

At October 31, 2010, and October 31, 2009, accrued dividends of approximately $1,728,000 and $1,651,000, respectively, were included in other accrued liabilities on the accompanying balance sheet.

Stock-Based Compensation

We have the following stock-based compensation programs that provide our Board of Directors discretion in creating employee equity incentives. As of October 31, 2010, there was a total of 902,551 shares reserved for future issuance under all of our equity incentive plans and our ESPP.

Employee Stock Purchase Plan. We maintain our shareholder-approved 1993 Employee Stock Purchase Plan (ESPP) with a six-month offering period, and have reserved 5,400,000 shares of common stock for issuance to employees under the ESPP. For offering periods beginning prior to December 1, 2008, the ESPP allowed eligible employees to purchase common stock through payroll deductions (which cannot exceed 10% of any employee's compensation) at 85% of the closing stock price at the lower of either the date of enrollment or the date of purchase. In 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 closing stock price on the date of purchase, and therefore, the ESPP is non-compensatory under the authoritative guidance for stock-based compensation. The remaining expense related to the final compensatory award under the ESPP was recognized in the first quarter of fiscal year 2009. As of October 31, 2010, 662,788 shares remain reserved for issuance and eligible for purchase under the 1993 Plan.

Stock Option Plan – 1991. Our 1991 Stock Option Plan (1991 Plan) provided for the granting of incentive stock options and non-qualified stock options to our employees, directors, and consultants at exercise 100% of the fair market value on the date of grant, and have a maximum term of ten years. The 1991 Plan expired on January 19, 2001, and all remaining shares reserved for issuance expired. Options to purchase an aggregate of 27,780 shares of our common stock remain outstanding under the 1991 Plan as of October 31, 2010, all of which are now fully vested.

Stock Option Plan – 2000. Our 2000 Stock Option Plan (2000 Plan) provided for the granting of non-qualified stock options to our employees and consultants at exercise prices ranging from 85% to 100% of the fair market value of the common stock on the date of grant. Options granted in 2004 through 2006 vest at the rate of 20% per year over five years, on the anniversary date of the grant date, and have a maximum term of 10 years. In fiscal year 2008, the Board of Directors terminated the 2000 Plan. Options to purchase an aggregate of 330,537 shares of our common stock remain outstanding under the 2000 Plan as of October 31, 2010.

Stock Option Plan – 2001. Our shareholder-approved 2001 Stock Option Plan (2001 Plan) provides for the granting of incentive stock options and non-qualified stock options to our employees, directors, and consultants at exercise prices ranging from 85% to 100% of the fair market value of the common stock on the date of grant. Options granted in 2004 and beyond vest at the rate of 20% per year over five years, on the anniversary date of the grant date, and have a maximum term of 10 years. Options to purchase an aggregate of 194,528 shares of our common stock are outstanding and 53,884 shares remain available for grant under the 2001 Plan as of October 31, 2010.

Stock Incentive Plan – 2004. Our shareholder-approved 2004 Stock Incentive Plan (2004 Plan) provides for the granting of incentive stock options, non-qualified stock options, restricted stock, and restricted stock unit awards to our employees, directors, and consultants. The exercise price for an option is equal to 100% of the fair market value of the common stock on the date of grant. No monetary payment is required as a condition of receiving a restricted stock or restricted stock unit award, since the consideration for the award shall be services actually rendered to us or for our benefit. The restrictions on our restricted stock grants typically will lapse in four equal annual installments, on each anniversary of the grant date, conditioned on continued employment. The restrictions on restricted stock granted to our directors typically lapse in three equal annual installments. Some options vest over five years, at the rate of 20%, one year after the date of grant and in equal monthly installments over the remaining 48 months, and have a maximum term of eight years. Other options vest over five years, at the rate of 20% per year. Options to purchase an aggregate of 176,000 shares of our common stock are outstanding and 185,879 shares remain available for grant under the 2004 Plan as of October 31, 2010.

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 the most recent accounting standards for stock-based compensation, adopted in fiscal year 2006. For stock-based compensation 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 prior accounting standard. We recognize expense for stock-based compensation awards 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 stock option grants, restricted stock awards, and shares purchased under our ESPP included in our condensed consolidated statements of operations (in thousands).

	Year Ended October 31,

	2010	2009	2008
Contract costs	$1,225	$1,397	$2,747
Research and development	51	76	177
General and administrative	779 ---------	763 ---------	1,855 ---------
Stock-based compensation expense before income taxes	$2,055	$2,236	$4,779
Income taxes	(775) ---------	(727) ---------	(1,029) ---------
Stock-based compensation expense after income taxes	$1,280	$1,509	$3,750
Reduction to basic net income per share	$0.10	$0.12	$0.30
Reduction to diluted net income per share	$0.10	$0.12	$0.30

We did not grant options during any of the fiscal years presented. Due to the non-compensatory nature of our ESPP Plan beginning December 1, 2008, we did not value any new ESPP grants during fiscal years 2010 and 2009. In fiscal year 2008, we estimated the fair value of shares issued under our ESPP by using the Black-Scholes valuation model using the following weighted average assumptions.

	Employee Stock Purchase Plan
	2008
Risk-free interest rate	2.0%
Expected life (years)	0.5
Expected volatility	39%
Expected dividends	3.9%
Weighted average fair value	$3.79

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. We determined that the combination of historical and market-based implied volatility provided a more accurate reflection of our market conditions and was 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 reflects estimated forfeitures that were based on historical forfeitures.

The net cash proceeds associated with our ESPP were $ 1,241,000, $2,137,000, and $3,195,000 for fiscal years 2010, 2009, and 2008, respectively.

The following table summarizes the option activity under all stock option plans.

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at October 31, 2007	1,409,724	$18.33		
Exercised	(77,730)	$10.91		

Forfeitures or expirations	(122,676) ---------	$25.78 ---------		
Outstanding at October 31, 2008	1,209,318	$18.05		
Exercised	(194,581)	$9.54		
Forfeitures or expirations	(67,590) ---------	$21.24 ---------		
Outstanding at October 31, 2009	947,147	$19.57		
Exercised	(90,753)	$10.87		
Forfeitures or expirations	(127,549) ---------	$25.09 ---------		
Outstanding at October 31, 2010	728,845	$19.69	3.22	$10,132,618
Vested or expected to vest at October 31, 2010	486,115	$29.48	4.81	$10,115,355
Exercisable at October 31, 2010	698,045	$19.77	3.12	$9,650,472

The aggregate intrinsic value in the table above represents the total pre-tax value (that is, the difference between our closing stock price on the last trading day of fiscal year 2010 and the exercise price for those options in the money, multiplied by the number of shares) that would have been received by the option holders had all option holders exercised their options on October 31, 2010. This amount changes based on the fair market value of our stock. Total intrinsic value of options exercised was approximately $946,000, $2,289,000, and $313,000, for fiscal years 2010, 2009, and 2008, respectively.

As of October 31, 2010, approximately $108,000 of total unrecognized compensation costs related to unvested stock options is expected to be recognized over a weighted average period of 0.5 years.

Net cash proceeds from the exercise of stock options were approximately $986,000, $1,857,000, and $848,000 for fiscal years 2010, 2009, and 2008, respectively.

The following table summarizes our restricted stock grant activity.

Nonvested Shares	Shares	Weighted Average Grant Date Fair Value Per Share
Nonvested at October 31, 2007	163,266	$17.35
Grants	95,000	$14.81
Vested	(69,753)	$17.35
Forfeitures	(13,111) ---------	$17.55
Nonvested at October 31, 2008	175,402	$16.11
Grants	71,300	$24.33
Vested	(55,326)	$16.38

Forfeitures	(9,643) ---------	$17.97
Nonvested at October 31, 2009	181,733	$17.69
Grants	489,585	$22.17
Vested	(68,788)	$17.38
Forfeitures	(16,081) ---------	$18.16
Nonvested at October 31, 2010	586,449	$22.03

The total fair value of restricted stock grants vested in fiscal years 2010, 2009, and 2008 was $1,196,000, $906,000, and $1,210,000, respectively. Our unrecognized compensation cost related to nonvested (restricted) stock is approximately $10,708,000 and is expected to be recognized over a weighted average period of 3.4 years. This balance includes a total of 381,085 shares granted to officers and employees during the fourth quarter of fiscal year 2010, that increased unrecognized compensation cost by approximately $8,119,000.

We realized income tax benefits from stock options exercised and restricted stock vested of approximately $44,000 and $400,000 during fiscal years 2010 and 2009, respectively. We realized an income tax deficiency from stock option exercises and restricted stock vested during fiscal year 2008 of approximately $247,000. As required, we present excess tax benefits from the exercise of stock options and the vesting of restricted stock, if any, as financing cash flows rather than operating cash flows.

Recent Accounting Pronouncements

In October 2009, the FASB issued ASC Update No. 2009-13, updating ASC Topic 605, *Revenue Recognition*. This update provides new standards for revenue recognition for arrangements with multiple deliverables. These new standards affect the determination of when the individual deliverables may be treated as separate units of accounting. Additionally, these new standards modify the method of allocating consideration to the deliverables. The relative fair value method based on selling prices will be required and the residual method of allocating arrangement consideration will no longer be permitted. These new standards are effective for our fiscal year beginning November 1, 2010. We do not expect the adoption of these standards to have a material impact on our consolidated financial statements.

In October 2009, the FASB issued ASC Update No. 2009-14, updating ASC Topic 985, *Software*. This update provides new standards that amend the scope of previous software revenue guidance by excluding non-software components of tangible products and certain software components of tangible products. These new standards are effective for our fiscal year beginning November 1, 2010. We do not expect the adoption of these standards to have a material impact on our consolidated financial statements.

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

Note 2: Customer Concentration

The following table identifies the source of our revenues for fiscal years 2010, 2009, and 2008 by market.

	FY10	FY09	FY08
Intelligence	89%	83%	80%
Defense	8%	12%	16%
Commercial	3%	5%	4%

Foreign	— ---------	— ---------	— ---------
	100% ======	100% ======	100% ======
a dash (—) designates less than 1% revenue concentration			

Within the customer types, contracts with two intelligence community customers and one defense customer represented a significant portion of revenues.

The table below identifies the revenue concentration (as a percentage of total revenues) from all contracts with each significant customer.

	FY10	FY09	FY08
Intelligence community customer 1	40%	33%	25%
Intelligence community customer 2	38%	43%	50%
Largest defense customer	6% ---------	9% ---------	12% ---------
	84% ======	85% ======	87% ======

Revenues from the United States Government can also be categorized as direct purchases and subcontracts, where we are the supplier to another contractor. The following table distinguishes revenue (as a percentage of total revenues) between those two categories.

	FY10	FY09	FY08
Direct purchases	66%	65%	65%
Subcontracts	30% ---------	30% ---------	31% ---------
	96% ======	95% ======	96% ======

Note 3: Inventory

Inventories are stated at the lower of average cost or market and we allocate costs from inventory to contracts based on the average cost per unit. Inventory consisted of the following (in thousands).

	October 31,	
	2010	2009
Raw materials	$569	$767
Work in process	8,016	7,070
Finished goods	1,637 ---------	541 ---------
	$10,222 ======	$8,378 ======

Inventory activities during fiscal year 2010 included disposals of obsolete products of approximately $155,000, and disposals of raw material of approximately $197,000. Inventory activities during fiscal year 2009 included a write-down of approximately $422,000 and disposals of obsolete products of approximately $304,000.

Note 4: Business Combinations

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

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

Acquisition of Seismic. The amount of goodwill recorded for the Seismic acquisition as of the acquisition date was approximately $21.5 million and reflected the value of the future engineering services revenue opportunities associated with the cyber security marketplace. As of October 31, 2010, measurement-period adjustments were not material.

The preliminary purchase price was approximately $26.7 million, which included cash consideration of $24.7 million and contingent consideration of approximately $2 million. Approximately $4.9 million that would otherwise be distributed to the sellers at the closing was deposited into an escrow account to provide a fund against which we may make claims for damages, if any, based on the breaches of the representations made by Seismic in the purchase agreement. Fifty percent of the escrow account will be released on the one-year anniversary of the closing date and the remainder in 18 months from the closing date, net of any claims made by us against Seismic or the sellers under the terms of the purchase agreement.

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

During the Initial Earn-Out Period program profits exceeded 12% of Seismic revenues and Seismic backlog was greater than $10 million on October 31, 2010. Therefore, the Earn-Out Distribution Amount will only be based on revenue recorded during both the Initial and Subsequent Earn-Out Periods.

We recorded a liability of $2 million reflecting the fair value of the anticipated Seismic Earn Out. This amount was also included in the preliminary purchase price. We estimated the fair value by using the expected cash flow approach with probability-weighted revenue inputs and using a discount rate of 5.6%. Changes in the fair value of the contingent liability are recognized in earnings in the period of the change through the settlement of the liability. In the second half of fiscal year 2010, we increased the liability for accretion due to the increased probability of achievement as well as the passage of time, and recognized $327,000 in general and administrative expense.

On January 10, 2011, we paid the shareholders of Seismic an accelerated earn-out payment of approximately $2,541,000 due to the Merger Agreement with Raytheon Company, as required by the terms of the agreement with Seismic.

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

In addition, substantially all of the Seismic employees are eligible to receive retention bonus payments if they remain employees of Applied Signal Technology, Inc. through the one-year anniversary of the acquisition. The aggregate amount that could be paid is approximately $1.0 million.

For the year ended October 31 2010, we recognized approximately $1,528,000 in our operating expenses for the retention and Earn-Out bonuses.

We incurred approximately $1,068,000 of transaction costs related to the Seismic acquisition during the year ended October 31, 2010. These costs are included in general and administrative expenses within our statement of operations.

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

Cash and cash equivalents	$1,068
Accounts receivable and other current assets	3,435
Property and equipment and other assets	100
Accounts payable, accrued payroll and other current liabilities	(2,053)
Notes payable	(1,240)
Seismic Earn Out	(2,047) ======
Estimated net tangible assets acquired	(737)
Amortizable intangible assets:	
Future contracts	1,310
Unfunded backlog	1,790
Funded backlog	570
Non-compete agreements	290 ---------
Total amortizable intangible assets	3,960

Goodwill	21,489 ---------
Total cash consideration	$24,712 ======

The purchase price allocation is subject to agreement on the final closing working capital. The fair value and gross contractual amount of accounts receivable acquired was approximately $3,275,000. As of October 31, 2010, we expect that no amount will be uncollectible.

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

	Year Ended	
	October 31, 2010	**October 31, 2009**
Revenue	$234,296	$216,470
Net income	$12,689	$20,461

Basic net income per share	$0.95	$1.57
Diluted net income per share	$0.94	$1.54

Seismic revenue and net income for the period from the date of acquisition, April 28, 2010 to October 31, 2010 included in the consolidated statement of operations for the year ended October 31, 2010 was $13.4 million and $1.2 million, respectively.

The unaudited pro forma financial information for the both fiscal years 2010 and 2009 includes charges to operating expense for performance bonuses of approximately $1,288,000, retention bonuses of approximately $998,000, and amortization of intangibles of approximately $1,041,000. In addition, all of these adjustments were adjusted for the tax impact.

Acquisition of Pyxis Engineering LLC. The amount of goodwill recorded for the Pyxis acquisition at October 31, 2009, was approximately $13.2 million and reflected the value of the future engineering services revenue opportunities associated with the cyber security marketplace. During fiscal year 2010, we increased the amount of the purchase price allocated to goodwill to $17.0 million. This reflects an increase of $3.75 million due to the additional consideration due under the Pyxis Earn Out determined as of October 31, 2010, and $0.1 million due to increased transaction costs. Under the accounting rules in effect at the time of this acquisition, the contingent consideration increases the purchase price and goodwill in the period when the contingency is resolved. The revised aggregate purchase price of $20.4 million includes $0.5 million in transaction costs. We allocated the purchase price to the tangible and identifiable intangible assets acquired and liabilities assumed based on their estimated fair values at the date of acquisition as follows (in thousands).

Cash and cash equivalents	$1,382
Accounts receivable and other current assets	4,047
Property and equipment	19
Accrued payroll and other current liabilities	(3,365)
Notes payable	(625) ---------
Net tangible assets acquired	1,458
Amortizable intangible assets:	
Future contracts	880
Unfunded backlog	610
Funded backlog	300
Non-compete agreements	140 ---------
Total amortizable intangible assets	1,930
Goodwill	17,017 ---------
Total purchase price	$20,405 ======

On December 21, 2010, we paid eighty-four percent of the Pyxis Earn-Out in AST common stock and 118,197 shares were issued. We paid the remaining portion in cash on December 29, 2010.

In addition, on December 15, 2010 we paid retention bonuses of approximately $0.6 million to the Pyxis employees who remained employees of AST through November 15, 2010. During fiscal year 2010 and fiscal year 2009, we recognized approximately $0.5 million and $0.1 million in operating expenses related to the Pyxis bonuses, respectively.

Note 5: Goodwill and Intangible Assets

The goodwill and identifiable intangible assets are related to our April 2010 acquisition of Seismic LLC, September 2009 acquisition of Pyxis Engineering LLC and July 2005 acquisition of Dynamics Technology, Inc. (DTI).

Goodwill

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

Goodwill balance at October 31, 2008	$19,964
Acquisition of Pyxis	13,194 ---------
Goodwill balance at October 31, 2009	33,158
Additional transaction costs (Pyxis acquisition)	73
Pyxis Earn Out	3,750
Acquisition of Seismic	21,489 ---------
Goodwill balance at October 31, 2010	$58,470 ======

Intangible Assets

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

		October 31, 2010		
	Useful Life	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Future contracts	7–8 years	$2,190	$(229)	$1,961
Unfunded backlog	3–4 years	2,400	(459)	1,941
Funded backlog	1–2 years	870	(443)	427
Non-compete agreements	2 years	430	(155)	275
Existing technology	5 years	340	(340)	—
Patent	18 years	60 ---------	(18) ---------	42 ---------
Total		$6,290 ======	$(1,644) ======	$4,646 ======

		October 31, 2009		
	Useful Life	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Future contracts	7 years	$880	$(21)	$859

Unfunded backlog	3 years	610	(34)	576
Funded backlog	1 year	300	(50)	250
Non-compete agreements	2 years	140	(12)	128
Existing technology	5 years	340	(295)	45
Patent	18 years	60 ---------	(14) ---------	46 ---------
Total		$2,330 ======	$(426) ======	$1,904 ======

All of our acquired identifiable intangible assets are subject to amortization and have approximate original estimated useful lives as noted in the table above. Amortization expense associated with our intangible assets was approximately $1,218,000, $188,000, and $454,000, during fiscal years 2010, 2009, and 2008, respectively.

As of October 31, 2010, the estimated future amortization expense for acquired identifiable intangible assets is as follows (in thousands).

Fiscal Years	
2011	$1,432
2012	1,125
2013	740
2014	517
Thereafter	832 ---------
Total	$4,646 ======

Note 6: Borrowing Arrangements

Revolving Line of Credit

Revolving line of credit. We entered into a new revolving line of credit (Line of Credit) on February 22, 2010, under which Wells Fargo Bank (Wells Fargo) could advance funds to us, up to a maximum principal amount of $35 million. For borrowings under the new Line of Credit, we have the option to bear interest at either Wells Fargo’s reference rate or at a fixed rate per annum equal to 2.5% above the London Inter-Bank Offered Rate (LIBOR), and interest on those borrowings is payable monthly. The Line of Credit expires on February 12, 2012.

As a subfeature under the Line of Credit, Wells Fargo may issue standby letters of credit for us, provided that the aggregate amount of all outstanding letters of credit shall not at any time exceed $3,000,000. At October 31, 2010, we had three standby letters of credit under the Line of Credit, totaling approximately $1,407,000. The first letter of credit, related to our Sunnyvale, California, facilities lease, had a committed balance of approximately $1,221,000 at October 31, 2010. The second letter of credit was a requirement of our workers compensation insurance, and had a committed balance of approximately $150,000 at October 31, 2010. The third letter of credit, a requirement of one of our customers, had a committed balance of $36,000 at October 31, 2010. We do not pay interest on the amounts associated with the standby letters of credit.

As a result of the committed but unused funds associated with the three letters of credit, the total amount under the Line of Credit available for future letters of credit was $1,593,000 and the total amount available for borrowing was approximately $33.6 million at October 31, 2010. No fees or interest were associated with this unused portion.

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

Term Loan and Interest Rate Swap

In connection with the 2005 acquisition of DTI, we entered into a term loan with Wells Fargo in the 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 rate per annum equal to 1.750% above the London Inter-Bank Offered Rate (LIBOR) (0.26% at October 31, 2010). 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.

Under the Line of Credit and the Term Loan, we are required to maintain certain financial covenants setting forth minimum ratios for quick ratio and fixed charge coverage and maximum ratios for total liabilities to tangible net worth. As of October 31, 2010, we were in compliance with these covenants.

The following table sets forth our scheduled debt maturities under the Term Loan (in thousands).

Year	Debt Maturities
2011	$1,429
2012	1,071 ---------
Total	$2,500 ======

We are exposed to market risk from changes in interest rates on the Term Loan, and manage this exposure through the use of an interest rate swap agreement with Wells Fargo. By locking in a fixed rate for the entire term of the loan, this strategy decreases the variability of earnings and cash flows resulting from interest rate fluctuations and lowers the overall borrowing costs should interest rates rise. The interest rate swap is accounted for under the authoritative guidance for derivative instruments, and it is designated as a cash flow hedge. We do not anticipate losses on the agreement due to counterparty credit issues. Under this swap, we pay an interest rate of 4.33% 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 October 31, 2010, the effective portion of the hedge was a deferred loss of approximately $93,000 on a gross basis. The deferred loss net of taxes was approximately $56,000 and was included in other comprehensive income and long-term liabilities on our balance sheet. For the years 2010, 2009, and 2008, we recognized losses related to the hedge of $35,000, $210,000, and $232,000, respectively, in other comprehensive income. During fiscal years 2010, 2009 and 2008, we recognized interest expense of approximately $130,000, $168,000, and $58,000, respectively, reclassified from other comprehensive income. Over the next twelve months, we expect to reclassify approximately $76,000 of the loss to interest expense as principle 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 October 31, 2010.

Note 7: Commitments

The following table sets forth our contractual obligations, excluding interest payments on our debt, as of October 31, 2010 (in thousands).

			Payments Due by Period			
Fiscal Year	Total	2011	2012	2013	2014	Thereafter
Operating lease obligations	$25,088	$7,616	$5,194	$3,973	$3,841	$4,464
Purchase obligations	7,799	7,799	—	—	—	—
Loan obligations – principal	2,500	1,429	1,071	—	—	—

Pyxis Earn out	3,750	3,750	—	—	—	—
Seismic Earn out	2,374 ---------	2,374 ---------	— ---------	— ---------	— ---------	— ---------
Total	$41,511 ======	$22,968 ======	$6,265 ======	$3,973 ======	$3,841 ======	$4,464 ======

Our operating lease obligations consist of non-cancelable lease agreements for our facilities, which expire at various dates between fiscal years 2011 and 2016. Certain leases contain escalation clauses and requirements for the payment of property taxes, insurance, and maintenance expenses. Rent expense under operating leases was approximately $7,639,000, $7,479,000, and $7,617,000 in fiscal years 2010, 2009, and 2008, respectively.

The Seismic Earn Out represents the fair value of the contingent liability related to the acquisition of Seismic as of October 31, 2010. On January 10, 2011, we paid the shareholders of Seismic an accelerated earn-out payment of approximately $2.5 million due to the Merger Agreement with Raytheon Company, as required by the terms of the agreement with Seismic.

The Pyxis Earn Out represents the contingent consideration to be paid to the former shareholders of Pyxis, for achieving targets identified in the purchase agreement dated September 1, 2009.

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 8: Income Taxes

The provision for income taxes for the years ended October 31, 2010, 2009, and 2008 consists of the following (in thousands).

	Year Ended October 31,		
	2010	**2009**	**2008**
Federal			
Current	$6,228	$5,687	$6,132
Deferred	323 ---------	1,423 ---------	(1,579) ---------
	6,551	7,110	4,553
State			
Current	2,347	1,519	1,200
Deferred	(85) ---------	(65) ---------	(222) ---------
	2,262 ---------	1,454 ---------	978 ---------
Total	$8,813 ======	$8,564 ======	$5,531 ======

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate to income before provision for income taxes as follows (in thousands).

	Year Ended October 31,		
	2010	**2009**	**2008**

Computed expected tax provision	$7,713	$8,083	$4,742
State income tax, net of federal benefit	1,087	1,148	722
Stock-based compensation	8	93	840
Research and development credit	(154)	(619)	(580)
Tax-exempt interest	(64)	(221)	(394)
Tax asset adjustment	—	—	(332)
Meals and entertainment	152	135	259
Other items	71 ---------	(55) ---------	274 ---------
Total	$8,813 ======	$8,564 ======	$5,531 ======
Effective tax rate	39.99%	37.08%	40.82%

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of our deferred tax assets and liabilities are as follows (in thousands).

	October 31,	
	2010	**2009**
Deferred tax assets:		
Accrued expenses and reserves	$4,932	$4,573
Stock-based compensation	1,984	2,008
Depreciation and amortization	2,471	2,803
Other items	412 ---------	531 ---------
Total deferred tax assets	9,799	9,915
Deferred tax liabilities:		
Accrued expenses and reserves	(894)	(699)
DTI and Pyxis– intangibles	(297) ---------	(57) ---------
Total deferred tax liabilities	(1,191) ---------	(756) ---------
Total deferred tax assets/(liabilities)	$8,608 ======	$9,159 ======

Current deferred tax asset balances at October 31, 2010, and 2009 were approximately $4,700,000 and $4,965,000, respectively, and are included in prepaids and other current assets in the accompanying balance sheets. Long-term deferred tax assets balances at October 31, 2010, and 2009 were approximately $3,908,000 and $4,196,000, respectively, and are included in long-term deferred tax assets in the accompanying balance sheets.

As of October 31, 2010, management has determined that our deferred tax assets are “more likely than not” to be realized in future periods and, therefore, we have not provided a valuation allowance on the deferred tax asset.

Based on the terms of the acquisitions of Pyxis and Seismic, we are able to amortize the combined acquired goodwill balance of $38,506,000 over a fifteen-year period from the date of acquisition for federal tax purposes.

In general, our income tax returns are subject to examination by United States federal tax authorities for tax years 2006 onward and by various United States state tax authorities for tax years 2005 onward. The activity of our uncertain tax positions, including all federal and state jurisdictions is as follows (in thousands).

Balance at October 31, 2008	$1,450
Additions for tax positions related to the current year	64
Additions for tax positions from the prior years	4
Reductions for tax positions from prior years	(1,307)
Statute of limitations expirations	— ---------
Balance at October 31, 2009	$211 ======
Additions for tax positions related to the current year	46
Additions for tax positions from the prior years	—
Reductions for tax positions from prior years	—
Statute of limitations expirations	— ---------
Balance at October 31, 2010	$257 ======

During fiscal year 2010, we recorded gross unrecognized tax benefits of approximately $46,000. If our balance as of October 31, 2010 is recognized, approximately $257,000 would impact our effective tax rate. Interest and penalties related to unrecognized tax benefits are included within the provision for income taxes in our statement of operations. We recognized approximately $2,000 of interest and penalties relating to unrecognized tax benefits as of October 31, 2010. 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 October 31, 2010, we do not expect any unrecognized tax benefits to be paid in the next twelve months.

During fiscal year 2009, we recorded gross unrecognized tax benefits of approximately $64,000, and reversed approximately $1,307,000 in unrecognized tax benefits. The reversal is primarily due the filing of an Application for Change in Accounting Method with the Internal Revenue Service (IRS) under the automatic-consent provisions related to our temporary differences and it created a reduction to income tax expense of approximately $245,000.

Note 9: Retirement Plan

All employees who perform at least 1,000 hours of service per year are covered under our retirement plans. These plans are maintained by an outside administrator. During fiscal year 2010, company contributions to the retirement plans were based on qualified compensation up to a maximum of 6% of $245,000 per employee, per annum at the rate of $0.75 per $1.00 contributed by the employee. Company contributions to the retirement plans for the former Pyxis and Seismic employees were calculated a rate of 10% and 5%, respectively, on qualified compensation per annum up to a maximum of $245,000 per employee. Contributions continue to be discretionary and we continue to accrue the accumulated contributions, which are payable biweekly, to the retirement plans. We have incurred approximately $5,511,000, $4,435,000, and $3,150,000 in expense under the retirement plans for fiscal years 2010, 2009, and 2008, respectively.

Note 10: 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. We have integrated the companies that we have acquired into our existing operating and financial reporting structure. Our CEO, who is the chief decision maker of our operations, reviews aggregate financial information for the Company as a whole. As the technologies and the operations of our divisions are highly integrated, he makes resource allocation decisions based on this aggregate financial information. Revenues and costs are reviewed monthly by management on an individual contract basis as a single business segment.

Note 11: 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 were approximately $346,000, $117,000, and $181,000 for fiscal years 2010, 2009, and 2008, 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 sheet as of October 31, 2010, or 2009.

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 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 have answered; each asserts standard patent case defenses. On October 15, 2009, ViaSat, Inc. filed a counterclaim against us for infringement of two patents. On November 9, 2009, we answered those counterclaims, denying infringement and alleging that the ViaSat patents are invalid. On May 14, 2010, ViaSat amended its counterclaims against us to assert a third patent and to add third-party claims for patent infringement against our licensee, Comtech EFData. A claim construction hearing is scheduled for January 2011. No trial date has been set. The Court referred the parties to participate in settlement conferences with a Magistrate Judge in the Northern District of California. As to ViaSat and Paradise, the parties were unable to come to a resolution. A settlement conference with Emerging Market Communications and EMC Satcom Technologies was conducted on July 22, 2010, which resulted in a settlement agreement in principle, which is being formalized. We do not anticipate a material impact on our financial condition or operations from the proposed settlement agreement if it is adopted in its current form.If we are unable to come to a resolution of the patent infringement claims with ViaSat and Paradise, we will continue to vigorously pursue our claims and defenses.

On January 11, 2011, the Company received a copy of an unfiled complaint and was informed that a putative shareholder class action lawsuit has been, or will be, filed in the Superior Court of the State of California, County of Santa Clara, captioned Jarackas v. Applied Signal Technology, Inc., et al. (Case No. 111CV191643) against the Company, the members of its board of directors, Raytheon Company and RN Acquisition Company (the "Complaint"). The Complaint alleges that the members of the Company's board of directors breached their fiduciary duties in connection with the board's recommendation to the Company's stockholders to accept the Offer, authorizing the Company to enter into the Merger Agreement and the disclosures regarding the Offer and the Merger. The Complaint seeks injunctive relief and does not seek an award of money damages. The Company believes the allegations are without merit and intends to defend vigorously the action.

Note 12: Subsequent Events

Raytheon Merger Agreement. On December 20, 2010, Raytheon and AST announced that the companies have signed a definitive merger agreement providing for the acquisition of AST by Raytheon for $38.00 per share in cash. The transaction has been approved by the boards of directors of both companies.

Under the terms of the definitive merger agreement, Raytheon commenced a cash tender offer on December 30, 2010, to purchase all of the outstanding shares of AST for $38.00 per share in cash. The closing of the tender offer is subject to customary terms and conditions, including the tender of a number of shares of our common stock that, together with the number of shares already owned by Raytheon, constitutes at least 76.3% of AST's outstanding shares of common stock, the minimum condition, and expiration or termination of the waiting period under the

Hart-Scott-Rodino Antitrust Improvements Act of 1976. In the event that the Minimum Condition is not met, and in certain other circumstances, the parties have agreed to complete the transaction through a one-step merger after receipt of shareholder approval. The Merger Agreement also provides that, in connection with the termination of the Merger Agreement under specified circumstances involving competing transactions or a change in AST's board of directors' recommendation, AST may be required to pay Raytheon a termination fee of $17.3 million and to reimburse Raytheon for up to $1 million of its out-of-pocket transaction expenses.

As a result of the Merger Agreement, we expect to pay BofA Merrill Lynch a fee totaling approximately $8.8 million, of which $1 million was earned upon delivery of its opinion during the first quarter of fiscal year 2011, and the remaining portion of which will be payable upon the consummation of the merger. In addition, we also expect to incur approximately $1.5–$2 million of additional transaction costs during the first quarter of fiscal year 2011.

On November 11, 2010, the Compensation Committee of the Board of Directors of AST approved a modification to Mr. Van Vleet's stock agreement such that in the event of a Change in Control, as defined in the Company's Executive Retention and Severance Plan (the "ERSP"), the vesting of forty percent (40%) of the number of unvested shares of restricted stock then held by Mr. Van Vleet shall accelerate (with such number coming first from the restricted stock grant made to Mr. Van Vleet in September 2010), with the remaining unvested shares subject to vesting in accordance with the original terms of grant and subject to acceleration in accordance with the terms of the ERSP.

On December 13, 2010, the Compensation Committee of the Board of Directors of AST approved certain amendments to the ERSP. The amendments to the ERSP (i) clarify the 2008 Retention Plan's compliance with Section 409A of the Internal Revenue Code and the scope of the term "Good Reason" as defined in the ERSP, and (ii) extend the "Change in Control Period" as defined in the ERSP for unvested equity awards until the date occurring 24 months following a Change in Control (as defined by the ERSP). In addition, the Company's 2004 Stock Incentive Plan (the "2004 Plan") was amended to provide for accelerated vesting in full of restricted stock awards in the event such holder is terminated without Cause (as defined in the 2004 Plan) or resigns for Good Reason (as defined in the 2004 Plan) within 24 months following a Change in Control as defined in the 2004 Plan. These amendments became effective as a result of the Merger Agreement.

Item 9: Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A: Controls and Procedures

Conclusions regarding disclosure controls and procedures. 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 annual report.

Management's report on internal control over financial reporting. Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Exchange Act Rule 13a-15(f). Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting by using the criteria established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control—Integrated Framework*. Based on our evaluation under the framework in *Internal Control—Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of October 31, 2010.

The effectiveness of our internal control over financial reporting as of October 31, 2010, has been audited by Ernst & Young LLP, an independent registered public accounting firm, as stated in their report, which is included in "Part II, Item 8: Consolidated Financial Statements and Supplementary Data" of this annual report on Form 10 K.

Changes in internal control over financial reporting. There was no change in our internal control over financial reporting during the fourth quarter of fiscal year 2010 that has materially affected, or is 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.

Item 9B: Other Information

None.

Part III

The information required by Part III is incorporated by reference to the proxy statement expected to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K.

Item 10: Directors, Executive Officers, and Corporate Governance

The information required by Item 10 is incorporated by reference to the proxy statement expected to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K.

Item 11: Executive Compensation

The information required by Item 11 is incorporated by reference to the proxy statement expected to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K.

Item 12: Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by Item 12 is incorporated by reference to the proxy statement expected to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K.

Item 13: Certain Relationships and Related Transactions, and Director Independence

The information required by Item 12 is incorporated by reference to the proxy statement expected to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K.

Item 14: Principal Accountant Fees and Services

The information required by Item 12 is incorporated by reference to the proxy statement expected to be filed no later than 120 days after the end of the fiscal year covered by this Form 10-K.

Part IV

Item 15: Exhibits and Consolidated Financial Statement Schedules

(a) (1) and (2) The following consolidated financial statements of Applied Signal Technology, Inc. are filed as part of this report under Item 8:

- Balance Sheets – October 31, 2010, and 2009
- Statements of Operations – Years ended October 31, 2010, 2009, and 2008
- Statement of Shareholders' Equity – Years ended October 31, 2010, 2009, and 2008
- Statements of Cash Flows – Years ended October 31, 2010, 2009, and 2008
- Notes to Consolidated Financial Statements – October 31, 2010

All schedules for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable, and therefore have been omitted.

(b) Listing of Exhibits – See Exhibit Index on page 86 of this report on Form 10-K.

Signatures

Pursuant to the requirements of Section 13 or 15(d) 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. (Registrant)
Dated January 13, 2011	/s/ William B. Van Vleet III William B. Van Vleet III, Director, President and Chief Executive Officer

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints William B. Van Vleet and James E. Doyle, and each of them, his or her true and lawful attorneys-in-fact, each with full power of substitution, for him or her in any and all capacities, to sign any amendments to this report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact or their substitute or substitutes may do or cause to be done by virtue hereof. Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Date	Title
/s/ William B. Van Vleet III -------------------------------------- William B. Van Vleet III	January 13, 2011	Director, President and Chief Executive Officer (Principal Executive Officer)
/s/ James E. Doyle -------------------------------------- James E. Doyle	January 13, 2011	Vice President of Finance and Chief Financial Officer (Principal Financial and Accounting Officer)
/s/ Milton E. Cooper -------------------------------------- Milton E. Cooper	January 13, 2011	Director
/s/ John P. Devine -------------------------------------- John P. Devine	January 13, 2011	Chairman of the Board
/s/ David D. Elliman -------------------------------------- David D. Elliman	January 13, 2011	Director
Marie S. Minton	January 13, 2011	Director
/s/ Robert J. Richardson -------------------------------------- Robert J. Richardson	January 13, 2011	Director
/s/ Dr. John R. Treichler -------------------------------------- John R. Treichler	January 13, 2011	Director

Annual Report on Form 10-K
Item 15(b)

Exhibits
Year Ended October 31, 2010

Applied Signal Technology Inc.
460 West California Avenue
Sunnyvale, CA 94086

AST
Index to Exhibits

Exhibit Number	Description of Document
2.1[18]	Agreement of Merger of Mercury Acquisition Corporation, a California Corporation, and Dynamics Technology, Inc., a California Corporation, dated July 1, 2005
2.2[32]	Membership Interest Purchase Agreement dated September 1, 2009 by and among Applied Signal Technology, Inc., Pyxis Engineering LLC and Eric Bennett as the Initial Seller
2.3	First Amendment Membership Interest Purchase Agreement dated November 13, 2009 by and among Applied Signal Technology, Inc., Pyxis Engineering LLC and Eric Bennett as the Initial Seller
2.4[35]	Membership Interest Purchase Agreement dated April 28,2010, by and among Applied Signal Technology, Inc., Seismic LLC and Patrick J. Gahan and Scott D. McDonald as sellers
2.5	Second Amendment Membership Interest Purchase Agreement dated December 17, 2010, by and among Applied Signal Technology, Inc., Pyxis Engineering LLC and Eric Bennett as the Initial Seller
2.6[37]	Agreement and Plan of Merger, dated as of December 18, 2010, among Raytheon Company, RN Acquisition Company and Applied Signal Technology, Inc.
3.1	Third Amended and Restated Articles of Incorporation
3.2[1]	Amended and Restated Bylaws
3.3[36]	Amendment to the Second Amended and restated Articles of Incorporation of Applied Signal Technology, Inc.
4.1[1]	Specimen Common Stock Certificate
10.1[1]	Form of Indemnification Agreement for directors and officers*
10.3[5]	1991 Stock Option Plan and forms of agreements thereunder*
10.4[1]	1993 Employee Stock Purchase Plan
10.6[1]	Summary Plan Description of 401(k) Retirement Plan*

10.7[2]	Lease Agreement, dated August 21, 1985, with Lincoln Mathilda Associates, Ltd. and Patrician Associates, Inc., and amendments thereto
10.8[3]	Lease Agreements, dated November 23, 1994, with Lincoln Property Company Management Services, Inc. for Buildings H and I
10.10[4]	Amendments to Lease Agreements, dated November 23, 1994, with Lincoln Property Company Management Services, Inc.
10.11[8]	2000 Stock Option Plan and forms and agreements thereunder
10.16[7]	Amendments to Lease Agreements, dated July 30, 2001, with Sunnyvale Business Park
10.17[6]	2001 Stock Option Plan and forms of agreements thereunder*
10.18[7]	Amendments to Lease Agreements, dated September 20, 2000, with Eden Roc Partnership
10.19[7]	Amendments to Lease Agreements, dated April 19, 2001, with Sunnyvale Business Park
10.20[9]	2001 Stock Option Plan (as amended through January 20, 2003)*
10.21[9]	Line of Credit Agreement, dated January 27, 2003, with Wells Fargo Bank, National Association
10.22[9]	Security Agreement, dated January 27, 2003, with Wells Fargo Bank
10.25[11]	Annual Incentive Plan*
10.26[12]	Amendment to the Line of Credit Agreement, dated February 12, 2004, with Wells Fargo Bank, National Association
10.27[12]	Security Agreement, dated February 12, 2004, with Wells Fargo Bank, National Association
10.28[39]	Stock Incentive Plan*
10.29[13]	Second Amendment to Lease Agreement, dated May 18, 2004, with Eden Roc Partnership
10.30[38]	Executive Retention and Severance Plan*
10.31[14]	Revised Notice of Option Grant Form for the 2000 Stock Option Plan*
10.32[14]	Revised Notice of Option Grant Form for the 2001 Stock Option Plan*
10.33[14]	Revised Notice of Grant Form for the 2004 Stock Incentive Plan*
10.34[19]	Executed Interest Rate Master Agreement, dated June 2, 2005
10.46[19]	Lease Agreement Between 1555 Wilson Boulevard Limited Partnership and Dynamics Technology, Inc., dated May 16, 2003
10.47[19]	First Amendment to Lease Agreement Between 1555 Wilson Boulevard Limited Partnership and Dynamics Technology, Inc., dated June 4, 2004
10.48[19]	Amendment to Executed Loan Agreement, dated June 8, 2005
10.49[19]	Fourth Amendment to Lease Between Eden Roc Partnership and Applied Signal Technology, Inc., dated May 3, 2005

10.50[15]	Second Amendment to Line of Credit Agreement, dated February 25, 2005, with Wells Fargo Bank, National Association
10.51[16]	Lease Agreement, dated January 31, 2003, with Tom M. Lacey Family Limited Partnership
10.52[17]	Executed Loan Agreement, dated June 8, 2005
10.53[20]	Second Amendment to Deed of Lease, dated August 31, 2005, with RREEF America Reit II Corp
10.54[21]	Second Amendment to Line of Credit Agreement, dated March 1, 2006, with Wells Fargo Bank, National Association
10.55[22]	First Amendment to Lease Termination and Mutual Release Agreement with NBP, 131-133-141, LLC
10.56[22]	Second Amendment to Agreement of Lease with NBP306, LLC
10.57[24]	Lease agreement with Hamilton Associates, LLC, dated December 15, 2006
10.58[25]	Amendment to Line of Credit Agreement, dated March 1, 2007, with Wells Fargo Bank, National Association
10.59[25]	Amendment to 1993 Employee Stock Purchase Plan, dated May 31, 2007
10.60[26]	Second Amendment to Agreement of Lease with NBP306, LLC
10.61[26]	Amendment to Line of Credit Agreement, dated February 21, 2008, with Wells Fargo Bank, National Association
10.62[27]	Third Amendment to Lease Agreement Between 1555 Wilson Boulevard Limited Partnership and Applied Signal Technology, Inc., dated July 25, 2008
10.63[28]	Severance Agreement and General Release of Claims between Applied Signal Technology, Inc. and Gary L. Yancey
10.64[29]	Amendment to 1993 Employee Stock Purchase Plan, dated August 20, 2008
10.65[29]	Amendment to Stock Incentive Plan, dated November 19, 2008*
10.66[29]	Amendment to Executive Retention and Severance Plan, dated November 19, 2008*
10.67[30]	Amendment to Line of Credit Agreement, dated February 20, 2009, with Wells Fargo Bank, National Association
10.68[30]	Sixth Amendment to Lease Agreement with KBF Properties, LLC, dated September 29, 2008
10.69[31]	Amendment to Applied Signal Technology, Inc. 1993 Employee Stock Purchase Plan, amended on March 18, 2009*
10.70[33]	Lease agreement with Silver Oak Anaheim Hills, LLC dated July 31, 2009
10.71[33]	Line of Credit Agreement, dated February 22, 1010, with Wells Fargo Bank, National Association
14.1[11]	Code of Business Conduct and Ethics
21.1	Subsidiaries of the Registrant
23.1	Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm
24.	Power of Attorney (included on signature page)
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

* Management contract or compensatory plan, contract, or arrangement

(1) Incorporated by reference to corresponding Exhibit filed as an Exhibit to Registrant's Registration Statement on Form S-1 filed January 28, 1993 (File No. 33-58168).

(2) Incorporated by reference to Exhibit 10.10 filed with the Registrant's Registration Statement on Form S-1 filed January 28, 1993 (File No. 33-58168).

(3) Incorporated by reference to Exhibit 10.11 filed with the Registrant's Form 10-K for fiscal year 1994 dated January 27, 1995.

(4) Incorporated by reference to Exhibit 10.16 filed with the Registrant's Form 10-K for fiscal year 1996 dated January 29, 1997.

(5) Incorporated by reference to Exhibit 10.17 filed with the Registrant's Form 10-Q filed on June 16, 1997, for the quarter ended May 2, 1997.

(6) Incorporated by reference to corresponding Exhibit filed with the Registrant's Definitive Proxy Statement for the 2001 Annual Meeting of Shareholders held on March 15, 2001, filed on February 5, 2001.

(7) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K/A No. 1 for fiscal year 2001 dated January 29, 2002.

(8) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K for fiscal year 2002 dated January 28, 2003.

(9) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2003 dated March 14, 2003.

(10) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K for fiscal year 2003 dated January 27, 2004.

(11) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2004 dated March 9, 2004.

(12) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the second quarter of fiscal year 2004 dated June 9, 2004.

(13) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the third quarter of fiscal year 2004 dated September 9, 2004.

(14) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K for fiscal year 2004 dated January 14, 2005.

(15) Incorporated by reference to Exhibit 10.31 filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2005 dated March 8, 2005.

(16) Incorporated by reference to Exhibit 10.32 filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2005 dated March 8, 2005.

(17) Incorporated by reference to Exhibit 10.33 filed with the Registrant's Form 10-Q for the third quarter of fiscal year 2005 dated September 7, 2005.

(18) Incorporated by reference to Exhibit 10.35 filed with the Registrant's Form 10-Q for the third quarter of fiscal year 2005 dated September 7, 2005.

(19) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the third quarter of fiscal year 2005 dated September 7, 2005.

(20) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K for fiscal year 2005 dated January 17, 2006.

(21) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2006 dated March 7, 2006.

(22) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the second quarter of fiscal year 2006 dated June 1, 2006.

(23) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K for fiscal year 2006 dated January 29, 2007

(24) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2007 dated March 9, 2007.

(25) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the second quarter of fiscal year 2007 dated June 11, 2007.

(26) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2008 dated March 10, 2008.

(27) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the third quarter of fiscal year 2008 dated September 9, 2008.

(28) Incorporated by reference to Exhibit 10.61 filed with the Registrant's Form 8-K dated May 23, 2008.

(29) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K for fiscal year 2008 dated January 12, 2009.

(30) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-Q for the first quarter of fiscal year 2009 dated March 9, 2009.

(31) Incorporated by reference to corresponding Exhibit filed as an Exhibit to our Current Report on Form 8-K filed on April 1, 2009.

(32) Incorporated by reference to corresponding Exhibit filed as an Exhibit to our Current Report on Form 8-K filed on September 4, 2009.

(33) Incorporated by reference to corresponding Exhibit filed with the Registrant's Form 10-K for fiscal year 2009 dated January 12, 2010.

(34) Incorporated by reference to corresponding Exhibit filed with the Registran't Form 10-Q for the first quarter of fiscal year 2010 dated March 8, 2010.

(35) Incorporated by reference to corresponding Exhibit filed as an Exhibit to our Current Report on Form 8-K filed on May 4, 2010.

(36) Incorporated by reference to corresponding Exhibit filed as an Exhibit to our Current Report on Form 8-K filed on March 23, 2010.

(37) Incorporated by reference to Exhibit 2.1 filed on our Current Report on Form 8-K filed on December 20, 2010.

(38) Incorporated by reference to Exhibit (e)(24) to our Schedule on 14D-9 filed on December 30, 2010.

(39) Incorporated by reference to Exhibit (e)(25) to our Schedule on 14D-9 filed on December 30, 2010.