

APPLIED SIGNAL TECHNOLOGY INC
Form 10-Q
June 08, 2005

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

Form 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the Period Ended April 29, 2005

or

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

Commission file number 0-21236

Applied Signal Technology, Inc.

(Exact name of registrant as specified in its charter)

California

77-0015491

(State or other jurisdiction of
incorporation or organization)

(I.R.S. Employer
Identification No.)

400 West California Avenue, Sunnyvale, CA 94086

(408) 749-1888

(Registrant's telephone number, including area code)
Not Applicable

(Former name, former address, and former fiscal year, if changed since
last report)

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

ü

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

ü

Yes No

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

Common Stock, no par value, 11,365,888 shares outstanding as of April 29, 2005.

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Applied Signal Technology, Inc.

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Part I. Financial Information

Item 1: Condensed Financial Statements

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

	April 29, 2005 (Unaudited)	October 31, 2004 (Note)
Assets		

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Current assets:		
Cash and cash equivalents	\$26,013	\$ 11,227
Short term investments	25,654	32,615
	-----	-----
Total cash and cash equivalents and short-term investments	51,667	43,842
Accounts receivable:		
Billed	16,229	23,407
Unbilled	13,148	20,361
	-----	-----
Total accounts receivable	29,377	43,768
Inventory	10,617	5,392
Prepaid and other current assets	4,528	4,340
	-----	-----
Total current assets	96,189	97,342
Property and equipment, at cost:		
Machinery and equipment	49,425	47,545
Furniture and fixtures	4,922	4,855
Leasehold improvements	10,851	10,696
Construction in process	79	9
	-----	-----
	65,277	63,105
Accumulated depreciation and amortization	(52,367)	(50,682)
	-----	-----
Net property and equipment	12,910	12,423
Other assets		
	1,715	1,687
	-----	-----
Total assets	\$110,814	\$111,452
	=====	=====

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

Liabilities and Shareholders' Equity	April 29, 2005 (Unaudited)	October 31, 2004 (Note)
Current liabilities:		
Accounts payable	\$3,650	\$6,307
Accrued payroll and related benefits	10,115	12,012
Other accrued liabilities	2,350	2,336
Income taxes payable	320	28
	-----	-----
Total current liabilities	16,435	20,683
Long-term accrued rent	1,119	1,098
Other liabilities	333	305
Shareholders' equity:		
Common stock, no par value: 20,000,000 shares authorized; issued and outstanding: 11,365,888 at April 29, 2005 and 11,210,738 at October 31, 2004	39,979	37,943
Retained earnings	52,962	51,448
Accumulated comprehensive loss	(14)	(25)
	-----	-----
Total shareholders' equity	92,927	89,366
	-----	-----
Total liabilities and shareholders' equity	\$110,814	\$111,452
	=====	=====

Note: The balance sheet at October 31, 2004 has been derived from the audited financial statements at that date but does not include all of the information required by accounting principles generally accepted in the United States for complete financial statements.

See Notes to Condensed Financial Statements.

Applied Signal Technology, Inc.
Statements of Operations
(Unaudited)
(In thousands, except per share data)

	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Revenues from contracts	\$32,053	\$36,811	\$62,163	\$65,105

Operating expenses:				
Contract costs	20,646	24,146	40,485	42,446
Research and development	3,139	3,419	6,316	5,556
General and administrative	4,541	4,534	8,363	9,215
	-----	-----	-----	-----
Total operating expenses	28,326	32,099	55,164	57,217
	-----	-----	-----	-----
Operating income	3,727	4,712	6,999	7,888
Interest income, net	217	137	380	278
	-----	-----	-----	-----
Income before provision for income taxes	3,944	4,849	7,379	8,166
Provision for income taxes	1,617	912	3,025	2,073
	-----	-----	-----	-----
Net income	\$2,327	\$3,937	\$4,354	\$6,093
	=====	=====	=====	=====
Net income per common share:				
Basic	\$0.20	\$0.36	\$0.38	\$0.56
Diluted	\$0.20	\$0.34	\$0.37	\$0.53
Number of shares used in calculating net income per common share:				
Basic	11,364	10,990	11,329	10,922
Diluted	11,770	11,565	11,823	11,500

See Notes to Condensed Financial Statements.

Applied Signal Technology, Inc.
Statements of Cash Flows
Increase in Cash and Cash Equivalents
(Unaudited)
(In thousands)

	Six Months Ended	
	April 29, 2005	April 30, 2004

Operating Activities:		
Net income	\$4,354	\$6,093
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	1,769	2,210
Changes in:		
Accounts receivable	14,391	(4,245)
Inventory, prepaids, and other assets	(5,441)	(400)
Accounts payable, taxes payable, and accrued expenses	(4,218)	5,564
	-----	-----
Net cash provided by operating activities	10,855	9,222
Investing Activities:		
Purchases of available-for-sale securities	(18,945)	(24,781)
Maturities of available-for-sale securities	25,917	38,317
Additions to property and equipment	(2,256)	(1,903)
	-----	-----
Net cash provided by investing activities	4,716	11,633
Financing Activities:		
Issuance of common stock	2,036	2,698
Dividends paid	(2,821)	(2,044)
	-----	-----
Net cash provided (used) by financing activities	(785)	654
Net increase in cash and cash equivalents	14,786	21,509
Cash and cash equivalents, beginning of period	11,227	5,372
	-----	-----
Cash and cash equivalents, end of period	\$26,013	\$26,881
	=====	=====
Supplemental disclosures of cash flow information:		
Interest paid	\$70	\$75
Income taxes paid	\$2,107	\$359

See Notes to Condensed Financial Statements.

April 29, 2005

Note 1: Summary of Significant Accounting Policies

Description of Business and Basis of Presentation

Applied Signal Technology, Inc. provides advanced digital signal processing products, systems, and services used in collection and processing of signals for intelligence gathering, a process referred to as signal intelligence (SIGINT). Our fundamental business area within SIGINT is communications intelligence (COMINT) and more recently, we have been investing to expand into another portion of SIGINT, which is electronic intelligence (ELINT). COMINT derives intelligence from telecommunications signals, whereas ELINT derives intelligence from signals associated with weapons systems. Our primary customer is the United States Government. Substantially, all of our revenues were from contracts with the United States Government, its agencies, or prime contractors for the United States Government.

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements, and should be read in conjunction with the financial statements and footnotes thereto included in our Annual Report on Form 10-K for the year ended October 31, 2004. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the three-month and six-month periods ending April 29, 2005 are not necessarily indicative of the results that may be expected for the year ending October 31, 2005.

Estimates

In order for us to prepare financial statements in conformity with accounting principles generally accepted in the United States, management is required to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ materially from those estimates.

Revenues and Contract Accounting

Revenues and cost recognition. The majority of our contracts are accounted for in accordance with the American Institute of Certified Public Accountants Statement of Opinion 81-1, *Accounting for Performance of Construction-Type and Production-Type Contracts*. These contracts are executed by using written contractual arrangements, most of which require us to design, develop, manufacture, and/or modify our complex products, and perform related services according to specifications provided by the customer.

We account for cost-reimbursement contracts by charging actual labor, materials, and other direct costs, plus estimated indirect costs of operations as incurred (incurred costs). Indirect costs include overhead, research and development, and general and administrative expenses. General and administrative costs are not applied to certain subcontract costs associated with our cost-reimbursement contracts. These subcontracts must be in excess of \$250,000 and meet certain other predetermined criteria.

We recognize contract revenues and profits on cost-reimbursement contracts by applying an estimated fee rate to all incurred costs on an individual contract basis. Fee calculations are based on either negotiated fee amounts or management's assessment of the fee amounts that are likely to be earned upon contract completion.

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's assessments are based 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. If management's assessment is incorrect, or there are changes in facts and circumstances, we may be required to revise our estimates and the adjustment to profits resulting from such revisions may affect future period earnings.

Our engineering services contracts are typically performed on a level-of-effort basis. Revenue is recognized in accordance with our policy regarding cost-reimbursement contracts.

We account for fixed-price contracts by using the percentage-of-completion method of accounting. Under this method, labor, materials, and other direct costs, plus estimated indirect costs of operations, are charged as incurred (incurred costs). A portion of the contract revenue, based on estimated profits and the degree of completion of the contract as measured by a comparison of the actual and estimated costs, is recognized as revenue each period. Unexpected increases in the cost to develop or manufacture a product under a fixed-price contract, whether due to inaccurate estimates in the bidding process, unanticipated increases in material costs, inefficiencies, or other factors, are borne by us, and could

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have a material, adverse effect on our results of operations.

The following table represents the revenue concentration by contract type:

	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Cost-reimbursement contracts	80%	76%	79%	75%
Fixed-price contracts	20%	24%	21%	25%

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

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

Revenues from our software licenses are accounted for under AICPA Statement of Position 97-2, *Software Recognition*. Revenues from our software licenses have been insignificant in all periods presented.

Indirect rate variance adjustments to operations. We record contract revenues and costs of operations for interim reporting purposes based on annual targeted indirect rates. At year-end, the revenues and costs are adjusted for actual indirect rates. During our interim reporting periods, variances may accumulate between the actual indirect rates and the annual targeted rates. All timing-related indirect spending variances are removed from contract costs, research and development, and general and administrative expenses, and are included in inventory as part of work in process during these interim reporting periods. These rates are reviewed regularly, and we record adjustments for any material, permanent variances in the period they become determinable.

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

If we anticipate that actual contract activities will be different than planned levels, there are alternatives we can utilize to absorb the variance: we can adjust our planned indirect spending during the year, modify our billing rates to our customers, or record adjustments to expense based on estimates of future contract activities.

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

At April 29, 2005, the unfavorable rate variance was approximately \$4,064,000 and at April 30, 2004 the favorable rate variance was \$2,572,000.

Accounts receivable and allowance for bad debt. Accounts receivable are segregated between billed and unbilled accounts. For cost-reimbursement contracts, we bill incurred costs and a portion of our fees on a regular basis. Under fixed-price contracts, we either bill contract costs on a milestone or unit of delivery basis or regularly progress bill 90% of incurred costs. Unbilled amounts result from our recognition of contract revenue in advance of contractual billing or progress billing terms.

When evaluating our need for a bad debt allowance, we consider our customer base and their payment history. The majority of our revenues are generated from the U.S. 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.

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At April 29, 2005 and October 31, 2004, there was no balance for the allowance for doubtful accounts. There was no charge to bad debt expense during the first six months of fiscal year 2005 or fiscal year 2004.

Income taxes. Our income tax expense at interim reporting periods is based on our estimated annual effective tax rate. This estimated tax rate is calculated based on the projected net income at the end of the fiscal year, and is reviewed at each reporting period. At the end of the fiscal year, income tax expense is adjusted for actual results. Our effective tax rate can differ from the statutory rate as a result of such expected benefits as R&D credits and the reversals of valuation allowances. Please refer to "Notes to Financial Statements, Note 5: Provision for Income Taxes" for the current year effective tax rate.

Price Redetermination

As a government contractor, we are subject to price redetermination on certain fixed-price contracts if it is determined that we did not price our products and services consistent with the requirements of the Federal Acquisition Regulations. During the first six months of fiscal year 2005 and 2004, we did not incur any price redeterminations on any of our contracts.

Cash Equivalents and Investments

We consider all highly liquid debt instruments purchased with an original maturity date of three months or less to be cash equivalents.

Our securities are classified as available-for-sale and are carried at fair market value in short-term investments. 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 retained earnings. The cost of securities sold is based on the specific identification method. Realized gains and losses on sales of available-for-sale securities were not material for the first six months of fiscal year 2005 and fiscal year 2004.

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

April 29, 2005				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	\$26,013	\$—	\$—	\$26,013
Short-term, available-for-sale securities:				
Asset-backed securities	3,561	—	(4)	3,557
Corporate securities	7,234	—	(6)	7,228
Government securities	7,905	—	(3)	7,902
Money market securities	6,968	—	(1)	6,967
	-----	-----	-----	-----
	\$51,681	\$—	(\$14)	\$51,667
	=====	=====	=====	=====

October 31, 2004				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Market Value
Cash and cash equivalents	\$11,227	\$—	\$—	\$11,227
Short-term, available-for-sale securities:				
Asset-backed securities	3,521	—	(15)	3,506

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Corporate securities	2,619	—	(3)	2,616
Government securities	4,002	—	(4)	3,998
Money market securities	22,498	—	(3)	22,495
	<u>43,867</u>	<u>\$—</u>	<u>(\$25)</u>	<u>43,842</u>

The following table summarizes the maturities of our short-term investments (in thousands):

	April 29, 2005	October 31, 2004
Due in one year or less	\$23,688	\$32,615
Due in one to three years	1,966	—
	<u>\$25,654</u>	<u>\$32,615</u>

Per Share Data

Basic net income per share is determined by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is determined by dividing net income by the weighted average number of common shares used in the basic earnings per share calculation, plus the number of common shares that would be issued assuming conversion of all potentially dilutive securities outstanding under the treasury stock method.

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

	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Numerator:				
Net income	\$2,327	\$3,937	\$4,354	\$6,093
	<u>2,327</u>	<u>3,937</u>	<u>4,354</u>	<u>6,093</u>
Denominator:				
Shares used to compute net income per common share – basic	11,364	10,990	11,329	10,922
Effect of dilutive stock options	406	575	494	578
	<u>406</u>	<u>575</u>	<u>494</u>	<u>578</u>
Shares used to compute net income per common share – diluted	11,770	11,565	11,823	11,500
	<u>11,770</u>	<u>11,565</u>	<u>11,823</u>	<u>11,500</u>
Net income per common share – basic	\$0.20	\$0.36	\$0.38	\$0.56
Net income per common share – diluted	\$0.20	\$0.34	\$0.37	\$0.53

The exercise price for approximately 408,000 and 120,000 of potential common shares for the three-month and six-month periods ending April 29, 2005 was greater than the market value, and therefore we excluded those shares from the diluted net income per common share computation for the second quarter and first six months of fiscal year 2005. For the same periods in fiscal year 2004, we excluded 5,000 and 50,000 potential common shares from the diluted net income per common share computation for the same reason as the second quarter and first six months of

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fiscal year 2005.

Comprehensive Income

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

	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Net income	\$2,327	\$3,937	\$4,354	\$6,093
Unrealized gain (loss) on securities	11	(73)	11	(71)
Comprehensive income	\$2,338	\$3,864	\$4,365	\$6,022

As of April 29, 2005, accumulated unrealized loss on securities was approximately \$14,000. As of October 31, 2004, accumulated unrealized loss on securities was approximately \$25,000.

Dividends

In November 2004, the Board of Directors approved the continuation of the dividend at the rate of \$0.50 per share per annum, payable quarterly. Dividends were paid on February 11, 2005 and May 13, 2005, and are payable on August 12, 2005 and November 11, 2005 to shareholders of record at January 28, 2005, April 29, 2005, July 29, 2005, and October 31, 2005, respectively.

We paid dividends of approximately \$2,821,000 during the first six months of fiscal year 2005 and approximately \$2,044,000 during the first six months of fiscal year 2004.

At April 29, 2005 and October 31, 2004, accrued dividends of approximately \$1,420,000 and \$1,401,000, respectively, were included in other accrued liabilities on the accompanying balance sheet.

Stock-Based Compensation

We apply Accounting Principles Board Opinion No. 25 and related Interpretations in accounting for our stock option plans. We have opted, under SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS 148, to disclose our stock-based compensation with no financial statement effect. Under APB 25, no stock-based compensation expense is charged for options granted at an exercise price equal to the fair market value of the underlying common stock on the date of grant. Had compensation expense for our stock plans been determined based upon the fair value at the grant date for awards under these plans consistent with the methodology prescribed under SFAS 123, our pro forma net income and net income per share would have been as follows (in thousands, except per share data):

	Three Months Ended		Six Months Ended	
	April 29, 2005	April 30, 2004	April 29, 2005	April 30, 2004
Net income, as reported	\$2,327	\$3,937	\$4,354	\$6,093
Deduct: total stock-based compensation expense determined at the fair value for all awards, net of related tax effects	(835)	(584)	(1,673)	(1,081)
Pro forma net income	\$1,492	\$3,353	\$2,681	\$5,012
Net income per share				

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Basic – As reported	\$0.20	\$0.36	\$0.38	\$0.56
– Pro forma	\$0.13	\$0.31	\$0.24	\$0.46
Diluted – As reported	\$0.20	\$0.34	\$0.37	\$0.53
– Pro forma	\$0.13	\$0.29	\$0.23	\$0.44

The fair value of options at the date of grant was estimated by using the Black-Scholes valuation model with the following weighted average assumptions:

	Employee Stock Options		Employee Stock Purchase Plan	
	Six Months Ended April 29, 2005	Six Months Ended April 30, 2004	Six Months Ended April 29, 2005	Six Months Ended April 30, 2004
Risk-free interest rate	3.8%	3.6%	2.8%	1.0%
Expected life (years)	5	5	0.5	0.5
Expected volatility	2.68	1.60	2.68	1.61
Expected dividends	1.3%	1.7%	1.3%	1.8%

Recent Accounting Pronouncements

In December 2004, the FASB issued Statement of Financial Accounting Standard No. 123R, *Share-Based Payment*, or SFAS 123R. SFAS 123R replaces SFAS 123. The statement requires that the costs resulting from share-based payment transactions be recognized in the financial statements. The statement requires companies to use the fair-value-based payment measurement method in accounting for share-based payment with employees as well as for goods and services received from non-employees. SFAS 123R is effective for all awards granted after the first annual reporting period that begins after June 15, 2005 with early adoption permitted. We have no plans for early adoption and therefore SFAS 123R will be effective beginning with our quarter ending January 27, 2006.

The effects of the adoption of SFAS No. 123R on our results of operations and financial position are dependent upon a number of factors, including the number of employee stock options outstanding and unvested, the number of employee options that may be granted in the future, the future market value and volatility of our stock price, movements in the risk-free rate of interest, stock option exercise and forfeiture patterns, and the stock option valuation model used to estimate the fair value of each option. As a result of these variables, it is not yet possible to reliably estimate the effect of the adoption of SFAS No. 123R on our results of operations and financial position, however, we expect that the adoption of SFAS 123R will have a material impact on our results of operations and earnings per share. Note 1 herein provides an indication of the effects of adoption assuming the use of the Black-Scholes option pricing model to estimate the fair value of employee stock options and employee stock purchase plan awards upon the results of operations for the three months and six months ended April 29, 2005 and April 30, 2004. We, however, have not determined whether the adoption will result in amounts that are similar to the current pro forma disclosures under SFAS No. 123.

Note 2: Inventory

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

	April 29, 2005	October 31, 2004
Raw materials	\$610	\$719
Work in process	9,735	4,428
Finished goods	157	222
	-----	-----
	10,502	5,369

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Precontract costs	115	23
	-----	-----
	\$10,617	\$5,392
	=====	=====

At April 29, 2005, the unfavorable inventoried indirect rate variance increased work in process by approximately \$4,064,000. At April 30, 2004, the favorable inventoried indirect rate variance decreased work in process by approximately \$2,572,000.

Precontract costs represent costs incurred in anticipation of specific expected future contract awards and cost incurred in connection with ongoing contracts for which contract modifications have not been defined.

Inventory activities during the first six months of fiscal year 2005 and 2004 included \$150,000 and \$1,000,000 of disposals of obsolete products, respectively. The disposed items consisted of units in various stages of completion.