

APPLIED SIGNAL TECHNOLOGY INC  
Form DEFR14A  
February 09, 2007

**Schedule 14A**

Schedule 14A Information  
Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material Pursuant to § 240.14a-11(c) or § 240.14a-12

.....  
Applied Signal Technology, Inc.  
(Name of Registrant as Specified in its Charter)

Applied Signal Technology, Inc.  
James E. Doyle  
Vice President-Finance, CFO  
400 West California Avenue  
Sunnyvale, CA 94086

.....  
Payment of Filing Fee (Check the appropriate box):

No fee required.

Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

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(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

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(1) Amount Previously Paid:

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(2) Form, Schedule or Registration Statement No.:

.....

(3) Filing Party:

.....

(4) Date Filed:

.....

## Applied Signal Technology, Inc.

### Notice of Annual Meeting of Shareholders to be Held March 14, 2007

#### To the Shareholders:

Notice is hereby given that the 2007 Annual Meeting of Shareholders of Applied Signal Technology, Inc. (the Company) will be held at the Sheraton Hotel, located at 1100 N. Mathilda Avenue, Sunnyvale, California, on March 14, 2007, at 4:00 p.m. local time, for the following purposes:

1. To elect four (4) Class I directors to hold office until the 2009 Annual Meeting of Shareholders or until their respective successors are elected and qualified.
2. To vote on a proposal to ratify the appointment of Ernst & Young LLP as the independent registered public accounting firm for the Company for the fiscal year ending October 31, 2007.
3. To vote on a proposal to amend the Company's 1993 Employee Stock Purchase Plan to increase by 600,000 shares the maximum number of shares of Common Stock that may be issued under this plan.
4. To transact such other business as may properly come before the meeting or any adjournment thereof.

Shareholders of record at the close of business on January 23, 2007, are entitled to notice of, and to vote at, this meeting and any continuation or adjournments thereof.

By Order of the Board of Directors

Sunnyvale, California  
February 14, 2007

Gary L. Yancey, President and Chief Executive Officer

WHETHER OR NOT YOU PLAN TO ATTEND THE MEETING, YOU ARE URGED TO SIGN AND PROMPTLY MAIL THE ENCLOSED PROXY IN THE RETURN ENVELOPE SO THAT YOUR STOCK MAY BE REPRESENTED AT THE MEETING.

### Proxy Statement 2007 Annual Meeting of Shareholders

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Applied Signal Technology, Inc.  
400 West California Avenue  
Sunnyvale, California 94086  
(408) 749-1888

This proxy statement is furnished in connection with the solicitation by the Board of Directors (the Board) of Applied Signal Technology, Inc., a California corporation (the Company), of proxies for use at the Annual Meeting of Shareholders (Annual Meeting) to be held on March 14, 2007, or any adjournment or postponement thereof, for the purposes set forth in the accompanying Notice of Annual Meeting of Shareholders. This proxy statement and accompanying proxy are first being sent to shareholders on approximately February 14, 2007. The cost of the solicitation of proxies will be borne by the Company. The Board may use the services of the Company's directors, officers, and others to solicit proxies, personally or by telephone. The Board may also arrange with brokerage houses and other custodians, nominees, and fiduciaries to forward solicitation material to the beneficial owners of the stock held of record by such persons, and the Company may reimburse them for their reasonable out-of-pocket expenses incurred in so doing. The Annual Report to Shareholders for the fiscal year ended October 31, 2006, including financial statements, is being mailed to shareholders concurrently with the mailing of this proxy statement.

### Voting Rights

**Voting Rights.** The voting securities of the Company entitled to vote at the Annual Meeting consist of shares of common stock. Only shareholders of record at the close of business on January 23, 2007, are entitled to notice of, and to vote at, the Annual Meeting. On that date, there were 12,137,612 shares of the Company's common stock issued and outstanding. Each shareholder of record as of that date is entitled to one vote for each share of common stock held by him or her. The Company's bylaws provide that a majority of all of the shares of common stock entitled to vote, whether present in person or by proxy, shall constitute a quorum for the transaction of business at the meeting. Votes for and against, abstentions, and "broker non-votes" will each be counted as present for purposes of determining the presence of a quorum. If an executed proxy is submitted without any instruction for the voting of such proxy, the proxy will be voted in favor of the proposals described.

**Voting of Proxies.** All shares represented by valid proxies received prior to the Annual Meeting will be voted, and where a shareholder specifies by means of the proxy a choice with respect to any matter to be acted upon, the shares will be voted in accordance with the specifications so made. A shareholder who signs and returns a proxy will have the power to revoke it at any time before it is voted. A proxy may be revoked by filing with the Secretary of the Company a written revocation or duly executed proxy bearing a later date, or by appearing at the Annual Meeting and electing to vote in person.

**Broker Non-Votes.** A broker non-vote occurs when a broker submits a proxy card with respect to shares held in a fiduciary capacity (typically referred to as being held in "street name") but declines to vote on a particular matter because the broker has not received voting instructions from the beneficial owner. Under the rules that govern brokers who are voting with respect to shares held in street name, brokers have the discretion to vote such shares on routine matters, but not on non-routine matters. Routine matters include the election of directors and ratification of auditors.

**Shareholder Proposals.** The deadline for submitting a shareholder proposal for inclusion in the Company's proxy statement and form of proxy for the Company's 2008 annual meeting of stockholders is October 18, 2007. The deadline for submitting a shareholder proposal or a nomination for director that is not to be included in such proxy statement and proxy is also October 18, 2007. Any such shareholder proposals must be submitted to the Company's Corporate Secretary in writing at 400 West California Avenue, Sunnyvale, CA 94086. Shareholders are also advised to review the Company's bylaws, which contain additional advance notice requirements, including requirements with respect to advance notice of shareholder proposals and director nominations. For further information, see page 26.

### Security Ownership of Certain Beneficial Owners and Management

The following table sets forth certain information regarding beneficial ownership of the Company's common stock as of January 23, 2007, by (i) each shareholder who is known by the Company to own beneficially more than five percent of the outstanding common stock of the Company, (ii) each of the Company's directors and director-nominees, (iii) the Chief Executive Officer and all other executive officers of the Company, and (iv) all directors and executive officers of the Company as a group.

Name of Beneficial Owner and Nature of Beneficial Ownership <sup>(1)</sup>	Shares Beneficially Owned	Percent of Common Stock Outstanding <sup>(2)</sup>
Wellington Management Company LLP 75 State Street Boston, MA 02109	1,250,500 <sup>(3)</sup>	10.30
	1,224,823 <sup>(4)</sup>	10.09

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Lazard Asset Management LLC 30 Rockefeller Plaza New York, NY 10112		
Kennedy Capital Management, Inc. 10829 Olive Blvd. St. Louis, MO 63141	919,472 <sup>(5)</sup>	7.58
Heartland Advisors, Inc. 789 N Water Street, Ste. 500 Milwaukee, WI 53202	849,595 <sup>(6)</sup>	7.0
State of Wisconsin Investment Board 121 East Wilson Street Madison, WI 53707	848,954 <sup>(7)</sup>	7.0
Neuberger Berman LLC 605 Third Avenue New York, NY 10158-3698	753,267 <sup>(8)</sup>	6.21
Dr. John R. Treichler	284,453 <sup>(9)</sup>	2.34
Gary L. Yancey	295,975 <sup>(10)</sup>	2.42
David Elliman	77,810 <sup>(11)</sup>	*
Bani M. Scribner, Jr.	58,058 <sup>(12)</sup>	*
James E. Doyle	57,759 <sup>(13)</sup>	*
Renato F. Roscher, Jr.	55,519 <sup>(14)</sup>	*
Stuart G. Whittelsey, Jr.	49,656 <sup>(15)</sup>	*
John P. Devine	42,055 <sup>(16)</sup>	*
Robert Richardson	36,875 <sup>(17)</sup>	*
Milton E. Cooper	29,375 <sup>(18)</sup>	*
Dr. Michael Ready	20,803 <sup>(19)</sup>	*
William B. Van Vleet III	15,916 <sup>(20)</sup>	*
Robert Blanchard	12,291 <sup>(21)</sup>	*
Dr. John F. Pesaturo Jr.	9,820 <sup>(22)</sup>	*
Dr. Joseph Leonelli	9,459 <sup>(23)</sup>	*
Robert T. Teague	8,400 <sup>(24)</sup>	*
All directors and executive officers as a group (16 persons)	1,064,124 <sup>(25)</sup>	8.46

\*Less than 1 percent

(1) Except as indicated in the footnotes to this table, the persons named in the table possess sole voting and investment power with respect to all shares of common stock shown as beneficially owned by them, subject to joint tenancy, tenancy-in-common, or community property laws, where applicable. Unless otherwise indicated, the business address of each of the beneficial owners is 400 W. California Avenue, Sunnyvale, California 94086.

(2) Calculated on the basis of 12,137,612 shares of common stock outstanding as of January 23, 2007, provided that under the rules of the Securities and Exchange Commission, a person is deemed to be the beneficial owner of shares that can be acquired by such person within 60 days of January 23, 2007 upon the exercise of options, warrants, or other instruments. Any additional shares that a shareholder has the right to acquire within 60 days after January 23, 2007, are deemed to be outstanding for the purpose of calculating that shareholder's percentage beneficial ownership.

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- (3) Based on information contained in Schedule 13F dated September 30, 2006, filed by Wellington Management Co. LLP with the SEC on November 14, 2006. Includes 316,400 shares over which the holder has sole voting power, 354,400 shares over which the holder has shared voting power, and 579,700 shares of which the holder has no voting power.
- (4) Based on information contained in Schedule 13G/A dated October 31, 2006, filed by Lazard Asset Management LLC with the SEC on November 13, 2006. Includes 1,183,723 shares over which the holder has sole voting power and 1,224,823 shares over which the holder has sole dispositive power.
- (5) Based on information contained in Schedule 13F dated September 30, 2006, filed by Kennedy Capital Management, Inc. with the SEC on November 14, 2006. Includes 891,737 shares over which the holder has sole voting power.
- (6) Based on information contained in Schedule 13F dated September 30, 2006, filed by Heartland Advisors, Inc. with the SEC on November 14, 2006. Includes 754,495 shares over which the holder has sole voting power, and 95,100 shares over which the holder has no voting power.
- (7) Based on information contained in Schedule 13F dated September 30, 2006, filed by State of Wisconsin Investment Board with the SEC on November 03, 2006. Includes 848,954 shares over which the holder has sole voting power.
- (8) Based on information contained in Schedule 13G dated October 31, 2006, filed by Neuberger Berman LLC with the SEC on November 08, 2006. Includes 753,267 shares over which the holder has shared voting and dispositive power.
- (9) Includes 30,000 shares subject to options that are exercisable within 60 days of January 23, 2007, and 7,500 shares of restricted stock subject to vesting restrictions. Also includes 25,000 shares held in the Robert K Treichler Trust, and 12,735 shares held in the Anne Eckel Treichler Revocable Trust, over which Dr. Treichler disclaims beneficial ownership. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.
- (10) Includes 90,234 shares subject to options that are exercisable within 60 days of January 23, 2007, and 20,000 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.
- (11) Includes 40,780 shares subject to options that are exercisable within 60 days of January 23, 2007, and 1,875 shares of restricted stock subject to vesting restrictions. Also includes 6,666 shares held in Trust u/d Avery Rockefeller, and 10,604 shares held by the Bawd Foundation, over which Mr. Elliman disclaims beneficial ownership. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains a director of the Company.
- (12) Includes 41,013 shares subject to options that are exercisable within 60 days of January 23, 2007, and 12,500 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.
- (13) Includes 48,271 shares subject to options that are exercisable within 60 days of January 23, 2007, and 7,500 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.
- (14) Includes 27,100 shares subject to options that are exercisable within 60 days of January 23, 2007, 10,000 shares of restricted stock subject to vesting restrictions, and 8,603 shares owned by his wife, over which he disclaims beneficial ownership. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.
- (15) Includes 40,780 shares subject to options that are exercisable within 60 days of January 23, 2007, and 1,875 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains a director of the Company.
- (16) Includes 39,180 shares subject to options that are exercisable within 60 days of January 23, 2007, and 1,875 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains a director of the Company.
- (17) Includes 35,000 shares subject to options that are exercisable within 60 days of January 23, 2007, and 1,875 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains a director of the Company.

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(18) Includes 27,500 shares subject to options that are exercisable within 60 days of January 23, 2007, and 1,875 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains a director of the Company.

(19) Includes 8,900 shares subject to options that are exercisable within 60 days of January 23, 2007, 6,000 shares of restricted stock subject to vesting restrictions, and 199 shares owned by his wife, over which he disclaims beneficial ownership. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.

(20) Includes 4,000 shares subject to options that are exercisable within 60 days of January 23, 2007, and 10,000 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.

(21) Includes 6,000 shares subject to options that are exercisable within 60 days of January 23, 2007, and 6,000 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.

(22) Includes 2,400 shares subject to options that are exercisable within 60 days of January 23, 2007, 6,000 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.

(23) Includes 2,400 shares subject to options that are exercisable within 60 days of January 23, 2007, and 6,000 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.

(24) Includes 2,400 shares subject to options that are exercisable within 60 days of January 23, 2007, and 6,000 shares of restricted stock subject to vesting restrictions. The restricted stock awards vest at a rate of 25% on each anniversary of the date of grant and are fully vested at the end of four years provided the grantee remains an employee of the Company.

(25) Includes 445,958 shares subject to options that are exercisable within 60 days of January 23, 2007.

### **Section 16(a) Beneficial Ownership Reporting Compliance**

Section 16(a) of the Securities Exchange Act of 1934 requires the Company's executive officers, directors, and persons who beneficially own more than 10 percent of the Company's common stock to file initial reports of ownership and reports of changes in ownership with the SEC. Such persons are required by SEC regulations to furnish the Company with copies of all Section 16(a) forms filed by them.

Based solely on our review of such forms furnished to the Company and written representations from certain reporting persons, the Company believes that during fiscal year 2006, all such filing requirements applicable to our executive officers, directors, and more-than-10-percent shareholders were complied with, except that Mr. Leonelli and Dr. Treichler each filed one late Form 4.

### **Proposal One: Election of Directors**

We have a classified Board of Directors consisting of two classes of directors, with each director serving a two-year term. The articles of incorporation and bylaws of the Company, as amended to date, provide that the number of directors shall be not less than six (6) nor more than eight (8), with the exact number of directors fixed within the limits specified by a resolution of the Board of Directors. The Board of Directors has set the number of directors at seven (7). The minimum or maximum number of directors may be changed only by amendment to the bylaws duly adopted by the affirmative vote of a majority of the outstanding shares of capital stock entitled to vote and by a resolution duly adopted by the Board of Directors. Vacancies in the Board of Directors may be filled by a majority of the directors then in office, whether or not less than a quorum, or by a sole remaining director. A director elected by the Board of Directors to fill a vacancy shall serve for the remainder of the full term of the class of directors in which the vacancy occurred and until such director's successor is elected and qualified.

At the 2007 Annual Meeting, the term of the four Class I directors are up for election. The Board has designated four current directors as nominees for election at this meeting as Class I directors (John P. Devine, David Elliman, Robert Richardson, and Gary L. Yancey). Directors elected at this meeting will serve until the 2009 Annual Meeting or until their respective successors are duly elected and qualified.

Management knows of no reason why any nominee should be unable or unwilling to serve. However, if any nominee(s) should for any reason be unable or unwilling to serve, the proxies will be voted for such substitute nominees as the Board may designate.

**Required Vote and Board Recommendation**

If a quorum is present and voting, the four nominees for Class I director receiving the highest number of votes will be elected as Class I directors. Abstentions and “broker non-votes” will be counted as present for purposes of determining the presence of a quorum but will have no affect on the outcome of the vote.

**THE BOARD OF DIRECTORS RECOMMENDS A VOTE “FOR” THE NOMINEES NAMED ABOVE.**

Set forth below is certain information with respect to the age and background for each of the nominees to be elected at this meeting:

<b>Name</b>	<b>Positions with the Company</b>	<b>Age</b>	<b>Director Since</b>
<i>Class I directors:</i>			
John P. Devine	Director	69	1995
David Elliman	Director	56	1991
Robert Richardson	Director	60	2003
Gary L. Yancey	President, CEO, and Chairman of the Board	61	1984

Set forth below is certain information with respect to the age and background for each of our current directors whose terms will continue after the Annual Meeting, and will expire at our 2008 Annual Meeting:

<i>Class II directors:</i>			
Milton E. Cooper	Director	68	2004
Dr. John R. Treichler	Chief Technical Officer and Director	59	1984
Stuart G. Whittelsey, Jr.	Director	77	1990

Set forth below is biographical information for each person nominated and each person whose term of office as a director will continue after the Annual Meeting.

**Nominees for Election for a Two-Year Term Expiring at the 2009 Annual Meeting****John P. Devine**

John P. Devine has been a director of the Company since May 1995. Mr. Devine served as Deputy Director, National Security Agency (NSA) for Technology and Systems from 1992 to 1995 and as Deputy Director, NSA for Research and Engineering from 1990 to 1992. From 1989 to 1990, Mr. Devine served as NSA Chief of Staff. Mr. Devine has been a consultant to the defense industry since his retirement from the NSA. Mr. Devine serves on the board of Ericsson Federal, Inc., EADS N.A. Defense Security Systems and Solutions, and Spirent Federal Systems.

**David Elliman**

David Elliman has been a director of the Company since 1991. Mr. Elliman is a professional investor. He is a founding partner of Elmrock Partners, which, along with affiliates, specializes in private equity, marketable equity, structured finance, and asset securitization investments. Elmrock Partners was founded in 1982. Mr. Elliman serves on the boards of a number of private companies and is an Overseer of the College of Arts and Sciences of the University of Pennsylvania.

**Robert Richardson**

Robert Richardson has been a director of the Company since February 2003. From November 1997 to January 2000, Mr. Richardson was Chairman and Chief Executive Officer of Unitrode Corporation, a publicly traded semiconductor company, which was acquired by Texas Instruments, Inc. in 2000. From June 1992 to November 1997, Mr. Richardson was President of SVG Lithography (formerly Perkin-Elmer) in Connecticut, and then Vice President, New Business Development and Corporate Marketing for Silicon Valley Group. From 1988 to 1992, Mr. Richardson was the President and General Manager for the Santa Cruz Division of Plantronics, Inc., a manufacturer of communications equipment, and from 1985 to 1988, he was Director, Motorola New Enterprises. Mr. Richardson currently serves as director for a number of private technology companies.

**Gary L. Yancey**

Gary L. Yancey, a co-founder of the Company, has served the Company as President, Chief Executive Officer, and Chairman of the Board since the Company's incorporation in January 1984. Prior to co-founding the Company, he was employed for ten years by ARGOSystems Inc., a manufacturer of electronic reconnaissance systems, most recently serving as Director of the Strategic Systems Division; and for seven years prior to that time as an engineer with GTE Sylvania, Inc., a defense electronics company.

**Directors Continuing in Office Until the 2008 Annual Meeting**

**Milton E. Cooper**

Milton E. Cooper has been a director of the Company since March 2004. Mr. Cooper was the President of the Federal Sector of Computer Sciences Corporation from January 1992 through February 2001. Prior to that time, he has also served in marketing and general management positions with IBM Corporation, Telex Corporation, and Raytheon Company. Mr. Cooper currently serves as a director of L-1 Identity Solutions, Inc., a provider of biometric recognition technology and services for identification of individuals, and EPlus, Inc., a business selling, leasing, and managing information technology and other assets.

**Dr. John R. Treichler**

Dr. John R. Treichler, a co-founder of the Company, has been a director and employee of the Company since its incorporation in 1984. He has served in the position of Senior Scientist since 1984 and as Chief Technical Officer since 1999. Prior to co-founding the Company, he worked at ARGOSystems, Inc. for seven years, most recently serving as a senior scientist in the Strategic Systems Division, and at Stanford University for three years in the Information Systems Laboratory. Prior to working at Stanford University, Dr. Treichler served for four years as an officer in the United States Navy.

**Stuart G. Whittelsey, Jr.**

Stuart G. Whittelsey, Jr. has been a director of the Company since 1990. Since April 1994, he has been a principal of his own consulting firm, Whittelsey Associates, which is engaged in corporate financial management. From July 1993 through April 1994, he was Chief Executive Officer of Lytton Gardens, Inc., a skilled nursing facility and seniors' residence in Palo Alto, California. Prior to that, he was Chief Financial Officer for several high-technology firms, including Informix, Inc.; Acurex Corp.; Stanford Telecommunications, Inc.; and Watkins Johnson Company.

The Board has determined that all of the members of the Board continuing in office after this Annual Meeting are "independent directors" within the meaning of Rule 4200 of the National Association of Securities Dealers, Inc. (NASD), other than Mr. Gary L. Yancey and Dr. John R. Treichler, who are not considered independent because each is an executive officer of the Company.

**Meetings of the Board of Directors and Board Committees**

During fiscal year 2006, the Board of Directors held four meetings. The Board of Directors has an Audit Committee, Compensation Committee, and a Nominating and Governance Committee. During fiscal year 2006, the Audit Committee held ten meetings, the Compensation Committee held four meetings, and the Nominating and Governance Committee held four meetings. No director serving on the Board in fiscal year 2006 attended less than 75 percent of such meetings of the Board and the committees on which he serves.

**Audit Committee.** The members of the Audit Committee during fiscal year 2006 were Stuart G. Whittelsey, Jr. (Chairman), Milton E. Cooper, David Elliman, and Robert Richardson. The Audit Committee meets at least quarterly with the Company's management and its independent registered public accounting firm to, among other things, review the results of the annual audit and quarterly reviews and discuss the financial statements, review the adequacy of accounting and financial controls, review the Company's critical accounting policies, review earnings releases issued by the Company and the Company's periodic reports filed with the Securities and Exchange Commission, and review and approve any related party transactions. In addition, the functions of the Audit Committee include retaining the independent registered public accounting firm, reviewing their independence, reviewing and approving the planned scope of the Company's annual audit, reviewing and approving any related fee arrangements, and reviewing and pre-approving any non-audit services that may be performed by the independent registered public accounting firm. The Audit Committee meets separately, at least once each quarter, with the independent registered public accounting firm. The Company maintains procedures for the receipt, retention, and handling of complaints, which the Audit Committee oversees. All of the members of the Audit Committee are independent directors within the meaning of Rule 4200 of the National Association of Securities Dealers, Inc. (NASD) and SEC Rule 10A-3(b)(1)(ii). The Board of Directors has determined that Mr. Whittelsey is an audit committee financial expert, within the meaning of applicable SEC rules.



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A copy of the Audit Committee Charter adopted by the Board of Directors is available through our website at [www.appsig.com/investor/charter\\_audit.htm](http://www.appsig.com/investor/charter_audit.htm).

**Compensation Committee.** The members of the Compensation Committee during fiscal year 2006 were David Elliman (Chairman), Stuart G. Whittelsey, Jr., John P. Devine, Robert Richardson, and Milton E. Cooper. The Compensation Committee sets, reviews, and administers the compensation program for the executive officers and directors of the Company, including the salary and bonus earned by the Chief Executive Officer, directors, and other executive officers of the Company. In addition, the Compensation Committee evaluates executive officer performance; approves all employment agreements with executive officers, including severance, retention, and change-in-control agreements; and determines all equity compensation payable to executive officers and directors, including the grant of restricted stock and stock options to executive officers and directors. All of the members of the Compensation Committee are independent directors within the meaning of Rule 4200 of the NASD and outside directors within the meaning of Section 162(m) of the Internal Revenue Code of 1986, as amended.

**Nominating and Governance Committee.** The members of the Nominating and Governance Committee during fiscal year 2006 were John P. Devine (Chairman), Robert Richardson, and Milton E. Cooper. The Nominating and Governance Committee determines the criteria for selecting new directors, considers qualified candidates for appointment and nomination for election to the Board of Directors, including candidates validly nominated by shareholders, and reviews and makes recommendations concerning qualification, appointment, and removal of committee members. In addition, the Committee oversees compliance with the Company's Code of Business Conduct and Ethics, reviews compliance with corporate governance listing requirements established by NASDAQ, assists with annual Committee and Board self-assessments, and assists the Board in new and continuing director orientation and education. All of the members of the Nominating and Governance Committee are independent directors within the meaning of Rule 4200 of the NASD.

### Director Nominations

The Company's bylaws contain provisions that address the process by which a shareholder may nominate an individual to stand for election to the Board of Directors at the Company's Annual Meeting. The Nominating and Governance Committee has adopted a policy regarding director nominations and regarding communications by shareholders with directors, including the process for evaluating director nominees proposed by shareholders. To date, the Company has not received any recommendations from shareholders requesting that the Nominating and Governance Committee (or any predecessor) consider a candidate for inclusion among the Committee's slate of nominees in the Company's proxy statement.

In evaluating director nominees, the Nominating and Governance Committee considers the following factors:

- the appropriate size of the Company's Board of Directors and its Committees;
- the perceived needs of the Board for particular skills, background, and business experience;
- the skills, background, reputation, and business experience of nominees compared to the skills, background, reputation, and business experience already possessed by other members of the Board;
- nominees' independence from management;
- applicable regulatory and listing requirements, including independence requirements and legal considerations, such as antitrust compliance;
- the benefits of a constructive working relationship among directors; and
- the desire to balance the considerable benefit of continuity with the periodic injection of the fresh perspective provided by new members.

Other than the foregoing, there are no stated minimum criteria for director nominees, and the Nominating and Governance Committee may also consider such other factors as it may deem are in the best interests of the Company and its shareholders. The Nominating and Governance Committee does, however, believe it appropriate for at least one member of the Board to meet the criteria for an "audit committee financial expert," that a majority of the members of the Board meet the definition of "independent director" under NASDAQ rules, and that one or more key members of management participate as members of the Board.

The Nominating and Governance Committee identifies nominees by first evaluating the current members of the Board of Directors willing to continue in service. Current members of the Board with skills and experience that are relevant to the Company's business and who are willing to continue in service are considered for re-nomination, balancing the value of continuity of service by existing members of the Board with that of obtaining a new perspective. If any member of the Board does not wish to continue in service or if the Nominating and Governance Committee or the Board decides not to re-nominate a member for re-election, the Nominating and Governance Committee identifies the desired skills and experience of a new nominee, and discusses with the Board suggestions as to individuals that meet the criteria. In addition, the Committee has in the past engaged third parties to identify, evaluate, or assist in identifying potential nominees.

The Nominating and Governance Committee will evaluate any recommendation for director nominee proposed by a stockholder. In order to be evaluated in connection with the Nominating and Governance Committee's established procedures for evaluating potential director nominees, any recommendation for director nominee submitted by a stockholder must be sent in writing to the Corporate Secretary, 400 West California Avenue, Sunnyvale, CA 94086, 120 days prior to the anniversary of the date proxy statements were mailed to stockholders in connection with

the prior year's annual meeting of stockholders and must contain the following information:

- the candidate's name, age, contact information, and present principal occupation or employment; and
- a description of the candidate's qualifications, skills, background, and business experience during, at a minimum, the last five years, including his/her principal occupation and employment and the name and principal business of any corporation or other organization in which the candidate was employed or served as a director.

### **Communication with Directors**

Shareholders who wish to communicate with the Board of Directors may do so by writing to: Applied Signal Technology, Inc., Attention: Board of Directors, 400 West California Avenue, Sunnyvale, CA 94086. The Corporate Secretary shall maintain a log of such communications and transmit as soon as practicable such communications to the identified director addressee(s), unless there are safety or security concerns that mitigate against further transmission of the communication or the communication contains commercial matters not related to the stockholder's stock ownership, as determined by the Corporate Secretary in consultation with the Chief Executive Officer and legal counsel. The Board of Directors or individual directors so addressed shall be advised of any communication withheld for any reason as soon as practicable.

### **Director Attendance at Annual Meetings**

The Company makes every effort to schedule its Annual Meeting at a time and date to maximize attendance by directors taking into account the directors' schedules. The Company believes that annual meetings provide an opportunity for shareholders to communicate with directors and has adopted a policy requesting that all directors make every effort to attend the Company's Annual Meeting. Historically, more than a majority of the directors have done so; for example, 100% of the directors attended the 2006 Annual Meeting.

### **Committee Charters and Other Corporate Governance Materials**

The Board has adopted a charter for each of the committees described above, as well as a Code of Business Conduct and Ethics that applies to all of our employees, officers, and directors. Links to these materials are now available on our website at [www.appsig.com/investor/ethics.htm](http://www.appsig.com/investor/ethics.htm). To date, there have not been any waivers by the Company of compliance with the code of ethics by any executive officer or director. Any amendments to, or waivers under, the code of ethics that are required to be disclosed by the rules of the SEC will be disclosed on the Company's website.

### **Compensation Committee Interlocks and Insider Participation in Compensation Decisions**

The members of the Compensation Committee, Messrs. Elliman, Cooper, Devine, Richardson, and Whittelsey, are each independent directors and are not and have never been employees or officers of the Company or of any company on which an executive officer of the Company serves as a member of the board of directors.

### **Report of the Audit Committee of the Board of Directors for Fiscal Year 2006**

The Audit Committee consists of four directors, each of whom, in the judgment of the Board, is an "independent director" as defined in the listing standards for the NASDAQ Stock Market and the applicable rules of the Securities and Exchange Commission. The Audit Committee assists the Board in the general oversight of the Company's financial reporting process, internal controls, and audit functions. The Audit Committee has responsibility for retaining the independent registered public accounting firm, reviewing their independence, reviewing and approving the planned scope of the Company's annual audit, reviewing and approving any related fee arrangements with them, reviewing and pre-approving any non-audit services that may be performed by them, reviewing the adequacy of the Company's accounting and financial controls, reviewing the Company's critical accounting policies, and reviewing and approving any related party transactions. The Audit Committee acts pursuant to a written charter that has been adopted by the Board of Directors. The Audit Committee Charter describes in greater detail the full responsibilities of the Committee and is available on our website at [www.appsig.com/investor/charter\\_audit.htm](http://www.appsig.com/investor/charter_audit.htm). The Audit Committee is comprised solely of independent directors as defined by the listing standards of National Association of Securities Dealers, Inc.

Management is responsible for the preparation, presentation, and integrity of the Company's financial statements; accounting and financial reporting principles; establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)); establishing and maintaining internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)); evaluating the effectiveness of disclosure controls and procedures; evaluating the effectiveness of internal control over financial reporting; and evaluating any change in internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting. Ernst & Young LLP is responsible for performing an independent audit of the consolidated financial statements and expressing an opinion on the conformity of those financial statements with accounting principles generally accepted in the United States of America, as well as expressing an opinion on (i) management's assessment of the effectiveness of internal control over financial reporting and (ii) the effectiveness of internal control over financial reporting.

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In fiscal 2006, management completed the documentation, testing, and evaluation of the Company's system of internal controls over financial reporting. The Audit Committee is kept apprised of the progress of the evaluation and provides oversight and advice to management. The Committee also holds regular private sessions with Ernst & Young to discuss their audit plan for the year, the financial statements, and risks of fraud. At the conclusion of the process, management provides the Committee with (and the Committee reviews) a report on the effectiveness of the Company's internal control over financial reporting. The Committee also reviews the report of management contained in the Company's Annual Report on Form 10-K for the fiscal year ended October 31, 2006 filed with the SEC, as well as Ernst & Young LLP's Report of Independent Registered Public Accounting Firm included in the Company's Annual Report on Form 10-K related to its integrated audit of the Company's fiscal 2006 (i) consolidated financial statements and financial statement schedule, (ii) management's assessment of the effectiveness of internal control over financial reporting, and (iii) the effectiveness of internal control over financial reporting.

The Audit Committee has discussed with Ernst & Young LLP the matters required to be discussed by Statement on Auditing Standards No. 61, as amended, "Communication with Audit Committees" and PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements."

The Audit Committee has received from Ernst & Young LLP a formal written statement describing all relationships between the auditors and the Company that might bear on Ernst & Young LLP's independence consistent with Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), discussed with the auditors any relationships that may impact their objectivity and independence, and satisfied itself as to the registered independent public accounting firm's independence.

In accordance with Audit Committee policy and the requirements of law, the Audit Committee pre-approves all services to be provided by Ernst & Young LLP. Pre-approval is required for audit services, audit-related services, tax services, and other services. Pre-approval is generally provided for up to one year and detailed as to the particular service or category of services. See "Principal Accountant Fees and Services" for more information regarding fees paid to Ernst & Young LLP for services in fiscal years 2006 and 2005.

In reliance on the reviews and discussions referred to above, the Committee recommended to the Board of Directors (and the Board has approved) that the audited financial statements be included in the Annual Report on Form 10-K for the year ended October 31, 2006 for filing with the Securities and Exchange Commission. The Committee has also recommended, subject to shareholder approval, the selection of Ernst & Young LLP as the Company's independent registered public accounting firm for the fiscal year ending October 31, 2007.

### Audit Committee

Stuart G. Whittelsey, Jr., Chairman  
Milton E. Cooper  
David Elliman  
Robert Richardson

## Proposal Two: Ratification of Appointment of the Independent Registered Public Accounting Firm

The Audit Committee of the Board of Directors has selected Ernst & Young LLP to serve as the independent registered public accounting firm to audit the financial statements of the Company for the fiscal year ending October 31, 2007. Ernst & Young LLP has acted in such capacity since its appointment in fiscal year 1985. Representatives of Ernst & Young LLP who will be present at the Annual Meeting will be given the opportunity to make a statement if the representatives desire and will be available to respond to appropriate questions.

Shareholder ratification of the selection of Ernst & Young LLP as the Company's independent registered public accounting firm is not required by the Company's bylaws or otherwise. However, the Board is submitting the selection of Ernst & Young LLP to the shareholders for ratification as a matter of good corporate practice. If the shareholders fail to ratify the selection, the Audit Committee will reconsider whether or not to retain that firm. Even if the selection is ratified, the Audit Committee in their discretion may appoint a different firm at any time during the year if they determine that such a change would be in the best interests of the Company and its shareholders.

## Principal Accountant Fees and Services

The following table sets forth the aggregate fees and services billed by Ernst & Young LLP to Applied Signal Technology, Inc. for the fiscal years ended October 31, 2006 and 2005.

	Fiscal Year 2006	Fiscal Year 2005
Audit Fees	\$1,232,000	\$1,319,000

Audit-Related Fees	\$108,000	\$60,150
Tax Fees	—	—
Non Audit-Related Fees	—	\$262,908
	-----	-----
Total Fees	\$1,340,000	\$1,642,058

#### **Audit and Audit-Related Fees**

Audit fees billed for services rendered in connection with the audit of the Company's annual financial statements were \$425,000 and \$430,000 for fiscal years 2006 and 2005, respectively. Fees billed for the audit of the effectiveness of our internal controls over financial reporting were \$460,000 and \$650,000 for fiscal year 2006 and 2005, respectively. Audit fees billed in connection with our fiscal year 2006 stock option review were approximately \$240,000. Fees billed for the review of the interim financial statements included in quarterly reports were \$80,000 and \$99,000 for fiscal years 2006 and 2005, respectively. Other audit fees billed in fiscal year 2006, associated with our annual goodwill impairment review and accounting database changes, were approximately \$27,000. Other audit fees billed in fiscal year 2005, associated with our 8-K filing related to the acquisition of Dynamics Technology, Inc. (DTI), were approximately \$140,000.

The audit-related fees billed for fiscal year 2005 were for the review of documentation prepared in anticipation of compliance with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, and were \$60,150. In fiscal year 2006, audit-related fees included \$53,000 for advisory services in connection with correspondence with the Securities and Exchange Commission, and \$55,000 for advisory services in connection with Financial Accounting Standard Board's revision to statement 123.

#### **Tax Fees**

There were no tax fees billed by Ernst & Young LLP during fiscal year 2006 or 2005, as the Company has retained another accounting firm to provide tax advice.

During fiscal year 2006, there were no fees billed by Ernst & Young LLP for financial information systems design and implementation.

#### **Non Audit-Related Fees**

The non audit-related fees billed for the review of the acquisition of DTI was \$262,908 during fiscal year 2005.

The Audit Committee has determined that the rendering of all non-audit services by Ernst & Young LLP is compatible with maintaining such auditor's independence.

#### **Policy on Committee Pre-Approval of Audit and Non-Audit Services of the Independent Registered Public Accounting Firm**

The Audit Committee's policy is to pre-approve all audit and non-audit services provided by the independent registered public accounting firm. These services may include audit services, audit-related services, tax services, and other services. Pre-approval is generally provided for up to one year and detailed as to the particular service or category of services. The independent auditor and management periodically report to the Audit Committee regarding the extent of the services provided by the independent auditors in accordance with this approval policy.

#### **Required Vote and Board Recommendation**

The affirmative vote of a majority of the votes cast at the meeting, at which a quorum is present, either in person or by proxy, is required to approve this proposal. Abstentions and broker non-votes will each be counted as present for purposes of determining the presence of a quorum but will not have any effect on the outcome of the proposal.

**THE BOARD UNANIMOUSLY RECOMMENDS A VOTE "FOR" THE RATIFICATION OF THE SELECTION OF ERNST & YOUNG LLP AS THE COMPANY'S INDEPENDENT ACCOUNTANTS FOR THE FISCAL YEAR ENDING OCTOBER 31, 2007.**

#### **Proposal Three: Amendment of the Company's 1993 Employee Stock Purchase Plan**

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At the Annual Meeting, the shareholders will be asked to approve an amendment to the Company's 1993 Employee Stock Purchase Plan (the Purchase Plan) to increase by 600,000 the maximum number of shares of Common Stock that may be issued under the Purchase Plan.

The Company's shareholders have previously approved the reservation of 4,300,000 shares of the Company's Common Stock (subject to adjustment upon certain changes in the capital structure of the Company) for issuance to employees under the Purchase Plan. As of January 23, 2007, 4,097,227 shares of Common Stock had been issued under the Purchase Plan, leaving 202,773 shares available for future purchases.

The Board of Directors believes that the Purchase Plan benefits the Company and its shareholders by providing its employees with an opportunity to purchase shares of Common Stock that is helpful in attracting, retaining, and motivating valued employees. To enable the Company to continue the Purchase Plan, the Board of Directors has amended the Purchase Plan, subject to approval by the shareholders, to increase the maximum number of shares that may be issued under the Purchase Plan by 600,000, to an aggregate of 4,900,000 shares.

The following summary of the Purchase Plan, as amended, is qualified in its entirety by the specific language of the Purchase Plan, a copy of which is available to any shareholder upon request.

**General.** The Purchase Plan is intended to qualify as an "employee stock purchase plan" under section 423 of the Internal Revenue Code of 1986, as amended (the Code). Each participant in the Purchase Plan is granted at the beginning of each offering under the plan the right to purchase through accumulated payroll deductions up to a number of shares of the Common Stock of the Company (a Purchase Right) determined on the first day of the offering. The Purchase Right is automatically exercised on each purchase date during the offering unless the participant has withdrawn from participation in the offering or the Purchase Plan prior to such date.

**Shares Subject to Purchase Plan.** The shareholders have previously authorized an aggregate of 4,300,000 shares of the Company's Common Stock for issuance upon the exercise of Purchase Rights granted under the Purchase Plan. As amended, the Purchase Plan would provide that the maximum aggregate number of authorized but unissued shares of Common Stock that may be issued under the plan is 4,900,000. Appropriate adjustments will be made to the shares subject to the Purchase Plan and to outstanding Purchase Rights upon any stock dividend, stock split, reverse stock split, recapitalization, combination, reclassification, or similar change in the capital structure of the Company, or in the event of any merger, sale of assets, or other reorganization of the Company. If any Purchase Right expires or terminates, the shares subject to the unexercised portion of such Purchase Right will again be available for issuance under the Purchase Plan.

**Administration.** The Purchase Plan is administered by the Board of Directors or a duly appointed committee of the Board of Directors (hereinafter referred to as the Board). The Board has delegated non-exclusive authority to administer the Purchase Plan to the Compensation Committee. Subject to the provisions of the Purchase Plan, the Board determines the terms and conditions of Purchase Rights granted under the plan. The Board will interpret the Purchase Plan and Purchase Rights granted thereunder, and all determinations of the Board or the Compensation Committee will be final and binding on all persons having an interest in the Purchase Plan or any Purchase Right.

**Eligibility.** Any employee of the Company or of any present or future parent or subsidiary corporation of the Company designated by the Board for inclusion in the Purchase Plan is eligible to participate in an offering under the plan, except for any employee who owns or holds options to purchase, or who, as a result of participation in the Purchase Plan, would own or hold options to purchase, five percent or more of the total combined voting power or value of all classes of stock of the Company or of any parent or subsidiary corporation of the Company. No employee of the Company owns or holds options to purchase five percent or more of the voting power of the outstanding Common Stock. As of January 23, 2007, approximately 649 employees, including 11 executive officers, were eligible to participate in the Purchase Plan.

**Offerings.** Generally, each offering of Common Stock under the Purchase Plan is for a period of 24 months (an Offering Period). Offering Periods will generally commence on or about June 1 and December 1 of each year (an Offering Date). Generally, each Offering Period is comprised of four six-month "Purchase Periods" ending on or about the last days of November and May (a Purchase Date). The Board may establish a different term for one or more Offerings or different commencement or ending dates for any Offering Period or Purchase Period.

**Participation and Purchase of Shares.** Participation in an offering under the Purchase Plan is limited to eligible employees who authorize payroll deductions prior to the applicable Offering Date. Payroll deductions may not exceed 10 percent (or such other rate as the Board determines) of an employee's compensation on any payday during the Offering Period. Once an employee becomes a participant in the Purchase Plan, that employee will automatically participate in each successive Offering Period until such time as the employee withdraws from the Purchase Plan, becomes ineligible to participate, or terminates employment. A participant may withdraw from an offering at any time without affecting his or her eligibility to participate in future offerings. However, once a participant withdraws from an offering, that participant may not again participate in the same offering.

Subject to certain limitations, each participant in an Offering Period has a Purchase Right equal to a number of whole shares determined by dividing \$50,000 by the fair market value of a share of Common Stock on the Offering Date. However, no participant may purchase under the Purchase Plan shares of Common Stock having a fair market value exceeding \$25,000 in any calendar year (measured by the fair market value of the Company's Common Stock on the first day of the Offering Period in which the shares are purchased).

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On each Purchase Date, the Company issues to each participant in the offering the number of shares of the Common Stock determined by dividing the amount of payroll deductions accumulated for the participant during the Offering Period by the purchase price, limited in any case by the number of shares subject to the participant's Purchase Right for that offering. The price at which shares are sold under the Purchase Plan is established by the Board but may not be less than 85 percent of the lesser of the fair market value per share of Common Stock on the Offering Date or on the Purchase Date. The fair market value of the Common Stock on any relevant date generally will be the closing price per share as reported on The Nasdaq Stock Market. On January 23, 2007, the closing price per share of Common Stock was \$14.34. Any payroll deductions under the Purchase Plan not applied to the purchase of shares will be returned to the participant without interest, unless the amount remaining is less than the amount necessary to purchase a whole share of Common Stock, in which case the remaining amount may be applied to the next Purchase Period.

**Change in Control.** The Purchase Plan provides that, in the event of (i) a sale or exchange by the shareholders of all or substantially all of the Company's stock, a merger or consolidation in which the Company is a party, or the sale, exchange, or transfer of all or substantially all of the assets of the Company, wherein, upon any such event, the shareholders of the Company before such event do not retain, directly or indirectly, at least a majority of the beneficial interest in the voting stock of the Company, its successor, or the corporation to which the assets of the Company were transferred, or (ii) a liquidation or dissolution of the Company (a Change in Control), the acquiring or successor corporation may assume the Company's rights and obligations under the Purchase Plan. However, if the acquiring or successor corporation elects not to assume the outstanding Purchase Rights in connection with a merger, the Board must provide that all outstanding Purchase Rights will become immediately exercisable prior to the Change in Control. Any Purchase Rights that are not assumed or exercised prior to the Change in Control will terminate.

**Termination or Amendment.** The Purchase Plan will continue until terminated by the Board or until all of the shares reserved for issuance under the plan have been issued. The Board may at any time amend or terminate the Purchase Plan, except that the approval of the Company's shareholders is required within twelve months of the adoption of any amendment increasing the number of shares authorized for issuance under the Purchase Plan or changing the definition of the corporations which may be designated by the Board as corporations the employees of which may participate in the Purchase Plan. Generally, outstanding Purchase Rights may not be adversely affected by amendment or termination of the Purchase Plan.

### Shares Purchased by Certain Persons

The aggregate numbers of shares of Common Stock purchased by certain persons under the Purchase Plan since its inception are as follows: (i) Bani M. Scribner, Chief Operating Officer, 48,893 shares; (ii) Renato F. Roscher, Executive Vice President, Multichannel-Systems Division, 36,810 shares; (iii) Michael Ready, Chief Marketing Officer, 30,858 shares; (iv) John R. Treichler, Chief Technical Officer, 21,257 shares; (v) James E. Doyle, Vice President-Finance, Chief Financial Officer, 5,491 shares; (vi) William Van Vleet III, Deputy Chief Operating Officer, 1,916 shares; (vii) John F. Pesaturo, Vice President, Ocean Systems Division, 1,320 shares; (viii) Joseph Leonelli, Vice President, Wireless Communication Systems Division, 459 shares; (ix) Robert Blanchard, Vice President, Electronic Systems Division; (x) all current executive officers as a group, an aggregate of 147,295 shares; and (xi) all employees, including current officers who are not executive officers, as a group, an aggregate of 4,097,227 shares. None of the directors who are not executive officers is eligible to participate in the Purchase Plan. Since its inception, no shares have been issued under the Purchase Plan to any other nominee for election as a director, or any associate of any such director, nominee, or executive officer, other than relatives of executive officers who are employed by the company in non-officer positions. No other person has been issued five percent or more of the total amount of shares issued under the Purchase Plan.

### Summary of United States Federal Income Tax Consequences

The following summary is intended only as a general guide as to the United States federal income tax consequences under current law of participation in the Purchase Plan and does not attempt to describe all possible federal or other tax consequences of such participation or tax consequences based on particular circumstances. Furthermore, tax consequences of an employee stock purchase plan are subject to change.

Generally, there are no tax consequences to an employee of either becoming a participant in the Purchase Plan or purchasing shares under the Purchase Plan. The tax consequences of a disposition of shares vary depending on the period such stock is held before its disposition. If a participant disposes of shares within two years after the Offering Date and within one year after the Purchase Date on which the shares are acquired (a disqualifying disposition), the participant recognizes ordinary income in the year of disposition in an amount equal to the difference between the fair market value of the shares on the Purchase Date and the purchase price. Such income may be subject to withholding of tax. Any additional gain or resulting loss recognized by the participant from the disposition of the shares is a capital gain or loss. If the participant disposes of shares at least two years after the Offering Date and at least one year after the Purchase Date on which the shares are acquired, the participant recognizes ordinary income in the year of disposition in an amount equal to the lesser of (i) the difference between the fair market value of the shares on the date of disposition and the purchase price or (ii) the difference between the fair market value of the shares on the Offering Date and purchase price (determined as if the Purchase Right were exercised on the Offering Date). Any additional gain recognized by the participant on the disposition of the shares is a capital gain. If the fair market value of the shares on the date of disposition is less than the purchase price, there is no ordinary income, and the loss recognized is a capital loss. If the participant owns the shares at the time of the participant's death, the lesser of (i) the difference between the fair market value of the shares on the date of death and the purchase price or (ii) the difference between the fair market value of the shares on the Offering Date and purchase price (determined as if the Purchase Right were

exercised on the Offering Date) is recognized as ordinary income in the year of the participant's death.

If the exercise of a Purchase Right does not constitute an exercise pursuant to an "employee stock purchase plan" under section 423 of the Code, the exercise of the Purchase Right will be treated as the exercise of a nonqualified stock option. The participant would therefore recognize ordinary income on the Purchase Date equal to the excess of the fair market value of the shares acquired over the purchase price. Such income is subject to withholding of income and employment taxes. Any gain or loss recognized on a subsequent sale of the shares, as measured by the difference between the sale proceeds and the sum of (i) the purchase price for such shares and (ii) the amount of ordinary income recognized on the exercise of the Purchase Right will be treated as a capital gain or loss, as the case may be.

A capital gain or loss will be long-term if the participant holds the shares for more than 12 months and short-term if the participant holds the shares for 12 months or less.

If the participant disposes of the shares in a disqualifying disposition, the Company should be entitled to a deduction equal to the amount of ordinary income recognized by the participant as a result of the disposition, except to the extent such deduction is limited by applicable provisions of the Code or the regulations thereunder. In all other cases, no deduction is allowed the Company.

### Vote Required and Board of Directors' Recommendation

The affirmative vote of a majority of the votes cast at the Annual Meeting, at which a quorum is present, either in person or by proxy, is required for approval of this proposal. Abstentions and broker non-votes will each be counted as present for purposes of determining the presence of a quorum, but will not have any affect on the outcome of this proposal.

The Board of Directors believes that the continued opportunity to purchase shares under the Purchase Plan at a discount from market price is important to attracting and retaining qualified officers and employees essential to the success of the Company, and that stock ownership is important to providing such persons with incentive to perform in the best interest of the Company.

**THE BOARD UNANIMOUSLY RECOMMENDS A VOTE "FOR" THE PROPOSAL TO AMEND THE PURCHASE PLAN TO INCREASE BY 600,000 THE MAXIMUM AGGREGATE NUMBER OF SHARES OF COMMON STOCK ISSUABLE UNDER THE PLAN.**

### Equity Compensation Plan Information

The Company currently maintains five compensation plans that provide for the issuance of common stock to officers and other employees, directors, and consultants. These consist of the 1991 Stock Option Plan, 1993 Employee Stock Purchase Plan, 2001 Stock Option Plan, and 2004 Stock Incentive Plan, which have been approved by shareholders, and the 2000 Stock Option Plan (the 2000 Plan), which has not been approved by shareholders. The 1991 Stock Option Plan expired in January 2001. The following table sets forth information regarding outstanding options and shares reserved for future issuance under the foregoing plans as of October 31, 2006.

Plan Category	Number of shares to be issued upon exercise of outstanding options, warrants, and rights (a)	Weighted-average exercise price of outstanding options, warrants, and rights (b)	Number of shares remaining available for future issuance under equity compensation plans (excluding shares reflected in column (a)) (c)
Equity compensation plans approved by shareholders			
1991 Stock Option Plan	213,296	\$8.65	—
1993 Employee Stock Purchase Plan	—	—	336,852
2001 Stock Option Plan	379,240	\$13.75	31,176
2004 Stock Incentive Plan	333,000	\$27.58	205,125

Equity compensation plans not approved by shareholders			
2000 Stock Option Plan	622,243	\$18.25	316,202
Total	1,547,779	\$17.83	889,355

### Material Features of the 2000 Plan

As of October 31, 2006, the Company has 316,202 remaining shares of common stock available for issuance under the 2000 Plan. The 2000 Plan provides for the granting of non-qualified stock options to employees and consultants with exercise prices equal to the fair market value of common stock on the date of grant. Options granted prior to August 2004 vest over five years, at a rate of 20% on the anniversary date of the grant and in equal monthly installments over the remaining 48 months. Options granted under the 2000 Plan after August 2004 vest at a rate of 20% each year on the anniversary of the date of grant, with full vesting at the end of five years from the date of grant. Options granted under the 2000 Plan generally have a ten-year term.

### Executive Officers of Registrant

Set forth below is certain information with respect to the age and background for each of the executive officers of the Company as of January 23, 2007.

Name	Age	Position
Gary L. Yancey	61	President, CEO, and Chairman of the Board
Dr. John R. Treichler	59	Chief Technical Officer
Robert Blanchard	50	Vice President – Electronic Systems Division
James E. Doyle	51	Vice President – Finance, Chief Financial Officer
Dr. Joseph Leonelli	51	Vice President – Wireless Communication Systems Division
Dr. John F. Pesaturo	52	Vice President – Ocean Systems Division
Dr. Michael J. Ready	53	Chief Marketing Officer
Renato F. Roscher, Jr.	54	Executive Vice President Multichannel – Systems Division
Bani M. Scribner, Jr.	62	Chief Operating Officer
Robert T. Teague	58	Vice President – National Security Systems Division
William B. Van Vleet III	48	Deputy Chief Operating Officer

**Gary L. Yancey**, a co-founder of the Company, has served the Company as President, CEO, and Chairman of the Board since the Company's incorporation in January 1984. For biographical information concerning Mr. Yancey, please see page 7.

**Dr. John R. Treichler**, a co-founder of the Company, has been employed by the Company since its incorporation in January 1984. For biographical information concerning Dr. Treichler, please see page 7.

**Robert Blanchard** joined the Company in November 2004 as Vice President of the Electronic Systems Division. Prior to joining the Company, he was the General Manager of Plano Microwave, Inc. (PMI), a wholly owned subsidiary of Sierra Nevada Corporation in Plano, Texas. Mr. Blanchard founded PMI in 1992, and was President and Chief Executive Officer from 1992 until its acquisition in October 2001. PMI was involved in the design, development, manufacture, and support of electronic intelligence (ELINT) systems, communications intelligence (COMINT) systems, and intelligence, surveillance, and reconnaissance (ISR) for the United States Military and U.S. Government allies.

**James E. Doyle** joined the Company in September 1991 as a Senior Contracts Administrator and was promoted to Department Manager in November 1991. In March 2000, he was elected Vice President of Finance and Chief Financial Officer.

**Dr. Joseph Leonelli** joined the Company in July 2005 as Vice President, Homeland Defense Division in connection with the Company's acquisition of Dynamics Technology, Inc. He was selected as the Vice President of the Wireless Communication Systems Division in November 2005. Dr. Leonelli was Vice President of Homeland Defense of Dynamics Technology, Inc. from 2004 to July 2005. Prior to that time, Dr.



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Leonelli was the Business Area Manager of Chemical, Biological, Radiological, Nuclear (CBRN) programs for the Advanced Information Systems business unit of General Dynamics from August 2003 to September 2004. Dr. Leonelli served as Vice President of the Applied Sciences Group and Deputy Director of the Applied Science and Technology Sector of Veridian Systems Division of Veridian Corporation from January 2003 until its acquisition by General Dynamics in August 2003. From June 2002 to January 2003, Dr. Leonelli was the Director of Special Programs at Oak Ridge National Laboratory UT-Batelle, LLC, and from March 1995 to June 2002, he was the Vice President and General Manager of the Special Programs Sector for the Battelle Memorial Institute.

**Dr. John F. Pesaturo** joined the Company in July 2005 as Vice President of the Ocean Systems Division in connection with the Company's acquisition of Dynamics Technology, Inc. Dr. Pesaturo was Senior Vice President of Marine Systems of Dynamics Technology, Inc. from September 2000 to July 2005. Prior to that time, Dr. Pesaturo was at Lockheed Federal Systems from November 1998 to September 2000, where he managed a line of business addressing a variety of acoustic and unmanned underwater vehicle systems and led the Defense Advanced Research Projects Agency Submarine Payloads and Sensors Program. He started his career in engineering development at Vitro Labs in 1977, and joined Westinghouse Ocean Division (later Northrop Grumman) in 1981.

**Dr. Michael J. Ready** joined the Company in May 1986. From 1987 to 1993, Dr. Ready was a manager within the Advanced Techniques Department. In 1995, he was promoted to Corporate Engineer overseeing programs across the corporation, including the company IR&D programs, and served in that capacity until August 2005, when he was elected Chief Marketing Officer.

**Renato F. Roscher, Jr.** joined the Company in January 1987 as a Senior Engineer. In June 1995, he was promoted to Corporate Engineer and served in that capacity until January 2001, when he was promoted to Deputy General Manager of the Technical Operations Group. In November 2004, he was elected Executive Vice President of the Communications Systems Group.

**Bani M. Scribner, Jr.**, joined the Company in June 1992 as senior staff reporting to the President. In November 1996, he was elected Vice President of the Strategic Systems Division. In 1999, he was elected Executive Vice President, General Manager of the Technical Operations Group and in November 2004, he was appointed Chief Operating Officer of the Company.

**Robert T. Teague** joined the Company in July 2005 as Vice President of the National Security Systems Division in connection with the Company's acquisition of Dynamics Technology, Inc. Mr. Teague was Senior Vice President of National Security Systems of Dynamics Technology, Inc. from 2003 to July 2005. Prior to that time, Mr. Teague spent 33 years with the Central Intelligence Agency, beginning with engineering development of photogrammetry systems, advancing through the Directorate of Science & Technology across a range of classified technical collection programs, addressing intelligence community programs and budgets, managing complex technical programs, and finally as the Director of the Office of Technical Collection.

**William B. Van Vleet III** joined the Company in July 2005 as Executive Vice President of the Sensor Signal Processing Group in connection with the Company's acquisition of Dynamics Technology, Inc. and was promoted to Deputy Chief Operating Officer in August 2006. Mr. Van Vleet was President and Chief Executive Officer of Dynamics Technology, Inc. from 2002 to July 2005. Prior to that time, Mr. Van Vleet worked at The Boeing Company for 22 years, where he served in a variety of engineering management positions, most recently as the General Manager of the Communications, Information, and Oceanic Systems Division, and then leading efforts on the U.S. Missile Defense National Team as the Director of Battle Management, C2 and Communications.

## Executive Compensation and Other Matters

### Compensation of Executive Officers

The following table sets forth information for each of the Company's last three fiscal years concerning the compensation of the chief executive officer of the Company and the four other most highly compensated executive officers of the Company (the Named Executive Officers).

#### Summary Compensation Table

Name and Principal Position	Fiscal Year	Annual Compensation		Long-Term Compensation	Restricted Stock Awards (#)	All Other Compensation <sup>(2)</sup>
		Salary (\$)	Bonus (\$) <sup>(1)</sup>	Securities Underlying Options (#)		
Gary L. Yancey President, CEO, and Chairman of the Board	2006	\$459,042	\$68,210	—	10,000	\$46,543
	2005	\$428,280	\$124,578	40,000	—	\$24,228
	2004	\$404,622	\$180,000	30,000	—	\$25,223

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Bani M. Scribner, Jr. Chief Operating Officer	2006	\$352,442	\$43,585	—	6,250	\$26,629
	2005	\$330,773	\$80,546	25,000	—	\$18,141
	2004	\$305,922	\$108,000	20,000	—	\$16,879
Dr. John R. Treichler Chief Technical Officer	2006	\$293,532	\$36,263	—	3,750	\$19,937
	2005	\$279,870	\$54,127	15,000	—	\$14,570
	2004	\$261,611	\$72,000	15,000	—	\$16,879
Albert Ovadia <sup>(3)</sup> Vice President, Multichannel Systems Division	2006	\$288,460	\$28,478	—	3,750	\$109,929
	2005	\$276,702	\$53,650	15,000	—	\$17,067
	2004	\$259,088	\$72,000	15,000	—	\$14,919
James E. Doyle Vice President-Finance, Chief Financial Officer	2006	\$287,180	\$35,514	—	3,750	\$18,053
	2005	\$270,974	\$52,504	15,000	—	\$12,463
	2004	\$255,425	\$72,000	15,000	—	\$12,418
William B. Van Vleet III Deputy Chief Operating Officer	2006	\$281,597	\$35,053	—	5,000	\$ 8,800
	2005	—	—	—	—	—
	2004	—	—	—	—	—

(1) Consists of bonuses earned during the fiscal year and paid during the following fiscal year pursuant to the Company's Annual Incentive Plan for executive officers.

(2) Consists primarily of Company-funded Applied Signal Technology 401(k) Retirement Plan contributions plus four percent of the salary over the maximum annual federal limit, the payment of excess life insurance benefits, vacation buy back, and certain service award payments and other compensation as shown in the table below.

(3) Mr. Ovadia retired as of October 31, 2006, and is no longer an executive officer of the Company.

### Summary of All Other Compensation

Name	Year	Retirement Bonus	401(k) Employer	Excess Life	Service Awards	Vacation Buy Back	Total
Gary Yancey	2006	\$32,981	\$8,800	\$3,206	\$1,556	—	\$46,543
	2005	\$12,764	\$8,400	\$3,064	—	—	\$24,228
	2004	\$13,378	\$8,200	\$2,089	\$1,556	—	\$25,223
Bani M. Scribner, Jr.	2006	\$14,623	\$8,800	\$3,206	—	—	\$26,629
	2005	\$6,576	\$8,400	\$3,165	—	—	\$18,141
	2004	\$6,476	\$8,200	\$2,089	—	—	\$16,765
John R. Treichler	2006	\$9,048	\$8,800	\$2,089	—	—	\$19,937
	2005	\$4,106	\$8,400	\$2,064	—	—	\$14,570
	2004	\$4,868	\$8,200	\$2,089	\$1,723	—	\$16,879
Albert Ovadia	2006	\$8,867	\$8,800	\$3,206	—	\$89,056	\$109,929
	2005	\$5,499	\$8,400	\$3,168	—	—	\$17,067
	2004	\$3,513	\$8,200	\$3,206	—	—	\$14,919
James E. Doyle	2006	\$8,524	\$8,800	\$729	—	—	\$18,053
	2005	\$3,343	\$8,400	\$720	—	—	\$12,463
	2004	\$3,489	\$8,200	\$729	—	—	\$12,418
William Van Vleet III	2006	\$5,477	\$8,800	\$729	—	—	\$15,006
	2005	—	—	—	—	—	—
	2004	—	—	—	—	—	—

### Stock Option Grants in Last Fiscal Year

No stock options were granted to any of the Named Executive Officers during fiscal year 2006. Instead, the Company made grants of restricted stock to each Named Executive Officer as set forth in the table above. The restricted stock is subject to vesting at the rate of 25% per year on the anniversary of the date of award over four years.

**Option Exercises in Last Fiscal Year and Fiscal Year 2006 Year-End Values**

The following table sets forth information concerning the exercises of options to purchase our common stock in fiscal year 2006 and unexercised options held as of October 31, 2006 by each of the Named Executive Officers for fiscal year 2006.

**Aggregated Option Exercises in Fiscal Year 2006 and Fiscal Year-End Option Values**

Name	Shares Acquired on Exercise (#) <sup>(2)</sup>	Value Realized (\$) <sup>(2)</sup>	Number of Securities Underlying Options at October 31, 2006		Value of Unexercised In-The-Money Options at October 31, 2006 <sup>(1)</sup>	
			Exercisable (#)	Unexercisable (#)	Exercisable (\$)	Unexercisable (\$)
Gary L. Yancey	—	—	77,567	53,433	\$384,080	\$17,610
Bani M. Scribner, Jr.	—	—	32,746	34,787	\$69,697	\$13,005
Dr. John R. Treichler	—	—	25,750	19,250	\$143,850	—
Albert Ovadia	5,000	\$73,515	33,915	23,584	\$90,194	\$11,008
James E. Doyle	—	—	42,666	23,584	\$174,117	\$11,008
William B. Van Vleet III	—	—	4,000	16,000	—	—

(1) The closing sale price for the common stock as reported by the NASDAQ Global Select Market on October 31, 2006, was \$14.84. The value is calculated based on the difference between the option exercise price and \$14.84, multiplied by the number of shares of common stock underlying the option.

(2) The values in this column are based on the last reported sale price of the common stock on the respective dates of exercise as reported by the NASDAQ Global Select Market, less the respective option exercise prices.

**Compensation of Directors**

Directors who are employees of the Company are not compensated by the Company for services provided as a director. During fiscal year 2006, non-employee directors were paid an annual retainer of \$40,250 plus an annual fee of \$2,875 to each chairman of a committee of the Board of Directors. The Company reimburses out-of-pocket travel expenses of non-employee directors in accordance with the Company's travel policy. Non-employee directors are eligible to participate in the 2001 Stock Option Plan and 2004 Stock Incentive Plan, and employee-directors are able to participate in the 1993 Employee Stock Purchase Plan, 2001 Stock Option Plan, 2004 Stock Incentive Plan, and 401(k) Plan. Options granted to non-employee directors are not intended to qualify as incentive stock options under the Internal Revenue Code. Any options granted to non-employee directors typically vest annually in three equal annual installments on the anniversary date of such grant and vest in full upon a change of control of the Company. A director who ceases to be a director for any reason may exercise the vested portion of his or her options within 12 months following such termination, to the extent not previously exercised. All options granted to non-employee directors under the 2001 Stock Option Plan expire ten years following the date of grant, and under the 2004 Stock Incentive Plan, expire eight years following the date of grant. Beginning in fiscal 2006, the Company made grants of restricted stock to non-employee directors rather than stock options.

In fiscal year 2006, David Elliman, John P. Devine, Stuart G. Whittelsey, Jr., Robert Richardson, and Milton Cooper were each awarded 1,875 shares of restricted stock. These shares each vest over four years at the rate of one-fourth on each anniversary of the date of grant, and vesting of such shares accelerates in full upon a change in control of the Company.

**Employment Contracts and Termination of Employment and Change-in-Control Arrangements****Executive Retention and Severance Plan**

On August 18, 2004, the Compensation Committee adopted the Executive Retention and Severance Plan (the Executive Severance Plan), which provides certain benefits to the Company's executive officers and key employees upon involuntary termination of employment and in connection with a change in control of Applied Signal Technology, Inc.

A participant who is terminated without cause or resigns following certain adverse changes in employment circumstances, including any such termination or resignation that occurs during a period from the first public announcement of a change in control and ending 12 months after a change in control will be entitled to specified severance benefits. In addition to accrued compensation, including any earned but unpaid prior

year bonus, and benefits earned under the Company's employee benefit and equity compensation plans, the terminated participant will receive cash severance payments equal to the aggregate of the participant's base salary for a period of 24 months in the case of the chief executive officer, and 12 months in the case of other executive officers, plus an amount equal to the participant's annual bonus for one year. In addition, participants will be entitled to receive for the same respective periods employer-paid health benefits substantially similar to those provided immediately prior to the termination. Provision of all such benefits is conditioned upon the participant's execution of a release of claims against the Company and entry into a covenant not to compete with the Company set forth in a restrictive covenants agreement. The participant may elect to terminate the restrictive covenants agreement, including the termination of the non-competition agreement, in exchange for forfeiting any additional severance payments payable after such termination.

The Executive Severance Plan provides that if, in the event of a change in control of the Company, the company acquiring Applied Signal Technology does not assume the outstanding Applied Signal Technology stock options of the participants in the Executive Severance Plan or substitute equivalent options for the acquiring company's stock, then the vesting and exercisability of the participants' options will be accelerated in full ten days prior to, but conditioned upon, the consummation of the change-in-control transaction. Furthermore, upon a change in control, any restricted stock or restricted stock unit awards held by participants in the Executive Severance Plan will vest in full. The treatment of any other stock options or other stock-based awards held by Executive Severance Plan participants upon a change-in-control will be determined under the plans or agreements providing for such options or awards.

Following a participant's termination of employment, the participant will be indemnified by the Company to the fullest extent permitted under applicable law and will be provided with directors' and officers' liability insurance (if applicable) for a period of six years, each as set forth in the Executive Severance Plan. If any payment or benefit received or to be received by the executive officer pursuant to the Executive Severance Plan or otherwise would be subject to the excise tax imposed by Section 4999 of the Internal Revenue Code, then the Company will pay the executive officer only such amounts as will not exceed the amount that produces the greatest after-tax benefit to the participant.

#### **Acceleration of Director Options upon a Change in Control**

Options to purchase our common stock and restricted stock granted to our non-employee directors provide that in the event of a change in control of the Company, each outstanding option, and each share of restricted stock, held by a non-employee whose service as a director has not terminated prior to such date shall be vested in full, and in the case of stock options, immediately exercisable and vested in full as of the date ten days prior to the change in control.

#### **Report of the Compensation Committee on Executive Compensation**

The Compensation Committee of the Board of Directors is comprised of the five non-employee directors of the Company, Messrs. Elliman (Chairman), Cooper, Devine, Richardson, and Whittelsey. The Compensation Committee is responsible for setting and administering the policies governing compensation of the executive officers and directors of the Company and reviews the performance of executive officers. The Compensation Committee has the authority to retain any independent, third party compensation consultant and to obtain independent advice and assistance from legal, accounting, and other advisors.

The Compensation Committee approves the compensation paid to the Chief Executive Officer and other executive officers of the Company, including salary, bonus, and any stock options, restricted stock, or other long-term incentive compensation granted to executive officers, and approves the compensation of and equity compensation granted to directors of the Company. Recommendations for annual salary for the executive officers other than the Chief Executive Officer are made to the Compensation Committee by the Company's Chief Executive Officer (CEO), the Chief Operations Officer, and the Company's Human Resources Manager. The Committee also reviews data provided by independent consultants on compensation practices at peer corporations, including comparable compensation paid by peer corporations to its executive officers, and the Company's competitive position concerning executive compensation.

#### **Compensation Philosophy**

The Compensation Committee follows a compensation and benefits philosophy and establishes compensation programs designed to assure that the Company's policies will attract, motivate, and retain key individuals necessary to support the Company's growth and success, and reward contributions to the Company's success. Salaries are generally set for the executive officers after evaluating their performance, reviewing the goals established for the function they perform, and the importance of each position to the achievement of the Company's overall strategic goals. In addition, the Compensation Committee compares compensation for the same positions at similarly sized defense and electronics companies operating in similar markets.

#### **Annual Base Salary and Incentive Bonuses**

The compensation of the Company's executive officers has consisted of salaries that are set toward the upper end of the appropriate salary ranges observed at similarly sized defense and electronics companies and relatively modest annual performance bonuses compared to similarly sized

companies. This has resulted in total cash compensation paid to the Company's executive officers within the range of the total cash compensation paid by similarly situated companies to executive officers at other defense and electronics companies.

With this philosophy as background, the Compensation Committee used the following criteria to establish compensation for its executive officers for fiscal 2006. First, the Committee considered the current importance of each position held by the executive officer to the ability of the Company to achieve its strategic objectives, including the importance of the function of the group managed by the executive officer as well as the group's management needs considering its organization and operation. Second, the Committee received and considered compensation survey data covering the total cash compensation (salary and bonus) paid by companies in the electronics industry with annual revenues similar to the Company. Finally, the Committee reviewed the evaluations of each executive officer and the CEO's annual review of all other executive officers, in the context of the Company's overall operating performance.

The Committee met in November 2005 to review the Company's fiscal year 2005 financial performance and specific compensation data in order to set salaries for the executive officers for fiscal year 2006. In view of the Company's fiscal 2005 performance, the outlook for fiscal 2006, and competitive market practices, in November 2005, the Committee approved competitive salary increases for all executive officers for fiscal year 2006.

At the beginning of fiscal 2006, the Compensation Committee approved the continuation of the annual incentive plan and established the parameters against which executive officer performance would be evaluated for fiscal year 2006. Under this plan, executive officers of the Company are entitled to payment of bonuses after the fiscal year end determined by using a common objective formula based upon the entire Company's financial performance. Bonuses are paid upon the achievement of a threshold performance goal, based upon the Company's expected earnings before interest and taxes, depreciation, and amortization set forth in the operating plan for the fiscal year, with minimum and maximum award multipliers of 0% and 180% of credited levels of attainment of performance goals for the fiscal year.

After reviewing the year-end performance of the Company for fiscal 2006, in November 2006, the Committee ratified the payment of bonuses to the executive officers, including the CEO, pursuant to the annual incentive plan, resulting in bonus payments to the executive officers for fiscal 2006 equal to between 10% and 15% of each such executive officer's annual base salary.

### **Long-Term Incentive Compensation**

Part of the Committee's compensation philosophy is to grant equity compensation to executive compensation, as well as to substantially all of the Company's employees. Prior to fiscal 2006, such compensation consisted of the grant of annual stock options. Beginning in fiscal 2006, the Compensation Committee elected to make awards of restricted stock rather than stock options. The Committee believes that the grant of restricted stock awards more closely aligns the compensation of Company executives with Company performance and the interests of shareholders. The restricted stock awards granted to executive officers during fiscal 2006 vest at the rate of 25% on each anniversary of the date of grant, and are fully vested at the end of four years, so long as the grantee remains an employee of the Company. At its April 2006 meeting, in recognition of the performance of the executive officers for fiscal year 2005, the Compensation Committee approved grants of restricted stock to the Company's executive officers. Details of these restricted stock awards are disclosed in the summary compensation table on page 20.

### **Executive Employment Agreements**

The Company's employees, including our executive officers, are employed "at will" and do not have employment agreements; provided, however, that our executive officers are participants in our Executive Retention and Severance Plan, which provides certain benefits to the Company's executive officers upon involuntary termination of employment and in connection with a change in control of the Company. The provisions of this Agreement are discussed above in this proxy under "Employment Contracts and Termination of Employment and Change-in-Control Arrangements – Executive Retention and Severance Plan."

### **Compliance with Section 162(m) of the Internal Revenue Code**

The Company's policy with respect to compensation paid to its executive officers is to deduct compensation that qualifies under Section 162(m) of the Internal Revenue Code, as amended, as an expense. Section 162(m) of the Internal Revenue Code and related Treasury Department regulations restrict deductibility of executive compensation paid to the Company's Chief Executive Officer and each of the four other most highly compensated executive officers holding office at the end of any year to the extent such compensation exceeds \$1,000,000 for any of such officers in any year and does not qualify for an exception under the statute or regulations. Income from options granted under the Company's stock option plans would generally qualify for an exemption from these restrictions so long as the options are granted by a committee whose members are non-employee directors, such as this Compensation Committee. Accordingly, grants made by the Committee to executive officers qualify for the exemption. The Company expects that the Compensation Committee will generally be comprised of non-employee directors, and that to the extent such Committee is not so constituted for any period of time, the options granted during such period will not be likely to result in compensation exceeding \$1,000,000 in any year. The Committee does not believe that other components of the Company's compensation will be likely to exceed \$1,000,000 for any executive officer in the foreseeable future and therefore concluded that no further action with respect to qualifying such compensation for deductibility was necessary at this time. In the future, the Committee will continue to evaluate the advisability

of qualifying its executive compensation for deductibility of such compensation.

### **Chairman and Chief Executive Officer Compensation**

The Compensation Committee followed the same philosophy described above in determining compensation for the Company's CEO, Gary Yancey, in fiscal 2006. In November 2005, the Committee evaluated Mr. Yancey's performance with respect to the Company's revenues, profit margin, the size and progress of the Company's research and development efforts, and the quality of his management of his line managers. As a result of the favorable performance review, and in light of the Company's financial and operating results and positioning for sustained long-term growth made during fiscal year 2005, the Compensation Committee increased Mr. Yancey's base salary to \$462,160 with a target bonus of 30% of base salary. In April 2006, the Compensation Committee granted him a restricted stock award of 10,000 shares of the Company's common stock. In consideration of the performance of the Company during fiscal year 2006 and in accordance with the terms of the annual incentive plan, in November 2006, the Compensation Committee approved a bonus payable to Mr. Yancey of approximately \$68,210, concurrent with the bonuses payable to the other executive officers of the Company.

#### Compensation Committee

David Elliman, Chairman  
Milton E. Cooper  
John P. Devine  
Robert Richardson  
Stuart G. Whittelsey, Jr.

### **Comparison of Shareholder Return**

Set forth below is a line graph comparing the annual percentage change in the cumulative total return on the Company's common stock with the cumulative total return of the Standard & Poor's MIDCAP 400 Index (S & P MIDCAP 400) and the Standard & Poor's Aerospace and Defense Index (S & P Aerospace and Defense) for the five-year period commencing on October 31, 2001, and ending on October 31, 2006.

<b>Cumulative Total Return</b>					
<b>10/01</b>	<b>10/02</b>	<b>10/03</b>	<b>10/04</b>	<b>10/05</b>	<b>10/06</b>
100.00	102.45	102.45	102.45	102.45	102.45
100.00	102.45	102.45	102.45	102.45	102.45
100.00	102.45	102.45	102.45	102.45	102.45

\* Assumes that \$100.00 was invested on 10/31/01 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.

### **Shareholder Proposals to be Presented at Next Annual Meeting**

Shareholder proposals may be included in the Company's proxy materials for an Annual Meeting so long as they are provided to the Company on a timely basis and satisfy the other conditions set forth in applicable SEC rules. The deadline for submitting a shareholder proposal for inclusion

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in the Company's proxy statement and form of proxy for the Company's 2008 Annual Meeting of Stockholders pursuant to Rule 14a-8, "Shareholder Proposals," of the Securities and Exchange Commission (the SEC) is October 18, 2007. The deadline for submitting a shareholder proposal or a nomination for director that is not to be included in such proxy statement and proxy is also October 18, 2007. For a shareholder proposal to be included in the Company's proxy materials for the 2008 Annual Meeting, the proposal must be received at the Company's principal executive offices ( 400 West California Avenue, Sunnyvale, California 94086), addressed to the Secretary, no later than October 18, 2007. Shareholders are also advised to review the Company's bylaws, which contain additional advance notice requirements, including requirement with respect to advance notice of stockholder proposals and director nominations. For further information regarding Director Nominations by shareholders, see page 8.

### **Transaction of Other Business**

At the date of this proxy statement, the only business that the Board intends to present or knows that others will present at the Annual Meeting is as set forth above. If any other matter or matters are properly brought before the Annual Meeting, or any adjournment thereof, it is the intention of the persons named in the accompanying form of proxy to vote the proxy on such matters in accordance with their best judgment.

By Order of the Board of Directors

Dated: February 14, 2007

Gary L. Yancey, President and Chief Executive Officer