

ADE CORP  
Form 10-Q  
December 10, 2004  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

\_\_\_\_\_  
**FORM 10-Q**  
\_\_\_\_\_

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended: **October 31, 2004**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-26714

\_\_\_\_\_  
**ADE CORPORATION**

(Exact Name of Registrant as Specified in its Charter)

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**Massachusetts**  
**(State or Other Jurisdiction of**  
**Incorporation or Organization)**

**04-2441829**  
**(I.R.S. Employer**  
**Identification No.)**

**80 Wilson Way, Westwood, Massachusetts 02090**

**(Address of Principal Executive Offices, Including Zip Code)**

**(781) 467-3500**

**(Registrant's Telephone Number, Including Area Code)**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). YES  NO

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

Common Stock, par value \$.01 per share  
Class

14,061,351 shares  
Outstanding at December 8, 2004

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**PART I.**  
**FINANCIAL INFORMATION**

**Item 1. Consolidated Financial Statements:**

**ADE CORPORATION**  
**CONSOLIDATED BALANCE SHEET**

(in thousands)

	(Unaudited)	
	October 31, 2004	April 30, 2004
	<u>          </u>	<u>          </u>
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 50,178	\$ 41,560
Marketable securities	893	1,084
Accounts receivable, net	22,044	13,604
Inventories	32,032	32,745
Prepaid expenses and other current assets	1,135	1,068
	<u>          </u>	<u>          </u>
Total current assets	106,282	90,061
Fixed assets, net	9,891	10,829
Investments	499	499
Assets held for sale	4,323	4,323
Intangible assets, net	608	683
Goodwill	1,318	1,318
Restricted cash	631	637
Other assets	118	125
	<u>          </u>	<u>          </u>
Total assets	\$ 123,670	\$ 108,475
	<u>          </u>	<u>          </u>
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Current portion of long-term debt	\$ 173	\$ 168
Accounts payable	6,249	6,364
Accrued expenses and other current liabilities	14,278	10,557
	<u>          </u>	<u>          </u>
Total current liabilities	20,700	17,089
Deferred gain on sale-leaseback	1,553	1,609
Long-term debt, net of current portion	3,521	3,608
	<u>          </u>	<u>          </u>
Total liabilities	25,774	22,306

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**Stockholders equity:**

Common stock, \$.01 par value; 25,000,000 shares authorized; 14,058,606 and 13,997,310 issued and outstanding at October 31, 2004 and April 30, 2004, respectively	141	141
Capital in excess of par value	106,963	106,399
Accumulated deficit	(9,710)	(21,071)
Accumulated other comprehensive income	502	700
	<u>97,896</u>	<u>86,169</u>
<b>Total stockholders equity</b>	<b>97,896</b>	<b>86,169</b>
	<u>\$ 123,670</u>	<u>\$ 108,475</u>
<b>Total liabilities and stockholders equity</b>	<b>\$ 123,670</b>	<b>\$ 108,475</b>

The accompanying notes are an integral part of these unaudited consolidated financial statements.

**Table of Contents****ADE CORPORATION****CONSOLIDATED STATEMENT OF OPERATIONS**

(in thousands, except per share data, unaudited)

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>October 31,</b>		<b>October 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
<b>Net Revenue:</b>				
Systems and parts	\$ 25,922	\$ 17,791	\$ 51,250	\$ 34,656
Service	3,367	2,415	6,351	4,615
<b>Total revenue</b>	<b>29,289</b>	<b>20,206</b>	<b>57,601</b>	<b>39,271</b>
<b>Cost of revenue:</b>				
Systems and parts	10,948	7,664	22,164	15,772
Service	2,595	2,559	4,770	4,982
<b>Total cost of revenue</b>	<b>13,543</b>	<b>10,223</b>	<b>26,934</b>	<b>20,754</b>
<b>Gross profit</b>	<b>15,746</b>	<b>9,983</b>	<b>30,667</b>	<b>18,517</b>
<b>Operating expenses:</b>				
Research and development	3,657	3,704	7,283	7,401
Marketing and sales	2,815	2,409	6,285	4,414
General and administrative	2,864	2,496	5,527	4,661
Restructuring charges				393
<b>Total operating expenses</b>	<b>9,336</b>	<b>8,609</b>	<b>19,095</b>	<b>16,869</b>
<b>Income from operations</b>	<b>6,410</b>	<b>1,374</b>	<b>11,572</b>	<b>1,648</b>
Gain on sale of long-term investment				1,729
Interest income	134	92	197	134
Interest expense	(82)	(41)	(134)	(294)
Other income	19	7	52	56
<b>Income before provision for (benefit from) income taxes and equity in net earnings of affiliated companies</b>	<b>6,481</b>	<b>1,432</b>	<b>11,687</b>	<b>3,273</b>
Provision for (benefit from) income taxes	178	(273)	326	(185)
<b>Income before equity in net earnings of affiliated companies</b>	<b>6,303</b>	<b>1,705</b>	<b>11,361</b>	<b>3,458</b>
Equity in net earnings of affiliated companies				48
<b>Net income</b>	<b>\$ 6,303</b>	<b>\$ 1,705</b>	<b>\$ 11,361</b>	<b>\$ 3,506</b>
<b>Basic earnings per share</b>	<b>\$ 0.45</b>	<b>\$ 0.12</b>	<b>\$ 0.81</b>	<b>\$ 0.25</b>
<b>Diluted earnings per share</b>	<b>\$ 0.44</b>	<b>\$ 0.12</b>	<b>\$ 0.80</b>	<b>\$ 0.25</b>

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Weighted average shares outstanding - basic	14,042	13,875	14,024	13,822
Weighted average shares outstanding - diluted	14,257	14,196	14,271	14,057

The accompanying notes are an integral part of these unaudited consolidated financial statements.

**Table of Contents****ADE CORPORATION****CONSOLIDATED STATEMENT OF CASH FLOWS**

(in thousands, unaudited)

	<b>Six months ended</b>	
	<b>October 31,</b>	
	<b>2004</b>	<b>2003</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 11,361	\$ 3,506
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,164	1,631
Long-lived asset impairment		200
Equity in net earnings of affiliate, net of dividends received		952
Gain on sale of long-term investment		(1,729)
Non-cash compensation	15	
Amortization of gain from sale-leaseback	(56)	(28)
Changes in assets and liabilities:		
Accounts receivable, net	(8,440)	(762)
Inventories	713	164
Prepaid expenses and other current assets	(67)	(8)
Accounts payable	(115)	720
Accrued expenses and other current liabilities	3,721	641
Deferred income on sales to affiliate		(2,259)
<b>Net cash provided by operating activities</b>	<b>8,296</b>	<b>3,028</b>
<b>Cash flows from investing activities:</b>		
Sales (purchases) of fixed assets	(151)	15
Change in restricted cash	6	2,101
Proceeds from sale of building, net		9,753
Proceeds from sale of long-term investment		4,000
Decrease in other assets	7	(15)
<b>Net cash provided by (used in) investing activities</b>	<b>(138)</b>	<b>15,854</b>
<b>Cash flows from financing activities:</b>		
Repayment of long-term debt	(82)	(6,896)
Proceeds from issuance of common stock	549	1,446
<b>Net cash provided by (used in) financing activities</b>	<b>467</b>	<b>(5,450)</b>
Effect of exchange rate changes on cash and cash equivalents	(7)	
<b>Net increase in cash and cash equivalents</b>	<b>8,618</b>	<b>13,432</b>
Cash and cash equivalents, beginning of period	41,560	21,476
<b>Cash and cash equivalents, end of period</b>	<b>\$ 50,178</b>	<b>\$ 34,908</b>



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The accompanying notes are an integral part of these unaudited consolidated financial statements.

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**ADE CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED**  
**FINANCIAL STATEMENTS**  
**(unaudited)**

**1. Basis of Preparation**

The accompanying unaudited consolidated financial statements of ADE Corporation (the Company) include, in the opinion of management, all adjustments (consisting only of normal and recurring adjustments) necessary for a fair statement of the Company's financial position, results of operations and cash flows at the dates and for the periods indicated. Results of operations for interim periods are not necessarily indicative of those to be achieved for full fiscal years.

Pursuant to accounting requirements of the Securities and Exchange Commission applicable to quarterly reports on Form 10-Q, the accompanying unaudited consolidated financial statements and these notes do not include all disclosures required by generally accepted accounting principles in the United States of America for complete financial statements. Accordingly, these statements should be read in conjunction with the financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended April 30, 2004.

**2. Comprehensive Income**

Comprehensive income was as follows:

	(in thousands)		(in thousands)	
	Three months ended		Six months ended	
	October 31, 2004	October 31, 2003	October 31, 2004	October 31, 2003
	(unaudited)		(unaudited)	
Net income	\$ 6,303	\$ 1,705	\$ 11,361	\$ 3,506
Other comprehensive income (loss):				
Unrealized gain (loss) on marketable securities, net of tax	62	209	(191)	855
Currency translation adjustments	(7)		(7)	
Other comprehensive income (loss):	55	209	(198)	855
Comprehensive income	\$ 6,358	\$ 1,914	\$ 11,163	\$ 4,361

**3. Inventories**

Inventories consist of the following:

	(in thousands)	
	October 31, 2004	April 30, 2004
	(unaudited)	
Raw materials and purchased parts	\$ 18,335	\$ 18,168
Work-in-process	11,791	13,357
Finished goods	1,906	1,220
	<u>\$ 32,032</u>	<u>\$ 32,745</u>

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**4. Assets Held for Sale**

In February 2003, the Company's Board of Directors approved a plan to sell the Company's Newton, Massachusetts property, which housed the Company's ATI subsidiary. The operations of ATI were relocated to the Company's Westwood, Massachusetts facility during the fourth quarter of fiscal 2003. The Company listed the property for sale and actively looked for a buyer. In accordance with Statement of Financial Accounting Standards No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-Lived Assets, the Company classified the assets associated with the Newton property as Available for Sale and ceased depreciation on the assets. As required by SFAS 144, in order to classify this property as Available for Sale, it must be probable that it will be sold within one year unless certain criteria are met. Since the Newton property was listed for sale, the real estate market for industrial properties in the Boston area has been sluggish. The Company responded to these market conditions by decreasing the asking price of the property and recorded charges of \$378,000 during the prior fiscal year to general and administrative expenses to reduce the net carrying value of the assets to the fair value less the cost to sell the property. The fair value of the property was determined by the Company's best estimate of the current market value of the property as a result of negotiations with potential buyers since the property was listed for sale. On June 25, 2004, the Company entered into a purchase and sale agreement with a buyer for the Newton property. The sale of the Newton property was completed on December 2, 2004. The Company received net proceeds of \$4.4 million. A gain of approximately \$70,000 was recognized on the transaction and will be recorded as income in the Company's consolidated statement of operations for the quarter ending January 31, 2005.

**5. Intangible Assets**

The Company has capitalized license fees for software included in the Company's products. These license fees are amortized at the greater of 1) the ratio that current gross revenue for the related products bears to the total current and anticipated future gross revenue for those products or 2) on a straight-line basis over the estimated useful life of the related products. The carrying amount and accumulated amortization for the Company's intangible assets are as follows:

	(in thousands)	
	October 31, 2004	April 30, 2004
	(unaudited)	
License fees at cost	\$ 1,400	\$ 1,400
Accumulated amortization	(792)	(717)
Net carrying value	\$ 608	\$ 683

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Amortization expense was \$38,000 for the three months ended October 31, 2004 and 2003, respectively, and \$75,000 for the six months ended October 31, 2004 and 2003, respectively. Estimated amortization is \$233,000, \$316,000 and \$133,000 for the fiscal years ending April 30, 2005, 2006 and 2007, respectively.

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**6. Accrued Expenses and Other Current Liabilities**

Accrued expenses and other current liabilities consist of the following:

	(in thousands)	
	October 31, 2004	April 30, 2004
	(unaudited)	
Accrued salaries, wages, vacation pay and incentive compensation	\$ 2,506	\$ 2,144
Accrued commissions	1,510	1,271
Accrued warranty costs	1,505	1,257
Accrued restructuring		8
Deferred revenue	4,980	2,367
Other	3,777	3,510
	\$ 14,278	\$ 10,557

**7. Stock-based Compensation**

Stock-based compensation awards to employees under the Company's stock plans are accounted for using the intrinsic value method prescribed in Accounting Principles Board Opinion ( APB ) No. 25, Accounting for Stock Issued to Employees, and related interpretations. The Company has adopted the disclosures required by SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-based Compensation. Had compensation cost for the stock-based compensation been determined based on the fair value at the grant dates of awards consistent with the provisions of SFAS 123, the Company's net income and earnings per share would have been reduced to the pro forma amounts as follows:

(In thousands, except per share data)	(In thousands, except per share data)
Three months ended	Six months ended
October 31,	October 31,

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	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Net income, as reported	\$ 6,303	\$ 1,705	\$ 11,361	\$ 3,506
Add back: Stock-based compensation included in net income, as reported	5		15	
Deduct: Total stock-based employee compensation expense determined under fair value based method, net of related income taxes	393	386	755	688
<b>Pro forma net income</b>	<b>\$ 5,915</b>	<b>\$ 1,319</b>	<b>\$ 10,621</b>	<b>\$ 2,818</b>
<b>Net earnings per share:</b>				
Basic - as reported	\$ 0.45	\$ 0.12	\$ 0.81	\$ 0.25
Basic - pro forma	\$ 0.42	\$ 0.10	\$ 0.76	\$ 0.20
Diluted - as reported	\$ 0.44	\$ 0.12	\$ 0.80	\$ 0.25
Diluted - pro forma	\$ 0.41	\$ 0.09	\$ 0.74	\$ 0.20

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**8. Earnings Per Share**

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share is computed using the weighted average number of common shares outstanding and gives effect to all dilutive potential common shares outstanding during the period. For the three months ended October 31, 2004 and 2003, respectively, 349,935 and 278,940 common shares issuable upon the exercise of stock options have been excluded from the computation of diluted earnings per share, as their effect would have been antidilutive because the exercise price of the options was greater than the average market value of the Company's common stock during the respective periods. For the six months ended October 31, 2004 and 2003, respectively, 331,660 and 625,827 common shares issuable upon the exercise of stock options have been excluded from the computation of diluted earnings per share, as their effect would have been antidilutive because the exercise price of the options was greater than the average market value of the Company's stock during the respective periods.

The following is a reconciliation of the shares used in calculating basic and diluted earnings per share:

	(in thousands)			
	(in thousands) Three months ended		Six months ended	
	October 31,		October 31,	
	2004	2003	2004	2003
Shares used in computation:				
Weighted average common stock outstanding used in computation of basic earnings per share	14,042	13,875	14,024	13,822
Dilutive effect of stock options outstanding	215	321	247	235
<hr/>				
Shares used in computation of diluted earnings per share	14,257	14,196	14,271	14,057

**9. Segment Reporting**

The Company has three reportable segments: ADE Semiconductor Systems Group ( SSG ), ADE Phase Shift ( PST ) and ADE Technologies ( ATI ). SSG manufactures and markets metrology and inspection systems to the semiconductor wafer and device manufacturing industries that are used to improve yield and capital productivity. Sales of the Company's stand-alone software products are also included in the SSG segment. PST manufactures and markets high performance, non-contact surface metrology equipment using advanced interferometric technology that



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provides enhanced yield management to the data storage, semiconductor and optics industries. ATI manufactures and markets high precision magnetic characterization and non-contact dimensional metrology gauging systems primarily to the data storage industry.

The Company's reportable segments are determined based upon information used to evaluate the business by the chief operating decision maker, which includes the nature of the products, the external customers and customer industries and the sales and distribution methods used to market the products. The Company evaluates performance based upon profit or loss from operations. The Company does not measure the assets allocated to the segments. Management fees representing certain services provided by corporate offices have been allocated to each of the reportable segments based upon the usage of those services by each segment. Additionally, other income (loss), the provision for (benefit from) income taxes and the equity in net earnings (loss) of affiliated companies are not included in segment profitability. For the reportable segments, intersegment sales are recorded at cost plus 20% and are eliminated in consolidation.

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**9. Segment Reporting (Continued)**

	(in thousands)			
	SSG	PST	ATI	Total
<b>For the quarter ended October 31, 2004</b>				
Revenue from external customers	\$ 18,815	\$ 7,615	\$ 2,859	\$ 29,289
Intersegment revenue		122	128	250
Income from operations	4,379	1,850	194	6,423
Depreciation and amortization expense	433	130	4	567
Capital expenditures	18		13	31
<b>For the quarter ended October 31, 2003</b>				
Revenue from external customers	\$ 13,219	\$ 4,235	\$ 2,752	\$ 20,206
Intersegment revenue	29		44	73
Income from operations	349	647	379	1,375
Depreciation and amortization expense	574	135	26	735
Capital expenditures	13	29		42
	(in thousands)			
	SSG	PST	ATI	Total
<b>For the six months ended October 31, 2004</b>				
Revenue from external customers	\$ 38,514	\$ 13,368	\$ 5,719	\$ 57,601
Intersegment revenue	46	194	220	460
Income from operations	8,029	3,289	280	11,598
Depreciation and amortization expense	887	267	10	1,164
Capital expenditures	134		17	151
<b>For the six months ended October 31, 2003</b>				
Revenue from external customers	\$ 26,009	\$ 8,766	\$ 4,298	\$ 39,073
Intersegment revenue	48		56	104
Income from operations	192	1,587	(164)	1,615
Depreciation and amortization expense	1,330	249	52	1,631
Long-lived asset impairment	200			200
Capital expenditures	45	29		74

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The following is a reconciliation for the above items where aggregate reportable segment amounts differ from amounts contained in the Company's consolidated financial statements.

	<b>Three months ended</b>		<b>Six months ended</b>	
	<b>October 31,</b>		<b>October 31,</b>	
	<b>2004</b>	<b>2003</b>	<b>2004</b>	<b>2003</b>
Total external revenue for reportable segments	\$ 29,289	\$ 20,206	\$ 57,601	\$ 39,073
Net impact of revenue recognition on sales to affiliate				198
<b>Total consolidated revenue</b>	<b>\$ 29,289</b>	<b>\$ 20,206</b>	<b>\$ 57,601</b>	<b>\$ 39,271</b>
Total operating income for reportable segments	\$ 6,423	\$ 1,375	\$ 11,598	\$ 1,615
Net impact of intercompany gross profit eliminations and deferred profit on sales to affiliate	(13)	(1)	(26)	33
<b>Total consolidated operating income</b>	<b>\$ 6,410</b>	<b>\$ 1,374</b>	<b>\$ 11,572</b>	<b>\$ 1,648</b>

**10. Commitments and Contingencies***Pending Litigation*

On October 12, 2000, the Company filed a patent infringement lawsuit against KLA-Tencor Corporation ( KLA ), a competitor, in United States District Court in Delaware. In the suit, the Company seeks damages and a permanent injunction against further infringement of United States Patent Numbers 6,118,525 and 6,292,259, both entitled Wafer Inspection System for Distinguishing Pits and Particles. KLA responded by filing counterclaims alleging that the Company has infringed four patents owned by KLA. KLA seeks damages for the alleged patent infringement and a permanent injunction against future infringement. In addition, KLA seeks a declaration that United States Patent Numbers 6,118,525 and 6,292,259, owned by the Company, are invalid and not infringed by KLA. On March 13, 2003, the District Court issued a ruling upholding KLA's principal arguments with respect to ADE's claims of infringement. On August 15, 2003, the District Court issued rulings upholding ADE's principal arguments with respect to KLA's claims of infringement for two of KLA's asserted patents. On February 4, 2004, a jury in the United States District Court in Delaware returned a verdict in favor of ADE invalidating all the remaining claims asserted by KLA. A final judgment has now been issued by the court in ADE's favor on all of KLA's counterclaims. The Company has appealed some of the District Court's rulings to the United States Court of Appeals for the Federal Circuit. Accordingly, at this time, the Company cannot predict the outcome or the amount of gain or loss, if any, from this lawsuit.

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On October 18, 2002, a former employee of the Company filed a civil action against the Company in Massachusetts Superior Court, Suffolk County, alleging that the Company breached his employment contract with the Company and seeking damages of approximately \$500,000. The Company has filed an answer to the former employee's complaint denying his allegations, and believes that the former employee's claim lacks merit. The Company has also filed counterclaims against the employee. On July 15, 2003, the former employee amended his complaint to add related allegations and to add Dr. Koliopoulos and Mr. James as individual defendants. The Company and the individual defendants plan to defend the civil action charges vigorously. Since the matters are at a preliminary stage, the Company is unable to predict the outcome or amount of the related expense, or loss, if any, associated with this litigation. However, the Company believes that a portion of the related expenses and losses, if any, will be covered under the Company's insurance policies.

In addition to the matters noted above, from time to time the Company is subject to legal proceedings and claims in the ordinary course of business. In the opinion of management, the amount of ultimate expense with respect to any other current legal proceedings and claims will not have a material adverse effect on the Company's financial position or results of operations.

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**(unaudited)**

*Guarantor agreements*

The Company has an agreement with a vendor whereby it guarantees the expenses incurred by certain of the Company's employees. The term of the agreement is from execution until cancellation and payment of any outstanding amounts. The Company would be required to pay any unsettled employee expenses upon notification from the vendor. The maximum potential amount of future payments the Company could be required to make under this agreement is not significant. As a result, the Company believes the estimated fair value of these agreements is minimal. Accordingly, no liabilities have been recorded for this guaranty as of October 31, 2004.

Pursuant to one of the provisions in the Company's standard terms and conditions of sale, the Company agrees, subject to certain limitations and conditions, to defend any suit or proceeding brought against a customer based on a claim that the Company's equipment, standing alone, infringes a United States patent or copyright or misappropriates a trade secret protected under United States law. Actions arising under such provision may only be brought by customers within two years after the cause of action arises. The maximum potential amount of payments the Company may be required to make under such provision is limited to the total purchase price of the Company's equipment sold under the particular contract. The Company has never incurred costs to defend lawsuits or settle claims related to these customer contract provisions. As a result, the Company believes the estimated exposure of these provisions is minimal. Accordingly, the Company has no liabilities recorded for these provisions as of October 31, 2004.

The Company warrants that its products will perform in all material respects in accordance with its standard published specifications. The term of the Company's standard warranty is 12 months. The Company accrues 2% or 3% of product revenues, based on history, to provide for estimated warranty costs, depending on which business unit made the sale. The following is a reconciliation of the quarterly activity in the Company's warranty liability for the three and six months ended October 31, 2004 and 2003.

	(in thousands)		(in thousands)	
	Three months ended October 31,		Six months ended October 31,	
	2004	2003	2004	2003
	(unaudited)		(unaudited)	
Accrued warranty, beginning balance	\$ 1,382	\$ 1,057	\$ 1,257	\$ 1,041
Accruals for warranties issued	381	273	717	374
Warranty settlements made	(258)	(251)	(469)	(336)
Accrued warranty, ending balance	\$ 1,505	\$ 1,079	\$ 1,505	\$ 1,079

**11. New Accounting Pronouncements**

In November 2004, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 151 ( SFAS 151 ), Inventory Costs. SFAS 151 amends the guidance in Accounting Review Board No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS 151 is effective for fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on the Company's financial position and results of operations.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations:**

#### **Introduction**

ADE Corporation (the Company) designs, manufactures, markets and services highly precise, automated measurement, defect detection and handling equipment with current applications in the production of semiconductor wafers, semiconductor devices and magnetic computer disks. The Company operates three major business segments, the Semiconductor Systems Group (SSG), ADE Phase Shift (PST) and ADE Technologies (ATI). SSG manufactures multifunctional semiconductor metrology and automation systems and optical wafer defect inspection equipment used to detect particles and other defects on silicon wafer surfaces primarily for the semiconductor wafer and device manufacturing industries. PST manufactures high-performance, non-contact surface metrology equipment using advanced interferometric technology that provides enhanced yield management to the data storage, semiconductor and optics industries. ATI manufactures high precision magnetic characterization and non-contact dimensional metrology gauging systems primarily for the data storage industry.

Historically, the semiconductor wafer and device industries and the magnetic data storage industry have been highly cyclical and have experienced both rapid periods of growth and rapid downturns that can be abrupt and result in significant changes in revenue and profits. During an industry wide downturn, the demand for capital equipment significantly decreases as the Company's customers reduce production of semiconductor wafers and devices. Beginning in fiscal year 2002, the Company experienced decreased demand for its products in all business segments as a result of the downturn in the semiconductor wafer and device manufacturing industries as well as the data storage industry. Consequently, the Company experienced reduced order levels and revenues during fiscal year 2002 and early fiscal 2003. In response to the industry downturn, the Company underwent cost reduction measures, including headcount reductions, and focused its research and development activities on projects to place the Company in the best possible position for the next wave of capital spending in the semiconductor wafer and device manufacturing industries as well as the magnetic data storage industry. Beginning in the second half of fiscal year 2003 and continuing through the first quarter of fiscal year 2005, the Company experienced sequential increases in quarterly orders, revenue and backlog in all but one quarter. As a result, the Company achieved profitability, on a quarterly basis, beginning in the third quarter of fiscal year 2003. These results were due in part to increased order activity from Asia during fiscal years 2003, 2004 and the first quarter of fiscal 2005 as well as the aforementioned cost reduction measures. However, although revenue for the second quarter of fiscal 2005 increased compared to the first quarter, the Company's bookings decreased slightly in the second quarter compared to the first quarter. At this time, the Company cannot determine if this quarterly decrease is indicative of a downward trend in order activity or if it is just a momentary pause. As such, the Company makes no assurances that current order, revenue, backlog and profit levels can be sustained in future periods.

The following information should be read in conjunction with the unaudited consolidated financial statements and notes thereto included in this quarterly report and the audited consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations contained in the Company's Annual Report on Form 10-K for the fiscal year ended April 30, 2004.

#### **Forward-Looking Statements**

This quarterly report on Form 10-Q contains statements which constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 and Federal securities laws. Statements that make reference to the Company's expectations, predictions and anticipations are subject to known and unknown risks and uncertainties that could cause actual results to differ materially from those expressed by such statements and should be considered forward-looking statements. These statements include, but are not limited to, expectations about the Company's performance in the third quarter of fiscal 2005, risks and uncertainties associated with the strength of the semiconductor and magnetic data storage markets, wafer pricing and wafer demand, the results of product development efforts, the success of the Company's product offerings in meeting customer needs within the timeframes required by customers in these markets, further increases in backlog, the Company's visibility, the Company's ability to maintain current gross profit levels, developments in the Company's ongoing litigation

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with KLA-Tencor Corporation ( KLA ) and its predictions of future financial outcomes. Subject to applicable law, the



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Company disclaims any intent or obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Further information on potential factors that could affect the Company's business is described in "Other Risk Factors and Trends" appearing at the end of this Management's Discussion and Analysis of Financial Condition and Results of Operations and in the Company's reports on file with the Securities and Exchange Commission, including its Form 10-K for the fiscal year ended April 30, 2004.

**Restructurings**

During the first quarter of fiscal 2004, as a result of continued cost cutting initiatives, the Company recorded a restructuring charge of \$393,000, which consisted primarily of severance expenses for 20 terminated employees. The employees were terminated from various functional areas within the Company's SSG and ATI business segments. The majority of all the severance payments from the first quarter restructuring were made by the end of fiscal year 2004. In connection with the first quarter restructuring, the Company did not renew its lease at its Bethel, Connecticut facility, which expired in August 2003. Prior to the end of the first quarter of fiscal 2004, the operations of the Bethel facility were relocated to the Westwood, Massachusetts and Tucson, Arizona facilities.

**Sale of Long-term Investment**

On July 24, 2003, the Company entered into an agreement to sell the majority of its 50% ownership in Japan ADE, Ltd. ( "JAL" ) to Kanematsu Electronics, Ltd., the other 50% owner of JAL. The Company received proceeds of \$4.0 million and realized a gain of \$1.7 million from this transaction. The Company retained a 9% ownership interest in JAL. Prior to the transaction, the Company accounted for its investment in JAL under the equity method. As a result of the decrease in both ownership and influence over the affairs of JAL, the Company accounts for its remaining 9% interest under the cost method.

The \$1.7 million gain on the transaction was calculated as follows:

ADE shares held prior to sale	1,500	50%
KEL shares held prior to sale	1,500	50%
	<hr/>	
Total ownership shares	3,000	100%
	<hr/>	
Shares sold by ADE	1,230	41%
Shares retained by ADE	270	9%
	(in thousands)	
Book value of ADE investment at 4/30/03	\$ 3,722	
Less: Dividend - received 7/10/03	(1,000)	
Add: Income from affiliate - April-June	48	
	<hr/>	
Book value of ADE investment before sale	\$ 2,770	
	<hr/>	
Book value per share - before sale	\$ 1.85	
Book value of shares sold	\$ 2,271	

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Proceeds from sale	\$ 4,000
Gain on sale of 41% ownership	\$ 1,729

Prior to July 24, 2003, when the Company was accounting for its investment in JAL under the equity method, the revenue from sales to JAL, which had not in turn been sold by JAL to unrelated third parties, was eliminated and the related profit on such sales was recorded as deferred income on sales to affiliate. As a result of the reduction of the Company's 50% investment in JAL to 9% and the change in accounting method for the remaining investment to the cost method, the Company recognized approximately \$6.4 million of system and parts revenue in its statement of

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operations that otherwise may have been deferred revenue on the balance sheet as of July 31, 2003. Cost of revenue, systems and parts in the statement of operations increased by \$2.5 million during the quarter ended July 31, 2003 as a result of the sale of part of the Company's JAL investment. Therefore, gross profit in the statement of operations increased by \$3.9 million during the same period.

### **Critical Accounting Policies, Significant Judgments and Estimates**

The discussion and analysis of the Company's financial condition and results of operations are based upon its consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure at the date of the Company's financial statements. On an on-going basis, management evaluates its estimates and judgments, including those related to bad debts, inventories, intangible assets, income taxes, and warranty obligations. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company considers certain accounting policies related to revenue recognition and allowance for doubtful accounts, inventory valuation, accounting for income taxes, valuation of goodwill and software and the accounting for leases to be critical policies due to the estimates and judgments involved in each.

#### *Revenue Recognition and Allowance for Doubtful Accounts*

The Company's revenue recognition policy complies with SEC Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition in Financial Statements. The Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the price is fixed or determinable and collectibility is reasonably assured. The Company's standard customer arrangement includes a signed purchase order, in which it offers payment terms of 30 to 90 days, no right of return of delivered products and a twelve month warranty. The Company assesses whether the fee associated with its revenue transactions is fixed or determinable based on the payment terms associated with the transaction. If a significant portion of the fee is due after the Company's normal payment terms, 30 to 90 days, it determines that the fee is not fixed or determinable. In these cases, the Company recognizes revenue as the fees become due. The Company assesses collectibility based on the credit worthiness of the customer and past transaction history. The Company performs on-going credit evaluations of its customers and does not require collateral from its customers. For many of the Company's international customers, it requires that an irrevocable letter of credit be issued by the customer before the purchase order is accepted. If the Company determines that collection of a fee is not reasonably assured, it defers the fee and recognizes the revenue at the time that collection becomes reasonably assured, which is generally upon the receipt of cash.

For some of the Company's sales transactions, a portion, usually 10%, of the fee is not due until installation occurs and the customer accepts the product. The other 90% of the fee is normally due 30 to 90 days after shipment. If the Company has met defined customer acceptance experience levels with a specific type of product, these transactions are accounted for as multiple-element arrangements with the deferral of the portion of the fee not due until installation is complete and customer acceptance has occurred. Management of the Company must make a determination of what constitutes an appropriate experience level with a product. This determination is based on, but not limited to, the extent to which a product contains significantly new technology, the number of similarly configured products previously delivered and the Company's experience with a particular customer. For new products, the Company must obtain at least three acceptances before it will recognize the 90% portion of the fee upon shipment. All other sales with customer acceptance provisions are recognized as revenue upon customer acceptance. The portion of the fee related to the installation of the product and customer training is classified as service revenue.

The Company's transactions frequently involve the sales of systems and services under multiple element arrangements. Revenue under multiple element arrangements is allocated to all elements except systems based upon



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the fair value of those elements. The amounts allocated to training are based upon the price charged when this element is sold separately and unaccompanied by the other elements. The amount allocated to installation revenue is based upon hourly rates and the estimated time to complete the service. The amount allocated to system and parts is done on a residual method basis. Under this method, the total arrangement value is allocated first to undelivered elements, based on their fair values, with the remainder being allocated to system revenue.

The Company accrues for anticipated warranty costs upon shipment. Service revenue is recognized as the services are performed provided collection of the related receivable is probable. Service contract revenue is recognized ratably over the contractual periods in which the services are provided. Revenue from software licenses is recognized when an agreement has been executed, software has been delivered, fees are fixed or determinable and collection of the related receivable is probable.

Revenue from systems sales to JAL, the Company's previously 50% owned affiliate and a distributor of the Company's products, by the SSG, ATI and PST segments has been reflected in segment revenue during the period they were shipped by the respective segment, which could differ from the period the revenue was recognized for consolidated financial reporting purposes. Consolidated revenue on systems sales to JAL was recognized when the related product or software was shipped to and accepted by the end user of the product or software. As a result of the Company's decreased investment in JAL, since July 24, 2003, all sales to JAL have been reflected in both segment and consolidated revenue in the same period.

The Company maintains an allowance for doubtful accounts based on a continuous review of customer accounts, payment patterns and specific collection issues. Where specific collection issues are identified, the Company records a specific allowance based on the amount that the Company believes will be collected. For accounts where specific collection issues are not identified, the Company will record a reserve based on the age of the receivable and historical collection patterns.

### *Inventory Valuation*

Inventories are valued at the lower of cost or market, cost being determined on a first-in, first-out basis. Management evaluates the need to record adjustments for impairment of inventory on a monthly basis. The Company's policy is to assess the valuation of all inventories, including raw materials, work-in-process, finished goods and spare parts. Inventory that, in the judgment of management, is obsolete or in excess of the Company's estimated usage is written-down to its estimated market value, if less than its cost. Inherent in the estimates of market value are management's estimates related to current economic trends, future demand for the Company's products, and technological obsolescence. Significant management judgments must be made when establishing the reserve for obsolete and excess inventory. If the Company's judgments and estimates relating to obsolete and excess inventory prove to be inadequate, its financial results could be materially adversely affected in future periods. If the inventory value is written down to its net realizable value, and subsequently there is an increased demand for the inventory at a higher value, the increased value of the inventory is not realized until the inventory is sold.

### *Accounting for Income Taxes*

The Company records income taxes using the asset and liability method. Deferred income tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective income tax bases, and operating loss and tax credit carryforwards. The Company's financial statements contain certain deferred tax assets, which have arisen primarily as a result of operating losses incurred in prior years, as well as other temporary differences between book and tax accounting. Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, requires the establishment of a valuation allowance to reflect the likelihood of the realization of deferred tax assets. Significant management judgment is required in

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determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against its net deferred tax assets. The Company evaluates the weight of all available evidence to determine whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized. As of October 31, 2004, the Company has a valuation

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allowance against the full amount of its deferred tax assets. The Company recorded a full valuation allowance during fiscal 2002. The decision to record the valuation allowance required significant judgment. Had the Company not recorded this allowance, it would have reported materially different results. If the realization of deferred tax assets in the future is considered more likely than not, an adjustment to the deferred tax assets would increase net income in the period such determination was made. The amount of the deferred tax asset considered realizable is based on significant estimates, and it is at least reasonably possible that changes in these estimates in the near term could materially affect the Company's financial condition and results of operations. The Company will continue to evaluate both the positive and negative evidence obtained from actual and forecasted results to determine if the deferred tax assets are realizable. It is possible that all, or a portion, of the valuation allowance will be released by the end of fiscal 2005. The Company's effective tax rate may vary from period to period based on changes in estimated taxable income or loss, changes to the valuation allowance, changes to federal, state or foreign tax laws, and deductibility of certain costs and expenses by jurisdiction.

*Valuation of Goodwill and Software*

Intangible assets consist of \$1.3 million of goodwill obtained through the acquisition of the Semiconductor Solutions Division of LPA Software, Inc. ( SSD ) in September 1997 as well as \$0.6 million, net of amortization, of capitalized license fees for software included in the Company's products. In July 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 142 ( SFAS 142 ), Goodwill and Other Intangible Assets, which was effective for the Company on May 1, 2002. SFAS 142 requires, among other things, the discontinuance of goodwill amortization and includes provisions for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, and reclassification of certain intangibles out of previously reported goodwill. In accordance with this statement, the Company discontinued the amortization of its net goodwill of \$1.3 million on May 1, 2002. In addition, the Company was required to perform a transitional impairment test for goodwill under SFAS 142. The impairment test under SFAS 142 uses a two-step process. The first step compares the fair value of the reporting unit with the unit's carrying value, including goodwill. If the carrying value of the reporting unit is greater than fair value, the unit's goodwill may be impaired, and the second step must be completed to measure the amount of the goodwill impairment charge, if any. In the second step, the implied fair value of the reporting unit's goodwill is compared with the carrying amount of the unit's goodwill. If the carrying amount is greater than the implied fair value, the carrying value of the goodwill must be written down to its implied fair value.

The Company is required to perform impairment tests under SFAS 142 annually and whenever events or changes in circumstances suggest that the goodwill may be impaired. Factors the Company considers important that could trigger the impairment review include:

significant underperformance relative to historical or projected future operating results;

significant negative industry or economic trends;

significant adverse change in legal factors or in the business climate;

significant decline in the Company's stock price for a sustained period;

significant decline in the Company's technological value as compared to the market;

the Company's market capitalization relative to net book value; and

unanticipated competition.

Net capitalized license fees of \$0.6 million for software included in the Company's products are amortized at the greater of 1) the ratio that current gross revenue for the related products bears to the total current and anticipated future gross revenue for those products or 2) on a straight-line basis over its estimated useful life. At each quarter-end, the carrying value of the software is compared to net realizable value (NRV). NRV is the estimated future gross revenues from products that incorporate the software reduced by the estimated future costs of disposal. If NRV is less than the carrying value, the excess is written-off and NRV becomes the new carrying value of the software.

Significant management judgments and estimates must be made when establishing criteria for future cash flows, estimating reporting unit fair value and assessing impairment. If the Company's judgments and estimates relating to



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goodwill and software prove to be inadequate, an asset may be determined to be impaired and the Company's financial results could be materially adversely impacted. Likewise, if a future event or circumstance indicates that an impairment assessment is required and, through the performance of that assessment, an asset is determined to be impaired, the Company's financial results could be materially and adversely impacted in future periods.

### *Accounting for Leases*

On July 29, 2003, the Company entered into a lease agreement for its corporate headquarters in Westwood, Massachusetts. The classification of this lease as an operating lease involved a significant judgement by the Company's management with respect to the Company's incremental borrowing rate. At the date of lease inception, the incremental borrowing rate is a significant element of the calculation in one of the four tests that must be performed to determine if a lease should be classified as an operating lease or a capital lease. The Company's management determined the Company's incremental borrowing rate based on an analysis of its negotiations with various financial institutions, the implicit interest rate in the lease for the Westwood, Massachusetts building and an estimate of the current yield on debt financing of comparable companies in the public securities markets. Because the criteria necessary for classification as a capital lease were not met, the lease was accounted for as an operating lease and the leased building and related liability have not been recorded in the Company's consolidated balance sheet. If the Company's incremental borrowing rate was determined to be lower than what was determined by the Company's management, the lease could have met the criteria for classification as a capital lease, which would have resulted in an asset of approximately \$8.6 million and a liability of approximately \$8.6 million being recorded in the Company's consolidated balance sheet at July 31, 2003.

### **Off-Balance Sheet Arrangements**

The Company has not created, and is not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating parts of its business that are not consolidated into its financial statements. The Company does not have any arrangements or relationships with entities that are not consolidated into its financial statements that are reasonably likely to materially affect its liquidity or the availability of capital resources, except as set forth below under Liquidity and Capital Resources.

**Table of Contents****Results of Operations****Three Months Ended October 31, 2004 compared to Three Months Ended October 31, 2003**

*Systems and parts revenue.* Systems and parts revenue increased 46% to \$25.9 million in the second quarter of fiscal 2005 from \$17.8 million in the second quarter of fiscal 2004. Systems and parts revenue in the SSG segment increased 43% to \$15.9 million in the second quarter of fiscal 2005 compared to \$11.1 million in the year earlier period. The increase in revenues from the Company's products in the SSG segment was due to increased demand for the Company's products throughout the world as semiconductor wafer manufacturers have continued to increase capacity in their production of 300mm wafers. System and parts revenue in the PST segment increased 84% to \$7.5 million in the second quarter of fiscal 2005 compared to \$4.1 million in the year earlier period. The increase in revenue from the PST segment was due primarily to increased demand for its semiconductor wafer industry products, particularly in Europe. Given the high dollar value of individual shipments, shipping one less or one more system in a quarter can have a significant impact on the reported revenues for one of the Company's business segments, particularly the ATI and PST segments.

The data storage industry has experienced extreme pricing pressure, consolidation and excess supply in many data storage market segments, which has resulted in reduced production and capital equipment purchases. More recently, the data storage industry has shown increased interest in the Company's magnetic data storage industry products. System and parts revenue from the products that are marketed to the data storage industry by the Company's ATI segment increased 6% to \$2.8 million in the second quarter of fiscal 2005 compared to \$2.6 million in the year earlier period. The increase can be attributed primarily to an increase in sales of ATI's dimensional products.

For the third quarter of fiscal 2005, the Company expects consolidated revenue, which consists primarily of revenue from the semiconductor industry, to be within a range of \$27 to \$30 million. The Company expects third quarter consolidated gross profit to be in the range of 50% to 52%. However, the Company can make no assurances that the expected revenue or the expected gross profit will occur or, if it does, that it can be sustained for the remainder of fiscal year 2005.

The Company's total revenue by industry is distributed as follows:

	<b>Three months ended</b>	
	<b>October 31,</b>	
	<b>2004</b>	<b>2003</b>
Wafer	81%	80%
Device / OEM	9%	6%
Magnetic Data Storage	10%	14%
<b>Total</b>	<b>100%</b>	<b>100%</b>

The Company's total revenue by region is distributed as follows:

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	<b>Three months ended</b>	
	<b>October 31,</b>	
	<b>2004</b>	<b>2003</b>
	<hr/>	<hr/>
United States	16%	12%
Japan	45%	60%
Asia	20%	20%
Europe	19%	8%
	<hr/>	<hr/>
Total	100%	100%
	<hr/>	<hr/>

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Revenue from Japan decreased to 45% of total revenue in the second quarter of fiscal 2005 compared to 60% in the second quarter of fiscal 2004. Although revenue from Japan decreased as a percentage of revenue in the second quarter of fiscal 2005 compared to the second quarter of fiscal 2004, it did increase on a dollar basis. The decrease of revenue from Japan as a percentage of total revenue was primarily due to the increase of revenue from Europe during the same period.

*Service revenue.* Service revenue increased 39% to \$3.4 million in the second quarter of fiscal 2005 compared to \$2.4 million in the second quarter of fiscal 2004. The Company's service revenue consists of fees for installation, training, product maintenance and technical support services. The majority of the Company's service revenue is derived from the SSG segment. The increase is primarily due to service calls related to customers bringing and keeping equipment back on-line to increase capacity and meet higher demand levels.

*Gross profit - systems and parts.* Gross profit on systems and parts increased to 58% in the second quarter of fiscal 2005 from 57% in the second quarter of fiscal 2004. Gross profit increased in the SSG segment due to continuing improvements in cost controls and efficiencies and changes in geographical sales mix. In general, sales to Japan are made through distributors who buy the Company's products at a discount and then resell the products to the end user. As a result, sales to Japan tend to have a lower gross margin than sales made to other parts of the world, which are made through internal and external sales representatives who are compensated by means of commissions. Commissions expense is included in marketing and sales expense. The increase in gross profit from the SSG segment was partially offset by decreases in gross profit in the ATI and PST segments. Gross profit decreased in the PST segment due to increased overhead expenses related to the ramp up in production to meet the increased demand for PST's semiconductor industry products. Gross profit decreased slightly in the ATI segment due to changes in product mix.

*Gross profit - service.* Gross profit from service increased to 23% in the second quarter of fiscal 2005 compared to (6%) in the second quarter of fiscal 2004. The increased gross profit was the result of both increased revenues related to service calls and decreased material and repair costs compared to the second quarter of fiscal 2004.

*Research and development.* Research and development expense for the second quarter of fiscal 2005 remained flat at \$3.7 million compared to the second quarter of fiscal 2004, but decreased as a percentage of revenue to 12% compared to 18% in the second quarter of fiscal 2004. The Company continues to invest in its semiconductor wafer and device industry products as well as new products for the magnetic storage industry, including those that measure the magnetic properties of materials used in manufacturing disk drives. The decrease in expense as a percentage of revenues reflects the increased revenue mentioned above. The Company expects research and development expense in the third quarter of fiscal 2005 to increase to a range of \$3.9 to \$4.1 million as it prepares for the launch of a new product this spring.

*Marketing and sales.* Marketing and sales expense increased \$0.4 million, or 17%, to \$2.8 million in the second quarter of fiscal 2005 from \$2.4 million in the second quarter of fiscal 2004 and decreased to 10% as a percentage of revenue compared to 12% the second quarter of fiscal 2004. The increased expense resulted primarily from an increase in payroll expense due to increased headcount as the Company expands its international sales organization. The mix of sales channels through which the Company's products are sold may also have a significant impact on the Company's marketing and sales expense and the results in any period may not be indicative of marketing and sales expense for future periods. The Company expects marketing and sales expense in the third quarter of fiscal 2005 to range from \$2.8 to \$3.0 million.

*General and administrative.* General and administrative expense increased \$0.4 million, or 15%, to \$2.9 million in the second quarter of fiscal 2005 from \$2.5 million in the second quarter of fiscal 2004 and decreased as a percentage of revenue to 10% from 12% in the second quarter of 2004. Expense increased primarily as a result of an increase of \$0.7 million in incentive compensation expense and \$0.2 million in Sarbanes-Oxley compliance related expense, which was partially offset by a decrease in legal expense of \$0.5 million as the Company's litigation with KLA-Tencor winds down. The Company expects general and administrative expense in the third quarter of fiscal 2005 to range from \$2.5 to \$2.8 million.

*Interest income.* Interest income was \$134,000 in the second quarter of fiscal 2005 compared to interest income of \$92,000 in second quarter of fiscal 2004. The increase in interest income was the result of an increase in invested cash balances during the second quarter of fiscal 2005.

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*Interest expense.* Interest expense was \$82,000 in the second quarter of fiscal 2005 compared to interest expense of \$41,000 in the second quarter of fiscal 2004. The increase in interest expense was primarily due to the fact that during the second quarter of fiscal 2004, the Company received a refund of the commitment fee that had previously been paid for the letter of credit associated with the 1996 Industrial Development Bond, which was retired in the first quarter of fiscal 2004.

*Income taxes.* The provision for income taxes was \$178,000 in the second quarter of fiscal 2005 compared to a benefit from income taxes of \$273,000 in the second quarter of fiscal 2004. The provision for income taxes consists of federal and state alternative minimum taxes and foreign income taxes. The benefit from income taxes in the second quarter of fiscal 2004 was due to a federal income tax refund of \$367,000 for the years 1996 through 2000, which was offset somewhat by state, foreign and alternative minimum income taxes. The Company has a full valuation allowance against its deferred tax assets at October 31, 2004. Significant management judgment is required in determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against its net deferred tax assets. The Company evaluates the weight of all available evidence to determine whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized. If the realization of deferred tax assets in the future is considered more likely than not, an adjustment to the deferred tax assets would increase net income in the period such determination was made. The amount of the deferred tax asset considered realizable is based on significant estimates, and it is at least reasonably possible that changes in these estimates in the near term could materially affect the Company's financial condition and results of operations. The Company will continue to evaluate both the positive and negative evidence obtained from actual and forecasted results to determine if the deferred tax assets are realizable. It is possible that all, or a portion, of the valuation allowance will be released by the end of fiscal 2005.

**Six Months Ended October 31, 2004 compared to Six Months Ended October 31, 2003**

*Systems and parts revenue.* Systems and parts revenue increased 48% to \$51.2 million in the six months ended October 31, 2004 from \$34.7 million in the year earlier period. Systems and parts revenue in the SSG segment increased 51% to \$33.0 million in the six months ending October 31, 2004 compared to \$21.9 million in the year earlier period. The increase in revenues from the Company's products in the SSG segment was due to increased demand for the Company's products throughout the world as semiconductor wafer manufacturers have continued to increase capacity in their production of 300mm wafers. System and parts revenue in the PST segment increased 54% to \$13.1 million in the six months ending October 31, 2004 compared to \$8.5 million in the year earlier period. The increase in revenue from the PST segment was due primarily to increased demand for its semiconductor wafer industry products, particularly in Europe.

The data storage industry has experienced extreme pricing pressure, consolidation and excess supply in many data storage market segments, which has resulted in reduced production and capital equipment purchases. More recently, the data storage industry has shown increased interest in the Company's magnetic data storage industry products. System and parts revenue from the products that are marketed to the data storage industry by the Company's ATI segment increased 36% to \$5.6 million in the six months ending October 31, 2004 compared to \$4.1 million in the year earlier period. The increase can be attributed to an increase in sales of both ATI's dimensional and magnetic data storage products.

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The Company's total revenue by industry is distributed as follows:

	Six months ended October 31,	
	2004	2003
Wafer	82%	81%
Device / OEM	8%	8%
Magnetic Data Storage	10%	11%
<b>Total</b>	<b>100%</b>	<b>100%</b>

The Company's total revenue by region is distributed as follows:

	Six months ended October 31,	
	2004	2003
United States	18%	13%
Japan	45%	61%
Asia	24%	16%
Europe	13%	10%
<b>Total</b>	<b>100%</b>	<b>100%</b>

Revenue from Japan decreased to 45% of total revenue in the six months ending October 31, 2004 compared to 61% in the year earlier period. Although revenue from Japan decreased as a percentage of revenue in the six months ending October 31, 2004 compared to the year earlier period, it did increase on a dollar basis. The decrease of revenue from Japan as a percentage of total revenue was primarily due to the increase of revenue from Europe and Asia during the same period.

*Service revenue.* Service revenue increased 38% to \$6.4 million in the six months ending October 31, 2004 compared to \$4.6 million in the year earlier period. The Company's service revenue consists of fees for installation, training, product maintenance and technical support services. The majority of the Company's service revenue is derived from the SSG segment. The increase is primarily due to service calls related to customers bringing and keeping equipment back on-line to increase capacity and meet higher demand levels.

*Gross profit - systems and parts.* Gross profit on systems and parts increased to 57% in the six months ending October 31, 2004 from 54% in the year earlier period. Gross profit increased in the SSG segment due to continuing improvements in cost controls and efficiencies and changes in geographical sales mix. In general, sales to Japan are made through distributors who buy the Company's products at a discount and then resell the products to the end user. As a result, sales to Japan tend to have a lower gross margin than sales made to other parts of the world, which are made through internal and external sales representatives who are compensated by means of commissions. Commissions expense is included in

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marketing and sales expense. The increase in gross profit from the SSG segment was partially offset by decreases in gross profit in the ATI and PST segments. Gross profit decreased in the PST segment due to increased overhead expenses related to the ramp up in production to meet the increased demand for PST's semiconductor industry products. Gross profit decreased slightly in the ATI segment due to changes in product mix.

*Gross profit - service.* Gross profit from service increased to 25% in the six months ending October 31, 2004 compared to (8%) in the year earlier period. The increased gross profit was the result of both increased revenues related to service calls and decreased material and repair costs in the six months ending October 31, 2004 compared to the year earlier period.



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*Research and development.* Research and development expense decreased \$0.1 million, or 2%, to \$7.3 in the six months ending October 31, 2004 compared to \$7.4 million in the year earlier period, but decreased as a percentage of revenue to 13% in the six months ending October 31, 2004 compared to 19% in the year earlier period. The Company continues to invest in its semiconductor wafer and device industry products as well as new products for the magnetic storage industry, including those that measure the magnetic properties of materials used in manufacturing disk drives. The decrease in expense as a percentage of revenues reflects the increased revenue mentioned above.

*Marketing and sales.* Marketing and sales expense increased \$1.9 million, or 42%, to \$6.3 million in the six months ending October 31, 2004 from \$4.4 million in the year earlier period and remained at 11% as a percentage of revenue in the six months ending October 31, 2004 compared to the year earlier period. The increased expense resulted primarily from an increase in commissions expense of \$1.2 million as a result of the increased revenue during the six months ending October 31, 2004. Also contributing to the increase in expense was an increase in payroll expense of \$0.4 million due to increased headcount as the Company expands its international sales organization and an increase of \$0.2 million in travel expense. The mix of sales channels through which the Company's products are sold may have a significant impact on the Company's marketing and sales expense and the results in any period may not be indicative of marketing and sales expense for future periods.

*General and administrative.* General and administrative expense increased \$0.9 million, or 19%, to \$5.5 million in the six months ending October 31, 2004 from \$4.7 million in the year earlier period and decreased as a percentage of revenue to 10% from 12% in the year earlier period. Expense increased primarily as a result of an increase of \$1.3 million in incentive compensation expense and \$0.3 million in Sarbanes-Oxley compliance related expense, which was partially offset by a decrease in legal expense of \$0.7 million as the Company's litigation with KLA-Tencor winds down.

*Interest income.* Interest income was \$197,000 in the six months ending October 31, 2004 compared to interest income of \$134,000 in the year earlier period. The increase in interest income was the result of an increase in invested cash balances during the six months ending October 31, 2004.

*Interest expense.* Interest expense was \$134,000 in the six months ending October 31, 2004 compared to interest expense of \$294,000 in the year earlier period. The decrease in interest expense was primarily due to the Company's retirement of its 1996 and 1997 Industrial Development Bonds in the first quarter of fiscal 2004.

*Income taxes.* The provision for income taxes was \$326,000 in the six months ending October 31, 2004 compared to a benefit from income taxes of \$185,000 in the year earlier period. The provision for income taxes in the six months ending October 31, 2004 consists of federal and state alternative minimum taxes and foreign income taxes. The benefit from income taxes in the six months ending October 31, 2003 was due to a federal income tax refund of \$367,000 for the years 1996 through 2000, which was offset somewhat by state, foreign and alternative minimum income taxes. The Company has a full valuation allowance against its deferred tax assets at October 31, 2004. Significant management judgment is required in determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against its net deferred tax assets. The Company evaluates the weight of all available evidence to determine whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized. If the realization of deferred tax assets in the future is considered more likely than not, an adjustment to the deferred tax assets would increase net income in the period such determination was made. The amount of the deferred tax asset considered realizable is based on significant estimates, and it is at least reasonably possible that changes in these estimates in the near term could materially affect the Company's financial condition and results of operations. The Company will continue to evaluate both the positive and negative evidence obtained from actual and forecasted results to determine if the deferred tax assets are realizable. It is possible that all, or a portion, of the valuation allowance will be released by the end of fiscal 2005.

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*Equity in net earnings of affiliated companies.* Equity in net earnings of affiliated companies was \$0 in the six months ending October 31, 2004 compared to \$48,000 in the year earlier period. As of July 24, 2003, as a result of the reduction of the Company's 50% investment in JAL to 9%, and the change in accounting method from the equity method to the cost method, the Company no longer records JAL's earnings in its statement of operations.

## **Liquidity and Capital Resources**

At October 31, 2004, the Company had \$50.2 million in cash and cash equivalents and \$85.6 million in working capital. In addition, the Company had \$0.6 million in restricted cash used as a security deposit for the Company's lease of its Westwood, Massachusetts headquarters.

Cash provided by operating activities for the six months ended October 31, 2004 was \$8.3 million. This amount resulted from net income of \$11.4 million adjusted for non-cash charges of \$1.1 million and a \$4.2 million net change in working capital accounts. Non-cash items consisted primarily of \$1.2 million of depreciation and amortization and \$0.1 million of amortization of gain from the sale-leaseback of the Westwood, Massachusetts headquarters and production facility in the first quarter of fiscal 2004. Working capital items consisted primarily of increases in accounts receivable of \$8.4 million, prepaid expenses and other current assets of \$0.1 million, and accrued expenses and other current liabilities of \$3.7 million and decreases in inventories of \$0.7 million and accounts payable of \$0.1 million. The increase in accounts receivable was due to an increase of shipments during the second quarter of fiscal 2005 as well as the timing of those shipments. The increase in prepaid expenses and other current assets was due to the timing of payments to vendors. The increase in accrued expenses and other current liabilities was primarily due to increases in accrued salaries, wages and incentive compensation of \$0.4 million and an increase in deferred revenue of \$2.6 million. The decrease in inventory was due to the shipment of products during the quarter and the decrease in accounts payable was primarily due to the timing of payments to vendors.

Cash used in investing activities for the six months ended October 31, 2004 was \$0.1 million, and consisted primarily of \$0.2 million in purchases of fixed assets.

Cash provided by financing activities for the six months ended October 31, 2004 was \$0.5 million, which consisted of \$0.5 million of aggregate proceeds from the issuance of common stock from the exercise of stock options and stock purchased through the Company's employee stock purchase plan. These proceeds were slightly offset by \$0.1 million of principal repayments of long-term debt.

The Company's Newton, Massachusetts facility was listed for sale in February 2003. On July 31, 2003, the Company retired the 1997 Industrial Development Bond (IDB), which was used to finance the acquisition of this property. On June 25, 2004, the Company entered into a purchase and sale agreement with a buyer for the Newton property. The sale of the Newton property was completed on December 2, 2004. The Company received net proceeds of \$4.4 million. The Company anticipates that the cash proceeds from this sale will be used for general corporate purposes.

On July 22, 2004, the Company entered into a Standby Letter of Credit Agreement with Fleet National Bank in the amount of \$4.5 million. One letter of credit issued under this facility serves as collateral for the \$3.9 million principal balance on Company's IDB issued through the Industrial Development Authority of the County of Pima, Arizona and replaces a letter of credit the Company had with another financial institution. Another letter of credit under this facility serves as collateral along with a \$0.6 million cash security deposit required by the lease agreement for the Company's Westwood, Massachusetts headquarters building. The facility bears a fee of 1.5% per annum of the face amount of each letter of credit. Under the terms of the Letter of Credit Agreement, the Company is required to comply with certain financial covenants. As of October 31, 2004, the Company is in compliance with these covenants.

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Under Generally Accepted Accounting Principles ( GAAP ) in the United States of America, certain obligations and commitments are not required to be included in the consolidated balance sheet. These obligations and commitments, while entered into in the normal course of business, may have a material impact on liquidity. The

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Company does not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As such, the Company is not exposed to any financing, liquidity, market or credit risk that could arise if the Company had engaged in such relationships. The following table discloses the Company's contractual payment obligations as of October 31, 2004. The operating lease and consulting agreement obligations are not included in the unaudited consolidated financial statements included in Item 1. Financial Information. The principal portion of the long-term debt is included in the unaudited consolidated financial statements. The long-term debt payments in the table below include both principal and interest. The unconditional purchase order obligations primarily represent open purchase orders for inventory, a significant portion of which is necessary to produce and ship orders from the Company's backlog.

	Payments due by period				
	(in thousands)				
	Less than 1 year	1-3 years	3-5 years	More than 5 years	Total
Long term debt obligations	\$ 372	\$ 744	\$ 3,382	\$	\$ 4,498
Operating lease obligations	1,727	3,021	2,524	10,989	18,261
Unconditional purchase obligations	6,975	134			7,109
Consulting agreement	196				196
	<u>\$ 9,270</u>	<u>\$ 3,899</u>	<u>\$ 5,906</u>	<u>\$ 10,989</u>	<u>\$ 30,064</u>

The Company expects to meet its near-term working capital needs and capital expenditures primarily through available cash and cash equivalents, which will primarily be generated from sales to both existing and new customers. However, the Company can provide no assurance that it will be able to maintain its current customer base or acquire new customers.

**Other Risk Factors and Trends**

Capital expenditures by semiconductor wafer and device manufacturers historically have been cyclical as they in turn depend upon the current and anticipated demand for integrated circuits. While the semiconductor industry appeared to have emerged from the most recent severe down cycle, it is not clear whether this recovery is still continuing for semiconductor wafer manufacturers, who have historically accounted for approximately 70% - 80% of the Company's revenue. In addition, the Company cannot determine at this time if the current uncertainty in the industry is indicative of an impending slowdown or if the recent upward cycle will resume. The data storage industry has been in a period of oversupply and excess manufacturing capacity for an extended period of time and this has also had an adverse impact on the Company. The data storage industry is also showing signs of recovery, but the outlook for sustained long-term growth in this industry is also uncertain. At October 31, 2004, the Company's backlog was \$48.1 million. The Company remains uncertain about how long current revenue levels can be sustained. The Company continues to evaluate its cost structure relative to expected revenue and will continue to implement aggressive cost containment measures where necessary. However, the Company cannot provide assurance that it will be able to implement cost containment measures in a timely or cost effective manner.

Furthermore, the Company's success is dependent upon supplying technologically superior products to the marketplace at appropriate times to satisfy customer needs. Product development requires substantial investment and is subject to technological risks. Delays or difficulties in product development or market acceptance of newly developed products could adversely affect the future performance of the Company.



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**New Accounting Pronouncements**

In November 2004, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards No. 151 ( SFAS 151 ), Inventory Costs. SFAS 151 amends the guidance in Accounting Review Board No. 43, Chapter 4, Inventory Pricing, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). SFAS 151 is effective for fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on the Company's financial position and results of operations.

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### **Item 3. Quantitative and Qualitative Disclosures About Market Risk:**

At October 31, 2004, the Company's exposure to market risk relates primarily to changes in interest rates on its investment portfolio. The Company's cash equivalents consist primarily of fixed income securities. The Company invests only with high credit quality issuers and does not use derivative financial instruments in its investment portfolio. The Company does not believe that a sharp increase or decrease in interest rates would have a material adverse impact on the fair value of its investment portfolio. The Company's long-term borrowings are at fixed interest rates.

In addition, a portion of the Company's business is conducted outside the United States through its foreign subsidiaries and an affiliate. The Company generally transacts business in international markets in United States currency, but pays its employees in local currencies. Accordingly, the Company is subject to exposure from adverse movements in foreign currency exchange rates. Historically, the Company's exposure to adverse foreign currency fluctuations has been immaterial.

### **Item 4. Controls and Procedures:**

The term "disclosure controls and procedures" is defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). These rules refer to the controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Exchange Act is recorded, processed, summarized and reported within required time periods. As of the end of the period covered by this Form 10-Q (the "Evaluation Date"), the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's chief executive officer and chief financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based upon that evaluation, the chief executive officer and chief financial officer have concluded that, as of the Evaluation Date, such disclosure controls and procedures were effective.

The Company maintains a system of internal accounting controls that are designed to provide reasonable assurance that the Company's transactions are properly recorded, that the Company's assets are safeguarded against unauthorized or improper use and that the Company's transactions are properly recorded and reported. As part of the evaluation of the Company's disclosure controls and procedures, the Company evaluated its internal control over financial reporting. There have been no changes to the Company's internal control over financial reporting during the second fiscal quarter of 2005 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## ISSUER PURCHASES OF EQUITY SECURITIES

<u>Period</u>	<u>Total Number of Shares Purchased (1)</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</u>
August 1 through August 31, 2004	0	0	0	0
September 1 through September 30, 2004	4,923	\$17.975	0	0
October 1 through October 31, 2004	0	0	0	0
<b>Total</b>	<b>4,923</b>	<b>\$17.975</b>	<b>0</b>	<b>0</b>

(1) Consists solely of shares tendered by employees as payment of the exercise price of stock options granted under the Company's equity compensation plans.

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

The Annual Meeting of Stockholders of the Company was held on September 15, 2004. The stockholders voted on the following matters:

1. Proposal to fix the size of the Board of Directors at five.

<u>For</u>	<u>Against</u>	<u>Abstain</u>
12,954,130	15,424	4,536



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2. Election of Directors

<u>Nominee</u>	<u>For</u>	<u>Withheld</u>
Harris Clay	12,696,633	277,457
Landon T. Clay	12,697,263	276,827
H. Kimball Faulkner	12,777,003	197,087
Chris L. Koliopoulos	9,934,524	3,039,566
Kendall Wright	10,000,406	2,973,684

There were no abstentions with respect to this matter.

3. Ratification of the appointment of PricewaterhouseCoopers LLP as the Company's independent public accountants for the fiscal year ending April 30, 2005.

<u>For</u>	<u>Against</u>	<u>Abstain</u>
12,931,572	39,998	2,520

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**Item 6. Exhibits:**

**Exhibit**

<b><u>Number</u></b>	<b><u>Description</u></b>
31.1	Certification of Chief Executive Officer required by Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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

**ADE CORPORATION**

Date: December 10, 2004

/s/ Chris L. Koliopoulos

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Chris L. Koliopoulos, Ph.D.  
President and Chief Executive Officer

Date: December 10, 2004

/s/ Brian C. James

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Brian C. James  
Executive Vice President and Chief Financial Officer