

ADE CORP  
Form 10-Q  
March 13, 2006  
Table of Contents

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the Quarterly Period Ended: January 31, 2006

**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

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**ADE CORPORATION**

(Exact Name of Registrant as Specified in its Charter)

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Massachusetts  
(State or Other Jurisdiction of

Incorporation or Organization)

80 Wilson Way, Westwood, Massachusetts 02090

(Address of Principal Executive Offices, Including Zip Code)

(781) 467-3500

04-2441829  
(I.R.S. Employer

Identification No.)

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(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (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

14,474,037 shares  
Outstanding at March 9, 2006

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**Table of Contents**

**ADE CORPORATION**

**INDEX**

	<b>Page</b>
<b><u>Part I. - Financial Information</u></b>	
Item 1. <u>Consolidated Financial Statements (unaudited)</u>	
<u>Consolidated Balance Sheet-</u> <u>January 31, 2006 and April 30, 2005</u>	3
<u>Consolidated Statement of Operations-</u> <u>Three and Nine Months Ended January 31, 2006 and 2005</u>	4
<u>Consolidated Statement of Cash Flows</u> <u>Nine Months Ended January 31, 2006 and 2005</u>	5
<u>Notes to Unaudited Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	14
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	26
Item 4. <u>Controls and Procedures</u>	26
<b><u>Part II. - Other Information</u></b>	
Item 6. <u>Exhibits</u>	27
<u>Signatures</u>	28

**Table of Contents****PART I.****FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements:****ADE CORPORATION****CONSOLIDATED BALANCE SHEET**

(in thousands, except share and per share information, unaudited)

	January 31, 2006	April 30, 2005
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 87,244	\$ 72,841
Marketable securities	932	836
Accounts receivable, net	19,274	18,499
Inventories	34,785	30,764
Prepaid expenses and other current assets	1,096	1,373
Deferred income taxes	11,017	10,601
<b>Total current assets</b>	<b>154,348</b>	<b>134,914</b>
Fixed assets, net	8,391	9,241
Deferred income taxes	3,194	6,616
Investments	499	499
Intangible assets, net	323	533
Goodwill	1,318	1,318
Other assets	110	105
<b>Total assets</b>	<b>\$ 168,183</b>	<b>\$ 153,226</b>
<b>Liabilities and stockholders equity</b>		
Current liabilities:		
Current portion of long-term debt	\$ 185	\$ 177
Accounts payable	7,764	6,027
Accrued expenses and other current liabilities	11,489	12,069
<b>Total current liabilities</b>	<b>19,438</b>	<b>18,273</b>
Deferred gain on sale-leaseback	1,411	1,496
Long-term debt, net of current portion	3,292	3,431
<b>Total liabilities</b>	<b>24,141</b>	<b>23,200</b>
Commitments and contingencies (Note 9)		
<b>Stockholders equity:</b>		
Preferred stock, \$1.00 par value; 1,000,000 shares authorized; none issued or outstanding		
Common stock, \$.01 par value: 25,000,000 shares authorized: 14,448,660 and 14,260,773 issued and outstanding at January 31, 2006 and April 30, 2005, respectively	143	143
Capital in excess of par value	113,017	109,597
Retained earnings	30,404	19,870

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Accumulated other comprehensive income	478	416
Total stockholders' equity	144,042	130,026
Total liabilities and stockholders' equity	\$ 168,183	\$ 153,226

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 January 31,</b>		<b>Nine months ended January 31,</b>	
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
<b>Net Revenue:</b>				
Systems and parts	\$ 23,049	\$ 26,426	\$ 65,558	\$ 77,677
Service	3,209	3,079	8,626	9,430
<b>Total revenue</b>	<b>26,258</b>	<b>29,505</b>	<b>74,184</b>	<b>87,107</b>
<b>Cost of revenue:</b>				
Systems and parts	8,658	11,507	25,089	33,671
Service	2,724	2,462	7,392	7,233
<b>Total cost of revenue</b>	<b>11,382</b>	<b>13,969</b>	<b>32,481</b>	<b>40,904</b>
<b>Gross profit</b>	<b>14,876</b>	<b>15,536</b>	<b>41,703</b>	<b>46,203</b>
<b>Operating expenses:</b>				
Research and development	4,113	4,130	11,743	11,412
Marketing and sales	2,933	2,715	9,382	9,000
General and administrative	2,754	2,413	7,936	7,940
<b>Total operating expenses</b>	<b>9,800</b>	<b>9,258</b>	<b>29,061</b>	<b>28,352</b>
<b>Income from operations</b>	<b>5,076</b>	<b>6,278</b>	<b>12,642</b>	<b>17,851</b>
Interest income	694	182	1,764	379
Interest expense	(65)	(70)	(185)	(203)
Other income	87	163	143	214
<b>Income before provision for income taxes</b>	<b>5,792</b>	<b>6,553</b>	<b>14,364</b>	<b>18,241</b>
Provision for income taxes	1,059	117	3,830	444
<b>Net income</b>	<b>\$ 4,733</b>	<b>\$ 6,436</b>	<b>\$ 10,534</b>	<b>\$ 17,797</b>
Basic earnings per share	\$ 0.33	\$ 0.46	\$ 0.73	\$ 1.27
Diluted earnings per share	\$ 0.32	\$ 0.45	\$ 0.72	\$ 1.25
Weighted average shares outstanding - basic	14,405	14,065	14,366	14,038
Weighted average shares outstanding - diluted	14,695	14,285	14,637	14,276

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>Nine months ended January 31,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 10,534	\$ 17,797
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,515	1,700
Gain on sale of building		(69)
Deferred income taxes	3,006	
Non-cash compensation	15	20
Tax benefit related to the exercise of stock options	389	
Amortization of gain from sale-leaseback	(85)	(85)
Changes in assets and liabilities:		
Accounts receivable	(775)	(5,669)
Inventories	(4,021)	2,271
Prepaid expenses and other current assets	277	(143)
Other assets	(5)	17
Accounts payable	1,737	289
Accrued expenses and other current liabilities	(580)	2,402
Net cash provided by operating activities	12,007	18,530
<b>Cash flows from investing activities:</b>		
Purchases of fixed assets	(456)	(402)
Change in restricted cash		6
Proceeds from sale of building, net of selling expenses		4,394
Net cash (used in) provided by investing activities	(456)	3,998
<b>Cash flows from financing activities:</b>		
Repayment of long-term debt	(131)	(125)
Proceeds from issuance of common stock	3,016	849
Net cash provided by financing activities	2,885	724
Effect of exchange rate changes on cash and cash equivalents	(33)	(9)
Net increase in cash and cash equivalents	14,403	23,243
Cash and cash equivalents, beginning of period	72,841	41,560
Cash and cash equivalents, end of period	\$ 87,244	\$ 64,803

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

**Table of Contents**

**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 ("SEC") 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 ("GAAP") 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, 2005. The Company maintains a website where copies of its reports filed with SEC may be accessed, as well as other information concerning the Company's business, products and news releases. The address of the Company's website is [www.ade.com](http://www.ade.com). The Company's website is included as a textual reference only and the information on the Company's website is not incorporated by reference into this Quarterly Report on Form 10-Q.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses and the disclosure of contingencies in the Company's unaudited consolidated financial statements. Areas particularly subject to estimation include the allowance for doubtful accounts, the valuation for potential excess and obsolete inventory, the carrying value of the Company's intangible assets and the valuation allowance on deferred tax assets. Actual results could differ from those estimates.

**2. Comprehensive Income**

Comprehensive income was as follows:

	(in thousands)		(in thousands)	
	Three months ended January 31, 2006 (unaudited)	January 31, 2005	Nine months ended January 31, 2006 (unaudited)	January 31, 2005 (unaudited)
Net income	\$ 4,733	\$ 6,436	\$ 10,534	\$ 17,797
Other comprehensive income (loss):				
Unrealized gain (loss) on marketable securities, net of tax	99	(10)	96	(200)
Currency translation adjustments		(2)	(33)	(9)
Other comprehensive income (loss)	99	(12)	63	(209)
Comprehensive income	\$ 4,832	\$ 6,424	\$ 10,597	\$ 17,588



**Table of Contents**

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

**3. Inventories**

Inventories consist of the following:

	(in thousands)	
	January 31, 2006	April 30, 2005
	(unaudited)	
Raw materials and purchased parts	\$ 17,794	\$ 16,820
Work-in-process	15,018	13,084
Finished goods	1,973	860
	\$ 34,785	\$ 30,764

**4. 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)	
	January 31, 2006	April 30, 2005
	(unaudited)	
License fees at cost	\$ 1,400	\$ 1,400
Accumulated amortization	(1,077)	(867)
Net carrying value	\$ 323	\$ 533

Amortization expense was \$79,000 and \$38,000 for the three months ended January 31, 2006 and 2005, respectively, and \$209,000 and \$113,000 for the nine months ended January 31, 2006 and 2005, respectively. Estimated annual amortization is \$289,000, \$216,000 and \$28,000 for the fiscal years ending April 30, 2006, 2007 and 2008, respectively.

**Table of Contents**

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

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

Accrued expenses and other current liabilities consist of the following:

	(in thousands)	
	January 31, 2006	April 30, 2005
	(unaudited)	
Accrued salaries, wages, vacation pay and incentive compensation	\$ 3,553	\$ 3,335
Accrued commissions	1,198	1,512
Accrued warranty costs	1,087	1,482
Deferred revenue	1,686	2,316
Other	3,965	3,424
	\$ 11,489	\$ 12,069

**6. 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 Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ) 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)	
	(In thousands, except per share data)		(In thousands, except per share data)	
	Three months ended January 31, 2006 2005		Nine months ended January 31, 2006 2005	
	(unaudited)		(unaudited)	
Net income, as reported	\$ 4,733	\$ 6,436	\$ 10,534	\$ 17,797
Add back: Stock-based compensation included in net income, as reported, net of taxes	3	5	9	20
Deduct: Total stock-based employee compensation expense determined under fair value based method, net of related income taxes	169	336	678	1,091
Pro forma net income	\$ 4,567	\$ 6,105	\$ 9,865	\$ 16,726
Net earnings per share:				
Basic - as reported	\$ 0.33	\$ 0.46	\$ 0.73	\$ 1.27

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Basic - pro forma	\$ 0.32	\$ 0.43	\$ 0.69	\$ 1.19
Diluted - as reported	\$ 0.32	\$ 0.45	\$ 0.72	\$ 1.25
Diluted - pro forma	\$ 0.31	\$ 0.43	\$ 0.68	\$ 1.17

**Table of Contents**

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

**7. Earnings Per Share**

Earnings per share are presented in accordance with SFAS No. 128, Earnings Per Share, which requires the presentation of basic earnings per share and diluted 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 potential dilutive common shares outstanding during the period. Potential dilutive common shares include shares issuable upon the assumed exercise of dilutive stock options. For the three months ended January 31, 2006, there were no common shares issuable upon the exercise of stock options that were antidilutive. For the three months ended January 31, 2005, 363,362 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 nine months ended January 31, 2006 and 2005, respectively, 45,250 and 361,000 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.

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

	(in thousands) Three months ended		(in thousands) Nine months ended	
	January 31,		January 31,	
	2006	2005	2006	2005
	(unaudited)		(unaudited)	
Shares used in computation:				
Weighted average common stock outstanding used in computation of basic earnings per share	14,405	14,065	14,366	14,038
Dilutive effect of stock options outstanding	290	220	271	238
Shares used in computation of diluted earnings per share	14,695	14,285	14,637	14,276

**8. 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 provides enhanced yield management to the data storage, semiconductor wafer and device manufacturing 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's chief operating decision maker is the President and Chief Executive Officer. 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. For the reportable segments, intersegment sales are recorded at cost plus 20% and are eliminated in consolidation.



**Table of Contents**

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

**8. Segment Reporting (Continued)**

	(in thousands, unaudited)			
	SSG	PST	ATI	Total
<b>For the quarter ended January 31, 2006</b>				
Revenue from external customers	\$ 12,558	\$ 9,650	\$ 4,050	\$ 26,258
Intersegment revenue	112	116	123	351
Income from operations	488	3,378	1,213	5,079
Depreciation and amortization expense	435	104	6	545
Capital expenditures	30	48	119	197
<b>For the quarter ended January 31, 2005</b>				
Revenue from external customers	\$ 15,528	\$ 10,719	\$ 3,258	\$ 29,505
Intersegment revenue	171	23	129	323
Income from operations	1,445	4,315	548	6,308
Depreciation and amortization expense	402	130	4	536
Capital expenditures	19	82	149	250
	(in thousands, unaudited)			
	SSG	PST	ATI	Total
<b>For the nine months ended January 31, 2006</b>				
Revenue from external customers	\$ 36,117	\$ 27,488	\$ 10,579	\$ 74,184
Intersegment revenue	149	317	560	1,026
Income from operations	264	9,432	2,985	12,681
Depreciation and amortization expense	1,181	316	18	1,515
Capital expenditures	222	166	119	507
<b>For the nine months ended January 31, 2005</b>				
Revenue from external customers	\$ 54,042	\$ 24,088	\$ 8,977	\$ 87,107
Intersegment revenue	216	217	350	783
Income from operations	9,474	7,604	828	17,906
Depreciation and amortization expense	1,290	397	13	1,700
Capital expenditures	155	82	165	402

**Table of Contents**

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

**8. Segment Reporting (Continued)**

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>Nine months ended</b>	
	<b>January 31,</b>	<b>January 31,</b>	<b>January 31,</b>	<b>January 31,</b>
	<b>2006</b>	<b>2005</b>	<b>2006</b>	<b>2005</b>
	<b>(unaudited)</b>		<b>(unaudited)</b>	
Total operating income for reportable segments	\$ 5,079	\$ 6,308	\$ 12,681	\$ 17,906
Net impact of intercompany gross profit eliminations	(3)	(30)	(39)	(55)
<b>Total consolidated operating income</b>	<b>\$ 5,076</b>	<b>\$ 6,278</b>	<b>\$ 12,642</b>	<b>\$ 17,851</b>

**9. Commitments and Contingencies***Litigation*

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 current legal proceedings and claims will not have a material adverse effect on the Company's financial position or results of operations.

*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 January 31, 2006.

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 this 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 this 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 this customer contract provision. As a result, the Company believes the estimated exposure of this provision is minimal. Accordingly, the Company has no liabilities recorded for this provision as of January 31, 2006.

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 currently accrues 2% of product revenues, based on history, to provide for estimated warranty costs. The following is a reconciliation of the quarterly activity in the Company's warranty liability for the nine months ended January 31, 2006 and 2005.





**Table of Contents**

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

**9. Commitments and Contingencies (Continued)**

	(in thousands)	
	Nine months ended	
	January 31,	
	2006	2005
	(unaudited)	
Accrued warranty, beginning balance	\$ 1,482	\$ 1,257
Accruals for warranties issued	981	881
Warranty settlements made	(1,376)	(653)
Accrued warranty, ending balance	\$ 1,087	\$ 1,485

**10. New Accounting Pronouncements**

In November 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 151, Inventory Costs ( SFAS 151 ). 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.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment ( SFAS 123R ). SFAS 123R requires that the cost resulting from all share-based payment transactions be measured using a fair-value method and be recognized in the financial statements. SFAS 123R is effective as of the beginning of the first interim or annual reporting period of the first fiscal year that begins on or after June 15, 2005. SFAS 123R is effective for the Company's first quarter of fiscal 2007 beginning May 1, 2006. SFAS 123R permits public companies to adopt its requirements using one of two methods:

1. A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date.
2. A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures for either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company has not yet determined whether it will adopt SFAS 123R using the modified prospective method or the modified retrospective method. Management is currently evaluating the impact that the adoption of SFAS 123R will have on the Company's financial position and results of operations.

**11. Income Taxes**

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For the three months ended January 31, 2006, the Company earned income before taxes of \$5.8 million and recorded a tax provision of \$1.1 million. The Company's effective tax rate in the third quarter of fiscal 2006 was approximately 18% compared to approximately 2% in the third quarter of fiscal 2005. The effective tax rate in the third quarter of fiscal 2006 includes a tax benefit of \$980,000 related to the deduction for the Extraterritorial Income exclusion that the Company elected to claim on its 2005 federal tax return after completing a benefit analysis in the current quarter. For the nine months ended January 31, 2006, the Company earned income before taxes of \$14.4 million and recorded a tax provision of \$3.8 million. The Company's effective tax rate in the nine months ended January 31, 2006 was approximately 27% compared to approximately 2% in the year earlier period. The effective tax rate for the nine months ended January 31, 2006 includes the tax benefit recorded in the third quarter of fiscal 2006 mentioned above. The provision for income taxes

**Table of Contents**

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

in the three and nine months ended January 31, 2005 consisted only of federal and state alternative minimum taxes and foreign income taxes because at that time, the Company had a full valuation allowance against its deferred tax assets.

**12. Subsequent Event**

On February 22, 2006, the Company entered into a definitive agreement and plan of merger with KLA-Tencor Corporation ( "KLA-Tencor" ). Pursuant to the agreement, which has been unanimously approved by the boards of directors of both companies, each share of the Company's common stock will be exchanged for 0.64 shares of KLA-Tencor common stock on a fixed basis. The transaction is anticipated to be a tax-free exchange to the Company's stockholders and is subject to the expiration of the applicable Hart-Scott-Rodino Act waiting period and customary closing conditions, including regulatory approvals and approval by the Company's stockholders. The transaction is expected to close by early in the third calendar quarter of 2006.

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**Table of Contents**

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

**Introduction and Business Outlook**

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. Earlier in fiscal 2006, there was evidence of a slight downturn in the semiconductor industry. As a result, prior to the second quarter of fiscal 2006, the Company had experienced four consecutive quarters of decreased bookings and, consequently, decreased revenues in the first half of fiscal 2006. However, the Company has experienced sequential increases in bookings in the second and third quarters of fiscal 2006. This fact, combined with an increase in quoting activity, suggests that the semiconductor industry may be entering a period of expansion. However, due to limited industry visibility, the Company cannot determine if this recent increase in order activity will continue and if so, for how long. Contrary to previous industry slow downs, the Company has maintained its profitability during those quarters of decreased order activity, albeit at a reduced level. 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, 2005.

**Merger with KLA-Tencor Corporation**

On February 22, 2006, the Company entered into a definitive agreement and plan of merger with KLA-Tencor Corporation (KLA-Tencor). Pursuant to the agreement, which has been unanimously approved by the boards of directors of both companies, each share of the Company's common stock will be exchanged for 0.64 shares of KLA-Tencor common stock on a fixed basis. The transaction is anticipated to be a tax-free exchange to the Company's stockholders and is subject to the expiration of the applicable Hart-Scott-Rodino Act waiting period and customary closing conditions, including regulatory approvals and approval by the Company's stockholders. The transaction is expected to close by early in the third calendar quarter of 2006.

In connection with the proposed transaction, KLA-Tencor plans to file a Registration Statement on Form S-4 containing a proxy statement/prospectus with the SEC. You are urged to read the Registration Statement and any other relevant documents filed with the SEC, including the proxy statement/prospectus that will be part of the Registration Statement, when they become available because they will contain important information about KLA-Tencor, the Company, the proposed transaction and related matters. You will be able to obtain free copies of the Registration Statement and the proxy statement/prospectus, when they become available, without charge, at the SEC's Internet site (<http://www.sec.gov>).

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## **Table of Contents**

### **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, plans 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 success of the Company's new and existing products, orders and revenue associated with those products for the remainder of fiscal 2006, market demand, the expected closing time for the merger, the expectation that the proposed merger will be tax free, the Company's limited visibility with respect to its industry's long term trends, expectations about the impact of SFAS No. 123 (revised 2004)

Share-Based Payment (SFAS 123R), and the Company's predictions of future financial outcomes. These statements involve risks and uncertainties including those 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, disruption from the proposed merger making it more difficult to maintain relationships with customers, vendors and employees, the failure to obtain and retain expected synergies from the proposed merger, the failure of ADE stockholders to approve the proposed merger, any delays in obtaining, or adverse conditions contained in, any required regulatory approvals in connection with the merger, failure to consummate or any delays in consummating the proposed merger for other reasons, changes in laws or regulations or other similar factors, further increases in backlog, the Company's ability to maintain current gross profit levels, optimism based on the Company's book-to-bill ratio, the potential of rapidly slowing order flow and the potential impact of promulgations. Subject to applicable law, the 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 other reports on file with the SEC, including its Annual Report on Form 10-K for the fiscal year ended April 30, 2005.

### **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 ongoing 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 and the valuation of goodwill and software 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, Revenue Recognition in Financial Statements (SAB 104). 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 of 30 to 90 days, it determines that the fee is not fixed or determinable. In these

## **Table of Contents**

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 initial 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 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.

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.

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**Table of Contents**

*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. SFAS 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 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. 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'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*

As of January 31, 2006, intangible assets consist of \$1.3 million of goodwill obtained through the acquisition of the Semiconductor Solutions Division of LPA Software, Inc. in September 1997 as well as \$0.3 million, net of amortization, of capitalized license fees for software included in the Company's products. The Company accounts for goodwill and other intangible assets in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142).

The Company is required to perform impairment tests under SFAS 142 annually during the fourth quarter of its fiscal year 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 \$0.3 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.

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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 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.



**Table of Contents**

**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 January 31, 2006 compared to Three Months Ended January 31, 2005**

*Systems and parts revenue.* Systems and parts revenue decreased 13% to \$23.0 million in the third quarter of fiscal 2006 from \$26.4 million in the third quarter of fiscal 2005. Systems and parts revenue in the SSG segment decreased 23% to \$10.0 million in the third quarter of fiscal 2006 compared to \$13.0 million in the third quarter of fiscal 2005. The decrease in revenues from the SSG segment is due primarily to decreased demand for the Company's Advanced Wafer Inspection System as the Company's latest-generation nano-particle inspection and defect classification tool, the WaferXam, is expected to begin generating revenue in late fiscal 2006. Systems and parts revenue in the PST segment decreased 11% to \$9.4 million in the third quarter of fiscal 2006 compared to \$10.6 million in the third quarter of fiscal 2005. The decrease in revenue from the PST segment was due primarily to a temporary decrease in demand that occurred earlier in fiscal 2006. System and parts revenue from the products that are marketed to the data storage industry by the Company's ATI segment increased 26% to \$4.0 million in the third quarter of fiscal 2006 compared to \$3.2 million in the third quarter of fiscal 2005. The increase can be attributed primarily to increased demand for the Company's magnetics systems and related parts.

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

	Three months ended January 31,	
	2006	2005
Wafer	66%	80%
Device / OEM	15%	10%
Magnetic Data Storage	19%	10%
Total	100%	100%

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

	Three months ended January 31,	
	2006	2005
United States	26%	13%
Japan	45%	51%
Asia-Pacific	24%	13%
Europe	5%	23%
Total	100%	100%

The geographical distribution of revenues can fluctuate from quarter to quarter due to differences in the timing and rate of capital expenditures by customers among geographical regions.

*Service revenue.* Service revenue increased 4% to \$3.2 million in the third quarter of fiscal 2006 compared to \$3.1 million in the third quarter of fiscal 2005. 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 in revenue is primarily the result of increased service contract revenue during the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005.

*Gross profit - systems and parts.* Gross profit on systems and parts increased to 62% in the third quarter of fiscal 2006 from 56% in the third quarter of fiscal 2005 due primarily to changes in product and geographical sales mix. Gross profit in the SSG segment increased to 64% in the third quarter of fiscal 2006 compared to 54% the third quarter of fiscal 2005 due primarily to changes in product and geographical sales mix. Gross profit in the PST



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**Table of Contents**

segment decreased slightly to 60% in the third quarter of fiscal 2006 compared to 61% in the third quarter of fiscal 2005 due primarily to changes in product and geographical sales mix. Gross profit in the ATI segment increased to 59% in the third quarter of fiscal 2006 compared to 47% in the third quarter of fiscal 2005 due primarily to increased shipments of ATI's magnetic data storage products. Changes in product mix can have a material impact on the Company's gross profit. Therefore, the gross profit in one period may not be indicative of the gross profit in future periods.

*Gross profit - service.* Gross profit from service decreased to 15% in the third quarter of fiscal 2006 compared to 20% in the third quarter of fiscal 2005. The decreased gross profit was primarily the result of an increase in costs related to service calls and increased facility and freight costs for overseas customer service sites compared to the third quarter of fiscal 2005.

*Research and development.* Research and development expense was \$4.1 million in the third quarter of both fiscal 2006 and 2005 and increased as a percentage of revenue to 16% in the third quarter of fiscal 2006 compared to 14% in the third quarter of fiscal 2005. The increase in expense as a percentage of revenue reflects the decrease of the Company's revenue described above. 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.

*Marketing and sales.* Marketing and sales expense for the third quarter of fiscal 2006 increased \$0.2 million, or 8%, to \$2.9 million compared to \$2.7 million in the third quarter of fiscal 2005 and increased to 11% as a percentage of revenue compared to 9% in the third quarter of fiscal 2005. The increase was due primarily to higher external commission expense. In general, sales to Japan are made to distributors who buy the Company's products at a discount and then perform installation and service after reselling the products to the end user. Sales to other parts of the world, including the Asia-Pacific region, are made through internal and external sales representatives who are compensated by means of commissions, which are recorded as marketing and sales expense. 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.

*General and administrative.* General and administrative expense increased \$0.3 million, or 14%, to \$2.8 million in the third quarter of fiscal 2006 from \$2.4 million in the third quarter of fiscal 2005 and increased as a percentage of revenue to 10% compared to 8% in the third quarter of fiscal 2005. This expense increased primarily as a result of an increase in incentive compensation and benefits expense.

*Interest income.* Interest income was \$0.7 million in the third quarter of fiscal 2006 compared to interest income of \$0.2 million in the third quarter of fiscal 2005. The increase in interest income was the result of an increase in invested cash balances and increased investment returns during the third quarter of fiscal 2006 compared to the third quarter of fiscal 2005.

*Interest expense.* Interest expense was \$65,000 in the third quarter of fiscal 2006 compared to interest expense of \$70,000 in the third quarter of fiscal 2005. The decrease in interest expense was primarily due to a decrease in the principal balance of the Company's 1999 Industrial Development Bond for its Tucson, Arizona facility.

*Income taxes.* The provision for income taxes was \$1.1 million in the third quarter of fiscal 2006 compared to a provision for income taxes of \$0.1 million in the third quarter of fiscal 2005. The increase of \$1.0 million was due primarily to increased federal income tax expense. In the fourth quarter of fiscal 2005, the Company reversed \$17.2 million of its deferred tax asset valuation allowance and began to recognize a higher effective tax rate starting in the first quarter of fiscal 2006. The Company's effective tax rate in the third quarter of fiscal 2006 was 18% compared to 2% in the third quarter of fiscal 2005. The Company's effective tax rate for the third quarter of fiscal 2006 includes a tax benefit related to the deduction for the Extraterritorial Income exclusion that the Company elected to claim on its 2005 federal tax return after completing a benefit analysis in the current quarter. The provision for income taxes in the third quarter of fiscal 2005 consisted only of federal and state alternative minimum taxes and foreign income taxes because at that time, the Company had a full valuation allowance against its deferred tax assets. The 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.

**Table of Contents****Nine Months Ended January 31, 2006 compared to Nine Months Ended January 31, 2005**

*Systems and parts revenue.* Systems and parts revenue decreased 16% to \$65.6 million in the nine months ended January 31, 2006 from \$77.7 million in the year earlier period. Systems and parts revenue in the SSG segment decreased 36% to \$29.2 million in the nine months ended January 31, 2006 compared to \$46.0 million in the year earlier period. The decrease in revenues from the SSG segment reflects both decreased orders for capacitance-based flatness tools in favor of the Company's newer optical-based flatness tools, which are sold by the Company's PST segment, and decreased demand for the Company's Advanced Wafer Inspection System as the Company's latest-generation nano-particle inspection and defect classification tool, the WaferXam, is expected to begin generating revenue in late fiscal 2006. System and parts revenue in the PST segment increased 13% to \$26.7 million in the nine months ended January 31, 2006 compared to \$23.6 million in the year earlier period. The increase in revenue from the PST segment was due primarily to increased demand for its optical-based flatness tools. System and parts revenue from the products that are marketed to the data storage industry by the Company's ATI segment increased 21% to \$10.7 million in the nine months ended January 31, 2006 compared to \$8.8 million in the year earlier period. The increase can be attributed primarily to increased demand for the Company's magnetics systems and related parts.

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

	<b>Nine months ended January 31,</b>	
	<b>2006</b>	<b>2005</b>
Wafer	64%	81%
Device / OEM	18%	9%
Magnetic Data Storage	18%	10%
Total	100%	100%

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

	<b>Nine months ended January 31,</b>	
	<b>2006</b>	<b>2005</b>
United States	22%	17%
Japan	39%	47%
Asia	30%	20%
Europe	9%	16%
Total	100%	100%

*Service revenue.* Service revenue decreased 9% to \$8.6 million in the nine months ended January 31, 2006 compared to \$9.4 million in the year earlier period. The decrease in revenue is primarily the result of fewer service calls in the nine months ended January 31, 2006 compared to year earlier period.

*Gross profit - systems and parts.* Gross profit on systems and parts increased to 62% in the nine months ended January 31, 2006 from 57% in the year earlier period. Gross profit in the SSG segment increased to 60% in the nine months ended January 31, 2006 from 58% in the year earlier period due primarily to changes in product and geographical sales mix. Gross profit in the PST segment increased to 63% in the nine months ended January 31, 2006 from 58% in the year earlier period due primarily to changes in geographical sales mix. Gross profit in the ATI segment increased to 58% in the nine months ended January 31, 2006 from 43% in the year earlier period due primarily to increased demand for the Company's magnetics systems and related parts.

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**Table of Contents**

*Gross profit – service.* Gross profit from service decreased to 14% in the nine months ended January 31, 2006 compared to 23% in the year earlier period. The decreased gross profit was primarily the result of fewer service calls and an increase in support expenses in the nine months ended January 31, 2006 compared to the year earlier period.

*Research and development.* Research and development expense increased \$0.3 million, or 3%, to \$11.7 million in the nine months ended January 31, 2006 compared to \$11.4 million in the year earlier period, and increased as a percentage of revenue to 16% in the nine months ended January 31, 2006 compared to 13% in the year earlier period. The increase was due primarily to a \$0.3 million increase in equipment expense associated with the Company's Westwood Applications Lab.

*Marketing and sales.* Marketing and sales expense increased \$0.4 million, or 4%, to \$9.4 million in the nine months ended January 31, 2006 from \$9.0 million in the year earlier period and increased as a percentage of revenue to 13% in the nine months ended January 31, 2006 compared to 10% in the year earlier period. Expense increased primarily as a result of higher commission expense during the nine months ended January 31, 2006.

*General and administrative.* General and administrative expense was \$7.9 million in both the nine months ended January 31, 2006 and 2005, but increased as a percentage of revenue to 11% in the nine months ended January 31, 2006 from 9% in the year earlier period. The increase in expense as a percentage of revenue reflects the decreased revenue mentioned above.

*Interest income.* Interest income was \$1.8 million in the nine months ended January 31, 2006 compared to interest income of \$0.4 million in the year earlier period. The increase in interest income was the result of an increase in invested cash balances and increased investment returns during the nine months ended January 31, 2006.

*Interest expense.* Interest expense was \$185,000 in the nine months ended January 31, 2006 compared to interest expense of \$203,000 in the year earlier period. The decrease in interest expense was primarily due to a decrease in the principal balance of the Company's 1999 Industrial Development Bond for its Tucson, Arizona facility.

*Income taxes.* The provision for income taxes was \$3.8 million in the nine months ended January 31, 2006 compared to a provision for income taxes of \$0.4 million in the year earlier period. The increase of \$3.4 million was due primarily to increased federal income tax expense. In the fourth quarter of fiscal 2005, the Company reversed \$17.2 million of its deferred tax asset valuation allowance and began to recognize a higher effective tax rate starting in the first quarter of fiscal 2006. The Company's effective tax rate in the nine months ended January 31, 2006 was 27% compared to 2% in year earlier period. The effective tax rate for the nine months ended January 31, 2006 includes a tax benefit of \$980,000 related to the deduction for the Extraterritorial Income exclusion that the Company elected to claim on its 2005 federal tax return after completing a benefit analysis in the current quarter. The provision for income taxes in the nine months ended January 31, 2005 consisted only of federal and state alternative minimum taxes and foreign income taxes because, at that time, the Company had a full valuation allowance against its deferred tax assets. The 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.

## **Table of Contents**

### **Liquidity and Capital Resources**

At January 31, 2006, the Company had \$87.2 million in cash and cash equivalents and \$134.9 million in working capital.

Cash provided by operating activities for the nine months ended January 31, 2006 was \$12.0 million. This amount resulted from net income of \$10.5 million adjusted for non-cash charges of \$4.8 million and a \$3.4 million net increase in working capital accounts. Non-cash items consisted primarily of \$1.5 million of depreciation and amortization and a \$3.0 million decrease in deferred income taxes.

Working capital items consisted primarily of decreases in prepaid expenses and other current assets of \$0.3 million and accrued expenses and other current liabilities of \$0.6 million combined with increases in accounts receivable of \$0.8 million, inventory of \$4.0 million and accounts payable of \$1.7 million. The decrease in prepaid expenses and other current assets was due to the timing of payments to vendors. The decrease in accrued expenses and other current liabilities was primarily due to a decrease in deferred revenue of \$0.5 million. The increase in accounts receivable was due to an increase in shipments during the third quarter of fiscal 2006. The increase in inventory was due to the timing of shipments. The increase in accounts payable was primarily due to the timing of payments to vendors.

Cash used in investing activities for the nine months ended January 31, 2006 consisted of \$0.5 million in purchases of fixed assets. During the nine months ended January 31, 2006, fixed assets of \$53,000 were transferred to inventory.

Cash provided by financing activities for the nine months ended January 31, 2006 was \$2.9 million, which consisted of \$3.0 million of aggregate proceeds from the issuance of common stock upon the exercise of stock options and common 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.

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 Company does not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance, variable interest 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 January 31, 2006. 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.

**Table of Contents**

	Payments due by period (in thousands)				Total
	Less than			More than	
	1 year	1-3 years	3-5 years	5 years	
Long term debt obligations	\$ 372	\$ 744	\$ 2,916	\$	\$ 4,032
Operating lease obligations	2,075	3,446	2,883	9,367	17,771
Purchase obligations	8,545	89			8,634
Total	\$ 10,992	\$ 4,279	\$ 5,799	\$ 9,367	\$ 30,437

The Company expects to meet its anticipated working capital needs, debt requirements and capital expenditures for the foreseeable future primarily through available cash and cash equivalents, which will primarily be generated from sales to both existing and new customers. However, the Company is subject to the risks and trends described below and 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 appears to have emerged from the most recent down cycle, it is not clear whether this recovery is still continuing for semiconductor wafer manufacturers, who have historically accounted for approximately 70% to 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 expansion, but the outlook for sustained long-term growth in this industry is also uncertain. At January 31, 2006, the Company's backlog was \$41.8 million. The Company remains uncertain about how long current revenue levels can be sustained and whether the current quarter increase in revenue can be sustained in future quarters. 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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**Table of Contents**

**New Accounting Pronouncements**

In November 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 151, Inventory Costs ( SFAS 151 ). 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.

In December 2004, the FASB issued SFAS 123R. SFAS 123R requires that the cost resulting from all share-based payment transactions be measured using a fair-value method and be recognized in the financial statements. SFAS 123R is effective as of the beginning of the first interim or annual reporting period of the first fiscal year that begins on or after June 15, 2005. SFAS 123R is effective for the Company's first quarter of fiscal 2007 beginning May 1, 2006. SFAS 123R permits public companies to adopt its requirements using one of two methods:

1. A modified prospective method in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123R for all share-based payments granted after the effective date and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123R that remain unvested on the effective date.
2. A modified retrospective method which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures for either (a) all prior periods presented or (b) prior interim periods of the year of adoption.

The Company has not yet determined whether it will adopt SFAS 123R using the modified prospective method or the modified retrospective method. Management is currently evaluating the impact that the adoption of SFAS 123R will have on the Company's financial position and results of operations.

**Table of Contents**

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

At January 31, 2006, 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 primarily in money market funds and commercial paper investments. 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 investee. 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.**

**Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures**

Under the supervision and with the participation of the Company's management, including its principal executive officer and principal financial officer, the Company conducted an evaluation of its disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report.

**Changes to Internal Control Over Financial Reporting**

There have been no changes to the Company's internal control over financial reporting during the third quarter of fiscal 2006 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents**

**PART II.**

**OTHER INFORMATION**

**Item 6. Exhibits.**

**Exhibit**

<b>Number</b>	<b>Description</b>
2.1	Agreement and Plan of Merger, dated as of February 22, 2006, by and among KLA-Tencor Corporation, South Acquisition Corporation and ADE Corporation (incorporated by reference from Exhibit 2.1 to the Company's Current Report on Form 8-K dated February 23, 2006).
10.1	Amendment No. 1 to Executive Employment Agreement, dated as of February 15, 2006, by and between ADE Corporation and Dr. Chris L. Koliopoulos (filed herewith).
10.2	Amendment No. 2 to Employment and Non-Competition Agreement, dated as of February 15, 2006, by and between ADE Corporation and Mr. Brian James (filed herewith).
10.3	Employment and Non-Competition Agreement, dated as of February 22, 2006, by and between ADE Corporation and David F. Basila (incorporated by reference from Exhibit 10.1 to the Company's Current Report on Form 8-K dated February 23, 2006).
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 (filed herewith).
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 (filed herewith).
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 (furnished herewith).
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 (furnished herewith).

**Table of Contents**

**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: March 13, 2006

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

Date: March 13, 2006

/s/ Brian C. James  
Brian C. James  
Executive Vice President and Chief Financial Officer