

ADE CORP  
Form 10-Q  
September 11, 2006  
Table of Contents

---

**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: July 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

---

**ADE CORPORATION**

(Exact Name of Registrant as Specified in its Charter)

---

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.)

Edgar Filing: ADE CORP - Form 10-Q

(Registrant's Telephone Number, Including Area Code)

---

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

14,553,320 shares  
Outstanding at September 5, 2006

---

---

**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- July 31, 2006 and April 30, 2006</u>                                  | 3           |
| <u>Consolidated Statement of Operations- Three Months Ended July 31, 2006 and 2005</u>               | 4           |
| <u>Consolidated Statement of Cash Flows Three Months Ended July 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> | 16          |
| 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 4. <u>Submission of Matters to a Vote of Security Holders</u>                                   | 27          |
| Item 6. <u>Exhibits</u>  | 27          |
| <u>Signatures</u>  | 28          |

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

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

|   | July 31,<br>2006  | April 30,<br>2006 |
|---|-------------------|-------------------|
| <b>Assets</b>   |                   |                   |
| Current assets:   |                   |                   |
| Cash and cash equivalents   | \$ 99,943         | \$ 91,573         |
| Marketable securities   | 23                |                   |
| Accounts receivable, net  | 19,231            | 23,164            |
| Inventories   | 35,935            | 35,855            |
| Prepaid expenses and other current assets   | 1,301             | 1,701             |
| Deferred income taxes   | 9,153             | 9,311             |
| <b>Total current assets</b>   | <b>165,586</b>    | <b>161,604</b>    |
| Fixed assets, net   | 8,642             | 8,946             |
| Deferred income taxes   | 4,742             | 4,742             |
| Investments   | 499               | 499               |
| Intangible assets, net  | 165               | 244               |
| Goodwill  | 1,318             | 1,318             |
| Other assets  | 101               | 109               |
| <b>Total assets</b>   | <b>\$ 181,053</b> | <b>\$ 177,462</b> |
| <b>Liabilities and stockholders equity</b>  |                   |                   |
| Current liabilities:  |                   |                   |
| Current portion of long-term debt   | \$ 190            | \$ 187            |
| Accounts payable  | 6,528             | 9,021             |
| Accrued expenses and other current liabilities  | 14,415            | 13,510            |
| <b>Total current liabilities</b>  | <b>21,133</b>     | <b>22,718</b>     |
| Deferred gain on sale-leaseback   | 1,355             | 1,383             |
| Long-term debt, net of current portion  | 3,195             | 3,244             |
| <b>Total liabilities</b>  | <b>25,683</b>     | <b>27,345</b>     |
| Commitments and contingencies (Note 10)   |                   |                   |
| <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: 14,549,835 and 14,493,401 issued and outstanding at July 31, 2006 and April 30, 2006, respectively | 145               | 145               |
| Capital in excess of par value  | 116,243           | 114,962           |
| Retained earnings   | 39,048            | 35,127            |
| Accumulated other comprehensive income  | (66)              | (117)             |

Edgar Filing: ADE CORP - Form 10-Q

|  |            |            |
|--|------------|------------|
| Total stockholders' equity                 | 155,370    | 150,117    |
| Total liabilities and stockholders' equity | \$ 181,053 | \$ 177,462 |

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)

|   | Three months   |           |
|---|----------------|-----------|
|   | ended July 31, |           |
|   | 2006           | 2005      |
| Net Revenue:                                  |                |           |
| Systems and parts                             | \$ 26,404      | \$ 21,721 |
| Service                                       | 3,330          | 2,591     |
| Total revenue                                 | 29,734         | 24,312    |
| Cost of revenue:                              |                |           |
| Systems and parts                             | 10,644         | 8,358     |
| Service                                       | 2,808          | 2,345     |
| Total cost of revenue                         | 13,452         | 10,703    |
| Gross profit                                  | 16,282         | 13,609    |
| Operating expenses:                           |                |           |
| Research and development                      | 4,130          | 3,812     |
| Marketing and sales                           | 3,469          | 3,509     |
| General and administrative                    | 3,533          | 2,758     |
| Total operating expenses                      | 11,132         | 10,079    |
| Income from operations                        | 5,150          | 3,530     |
| Interest income                               | 994            | 482       |
| Interest expense                              | (58)           | (49)      |
| Other income                                  | 59             | 53        |
| Income before provision for income taxes      | 6,145          | 4,016     |
| Provision for income taxes                    | 2,224          | 1,131     |
| Net income                                    | \$ 3,921       | \$ 2,885  |
| Basic earnings per share                      | \$ 0.27        | \$ 0.20   |
| Diluted earnings per share                    | \$ 0.27        | \$ 0.20   |
| Weighted average shares outstanding - basic   | 14,519         | 14,318    |
| Weighted average shares outstanding - diluted | 14,777         | 14,611    |

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)

|   | Three months     |                  |
|---|------------------|------------------|
|   | ended July 31,   |                  |
|   | 2006             | 2005             |
| <b>Cash flows from operating activities:</b>                                      |                  |                  |
| Net income  | \$ 3,921         | \$ 2,885         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Depreciation and amortization   | 537              | 459              |
| Deferred income taxes   | 158              | 1,012            |
| Stock-based compensation related to stock options and employee stock purchases    | 300              | 5                |
| Amortization of gain from sale-leaseback  | (28)             | (28)             |
| Changes in assets and liabilities:  |                  |                  |
| Accounts receivable   | 3,933            | 357              |
| Inventories   | (80)             | (944)            |
| Prepaid expenses and other current assets   | 400              | (148)            |
| Other assets  | 8                | (9)              |
| Accounts payable  | (2,493)          | (397)            |
| Accrued expenses and other current liabilities                                    | 905              | 672              |
| <b>Net cash provided by operating activities</b>                                  | <b>7,561</b>     | <b>3,864</b>     |
| <b>Cash flows from investing activities:</b>                                      |                  |                  |
| Purchases of fixed assets   | (154)            | (256)            |
| <b>Net cash used in investing activities</b>                                      | <b>(154)</b>     | <b>(256)</b>     |
| <b>Cash flows from financing activities:</b>                                      |                  |                  |
| Repayment of long-term debt   | (46)             | (43)             |
| Proceeds from issuance of common stock  | 981              | 1,753            |
| <b>Net cash provided by financing activities</b>                                  | <b>935</b>       | <b>1,710</b>     |
| <b>Effect of exchange rate changes on cash and cash equivalents</b>               | <b>28</b>        | <b>(12)</b>      |
| <b>Net increase in cash and cash equivalents</b>                                  | <b>8,370</b>     | <b>5,306</b>     |
| <b>Cash and cash equivalents, beginning of period</b>                             | <b>91,573</b>    | <b>72,841</b>    |
| <b>Cash and cash equivalents, end of period</b>                                   | <b>\$ 99,943</b> | <b>\$ 78,147</b> |

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, 2006. 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, the valuation allowance on deferred tax assets and stock-based compensation. Actual results could differ from those estimates.

**2. Comprehensive Income**

Comprehensive income was as follows:

|  | (in thousands)                         |                  |
|--|--|------------------|
|  | Three months ended<br>July 31,<br>2006 | July 31,<br>2005 |
|  | (unaudited)                            |                  |
| Net income   | \$ 3,921                               | \$ 2,885         |
| Other comprehensive income (loss):                   |  |                  |
| Unrealized gain on marketable securities, net of tax | 21                                     | 13               |
| Currency translation adjustments                     | 29                                     | (12)             |
| Other comprehensive income                           | 50                                     | 1                |
| Comprehensive income                                 | \$ 3,971                               | \$ 2,886         |



**Table of Contents**

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

**3. Inventories**

Inventories consist of the following:

|                                   | (in thousands)   |                   |
|-----------------------------------|------------------|-------------------|
|                                   | July 31,<br>2006 | April 30,<br>2006 |
|                                   | (unaudited)      |                   |
| Raw materials and purchased parts | \$ 16,978        | \$ 18,584         |
| Work-in-process                   | 17,091           | 15,564            |
| Finished goods                    | 1,866            | 1,707             |
|                                   | \$ 35,935        | \$ 35,855         |

**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)   |                   |
|--------------------------|------------------|-------------------|
|                          | July 31,<br>2006 | April 30,<br>2006 |
|                          | (unaudited)      |                   |
| License fees at cost     | \$ 1,400         | \$ 1,400          |
| Accumulated amortization | (1,235)          | (1,156)           |
| Net carrying value       | \$ 165           | \$ 244            |

Amortization expense was \$79,000 and \$51,000 for the three months ended July 31, 2006 and 2005, respectively. Estimated annual amortization is \$216,000 and \$28,000 for the fiscal years ending April 30, 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)   |                   |
|--|------------------|-------------------|
|  | July 31,<br>2006 | April 30,<br>2006 |
|  | (unaudited)      |                   |
| Accrued salaries, wages, vacation pay and incentive compensation | \$ 2,993         | \$ 3,803          |
| Accrued commissions  | 2,375            | 2,409             |
| Accrued warranty costs   | 1,201            | 1,151             |
| Deferred revenue   | 1,903            | 2,289             |
| Accrued income taxes   | 3,346            | 1,400             |
| Other  | 2,597            | 2,458             |
|  | \$ 14,415        | \$ 13,510         |

**6. Stock-Based Compensation**

Effective May 1, 2006, the Company adopted Financial Accounting Standards No. 123 ( SFAS ) (revised 2004), Share-Based Payment ( SFAS 123R ), which revises the accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured as of the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. The Company previously applied Accounting Principles Board ( APB ) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations and provided the required pro forma disclosures of SFAS No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ).

*Stock Option Plans*

In August 1995, the Company adopted the 1995 Stock Option Plan (the 1995 Plan ). The 1995 Plan provides for the issuance to employees of stock options or stock awards to purchase 400,000 shares of common stock. In October 1997, the Company adopted the 1997 Employee Stock Option Plan (the 1997 Plan ). The 1997 Plan provides for the issuance to employees of stock options or stock awards to purchase 500,000 shares plus the number of shares reserved under the 1995 Plan that have not been issued or have been issued and subsequently cancelled.

Options are granted under the 1995 and 1997 Plans as either incentive stock options or non-qualified stock options and at exercise prices not less than the fair value of the stock on the date of grant or less than 110% of the fair value in the case of optionees holding more than 10% of the total combined voting power of all classes of stock of the Company. The terms of the options generally may not exceed ten years or five years in the case of optionees holding more than 10% of the total combined voting power of all classes of stock of the Company. The options are exercisable over periods determined by the compensation committee of the Board of Directors, generally at the rate of 20% per year, on a cumulative basis, beginning with the first anniversary of the date of grant.

*Pro Forma Information for Periods Prior to the Adoption of SFAS 123R*

## Edgar Filing: ADE CORP - Form 10-Q

Prior to the adoption of SFAS 123R, the Company provided the disclosures required under SFAS 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosures.

The pro forma information for the three months ended July 31, 2005 was as follows:

|  | <b>(In thousands, except<br/>per share data)<br/>Three months<br/>ended<br/>July 31, 2005<br/>(unaudited)</b> |
|--|---|
| Net income, as reported  | \$ 2,885  |
| Add back: Stock-based compensation included in net income, as reported   | 5   |
| Deduct: Total stock-based employee compensation expense determined under fair value based method, net of related taxes | 258   |
| <br>Pro forma net income   | <br>\$ 2,632  |
| <br>Net earnings per share:  |   |
| Basic - as reported  | \$ 0.20   |
| Basic - pro forma  | \$ 0.18   |
| Diluted - as reported  | \$ 0.20   |
| Diluted - pro forma  | \$ 0.18   |

Table of Contents

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

*Impact of the adoption of SFAS 123R*

The Company elected to adopt the modified prospective application method as provided by SFAS 123R. Accordingly, during the three months ended July 31, 2006, the Company recorded stock-based compensation cost totaling the amount that would have been recognized had the fair value method been applied since the effective date of SFAS 123R. Previously reported amounts have not been revised. The effect of recording stock-based compensation for the three months ended July 31, 2006 was as follows:

|   | (in thousands)<br>Three<br>months<br>ended<br><br>July 31, 2006<br>(unaudited) |
|---|--|
| Stock-based compensation expense by type of award:                        |  |
| Employee stock options  | \$ 235   |
| Employee stock purchase plan  | 65   |
| Total stock-based compensation  | 300  |
| Tax effect on stock-based compensation included in income from operations | (108)  |
| Net effect on net income  | \$ 192   |
| Tax effect on:  |  |
| Cash flows from operations  | 108  |
| Effect on earnings per share:   |  |
| Basic   | \$ 0.01  |
| Diluted   | \$ 0.02  |

The effect of recording stock-based compensation by consolidated statement of operations line item for the three months ended July 31, 2006 was as follows:

|                            | (in thousands)<br>Three<br>months<br>ended<br><br>July 31, 2006<br>(unaudited) |
|----------------------------|--|
| Cost of revenue            | \$ 46  |
| Research and development   | 69   |
| Marketing and sales        | 71   |
| General and administrative | 114  |

|                            |        |
|----------------------------|--------|
| Total compensation expense | \$ 300 |
|----------------------------|--------|

*Valuation Assumptions*

In connection with the adoption of SFAS 123R, the Company reassessed its valuation technique and related assumptions. The Company estimates the fair value of stock options using the Black-Scholes valuation model, consistent with the provisions of SFAS 123, SEC Staff Accounting Bulletin No. 107 and the Company's prior period pro forma disclosures of net earnings, including stock-based compensation (determined under a fair value method as prescribed by SFAS 123). The fair value of each option grant is estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach with the following weighted-average assumptions:

|                                     | <b>Three months ended</b> |             |
|-------------------------------------|---------------------------|-------------|
|                                     | <b>July 31,</b>           |             |
|                                     | <b>2006</b>               | <b>2005</b> |
| <b>Stock option plan:</b>           |                           |             |
| Expected stock price volatility     | 56%                       | 60%         |
| Risk free interest rate             | 4.74%                     | 4.17%       |
| Expected life of options (in years) | 5                         | 6.5         |
| <b>Stock purchase plan:</b>         |                           |             |
| Expected stock price volatility     | 56%                       | 60%         |
| Risk free interest rate             | 4.74%                     | 4.17%       |
| Expected life of options (in years) | 0.25                      | 0.25        |

**Table of Contents**

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

*Valuation and Amortization Method.* We estimate the fair value of stock options granted before and after the adoption of SFAS 123R using the Black-Scholes option valuation model. We estimate the fair value using a single option approach and amortize the fair value on a straight-line basis for options expected to vest. All options are amortized over the requisite service period of the awards, which are generally the vesting periods.

*Expected Term.* The expected term of options granted represents the period of time that they are expected to be outstanding. We estimate the expected term of options granted based on our historical experience of grants, exercises and post-vesting cancellations in our option database. Contractual term expirations have not been significant.

*Expected Volatility.* We estimate the volatility of our stock at the date of grant using historical volatility. Historical volatility is calculated based on the historical prices of our common stock over a period at least equal to the expected term of our option grants.

*Risk Free Interest Rate.* The risk free interest rate that we use in the Black-Scholes option valuation model is the implied yield in effect at the time of option grant based on U.S. Treasury Notes with remaining terms equivalent to the expected term of our option grants.

*Dividends.* We have never paid any cash dividends on our common stock and we do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model.

*Forfeitures.* We use historical data to estimate pre-vesting option forfeitures. As required by SFAS 123R, we record stock-based compensation expense only for those awards that are expected to vest. For the three months ended July 31, 2006, our estimated annual weighted average forfeiture rate was 9.5%.

The weighted average fair value of options granted during the three months ended July 31, 2006 and 2005 was \$19.94 and \$12.90, respectively.

*Stock-based Payment Award Activity*

Stock option activity is summarized as follows:

|                                       | Shares   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in<br>Years) | Aggregate<br>Intrinsic<br>Value |
|---------------------------------------|----------|--|---|---------------------------------|
| Options outstanding at April 30, 2006 | 680,409  | \$ 15.59                                 |   |                                 |
| Granted                               | 11,000   | 32.09                                    |   |                                 |
| Exercised                             | (51,990) | 16.60                                    |   |                                 |
| Cancelled                             | (4,600)  | 14.64                                    |   |                                 |
| Options outstanding at July 31, 2006  | 634,819  | \$ 15.80                                 | 6.5   | \$ 10,395                       |
| Exercisable at July, 31, 2006         | 380,291  | \$ 13.64                                 | 5.4   | \$ 7,049                        |

## Edgar Filing: ADE CORP - Form 10-Q

The aggregate intrinsic value of options outstanding at July 31, 2006 is calculated as the difference between the exercise price of the underlying options and the market price of our common stock for the 634,819 shares that had exercise prices that were lower than the market price of our common stock as of July 31, 2006. The intrinsic value of options exercised during the three months ended July 31, 2006 was \$0.8 million, determined as of the date of exercise. The total cash received from employees as a result of stock option exercises during the three months ended July 31, 2006 was \$0.8 million. The Company settles employee stock option exercises with newly issued common stock.

As of July 31, 2006, there was \$2.4 million of total unrecognized compensation cost related to unvested stock options, which is expected to be recognized over a weighted-average period of 3.4 years.

### *Employee Stock Purchase Plan*

The Company's Employee Stock Purchase Plan (the Purchase Plan) provides eligible employees the opportunity to purchase common shares, on a quarterly basis, at 85% of the fair market value of the shares on either the first or last day of the applicable calendar quarter, whichever is lower. The compensation cost in connection with the Purchase Plan for the three months ended July 31, 2006 was approximately \$66,000. The total cash received from employees for the issuance of shares under the Purchase Plan was approximately \$174,000 during the three months ended July 31, 2006. At July 31, 2006, a total of 562,047 shares were reserved and available for issuance under the Purchase Plan.

**Table of Contents**

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

**7. Merger with KLA-Tencor Corporation**

On February 22, 2006, the Company entered into a definitive Agreement and Plan of Merger (the "Merger Agreement") with KLA-Tencor Corporation ("KLA-Tencor") and South Acquisition Corporation, a wholly owned subsidiary of KLA-Tencor ("South"). Pursuant to the Merger Agreement, each share of the Company's common stock was to be exchanged for 0.64 shares of KLA-Tencor common stock on a fixed basis.

On May 26, 2006, the Company entered into a definitive Amended and Restated Agreement and Plan of Merger (the "Amended Merger Agreement") with KLA-Tencor and South. The Amended Merger Agreement amended and restated the Merger Agreement, and changed the consideration payable to the Company's stockholders from 0.64 shares of KLA-Tencor common stock to \$32.50 in cash per share of the Company's common stock.

The Amended Merger Agreement provides that, among other things, upon the terms and subject to the conditions set forth in the Amended Merger Agreement, South will merge with and into the Company, with the Company continuing as the surviving corporation and a wholly owned subsidiary of KLA-Tencor (the "Merger"). The Company's stockholders approved the Merger on July 13, 2006. Consummation of the Merger is subject to customary closing conditions, including the approval of German antitrust authorities.

On July 10, 2006, German antitrust authorities notified KLA-Tencor of the commencement of a Phase II investigation of the proposed Merger. On August 23, 2006, the Company extended from August 28, 2006 to November 10, 2006 the "end date" under the Amended Merger Agreement to allow KLA-Tencor additional time to obtain regulatory clearance from the German antitrust authorities.

**8. 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, which includes consideration of stock-based compensation required by SFAS 123R. Potential dilutive common shares include shares issuable upon the assumed exercise of dilutive stock options. For the three months ended July 31, 2006 and 2005, respectively, 75,064 and 24,250 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 |        |
|   | July 31,           |        |
|   | 2006               | 2005   |
|   | (unaudited)        |        |
| Shares used in computation:   |                    |        |
| Weighted average common stock outstanding used in computation of basic earnings per share | 14,519             | 14,318 |
| Dilutive effect of stock options outstanding  | 258                | 293    |



Shares used in computation of diluted earnings per share

14,777 14,611

**Table of Contents****ADE CORPORATION****NOTES TO UNAUDITED CONSOLIDATED****FINANCIAL STATEMENTS****(unaudited)****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 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.

|  | (in thousands, unaudited) |           |          |           |
|--|---------------------------|-----------|----------|-----------|
|  | SSG                       | PST       | ATI      | Total     |
| <b>For the quarter ended July 31, 2006</b> |                           |           |          |           |
| Revenue from external customers            | \$ 15,182                 | \$ 11,218 | \$ 3,334 | \$ 29,734 |
| Intersegment revenue                       | 11                        | 211       | 241      | 463       |
| Income from operations                     | 1,078                     | 3,310     | 787      | 5,175     |
| Depreciation and amortization expense      | 395                       | 123       | 19       | 537       |
| Capital expenditures                       | 53                        | 61        | 40       | 154       |
| <b>For the quarter ended July 31, 2005</b> |                           |           |          |           |
| Revenue from external customers            | \$ 11,005                 | \$ 10,244 | \$ 3,063 | \$ 24,312 |
| Intersegment revenue                       |                           | 83        | 296      | 379       |
| Income from operations                     | (820)                     | 3,678     | 675      | 3,533     |
| Depreciation and amortization expense      | 353                       | 100       | 6        | 459       |
| Capital expenditures                       | 183                       | 118       |          | 301       |

**Table of Contents**

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

**9. 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<br/>ended July 31,<br/>2006      2005<br/>(unaudited)</b> |                 |
|--|---|-----------------|
| Total operating income for reportable segments       | \$ 5,175  | \$ 3,533        |
| Net impact of intercompany gross profit eliminations | (25)  | (3)             |
| <b>Total consolidated operating income</b>           | <b>\$ 5,150</b>   | <b>\$ 3,530</b> |

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

On June 7, 2006, Dean Drulias, a purported stockholder of the Company, filed a complaint in Massachusetts Superior Court, Norfolk County, against the Company, each of the Company's directors, KLA-Tencor and South entitled Dean Drulias v. ADE Corporation, et al. (Civil Action No. 06-00963). The complaint alleged, among other things, that, in connection with the Merger, the directors of the Company breached their fiduciary duties, the Company's preliminary proxy statement related to the Merger contained inaccurate statements of material facts and omitted material facts, and KLA-Tencor aided and abetted the Company's directors in their alleged breaches of fiduciary duties. Among other things, the complaint sought a determination that the class action status was proper, an injunction preventing the Merger or, if the Merger were consummated, a rescission of the Merger, and the payment of compensatory damages and other fees and costs. The defendants removed the action to federal court (United States District Court for the District of Massachusetts). On June 14, 2006, the Company filed a definitive proxy statement with the SEC and mailed it to all of the Company's stockholders of record as of the close of business on May 30, 2006; and, on June 27, 2006, plaintiff filed an amended complaint that alleged, among other things, that, in connection with the Merger, the directors of the Company breached their fiduciary duties, the Company's definitive proxy statement related to the Merger contained inaccurate statements of material facts and omitted material facts and KLA-Tencor aided and abetted the Company's directors in their alleged breaches of fiduciary duties. Among other things, the amended complaint sought a determination that the class action status was proper, an injunction preventing the Merger unless certain disclosures were made in advance of the Merger, and the payment of compensatory damages and other fees and costs. Plaintiff has not identified or alleged an amount of damages that are sought in the action. On June 30, 2006, plaintiff filed a motion for a preliminary injunction and a hearing on the motion took place on July 6, 2006. On July 7, 2006, a supplement to the definitive proxy statement was mailed to all of the Company's stockholders of record as of the close of business on May 30, 2006, and the Court was notified that defendants and plaintiff were in settlement discussions. On July 11, 2006, the Court dismissed the action as settled and without prejudice. The parties continued their settlement discussions; and, on July 19, 2006, entered into a Memorandum of Understanding (the "MOU") agreeing in principle to settle all claims brought on behalf of the putative class. However, effectuation of the settlement embodied in the MOU is contingent on, among other things, the Court's review and final approval of the settlement, and entry of a final order and judgment. Therefore, on July 28, 2006, the parties requested that the Court reopen the action. On August 2, 2006, the Court re-opened the action. Although the ultimate outcome of this matter cannot yet be predicted definitively, and litigation poses a risk of uncertainty, the Company believes that the likelihood of a settlement, as embodied in the MOU, is high. However, the Company also believes that the claims in the original and amended complaints are without merit and it and the other defendants intend to vigorously defend the lawsuit if necessary.

From time to time, the Company is subject to other 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.

**Table of Contents**

**ADE CORPORATION**  
**NOTES TO UNAUDITED CONSOLIDATED**  
**FINANCIAL STATEMENTS**  
**(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 July 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 July 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 three months ended July 31, 2006 and 2005.

|                                     | (in thousands)              |          |
|-------------------------------------|-----------------------------|----------|
|                                     | Three months ended July 31, |          |
|                                     | 2006                        | 2005     |
|                                     | (unaudited)                 |          |
| Accrued warranty, beginning balance | \$ 1,151                    | \$ 1,482 |
| Accruals for warranties issued      | 528                         | 263      |
| Warranty settlements made           | (478)                       | (455)    |
| Accrued warranty, ending balance    | \$ 1,201                    | \$ 1,290 |

**11. New Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is currently analyzing the impact that the adoption of FIN 48 will have on the Company's financial position and results of operations.

**Table of Contents**

**ADE CORPORATION**

**NOTES TO UNAUDITED CONSOLIDATED**

**FINANCIAL STATEMENTS**

**(unaudited)**

**12. Income Taxes**

For the three months ended July 31, 2006, the Company earned income before taxes of \$6.1 million and recorded a tax provision of \$2.2 million. The Company's effective tax rate in the first quarter of fiscal 2007 was approximately 36.2% compared to approximately 28% in the first quarter of fiscal 2006. The increase in the Company's effective tax rate in the first quarter of fiscal 2007 is primarily due to the expiration of the Extraterritorial Income tax exclusion regime that the Company will claim on its 2006 federal tax return.

---

**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. Early 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 quarterly revenues in the first half of fiscal 2006. However, the Company has experienced sequential increases in bookings since the second quarter of fiscal 2006. This fact, combined with increased quoting activity, suggests that the semiconductor industry may be experiencing a period of expansion. However, due to limited industry visibility, the Company cannot determine if this current increase in order activity will continue and if so, for how long. 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, 2006.

**Merger with KLA-Tencor Corporation**

On February 22, 2006, the Company entered into a definitive Merger Agreement with KLA-Tencor and South. Pursuant to the Merger Agreement, each share of the Company's common stock was to be exchanged for 0.64 shares of KLA-Tencor common stock on a fixed basis.

On May 26, 2006, the Company entered into a definitive Amended Merger Agreement with KLA-Tencor and South. The Amended Merger Agreement amended and restated the Merger Agreement, and changed the consideration payable to the Company's stockholders from 0.64 shares of KLA-Tencor common stock to \$32.50 in cash per share of the Company's common stock.

The Amended Merger Agreement provides that, among other things, upon the terms and subject to the conditions set forth in the Amended Merger Agreement, South will merge with and into the Company, with the Company continuing as the surviving corporation and a wholly owned subsidiary of KLA-Tencor. The Company's stockholders approved the Merger on July 13, 2006. Consummation of the Merger is subject to customary closing conditions, including the approval of German antitrust authorities.

On July 10, 2006, German antitrust authorities notified KLA-Tencor of the commencement of a Phase II investigation of the proposed Merger. On August 23, 2006, the Company extended from August 28, 2006 to November 10, 2006 the end date under the Amended Merger Agreement to allow KLA-Tencor additional time to obtain regulatory clearance from the German antitrust authorities.

**Table of Contents****Stock-Based Compensation**

Effective May 1, 2006, the Company adopted SFAS 123R, which revises the accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured as of the grant date, based on the fair value of the award, and is recognized as an expense over the requisite service period. The Company previously applied APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations and provided the required pro forma disclosures of SFAS 123.

The impact on our results of operations due to SFAS 123R for the three months ended July 31, 2006 was as follows:

|                                   | (in thousands)   |
|-----------------------------------|--|
|                                   | Three<br>months<br>ended<br>July 31, 2006<br>(unaudited) |
| Cost of revenue                   | \$ 46  |
| Research and development          | 69   |
| Marketing and sales               | 71   |
| General and administrative        | 114  |
| <b>Total compensation expense</b> | <b>\$ 300</b>  |

**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 2007, market demand, the expected closing time for the Merger, the Company's limited visibility with respect to its industry's trends, 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, 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 and the potential of rapidly slowing order flow. 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, 2006 and, in particular, the section therein entitled Risk Factors.



---

**Table of Contents**

**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, the valuation of goodwill and software and stock-based compensation 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 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.

## **Table of Contents**

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.

### *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 July 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 \$0.2 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).

---

## **Table of Contents**

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 \$0.2 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 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.

### *Stock-based Compensation*

Beginning on May 1, 2006, the Company began accounting for stock-based compensation under the provisions of SFAS 123R, which requires the recognition of the fair value of stock-based compensation. Under the fair value recognition provisions of SFAS 123R, stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and recognized as expense ratably over the requisite service period of the award. We have used the Black-Scholes valuation model to estimate fair value of our stock-based awards, which requires various judgmental assumptions including estimating stock price volatility, forfeiture rates, and expected life. Our computation of expected volatility is based on historical volatility. In addition, we consider many factors when estimating expected forfeitures and expected life, including types of awards, employee class, and historical experience. If any of the assumptions used in the Black-Scholes model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

### **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 July 31, 2006 compared to Three Months Ended July 31, 2005**

*Systems and parts revenue.* Systems and parts revenue increased 22% to \$26.4 million in the first quarter of fiscal 2007 from \$21.7 million in the first quarter of fiscal 2006. Systems and parts revenue in the SSG segment increased 42% to \$12.6 million in the first quarter of fiscal 2007 compared to \$8.9 million in the first quarter of fiscal 2006. The increase in revenues from the SSG segment reflects increased demand for the Company's Advanced Wafer Inspection System as well as increased demand for some of its capacitance based products. Systems and parts revenue in the PST segment increased 8% to \$10.9 million in the first quarter of fiscal 2007 compared to \$10.0 million in the first quarter of fiscal 2006. The increase in revenue from the PST segment was due to increased demand for the Company's 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 6% to \$3.4 million in the first quarter of fiscal 2007 compared to \$3.2 million in the first quarter of fiscal 2006. 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>Three months ended July 31,</b> |             |
|-----------------------|------------------------------------|-------------|
|                       | <b>2006</b>                        | <b>2005</b> |
| Wafer                 | 76%                                | 55%         |
| Device / OEM          | 9%                                 | 28%         |
| Magnetic Data Storage | 15%                                | 17%         |
| Total                 | 100%                               | 100%        |

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

|               | <b>Three months ended July 31,</b> |             |
|---------------|------------------------------------|-------------|
|               | <b>2006</b>                        | <b>2005</b> |
| United States | 18%                                | 21%         |
| Japan         | 41%                                | 24%         |
| Asia-Pacific  | 30%                                | 38%         |
| Europe        | 11%                                | 17%         |
| 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 29% to \$3.3 million in the first quarter of fiscal 2007 compared to \$2.6 million in the first quarter of fiscal 2006. 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 first quarter of fiscal 2007 compared to the first quarter of fiscal 2006.

*Gross profit - systems and parts.* Gross profit on systems and parts decreased to 60% in the first quarter of fiscal 2007 from 62% in the first quarter of fiscal 2006 due primarily to changes in product and geographical sales mix. Gross profit in the SSG segment increased to 59% in the first quarter of fiscal 2007 compared to 58% in the first quarter of fiscal 2006 due primarily to changes in product and geographical sales mix. Gross profit in the PST segment decreased to 60% in the first quarter of fiscal 2007 compared to 64% in the first quarter of fiscal 2006 due primarily to changes in product and geographical sales mix. Gross profit in the ATI segment was 55% in both the



---

**Table of Contents**

first quarter of fiscal 2007 and the first quarter of fiscal 2006. 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 increased to 16% in the first quarter of fiscal 2007 compared to 9% in the first quarter of fiscal 2006. The increased gross profit was primarily the result of the increase in revenue mentioned above which was not offset by increased costs.

*Research and development.* Research and development expense increased \$0.3 million, or 8%, to \$4.1 million in the first quarter of fiscal 2007 compared to \$3.8 million in the first quarter of fiscal 2006 and decreased as a percentage of revenue to 14% in the first quarter of fiscal 2007 compared to 16% in the first quarter of fiscal 2006. The decrease in expense as a percentage of revenue reflects the increase 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 was \$3.5 million in both the first quarter of fiscal 2007 and the first quarter of fiscal 2006 and decreased to 12% as a percentage of revenue compared to 14% in the first quarter of fiscal 2006. During the first quarter of fiscal 2007, an increase in payroll and related expenses of \$0.2 million was offset by a decrease in commission expense of \$0.2 million. 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 \$0.8 million, or 28%, to \$3.5 million in the first quarter of fiscal 2007 compared to \$2.8 million in the first quarter of fiscal 2006 and increased as a percentage of revenue to 12% compared to 11% in the first quarter of fiscal 2006. This expense increased primarily as a result of an increase in payroll and incentive compensation expense of \$0.3 million and an increase in legal expenses related to the Merger with KLA-Tencor of \$0.4 million.

*Interest income.* Interest income was \$1.0 million in the first quarter of fiscal 2007 compared to interest income of \$0.5 million in the first quarter of fiscal 2006. The increase in interest income was the result of an increase in invested cash balances and increased investment returns during the first quarter of fiscal 2007 compared to the first quarter of fiscal 2006.

*Interest expense.* Interest expense was \$58,000 in the first quarter of fiscal 2007 compared to interest expense of \$49,000 in the first quarter of fiscal 2006. The increase in interest expense was primarily due to fees related to the standby letter of credit required by the Company's 1999 Industrial Development Bond for its Tucson, Arizona facility.

*Income taxes.* The provision for income taxes increased \$1.1 million to \$2.2 million in the first quarter of fiscal 2007 compared to a provision for income taxes of \$1.1 million in the first quarter of fiscal 2006. The Company's effective tax rate in the first quarter of fiscal 2007 was 36.2% compared to 28% in the first quarter of fiscal 2006. The increase in the Company's effective tax rate in the first quarter of fiscal 2007 is primarily due to the expiration of the Extraterritorial Income tax exclusion regime that the Company will claim on its 2006 federal tax return. 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 July 31, 2006, the Company had \$99.9 million in cash and cash equivalents and \$144.5 million in working capital.

Cash provided by operating activities for the three months ended July 31, 2006 was \$7.6 million. This amount resulted from net income of \$4.0 million adjusted for non-cash charges of \$1.0 million and a \$2.6 million net increase in working capital accounts. Non-cash items consisted primarily of \$0.5 million of depreciation and amortization, a \$0.2 million decrease in deferred income taxes and \$0.3 million of stock-based compensation.

Working capital items consisted primarily of decreases in prepaid expenses and other current assets of \$0.4 million, accounts receivable of \$3.9 million and accounts payable of \$2.5 million combined with increases in inventory of \$0.1 million and accrued expenses and other current liabilities of \$0.9 million. The decrease in prepaid expenses and other current assets was due to the timing of payments to vendors. The decrease in accounts receivable was due to the timing of shipments and improved collections during the first quarter of fiscal 2007. The decrease in accounts payable was primarily due to the timing of payments to vendors. The increase in inventory was due to the timing of material purchases. The increase in accrued expenses and other current liabilities was primarily due to an increase in accrued income taxes offset by a decrease in accrued salaries.

Cash used in investing activities for the three months ended July 31, 2006 consisted of \$0.2 million in purchases of fixed assets.

Cash provided by financing activities for the three months ended July 31, 2006 was \$0.9 million, which consisted of \$1.0 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 July 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)         |           |           |                      |           |
|                             | Less than<br>1 year    | 1-3 years | 3-5 years | More than<br>5 years | Total     |
| Long term debt obligations  | \$ 372                 | \$ 3,474  | \$        | \$                   | \$ 3,846  |
| Operating lease obligations | 1,951                  | 3,396     | 2,605     | 8,774                | 16,726    |
| Purchase obligations        | 8,614                  | 108       |           |                      | 8,722     |
| Total                       | \$ 10,937              | \$ 6,978  | \$ 2,605  | \$ 8,774             | \$ 29,294 |

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 July 31, 2006, the Company's backlog was \$60.5 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.

**Table of Contents**

**New Accounting Pronouncements**

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The adoption of FIN 48 is not expected to have a material impact on the Company s financial position and results of operations.

**Table of Contents**

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

At July 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 first quarter of fiscal 2007 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 4. Submission of Matters to a Vote of Security Holders.**

A Special Meeting of Stockholders of the Company was held on July 13, 2006. The matters voted on by the stockholders and the voting results are as follows:

1. To approve the Amended and Restated Agreement and Plan of Merger, dated as of May 26, 2006, among KLA-Tencor Corporation, the Company and South Acquisition Corporation.

| <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|------------|----------------|----------------|
| 10,635,581 | 17,834         | 56,928         |

2. To permit the Company's board of directors or its chairman, in its or his discretion, to adjourn or postpone the special meeting if necessary for further solicitation of proxies if there are not sufficient votes at the originally scheduled time of the special meeting to approve proposal 1 above.

| <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|------------|----------------|----------------|
| 9,959,960  | 693,002        | 57,381         |

There were no broker non-votes for either of the above matters.

**Item 6. Exhibits.**

| <b>Exhibit Number</b> | <b>Description</b>  |
|-----------------------|---|
| 2.1                   | Amended and Restated Agreement and Plan of Merger, dated as of May 26, 2006, by and among KLA-Tencor Corporation, South Acquisition Corporation and the Company (incorporated by reference from Exhibit 2.1 of KLA-Tencor Corporation's Current Report on Form 8-K (file no. 0-09992) filed with the Securities and Exchange Commission on May 26, 2006). |
| 31.1                  | Rule 13a-14(a) Certification of Chief Executive Officer (filed herewith).   |
| 31.2                  | Rule 13a-14(a) Certification of Chief Financial Officer (filed herewith).   |
| 32.1                  | Section 1350 Certification of Chief Executive Officer (furnished herewith).   |
| 32.2                  | Section 1350 Certification of Chief Financial Officer (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: September 11, 2006

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

Date: September 11, 2006

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