Table of Contents

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION <br> Washington, D.C. 20549 

## FORM 10-Q

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

For the quarterly period ended July 1, 2005
OR
$\square$ 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 001-15885

# BRUSH ENGINEERED MATERIALS INC. <br> (Exact name of Registrant as specified in charter) 

## Ohio

(State or other jurisdiction of incorporation or organization)
17876 St. Clair Avenue, Cleveland, Ohio
(Address of principal executive offices)

34-1919973
(I.R.S. Employer Identification No.)

44110
(Zip Code)

216-486-4200
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 $\boxtimes$

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes $\boxtimes$
No
As of July 29, 2005 there were $19,226,832$ shares of Common Stock, no par value, outstanding.

## TABLE OF CONTENTS

## PART I FINANCIAL INFORMATION

Item 1
Financial Statements
Management's Discussion and Analysis of Financial Condition and Results of Operations
Item 2
Item 3.
Quantitative and Qualitative Disclosure about Market Risk
Item 4.
Controls and Procedures
PART II OTHER INFORMATION
Item 1.
Legal Proceedings

| Item 4. | Submission of Matters to a Vote of Security Holders |
| :--- | :--- |
| Item 6. | Exhibits |
| SIGNATURES | 23 |
| EX-10(a) Amendment \#2 to Brush Key Employee Share Option Plan |  |
| EX-11 Computation of Per Share Earnings |  |
| EX-31.1 302 Certification - Chief Executive Officer |  |
| EX-31.2 302 Certification - Chief Financial Officer |  |
| EX-32.1 906 Certification - CEO and CFO |  |

## PART I FINANCIAL INFORMATION BRUSH ENGINEERED MATERIALS INC. AND SUBSIDIARIES

## Item 1. Financial Statements

The consolidated financial statements of Brush Engineered Materials Inc. and its subsidiaries for the quarter ended July 1, 2005 are as follows:

Consolidated Statements of Income -
Second Quarter and first half ended July 1, 2005 and July 2, 2004
Consolidated Balance Sheets -
July 1, 2005 and December 31, 2004
Consolidated Statements of Cash Flows -
First half ended July 1, 2005 and July 2, 2004

Table of Contents

## Consolidated Statements of Income (Unaudited)

| (Dollars in thousands except share and per share amounts) | Second Quarter Ended |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | July 1, 2005 |  | July 2, 2004 |  | July 1, 2005 |  | July 2, 2004 |  |
| Net sales | \$ | 134,651 | \$ | 128,639 | \$ | 265,023 | \$ | 254,501 |
| Cost of sales |  | 105,545 |  | 99,198 |  | 207,340 |  | 195,483 |
| Gross margin |  | 29,106 |  | 29,441 |  | 57,683 |  | 59,018 |
| Selling, general and administrative expense |  | 18,933 |  | 19,161 |  | 37,634 |  | 38,208 |
| Research and development expense |  | 1,295 |  | 1,098 |  | 2,536 |  | 2,366 |
| Other - net |  | 1,453 |  | 127 |  | 3,664 |  | 3,319 |
| Operating profit |  | 7,425 |  | 9,055 |  | 13,849 |  | 15,125 |
| Interest expense |  | 1,646 |  | 2,389 |  | 3,268 |  | 4,607 |
| Income before income taxes |  | 5,779 |  | 6,666 |  | 10,581 |  | 10,518 |
| Income taxes |  | 249 |  | 95 |  | 764 |  | 194 |
| Net income | \$ | 5,530 | \$ | 6,571 | \$ | 9,817 | \$ | 10,324 |
| Per share of common stock: basic | \$ | 0.29 | \$ | 0.39 | \$ | 0.51 | \$ | 0.62 |
| Weighted average number of common shares outstanding |  | 19,224,298 |  | 16,704,568 |  | 19,210,887 |  | 16,661,099 |
| Per share of common stock: diluted | \$ | 0.29 | \$ | 0.38 | \$ | 0.51 | \$ | 0.60 |
| Weighted average number of common shares outstanding |  | 19,351,865 |  | 17,127,698 |  | 19,374,139 |  | 17,107,295 |

See notes to consolidated financial statements.

Table of Contents

## Consolidated Balance Sheets <br> (Unaudited)

| (Dollars in thousands) | $\begin{gathered} \text { July 1, }, \\ 2005 \\ \hline \end{gathered}$ |  | $\underset{2004}{\substack{\text { Dec. 31, } \\ \hline}}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| Assets |  |  |  |  |
| Current assets |  |  |  |  |
| Cash and cash equivalents | \$ | 11,206 | \$ | 49,643 |
| Accounts receivable |  | 67,939 |  | 59,229 |
| Inventories |  | 101,664 |  | 95,271 |
| Prepaid expenses |  | 9,283 |  | 8,348 |
| Deferred income taxes |  | 531 |  | 275 |
| Total current assets |  | 190,623 |  | 212,766 |
| Other assets |  | 8,785 |  | 14,876 |
| Long-term deferred income taxes |  | 658 |  | 928 |
| Property, plant and equipment |  | 547,828 |  | 540,937 |
| Less allowances for depreciation, depletion and impairment |  | 374,483 |  | 363,318 |
|  |  | 173,345 |  | 177,619 |
| Goodwill |  | 10,805 |  | 7,992 |
|  | \$ | 384,216 | \$ | 414,181 |

Liabilities and Shareholders' Equity
Current liabilities

| Short-term debt | 10,973 | $\$$ |
| :--- | ---: | ---: |
| Current portion of long-term debt | 636 | 11,692 |
| Accounts payable | 19,457 | 19,209 |
| Other liabilities and accrued items | 32,930 | 13,234 |
| Unearned revenue | - | 50,452 |
| Income taxes | 1,008 | 7,789 |
| Total current liabilities | 65,004 | 1,591 |
| Other long-term liabilities | 9,921 | 103,967 |
| Retirement and post-employment benefits | 56,044 | 10,798 |
| Long-term debt | 41,515 | 49,729 |
| Shareholders' equity | 211,732 | 41,549 |
|  | $\boxed{3}$ | 384,216 |

See notes to consolidated financial statements.

## Consolidated Statements of Cash Flows <br> (Unaudited)

| (Dollars in thousands) | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \hline \text { July 1, }, \\ 2005 \\ \hline \end{gathered}$ |  | July 2, 2004 |  |
| Net income | \$ | 9,817 | \$ | 10,324 |
| Adjustments to reconcile net income to net cash used in operating activities: |  |  |  |  |
| Depreciation, depletion and amortization |  | 10,680 |  | 12,025 |
| Amortization of deferred financing costs in interest expense |  | 579 |  | 722 |
| Derivative financial instrument ineffectiveness |  | (94) |  | (1) |
| Decrease (increase) in accounts receivable |  | $(8,785)$ |  | $(13,344)$ |
| Decrease (increase) in inventory |  | $(7,541)$ |  | $(12,923)$ |
| Decrease (increase) in prepaid and other current assets |  | 1,359 |  | 293 |
| Increase (decrease) in accounts payable and accrued expenses |  | $(7,894)$ |  | 3,033 |
| Increase (decrease) in unearned revenue |  | $(7,789)$ |  | 1,254 |
| Increase (decrease) in interest and taxes payable |  | $(1,969)$ |  | $(1,033)$ |
| Increase (decrease) in other long-term liabilities |  | 1,348 |  | $(1,083)$ |
| Other - net |  | 984 |  | 1,771 |
| Net cash provided from (used in) operating activities |  | $(9,305)$ |  | 1,038 |
| Cash flows from investing activities: |  |  |  |  |
| Payments for purchase of property, plant and equipment |  | $(4,860)$ |  | $(2,959)$ |
| Payments for purchase of business less cash received |  | $(3,982)$ |  | - |
| Payments for mine development |  | - |  | (120) |
| Purchase of equipment previously held under operating lease |  | (448) |  | - |
| Proceeds from sale of property, plant and equipment |  | 45 |  | 15 |
| Other investments - net |  | (11) |  | 14 |
| Net cash used in investing activities |  | $(9,256)$ |  | $(3,050)$ |
| Cash flows from financing activities: |  |  |  |  |
| Proceeds from issuance/(repayment) of short-term debt |  | (673) |  | 13,557 |
| Proceeds from issuance of long-term debt |  | - |  | 24 |
| Repayment of long-term debt |  | $(18,607)$ |  | $(8,629)$ |
| Issuance of common stock under stock option plans |  | 364 |  | 2,381 |
| Net cash provided from (used in) financing activities |  | $(18,916)$ |  | 7,333 |
| Effects of exchange rate changes |  | (960) |  | (58) |
| Net change in cash and cash equivalents |  | $(38,437)$ |  | 5,263 |
| Cash and cash equivalents at beginning of period |  | 49,643 |  | 5,062 |
| Cash and cash equivalents at end of period | \$ | $\underline{ }$ | \$ | $\underline{ }$ |

See notes to consolidated financial statements.

## Table of Contents

## Notes to Consolidated Financial Statements

(Unaudited)

## Note A - Accounting Policies

In management's opinion, the accompanying consolidated financial statements contain all adjustments necessary to present fairly the financial position as of July 1, 2005 and December 31, 2004 and the results of operations for the second quarter and first half ended July 1, 2005 and July 2, 2004. All of the adjustments were of a normal and recurring nature. Certain items in the prior year have been reclassified to conform to the 2005 consolidated financial statement presentation.

## Note B - Inventories

| (Dollars in thousands) | July 1, <br> 2005 |  | $\begin{gathered} \text { Dec. 31, } \\ 2004 \\ \hline \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| Principally average cost: |  |  |  |  |
| Raw materials and supplies | \$ | 24,521 | \$ | 22,705 |
| Work in process |  | 79,976 |  | 77,438 |
| Finished goods |  | 29,981 |  | 27,538 |
| Gross inventories |  | 134,478 |  | 127,681 |
| Excess of average cost over LIFO |  |  |  |  |
| Inventory value |  | 32,814 |  | 32,410 |
| Net inventories | \$ | 101,664 | \$ | 95,271 |

## Note C - Comprehensive Income (Loss)

The reconciliation between net income and comprehensive income (loss) for the second quarter and first half ended July 1, 2005 and July 2 , 2004 is as follows:

| (Dollars in thousands) | Second Quarter Ended |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \hline \text { July 1, } \\ \hline 2005 \\ \hline \end{gathered}$ |  | July 2, 2004 |  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \\ \hline \end{gathered}$ |  | July 2, 2004 |  |
| Net income | \$ | 5,530 | \$ | 6,571 | \$ | 9,817 | \$ | 10,324 |
| Cumulative translation adjustment |  | (123) |  | (356) |  | (997) |  | (131) |
| Change in the fair value of derivative financial instruments |  | 2,389 |  | 1,424 |  | 5,649 |  | 2,353 |
| Minimum pension liability |  | $(11,138)$ |  | - |  | 11,138) |  | - |
| Comprehensive income (loss) | \$ | $(3,342)$ | \$ | 7,639 | \$ | 3,331 | \$ | 12,546 |

The $\$ 11.1$ million charge to comprehensive loss in the second quarter 2005 for the minimum pension liability resulted from the remeasurement of the domestic defined benefit pension plan as described in Note F to the Consolidated Financial Statements.

## Note D - Segment Reporting

Effective January 1, 2005, the operating results of Brush Resources Inc. are included as part of the Metal Systems Group. Previously, the operating results of Brush Resources were included as part of All Other in the segment disclosures. Brush Resources sells beryllium hydroxide, produced through its Utah operations, to outside customers and to businesses within the Metal Systems Group. This change is more reflective of how

## Table of Contents

the Company's businesses are evaluated. The 2004 amounts presented below have been reclassified to reflect this change.

| (Dollars in thousands) | Metal <br> Systems |  | Micro- <br> Electronics |  | Total Segments |  | All Other |  | Total |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Second Quarter 2005 |  |  |  |  |  |  |  |  |  |  |
| Revenues from external customers | \$ | 78,503 | \$ | 56,148 | \$ | 134,651 | \$ | - | \$ | 134,651 |
| Intersegment revenues |  | 630 |  | 543 |  | 1,173 |  | - |  | 1,173 |
| Operating profit (loss) |  | 3,490 |  | 4,766 |  | 8,256 |  | (831) |  | 7,425 |
| Second Quarter 2004 |  |  |  |  |  |  |  |  |  |  |
| Revenues from external customers | \$ | 77,129 | \$ | 51,510 | \$ | 128,639 | \$ |  | \$ | 128,639 |
| Intersegment revenues |  | 856 |  | 391 |  | 1,247 |  | - |  | 1,247 |
| Operating profit |  | 2,809 |  | 4,804 |  | 7,613 |  | 1,442 |  | 9,055 |
| First Half 2005 |  |  |  |  |  |  |  |  |  |  |
| Revenues from external customers | \$ | 157,984 | \$ | 107,039 | \$ | 265,023 | \$ | - | \$ | 265,023 |
| Intersegment revenues |  | 1,221 |  | 773 |  | 1,994 |  | - |  | 1,994 |
| Operating profit (loss) |  | 6,108 |  | 8,462 |  | 14,570 |  | (721) |  | 13,849 |
| First Half 2004 |  |  |  |  |  |  |  |  |  |  |
| Revenues from external customers | \$ | 153,087 | \$ | 101,414 | \$ | 254,501 | \$ | - | \$ | 254,501 |
| Intersegment revenues |  | 2,070 |  | 687 |  | 2,757 |  | - |  | 2,757 |
| Operating profit (loss) |  | 5,407 |  | 10,293 |  | 15,700 |  | (575) |  | 15,125 |

## Note E- Income Taxes

A tax provision or benefit was not applied against the income before income taxes in either the second quarter or the first half of 2005 or 2004 for certain domestic and foreign taxes as a result of the deferred tax valuation allowance recorded in 2003 and previous periods in accordance with Statement No. 109. "Accounting for Income Taxes" due to the uncertainty regarding the full utilization of the Company's deferred income taxes. The valuation allowance was reduced offsetting a portion of the net tax expense in both the second quarter 2005 and 2004 as well as in the first half of 2005 and 2004. The Company intends to maintain the valuation allowance until additional realization events occur, including the generation of future sustainable taxable income, that would support reversal of all or a portion of the allowance. The deferred tax assets recorded on the consolidated balance sheet are shown net of the valuation allowance. The tax expense was $\$ 0.2$ million in the second quarter 2005 and $\$ 0.1$ million in the second quarter 2004. For the first half of the year, the tax expense was $\$ 0.8$ million in 2005 and $\$ 0.2$ million in 2004. The tax expense for each period represents taxes from various state and local jurisdictions and foreign taxes from Japan and Singapore, while the tax expense for the first half of 2005 also includes $\$ 0.1$ million for the alternative minimum tax liability.

## Note F - Pensions and Other Post-retirement Benefits

The Company amended its domestic defined benefit pension plan effective in the second quarter 2005. The amendment revised the pension benefit payout formula for the majority of the plan participants and various other aspects of the plan as well. The amendment was determined to be a significant event and therefore the plan assets, liabilities and net periodic cost were remeasured in accordance with Statement No. 87, "Employers' Accounting for Pensions".

The discount rate used to remeasure the benefit obligation and the net cost was reduced to $5.875 \%$ from a rate of $6.125 \%$ used at December 31, 2004 based upon management's analysis. Management also determined that other key valuation assumptions, including the expected rate of return on plan assets and the rate of compensation increases, should remain the same as the rates used as of December 31, 2004.

As a result of the remeasurement, the prior service cost asset of $\$ 5.0$ million, previously recorded in other assets on the consolidated balance sheet, was charged off against other comprehensive income, a component of

## Table of Contents

shareholders' equity. The minimum pension liability, which is included in retirement and post-employment benefits on the consolidated balance sheet, increased $\$ 6.1$ million as a result of the remeasurement, primarily due to the lower discount rate and the change in asset values. The increase to the minimum pension liability was also charged against other comprehensive income, resulting in a total charge to other comprehensive income of $\$ 11.1$ million.

| (Dollars in thousands) | Pension Benefits Second Quarter Ended |  |  |  | Other Benefits <br> Second Quarter Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \hline \text { July 1, }, \\ 2005 \\ \hline \end{gathered}$ |  | July 2, 2004 |  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \\ \hline \end{gathered}$ |  | July 2, 2004 |  |
| Components of net periodic benefit cost |  |  |  |  |  |  |  |  |
| Service cost | \$ | 1,206 | \$ | 1,060 | \$ | 64 |  | 70 |
| Interest cost |  | 1,398 |  | 1,725 |  | 493 |  | 696 |
| Expected return on plan assets |  | $(2,205)$ |  | $(2,267)$ |  | - |  | - |
| Amortization of prior service cost |  | (484) |  | 162 |  | (15) |  | (28) |
| Amortization of net loss/(gain) |  | 425 |  | (3) |  | (90) |  | 122 |
| Net periodic benefit cost | \$ | 340 | \$ | 677 | \$ | 452 | \$ | 860 |
|  |  | Pensio <br> First | nd |  |  | Othe First | efit |  |
| (Dollars in thousands) |  | $\begin{aligned} & \text { July 1, } \\ & 2005 \\ & \hline \end{aligned}$ |  | $\begin{gathered} \hline \text { July 2, } \\ 2004 \\ \hline \end{gathered}$ |  | $\mathbf{2 l y} \mathbf{1 , 2},$ |  | $\begin{aligned} & \hline 1 \mathrm{ly} 2, \\ & 004 \\ & \hline \end{aligned}$ |
| Components of net periodic benefit cost |  |  |  |  |  |  |  |  |
| Service cost | \$ | 2,374 | \$ | 2,121 | \$ | 150 | \$ | 140 |
| Interest cost |  | 3,231 |  | 3,450 |  | 1,122 |  | 1,392 |
| Expected return on plan assets |  | $(4,377)$ |  | $(4,535)$ |  | - |  | - |
| Amortization of prior service cost |  | (337) |  | 323 |  | (43) |  | (56) |
| Amortization of net loss/(gain) |  | 642 |  | (5) |  | - |  | 243 |
| Net periodic benefit cost | \$ | 1,533 | \$ | 1,354 | \$ | 1,229 | \$ | 1,719 |

## Note G - Stock-Based Compensation

The Company has adopted the disclosure only provisions of Statement No. 123, "Accounting for Stock-Based Compensation" and applies the intrinsic value method in accordance with APB Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations in accounting for its stock incentive plan. In accordance with Statement No. 148, "Accounting for Stock-Based Compensation - Transition and

## Table of Contents

Disclosure," the following table presents the effect on net income and net income per share had compensation cost for the Company's stock plans been determined consistent with Statement No. 123.

| (Dollars in thousands except per share amounts) | Second QuarterEnded |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \\ \hline \end{gathered}$ |  | July 2, 2004 |  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \\ \hline \end{gathered}$ |  | $\begin{aligned} & \hline \text { July 2, }, \\ & 2004 \\ & \hline \end{aligned}$ |  |
| Net income, as reported | \$ | 5,530 | \$ | 6,571 | \$ | 9,817 | \$ | 10,324 |
| Less stock-based compensation expense determined under fair value method for all stock options, net of related income tax benefit |  | 699 |  | 722 |  | 1,151 |  | 1,224 |
| Pro forma net income | \$ | 4,831 | \$ | 5,849 | \$ | 8,666 | \$ | 9,100 |
| Basic income per share, as reported | \$ | 0.29 | \$ | 0.39 | \$ | 0.51 | \$ | 0.62 |
| Diluted income per share, as reported |  | 0.29 |  | 0.38 |  | 0.51 |  | 0.60 |
| Basic income per share, pro forma |  | 0.25 |  | 0.35 |  | 0.45 |  | 0.55 |
| Diluted income per share, pro forma |  | 0.25 |  | 0.34 |  | 0.45 |  | 0.53 |

The fair value was estimated on the grant date using the Black-Scholes option pricing model with the following assumptions for options issued:

|  | Second Quarter Ended |  | First Half Ended |  |
| :---: | :---: | :---: | :---: | :---: |
|  | $\begin{aligned} & \hline \text { July } 1, \\ & 2005 \\ & \hline \end{aligned}$ | July 2, 2004 | $\begin{gathered} \hline \text { July } 1, \\ 2005 \\ \hline \end{gathered}$ | July 2, 2004 |
| Risk free interest rates | 3.34\% | 1.81\% | 4.66\% | 3.26\% |
| Dividend yield | 0\% | 0\% | 0\% | 0\% |
| Volatility | 42.0\% | 41.8\% | 42.0\% | 41.8\% |
| Expected lives (in years) | 6 | 6 | 6 | 6 |

## Note H — Indemnity Agreements

Williams Advanced Materials Inc. (WAM), a wholly owned subsidiary, and a small number of WAM's customers are defendants in a patent infringement legal case. WAM has provided an indemnity agreement to certain of those customers under which WAM will pay any damages awarded by the court. WAM believes it has numerous and strong defenses applicable to both WAM and its customers and is contesting this action. WAM has not made any indemnification payments nor have they recorded a reserve for losses under these agreements as of July 1, 2005. WAM does not believe a range of potential losses, if any, can be estimated at the present time.

## Note I - Acquisition

WAM, through its subsidiary in The Netherlands, purchased OMC Scientific Holdings Limited (OMCS) of Limerick, Ireland for approximately $\$ 4.0$ million in cash in the second quarter 2005. OMCS provides physical vapor deposition material cleaning and reconditioning services to customers in the magnetic and optical data storage, semiconductor and other markets in Europe. The preliminary goodwill recorded as a result of the purchase was approximately $\$ 2.8$ million.

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

## Overview

We are an integrated producer of engineered materials used in a variety of high performance electrical, electronic, thermal and structural applications. Major markets for our materials include telecommunications

## Table of Contents

and computer, automotive electronics, magnetic and optical data storage, industrial components, appliance, aerospace and defense.
Our sales in the second quarter 2005 were the highest quarterly total since the first quarter 2001, which was the last full quarter prior to the start of the significant decline in demand from the telecommunications and computer market, our largest market. Sales have now grown for ten consecutive quarters as compared to the same quarter in the previous year. Gross margins in the second quarter 2005, however, continued to be unfavorably affected by changes in product mix, higher copper prices and other factors. Our selling, general and administrative expenses in the second quarter of 2005 were below last year's level, but a derivative valuation and other miscellaneous expenses were higher. As a result of the above, we generated an operating profit of $\$ 7.4$ million in the second quarter 2005, which was down $\$ 1.7$ million from the profit earned in the second quarter 2004. However, after incurring operating losses in the 2002 to 2003 time frame, we have now recorded an operating profit for the past six consecutive quarters.

Our capital structure continued to improve in 2005 as we have reduced debt by $\$ 19.3$ million this year, including the early repayment of two term loans totaling $\$ 18.6$ million in the first quarter 2005. After using cash in operations in the first quarter 2005, primarily due to the 2004 employee incentive compensation payments and a pension plan contribution, cash flow from operations was a strong $\$ 8.9$ million in the second quarter 2005.

## Results of Operations

| (Millions, except per share data) | Second Quarter Ended |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{aligned} & \hline \text { July 1, } \\ & \hline 2005 \\ & \hline \end{aligned}$ |  | $\begin{gathered} \hline \text { July 2, } \\ 2004 \\ \hline \end{gathered}$ |  | $\begin{aligned} & \hline \text { July 1, }, \\ & 2005 \\ & \hline \end{aligned}$ |  | $\begin{gathered} \hline \text { July 2, } \\ 2004 \end{gathered}$ |  |
| Sales | \$ | 134.7 | \$ | 128.6 | \$ | 265.0 | \$ | 254.5 |
| Operating Profit |  | 7.4 |  | 9.1 |  | 13.8 |  | 15.1 |
| Net Income |  | 5.5 |  | 6.6 |  | 9.8 |  | 10.3 |
| Diluted E.P.S | \$ | 0.29 | \$ | 0.38 | \$ | 0.51 | \$ | 0.60 |

Sales of $\$ 134.7$ million in the second quarter 2005 were $5 \%$ higher than sales of $\$ 128.6$ million in the second quarter 2004. Second quarter 2005 year-to-date sales were $\$ 265.0$ million, a $4 \%$ growth rate over second quarter 2004 year-to-date sales. Sales under the $\$ 18.0$ million James Webb Space Telescope (JWST) supply contract were $\$ 4.2$ million in the second quarter 2005 and $\$ 10.3$ million for the first half of 2005 compared to $\$ 0.9$ million in the first half of 2004 , all of which occurred in the first quarter of that year. Shipments of beryllium hydroxide also contributed to the growth in sales in the second quarter and first half of 2005.

Demand from the telecommunications and computer and automotive electronics markets, our largest two markets, was sluggish in the first half of 2005. Demand for defense applications softened in the second quarter 2005 as well. This softness was offset in part by improved demand from other markets and applications, including plastic tooling, magnetic and optical data storage, oil and gas, semiconductor and various new products.

International sales, which include sales from foreign operations as well as direct exports from the United States, were $\$ 41.5$ million in the second quarter 2005 and $\$ 42.8$ million in the second quarter 2004, a decline of approximately $3 \%$. Second quarter year-to-date international sales were $\$ 83.9$ million in 2005 and $\$ 85.1$ million in 2004 . Domestic sales grew $9 \%$ in the second quarter 2005 over the second quarter 2004 and $7 \%$ in the first half of 2005 over the first half of 2004.

Our sales are affected by metal prices, as changes in precious metal prices and a significant portion of changes in base metal prices (primarily copper and nickel) are passed on to customers. Sales are also affected by foreign currency exchange rates, as changes in the dollar's value relative to other currencies will result in an increase or decrease in the translated value of foreign currency denominated sales. Precious and base metal prices on average were higher while the dollar was weaker on average versus the applicable currencies in the

## Table of Contents

second quarter and first half of 2005 compared to the year ago periods. We estimate that the combination of these two factors accounted for approximately $\$ 2.6$ million of the sales growth in the second quarter 2005 and $\$ 4.9$ million of the growth in the first half of 2005 over the comparable periods in the prior year.

The new sales order entry rate was lower than sales during the second quarter 2005 and for the first half of the year. The sales order backlog declined accordingly during 2005, in part due to the large shipments under the JWST program in 2005, the orders for which were received in 2004.

The gross margin was $\$ 29.1$ million, or $22 \%$ of sales, in the second quarter 2005, compared to $\$ 29.4$ million, or $23 \%$ of sales, in the second quarter 2004 as the gross margin declined $\$ 0.3$ million despite a $\$ 6.1$ million increase in sales. For the first half of the year, gross margin was $\$ 57.7$ million in 2005 , or $22 \%$ of sales, and $\$ 59.0$ million, or $23 \%$ of sales, in 2004 . While the higher sales volumes served to improve margins by approximately $\$ 1.8$ million in the second quarter 2005 and $\$ 2.9$ million in the first half of 2005 over the comparable periods in 2004 , other factors, including the product mix effect, production levels and an increase in raw material costs, combined to reduce margins by $\$ 2.1$ million in the quarter and $\$ 4.2$ million in the first half of 2005 , more than offsetting the benefits from the higher sales volumes. The change in product mix was negative, meaning that sales of various higher-margin generating products declined while sales of lower-margin generating products increased. Higher base metal prices, primarily copper and nickel, could not be passed through to customers in all cases due to price contracts, pricing practices in the international markets and/or competitive pressures. Manufacturing overhead costs were slightly lower in the second quarter 2005 than in the second quarter 2004 after being relatively unchanged in the first quarter 2005 from the first quarter 2004.

Selling, general and administrative expenses (SG\&A) were $\$ 18.9$ million, or $14 \%$ of sales, in the second quarter 2005, compared to $\$ 19.2$ million, or $15 \%$ of sales, in the second quarter 2004. For the first half of the year, SG\&A expenses were $\$ 37.6$ million in 2005, a decline of $\$ 0.6$ million from the $\$ 38.2$ million expense in 2004. Expenses also declined to $14 \%$ of sales in the first half of 2005 from $15 \%$ of sales in the first half of 2004. Incentive compensation expense was approximately $\$ 2.5$ million lower in the second quarter 2005 than in the second quarter 2004 and $\$ 3.2$ million lower in the first half of 2005 than the first half of 2004. The currency impact on the translation of the foreign subsidiaries' expenses was an unfavorable $\$ 0.1$ million in the second quarter 2005 and $\$ 0.3$ million for the first half of 2005. Other administrative expenses increased in the current year, including compliance costs with Section 404 of the Sarbanes-Oxley Act, which were $\$ 0.5$ million higher in the first half of 2005 than the comparable period of 2004. Various sales-related expenses were higher in the current year as well. The acquisition of OMC Scientific Holdings Limited (OMCS) by Williams Advanced Materials Inc. (WAM), one of our wholly owned subsidiaries, early in the second quarter added to SG\&A expenses in the quarter and the year.

Research and development expense (R\&D) of $\$ 1.3$ million in the second quarter 2005 increased slightly from the $\$ 1.1$ million expense in the second quarter 2004. For the first half of the year, R\&D expense was $\$ 2.5$ million in 2005 and $\$ 2.4$ million in 2004. R\&D expense remained at approximately $1 \%$ of sales in both the first half of 2005 and 2004. Our R\&D efforts remain closely aligned with our marketing and manufacturing operations to develop new products and improve processes.

## Table of Contents

The major components of other-net expense for the second quarter and first half of 2005 and 2004 were as follows:

| (Millions) | Income/(Expense) |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { Second Quarter } \\ \text { Ended } \end{gathered}$ |  |  |  | First Half Ended |  |  |  |
|  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \end{gathered}$ |  | July 2, 2004 |  | July 1,$2005$ |  | $\begin{aligned} & \hline \text { July 2, }, \\ & 2004 \\ & \hline \end{aligned}$ |  |
| Exchange gains (losses) | \$ | (0.9) | \$ | (0.8) | \$ | (2.1) | \$ | (2.0) |
| Directors' deferred compensation |  | 0.4 |  | 0.3 |  | 0.4 |  | (0.4) |
| Derivative ineffectiveness |  | (0.4) |  | 0.5 |  | 0.1 |  | - |
| Write-off of deferred costs |  | - |  | - |  | (0.6) |  | - |
| Other items |  | (0.6) |  | (0.1) |  | (1.5) |  | (0.9) |
| Total | \$ | (1.5) | \$ | (0.1) | \$ | (3.7) | \$ | (3.3) |

Exchange losses are caused by the movement in the U.S. dollar's value relative to the euro, yen and pound sterling as well the impact of matured hedge contracts. The difference in the valuation adjustment on the directors' deferred compensation plan between periods is primarily a function of the relative movements in the market price of our common stock as our liability to the plan, and therefore expense, increases as the price of the stock increases. The derivative ineffectiveness resulted from changes in the fair value of an outstanding interest rate swap that does not qualify for the favorable hedge accounting treatment. The relative movement of this valuation resulted in a $\$ 0.9$ million unfavorable change between the second quarter 2005 and the second quarter 2004. We wrote-off $\$ 0.6$ million of deferred financing costs associated with the early repayment of two term loans in the first quarter 2005. These costs were scheduled to be amortized through the fourth quarter 2008 had the loans not been paid off. Other-net also includes metal financing fees, bad debt expense, gains and losses on the disposal of fixed assets, amortization of intangible assets, cash discounts and other non-operating items.

We generated an operating profit of $\$ 7.4$ million in the second quarter 2005, a decline of $\$ 1.7$ million from the profit earned in the second quarter 2004. For the first half of the year, operating profit was $\$ 13.8$ million in 2005 and $\$ 15.1$ million in 2004. The lower operating profit in 2005 resulted primarily from the unfavorable product mix effect, higher copper costs and other factors more than offsetting the margin benefit on the higher sales.

Interest expense was $\$ 1.6$ million in the second quarter 2005 compared to $\$ 2.4$ million in the second quarter 2004. For the first half of the year, we reduced interest expense by $\$ 1.3$ million, from $\$ 4.6$ million in 2004 to $\$ 3.3$ million in 2005, primarily as a result of the lower level of outstanding debt. We used portions of the cash generated by operations during the second half of 2004 and a portion of the proceeds from a common stock offering in the third quarter 2004 to reduce borrowings under the revolving credit agreement and the subordinated term note in the second half of 2004 and to pay off the term notes in the first quarter 2005. Balance sheet debt was $\$ 53.1$ million at the end of the second quarter 2005 compared to $\$ 104.1$ million at the end of the second quarter 2004.

Income before income taxes was $\$ 5.8$ million in the second quarter 2005 and $\$ 6.7$ million in the second quarter 2004. For the first half of the year, income before income taxes was $\$ 10.6$ million in 2005, a slight improvement over the $\$ 10.5$ million earned in 2004.

A tax provision was not applied against the income or loss before income taxes in the three and six month periods ending July 1,2005 and July 2, 2004 for certain domestic and foreign taxes as a result of the deferred tax valuation allowance recorded in previous periods in accordance with Statement No. 109, "Accounting for Income Taxes", due to the uncertainty regarding full utilization of the deferred income tax assets. The valuation allowance was reduced, offsetting a portion of the net tax expense, in the second quarter and first half of both 2005 and 2004. The tax expense in each period presented on the accompanying financial statements represents taxes related to various state and local jurisdictions and foreign taxes in Japan and Singapore. The

## Table of Contents

tax expense in the second quarter and first half of the year includes a relatively minor amount for the alternative minimum tax liability.
Net income was $\$ 5.5$ million in the second quarter 2005 compared to net income of $\$ 6.6$ million earned in the second quarter 2004. Net income was $\$ 9.8$ million in the first half of 2005 compared to $\$ 10.3$ million in the first half of 2004 . Net income was $4 \%$ of sales in both the first half of 2005 and 2004. The number of shares used to compute basic and diluted earnings per share is higher in 2005 than the comparable periods in 2004 as a result of the common stock offering in the third quarter 2004. Diluted earnings per share were $\$ 0.29$ in the second quarter 2005 and $\$ 0.51$ in the first half of 2005 compared to $\$ 0.38$ and $\$ 0.60$ in the respective periods in 2004.

We aggregate our businesses into two reportable segments - the Metal Systems Group and the Microelectronics Group (MEG). Beginning in 2005, Brush Resources Inc., a wholly owned subsidiary that manages our mining and milling operations in Utah, is included in the Metal Systems Group while previously it was included in the "All Other" column in the segment reporting details. We made this change because we believe that the operating issues affecting Brush Resources, the management of the operations and the flow of materials are more closely aligned with the Metal Systems Group and this change is more reflective of how the operations are now managed. The segment results for the prior year comparisons have been restated to reflect this change. Our parent company and other corporate expenses, as well as the operating results from BEM Services, Inc., a wholly owned subsidiary, are not part of either segment and remain in the All Other column. BEM Services charges a management fee for the services it provides, primarily corporate, administrative and financial oversight, to our other businesses on a cost-plus basis.

The differences in the operating results within All Other between the respective periods presented was primarily due to differences in the valuation adjustments in the directors' compensation plan and the interest rate swap as previously described, the deferred financing cost writeoff in 2005 and other administrative costs. Incentive compensation expense for the corporate office was lower in 2005 than in 2004.

## Metal Systems Group

|  | Second QuarterEnded |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| (Millions) | $\begin{gathered} \hline \text { July 1, } \\ 2005 \end{gathered}$ |  | $\begin{gathered} \hline \text { July 2, } \\ 2004 \\ \hline \end{gathered}$ |  | $\begin{gathered} \text { July 2, } \\ 2005 \end{gathered}$ |  | $\begin{gathered} \hline \text { July 2, } \\ 2004 \\ \hline \end{gathered}$ |  |
| Sales | \$ | 78.5 | \$ | 77.1 | \$ | 158.0 | \$ | 153.1 |
| Operating Profit | \$ | 3.5 | \$ | 2.8 | \$ | 6.1 | \$ | 5.4 |

The Metal Systems Group, the larger of our two reportable segments, accounting for approximately $60 \%$ of sales and total assets, consists of Alloy Products, Technical Materials, Inc. (TMI), Beryllium Products and Brush Resources. The following chart summarizes sales by business unit within the Metal Systems Group:

| (Millions) | Second Quarter Ended |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \text { July 1, } \\ \mathbf{2 0 0 5} \end{gathered}$ |  | July 2, 2004 |  | $\begin{gathered} \hline \text { July 1, }, \\ 2005 \end{gathered}$ |  | $\begin{gathered} \hline \text { July 2, } \\ 2004 \\ \hline \end{gathered}$ |  |
| Alloy Products | \$ | 51.1 | \$ | 54.7 | \$ | 103.7 | \$ | 107.2 |
| TMI |  | 12.5 |  | 14.6 |  | 25.3 |  | 28.4 |
| Beryllium Products |  | 11.7 |  | 7.8 |  | 25.8 |  | 17.5 |
| Brush Resources |  | 3.2 |  | - |  | 3.2 |  | - |
| Total | \$ | 78.5 | \$ | 77.1 | \$ | 158.0 | \$ | 153.1 |

Alloy Products manufactures two main product families - strip products and bulk products. Strip products include precision strip and thin diameter rod and wire copper and nickel beryllium alloys that are sold into the telecommunications and computer, automotive and appliance markets. Major applications for strip products include connectors, contacts, switches, relays and shielding. Bulk products are copper and nickel-based alloys manufactured in rod, tube, plate, bar and other customized forms that are sold into the industrial

## Table of Contents

component market, which includes oil and gas, aerospace, plastic tooling and heavy equipment, as well as portions of the telecommunications and computer and other markets. The majority of bulk products also contain beryllium. Applications for bulk products include plastic mold tooling, bushings, bearings and welding rods.

Sales by Alloy Products of $\$ 51.1$ million in the second quarter 2005 declined $7 \%$ from sales of $\$ 54.7$ million in the second quarter 2004 while sales of $\$ 103.7$ million in the first half of 2005 were $3 \%$ lower than sales in the year ago period. Strip product sales volumes declined $12 \%$ in both the second quarter 2005 and first half of 2005 from the comparable periods in 2004. Bulk volumes, however, grew $11 \%$ in the second quarter 2005 over the second quarter 2004 and $14 \%$ in the first half of 2005 over the first half of 2004. The decline in strip sales volumes was due to weaker demand from the automotive electronic and telecommunications and computer markets. Price pressures from competitive (and non-beryllium containing) materials also have negatively impacted strip sales. The growth in bulk products sales volumes resulted from improved demand from various key end-use applications and markets, including oil and gas, plastic tooling, aerospace and welding rods. New products and applications also contributed to the sales growth, including sales of non-beryllium-based alloy systems for heavy equipment applications. The majority of the fall-off in sales of Alloy Products' sales in the first half of 2005 from the first half of 2004 occurred domestically, as international sales declined slightly between periods.

TMI manufactures specialty strip products, including clad inlay and overlay metals, precious and base metal electroplated systems, electron beam welded systems, contour profiled systems and solder coated systems. Applications for TMI products include connectors, contacts and semiconductors. TMI's sales were $\$ 12.5$ million in the second quarter 2005 compared to $\$ 14.6$ million in the second quarter 2004, a $14 \%$ decrease. TMI's second quarter year-to-date sales of $\$ 25.3$ million in 2005 were $11 \%$ lower than sales of $\$ 28.4$ million in the first six months of 2004, with the inlay product line showing the largest year-to-date decline. Demand from the automotive market, TMI's largest market, was soft in the second quarter 2005. Demand from the telecommunications and computer market, TMI's second largest market, while soft in the fourth quarter 2004 and first quarter 2005 due in part to a downstream inventory correction, showed improvement in the second quarter 2005. The continued development of new disk drive arm applications contributed to this improvement. Development work on new products and applications that serve TMI's large existing markets as well as new emerging markets, including energy and medical products, also had a positive impact on sales in 2005, helping to offset a portion of the decline in sales of traditional products.

Beryllium Products manufactures pure beryllium and beryllium aluminum alloys in rod, tube, sheet and a variety of customized forms. These materials have high stiffness and low density and tend to be premium priced due to this unique combination of properties. Sales by Beryllium Products were $\$ 11.7$ million in the second quarter 2005, a $49 \%$ increase over sales of $\$ 7.8$ million in the second quarter 2004, while sales for the first half of the year of $\$ 25.8$ million were $47 \%$ higher than the year ago period. The increase in sales in 2005 was due to shipments under the material supply contract for the JWST program. With the shipments in the second quarter 2005, our obligations under that original contract are now complete. Sales of other pure beryllium metal products increased slightly in the first half of 2005 over 2004, but sales of beryllium aluminum alloys declined, partially due to delays and stretch-outs in a variety of U.S. government defense programs. Performance automotive sales were lower in the first half of 2005 than the first half of 2004 as expected. Based upon the recent order entry pattern and other analyses, we believe that sales of Beryllium Products may slow down in the second half of this year.

Brush Resources produces beryllium hydroxide primarily for use as a raw material input for our other businesses. Brush Resources also sells hydroxide to external customers. External sales of beryllium hydroxide totaled $\$ 3.2$ million in the first half of 2005, all of which occurred in the second quarter. There were no external sales of hydroxide in the first half of 2004.

The gross margin on Metal System Group sales was $\$ 19.0$ million, or $24 \%$ of sales, in the second quarter 2005 compared to $\$ 19.7$ million, or $26 \%$ of sales, in the second quarter 2004. For the first half of the year, the gross margin was $\$ 38.8$ million in 2005 , or $25 \%$ of sales, and $\$ 39.1$ million, or $26 \%$ of sales, in 2004. The higher sales volume generated approximately an additional $\$ 1.2$ million of margin in the second quarter and

## Table of Contents

$\$ 2.5$ million in the first half of 2005 . The change in product mix was unfavorable between both the second quarter 2005 and the first half of 2005 and the respective periods in 2004. The unfavorable product mix effect was evident by a decline in the sales of the higher beryllium containing and therefore higher-priced strip product alloys. A portion of the bulk product sales growth was in the lower-priced and therefore lower margin generating products. The mix effect within TMI was unfavorable as well, particularly in the first quarter of 2005 . The decline in beryllium aluminum alloys within Beryllium Products also had a negative mix effect on gross margins, but this was more than offset by the favorable impact of the JWST sales. The increase in copper and nickel costs could not all be passed through to Metal Systems' customers and, as a result, reduced gross margins by an estimated $\$ 0.6$ million in the second quarter 2005 and $\$ 1.3$ million in the first half of 2005 as compared to the respective periods in 2004. Manufacturing performance and production levels within portions of the Metal Systems Group had an unfavorable impact on margins as well. Manufacturing overhead expenses were slightly lower in the second quarter 2005 and the first half of 2005 versus the comparable periods in 2004, offsetting a portion of these margin reductions.

The Metal Systems Group's SG\&A, R\&D and Other-net expenses totaled $\$ 15.5$ million in the second quarter 2005 and $\$ 16.9$ million in the second quarter 2004. As a percent of group sales, expenses declined to $20 \%$ in the second quarter 2005 from $22 \%$ in the second quarter 2004. For the first half of the year, these expenses totaled $\$ 32.7$ million, or $21 \%$ of sales, in 2005 and $\$ 33.7$ million, or $22 \%$ of sales, in 2004 . The lower expense in both the second quarter and first half of 2005 was primarily due to a decrease in incentive compensation. These savings were offset in part by the unfavorable translation impact on the foreign subsidiaries' expenses and an increase in various administrative and selling expenses.

Operating profit for the Metal Systems Group was $\$ 3.5$ million for the second quarter 2005, a $\$ 0.7$ million improvement over the second quarter 2004, while profit for the first half of 2005 was $\$ 6.1$ million compared to $\$ 5.4$ million in the first half of 2004. The profit improvement was due to the lower SG\&A, R\&D and Other-net expenses, as the benefits from the higher sales volumes were offset by unfavorable changes in product mix and higher base metal costs. Operating profit was approximately $4 \%$ of sales in the first half of both years.

## Microelectronics Group

|  | Second Quarter Ended |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| (Millions) | $\begin{aligned} & \hline \begin{array}{c} \text { July 1, } \\ 2005 \end{array} \end{aligned}$ |  | July 2, 2004 |  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \end{gathered}$ |  | $\begin{aligned} & \hline \text { July 2, }, \\ & 2004 \\ & \hline \end{aligned}$ |  |
| Sales | \$ | 56.1 | \$ | 51.5 | \$ | 107.0 | \$ | 101.4 |
| Operating Profit | \$ | 4.8 | \$ | 4.8 | \$ | 8.5 | \$ | 10.3 |

The MEG consists of WAM and Electronic Products. The following chart summarizes business unit sales within the MEG:

| (Millions) | Second QuarterEnded |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \end{gathered}$ |  | July 2, 2004 |  | $\begin{gathered} \hline \text { July 1, } \\ 2005 \\ \hline \end{gathered}$ |  | July 2, 2004 |  |
| WAM | \$ | 49.8 | \$ | 43.5 | \$ | 94.0 | \$ | 85.6 |
| Electronic Products |  | 6.3 |  | 8.0 |  | 13.0 |  | 15.8 |
| Total | \$ | 56.1 | \$ | 51.5 | \$ | 107.0 | \$ | 101.4 |

WAM manufactures precious, non-precious and specialty metal products, including vapor deposition targets, frame lid assemblies, clad and precious metal preforms, high temperature braze materials and ultra-fine wire. WAM's sales of $\$ 49.8$ million in the second quarter 2005 were $15 \%$ higher than the second quarter 2004 while sales of $\$ 94.0$ million in the first half of 2005 were $10 \%$ higher than sales in the first half of 2004. The cost of the precious metal sold by WAM is passed through to its customers and WAM generates its margin on its fabrication efforts and not on the particular metal sold. In both the second quarter 2005 and the first half of 2005, metal prices, on average, were higher than in the respective periods of 2004, thereby increasing sales without a proportional flow through to margins.

## Table of Contents

Sales from WAM's Brewster, New York facility for giant magnetic resistance thin film and other applications within the magnetic and optical data storage market accounted for a significant portion of the growth in WAM's sales in the second quarter and first half of 2005. Vapor deposition target sales grew in the second quarter 2005 after declining in the first quarter 2005 from the respective year ago periods. Sales of preforms were lower in the first quarter of 2005 than the first quarter of 2004, but demand for these products from the wireless handset market started to improve in the second quarter 2005. Sales of specialty alloys, while still a relatively small portion of WAM's business, increased in both the second quarter and first half of 2005. Qualification trials and new application development for the semiconductor market continued during the second quarter 2005.

Early in the second quarter 2005, WAM purchased OMCS of Limerick, Ireland. OMCS provides physical vapor deposition cleaning and reconditioning services to customers in Europe. OMCS contributed to the increase in WAM's sales in the second quarter 2005.

Electronic Products includes Brush Ceramic Products Inc. and Zentrix Technologies Inc., two wholly owned subsidiaries. These operations produce beryllia ceramics, electronic packages and circuitry for sale into the telecommunications and computer, medical, electronics, automotive and defense markets. Sales from Electronic Products were $\$ 6.3$ million in the second quarter 2005 compared to $\$ 8.0$ million in the second quarter 2004. For the first half of the year, sales of $\$ 13.0$ million were $18 \%$ lower in 2005 than in the comparable period in 2004. This decline in both the quarter and first half sales was primarily due to lower shipments of electronic packages to the telecommunications and computer market. Sales to the automotive market were lower in the first half of 2005 than in the first half of 2004 as well. Sales of beryllia ceramics also declined in both quarters of 2005 from the 2004 levels while circuitry sales declined in the second quarter 2005 after increasing slightly in the first quarter 2005.

The gross margin on MEG sales was $\$ 10.5$ million in the second quarter 2005 compared to $\$ 10.0$ million in the second quarter 2004. As a percent of sales, the margin remained relatively unchanged at approximately $19 \%$ in both quarters. For the first half of the year, the gross margin was $\$ 19.6$ million, or $18 \%$ of sales, in 2005 and $\$ 20.9$ million, or $21 \%$ of sales, in 2004 . The margin growth in the second quarter 2005 was due to the additional volume, offset in part by an increase in manufacturing overhead costs. The margin decline in the first half of the year was largely due to an unfavorable change in the product mix. For example, sales into the automotive market, which typically generate higher margins, declined in 2005. Competitive pressures on prices hampered margins on vapor deposition sales, particularly in the first quarter 2005. An unfavorable inventory valuation adjustment was recorded in the first quarter 2005 further reducing the gross margins in that period. Manufacturing overhead costs were higher in the first half of 2005 than in the first half of 2004, with the increase occurring in the second quarter.

The MEG's SG\&A, R\&D and Other-net expenses were $\$ 5.7$ million in the second quarter 2005, an increase of $\$ 0.5$ million over the second quarter 2004 expense. The majority of this increase was due to expenses incurred by OMC subsequent to the acquisition. Expenses for the first half of the year were $\$ 11.2$ million in 2005 and $\$ 10.6$ million in 2004 . Expenses were $10 \%$ of sales in both periods. In addition to the impact of expenses from OMC, expenses were higher as a result of a small increase in other administrative expenses and miscellaneous net-other expense items which were partially offset by a slight decline in the incentive compensation expense.

Operating profit from the MEG was $\$ 4.8$ million in both the second quarter 2005 and 2004. For the first half of the year, operating profit was $\$ 8.5$ million, or $8 \%$ of group sales, in 2005 and $\$ 10.3$ million, or $10 \%$ of group sales, in 2004.

## Legal

One of our subsidiaries, Brush Wellman Inc., is a defendant in proceedings in various state and federal courts brought by plaintiffs alleging that they have contracted chronic beryllium disease or other lung conditions as a result of exposure to beryllium. Plaintiffs in beryllium cases seek recovery under negligence and various other legal theories and seek compensatory and punitive damages, in many cases of an unspecified sum. Spouses, if any, claim loss of consortium.

## Table of Contents

The following table summarizes the associated activity with beryllium cases.

|  | Quarter Ended July 1, 2005 |  | Quarter EndedApr. 1, 2005 |  |
| :---: | :---: | :---: | :---: | :---: |
| Total cases pending |  | 16 |  | 16 |
| Total plaintiffs |  | 61 |  | 61 |
| Number of claims (plaintiffs) filed during period ended |  | 1(2) |  | 4(5) |
| Number of claims (plaintiffs) settled during period ended |  | 0 (0) |  | 0 (0) |
| Aggregate cost of settlements during period ended (dollars in thousands) | \$ | 2 | \$ | - |
| Number of claims (plaintiffs) otherwise dismissed |  | 1(2) |  | (0) |
| Number of claims (plaintiffs) voluntarily withdrawn |  | 0 (0) |  | 0 (0) |

Settlement payment and dismissal for a single case may not occur in the same period.
Additional beryllium claims may arise. Management believes that we have substantial defenses in these cases and intends to contest the suits vigorously. Employee cases, in which plaintiffs have a high burden of proof, have historically involved relatively small losses to us. Third-party plaintiffs (typically employees of customers or contractors) face a lower burden of proof than do employees or former employees, but these cases are generally covered by varying levels of insurance. A reserve was recorded for beryllium litigation of $\$ 2.2$ million at July 1 , 2005 and $\$ 1.9$ million at December 31, 2004. A receivable of $\$ 2.3$ million was recorded at July 1, 2005, unchanged from December 31, 2004, from our insurance carriers as recoveries for insured claims. An additional $\$ 0.4$ million was reserved at both July 1, 2005 and December 31, 2004 for insolvencies related to claims still outstanding as well as claims for which partial payments have been received.

Although it is not possible to predict the outcome of the litigation pending against us and our subsidiaries, we provide for costs related to these matters when a loss is probable and the amount is reasonably estimable. Litigation is subject to many uncertainties, and it is possible that some of these actions could be decided unfavorably in amounts exceeding our reserves. An unfavorable outcome or settlement of a pending beryllium case or additional adverse media coverage could encourage the commencement of additional similar litigation. We are unable to estimate our potential exposure to unasserted claims.

While we are unable to predict the outcome of the current or future beryllium proceedings, based upon currently known facts and assuming collectibility of insurance, we do not believe that resolution of these proceedings will have a material adverse effect on our financial condition or cash flow. However, our results of operations could be materially affected by unfavorable results in one or more of these cases. As of July 1 , 2005, four purported class actions were pending.

Regulatory Matters. Standards for exposure to beryllium are under review by the United States Occupational Safety and Health Administration, and by private standard-setting organizations. One result of these reviews might be more stringent worker safety standards. More stringent standards may affect buying decisions by the users of beryllium-containing products. If the standards are made more stringent or our customers decide to reduce their use of beryllium-containing products, our operating results, liquidity and capital resources could be materially adversely affected. The extent of the adverse effect would depend on the nature and extent of the changes to the standards, the cost and ability to meet the new standards, the extent of any reduction in customer use and other factors that cannot be estimated.

## Financial Position

Net cash used in operating activities was $\$ 9.3$ million in the first half of 2005 as changes in working capital items, including increases to accounts receivable and inventory, payment of the employee incentive compensation for 2004 and a contribution to the domestic defined benefit pension plan, more than offset net income and the benefits of depreciation and amortization. This use of cash in operations occurred in the first quarter 2005 as operations in the second quarter generated cash. Cash used in operations totaled $\$ 18.2$ million in the first quarter 2005 while cash provided by operations totaled $\$ 8.9$ million in the second quarter 2005.

## Table of Contents

Cash balances stood at $\$ 11.2$ million at the end of the second quarter 2005, a decrease of $\$ 38.4$ million from the prior year end as a result of the year-to-date cash used in operations and the funding of capital expenditures and debt repayments.

Accounts receivable increased $\$ 8.7$ million during the first half of 2005 , in large part due to the higher sales. Sales in the second quarter 2005 were $16 \%$ higher than sales in the fourth quarter 2004. The days sales outstanding (DSO), a measure of the average time to collect receivables, improved slightly from the first quarter, but was still higher than the quite low level in the fourth quarter 2004 and contributed to the increase in receivables. Accounts written off to bad debt expense totaled $\$ 0.2$ million in the first half of 2005, relatively unchanged from the first half of 2004.

Inventories increased by $\$ 6.4$ million, or $7 \%$, during the first half of 2005 in part to support the higher sales level. However, the inventory turnover ratio, a measure of how quickly inventory is sold on average, improved from the end of last year. The increase in the first-in, first-out (FIFO) inventory value during 2005 was in the Metal Systems Group, with Alloy Products accounting for the majority of the inventory build. Alloy Products' pounds in inventory increased by $8 \%$ during the first half of 2005 . The MEG inventories increased $2 \%$ from year end.

Capital expenditures for property, plant and equipment totaled $\$ 4.9$ million in the first half of 2005 as capital spending remained below the level of depreciation. The Metal Systems Group accounted for just over half of the spending in the current year. Spending within the Elmore, Ohio facility, which supports all of the businesses within the Metal Systems Group, was $\$ 1.4$ million. Within the MEG, spending at the various WAM facilities totaled $\$ 1.9$ million. In addition to the $\$ 4.9$ million of capital spending, we purchased assets for $\$ 0.4$ million used by the MEG that previously were held under an operating lease. We also purchased the stock of OMCS for approximately $\$ 4.0$ million in cash. The preliminary goodwill assigned as a result of the OMCS purchase totaled $\$ 2.8$ million.

Other liabilities and accrued items declined $\$ 17.5$ million largely as a result of the payment in the first quarter 2005 of the incentive compensation earned by employees in 2004 and a $\$ 5.0$ million contribution to the domestic defined benefit pension plan. Offsetting a portion of this decline in other liabilities and accruals were changes in the accruals for the 2005 incentive compensation plans and changes in other miscellaneous accrual balances.

Unearned revenue, which is a liability representing products invoiced to customers but not shipped, was $\$ 7.8$ million at December 31, 2004 and zero as of July 1, 2005. The majority of the prior year end balance related to the JWST project.

Other long-term liabilities of $\$ 9.9$ million as of the end of the second quarter 2005 were $\$ 0.9$ million lower than at the prior year end. This decline was due to changes in the fair value of derivative financial instruments, primarily an interest rate swap, net of a slight increase in the accrued legal reserves. The retirement and post-employment obligation balance was $\$ 56.0$ million at the end of the second quarter 2005 compared to $\$ 49.7$ million at December 31, 2004. This balance represents the long-term liability under our domestic defined benefit pension plan, the retiree medical plan and other retirement plans and post-employment obligations. The major cause for the increased liability was a remeasurement of the pension plan as a result of a plan amendment as described in the critical accounting policy section of this Management's Discussion and Analysis.

Total balance sheet debt of $\$ 53.1$ million at the end of the second quarter 2005 was $\$ 19.3$ million lower than at December 31, 2004. We repaid two term notes totaling $\$ 18.6$ million during the first quarter 2005 that were originally scheduled to be paid off in installments through 2008. We retain the ability to re-borrow these funds under the revolving credit agreement up to amounts limited by the original term notes' amortization schedules. The notes were repaid early using the cash balances on hand in order to reduce interest expense going forward. As of July 1,2005 , short-term debt totaled $\$ 11.0$ million, which included foreign currency denominated loans and a gold-denominated loan, while the current portion of long-term debt totaled $\$ 0.6$ million and long-term debt totaled $\$ 41.5$ million. We were in compliance with all of our debt covenants as of the end of the second quarter 2005.

## Table of Contents

We received $\$ 0.4$ million for the exercise of approximately 28,800 options to purchase shares of our common stock during the first half of 2005.

Total shareholders' equity increased from $\$ 208.1$ million at the beginning of the first quarter 2005 to $\$ 211.7$ million at the end of the second quarter 2005. The increase was due primarily to comprehensive income of $\$ 3.3$ million, which includes the valuation adjustments associated with the minimum pension liability and derivative financial instruments (see Note $\mathbf{C}$ to the Consolidated Financial Statements), and the exercise of options.

The balance outstanding under the off-balance sheet precious metal consigned inventory arrangements increased $\$ 14.0$ million during the first half of 2005, due to higher volumes of metal on hand as the impact of changes in prices between the end of the second quarter 2005 and year-end 2004 was minimal. During 2005, we negotiated a new precious metal consigned inventory agreement that increased the capacity and allowed for other more favorable terms.

There have been no substantive changes in the summary of contractual payments under long-term debt agreements, operating leases and material purchase commitments as of July 1, 2005 from the year-end 2004 totals as disclosed on page 23 of our annual report to shareholders for the period ended December 31, 2004.

Net cash provided from operations was $\$ 1.0$ million in the first half of 2004 as the net income and benefits of depreciation more than offset the increases in various working capital items, primarily receivables and inventory. Receivables grew $\$ 12.9$ million due to the higher sales volume in the quarter and a slightly slower DSO. Total inventories increased $\$ 12.6$ million, or $14 \%$, in the first half of 2004 , although the inventory turnover period improved. The majority of the inventory increase was in the Metal Systems Group, with a portion of that inventory build in support of the planned shipments under the JWST program. Capital expenditures totaled $\$ 3.1$ million for the first two quarters of 2004, as the quarterly spending remained under $\$ 2.0$ million for the sixth consecutive quarter. Accounts payable and other liabilities and accrued items increased $\$ 1.8$ million due to changes in business levels. Balance sheet debt totaled $\$ 104.1$ million at the end of the second quarter 2004, an increase of $\$ 5.0$ million during the first half of that year, which was mainly used to fund the capital expenditures. We received $\$ 2.4$ million for the exercise of employee stock options during the first half of 2004. The cash balance stood at $\$ 10.3$ million at the end of the second quarter 2004, an increase of $\$ 5.3$ million during the year.

We believe funds from operations and the available borrowing capacity are adequate to support operating requirements, capital expenditures, projected pension plan contributions and environmental remediation projects. Our debt-to-total capital ratio improved during the first half of 2005 . We had approximately $\$ 78.5$ million of available borrowing capacity under the existing lines of credit as of July 1,2005 .

## Critical Accounting Policies

Pension: We amended our domestic defined benefit plan in 2005. The amendment, which revised the benefit payout formula for the majority of the participants among other changes, was deemed to be a significant event in accordance with Statement No. 87, "Employers' Accounting for Pensions" and the plan's assets and liabilities were remeasured accordingly. As a result of the remeasurement, the prior service cost intangible asset of $\$ 5.0$ million, which previously was included in other assets on the Consolidated Balance Sheet, was charged off against other comprehensive income, a component of shareholders' equity. The minimum pension liability increased $\$ 6.1$ million as a net result of the amendment and the impact of a reduction in the discount rate and changes in other valuation factors. The change in the minimum pension liability was also charged to other comprehensive income. The remeasurement also reduced the 2005 estimated annual expense of the domestic defined benefit plan to $\$ 3.1$ million from $\$ 4.8$ million as previously estimated. As part of the remeasurement process, management reviewed the discount rate, expected rate of return and other valuation assumptions and made revisions as warranted. See Note F to the Consolidated Financial Statements.

Deferred Taxes: A valuation allowance was initially recorded against domestic and certain foreign deferred tax assets in the fourth quarter 2002 as a result of our then recent cumulative losses. The valuation

## Table of Contents

allowance was adjusted in 2003 and 2004 and charged or credited to income or other comprehensive income as appropriate. The valuation allowance was reduced in the first half of 2005, offsetting a portion of the tax expense that would have been recorded against pre-tax income. In subsequent periods when we generate pre-tax income, a federal tax expense will not be recorded to the extent that the remaining valuation allowance can be used to offset that expense. Once a consistent pattern of pre-tax income is established or other events occur that indicate that the deferred tax assets will be realized, additional portions or all of the remaining valuation allowance will be reversed back to income. Should we generate pre-tax losses in subsequent periods, a tax benefit will not be recorded and the valuation allowance will be increased. Despite the valuation allowance, we retain the ability to utilize the benefits of the domestic loss carry-forwards and other deferred tax assets on future tax returns.

For additional information regarding this and other critical accounting policies, please refer to pages 24 to 26 of our annual report to shareholders for the period ended December 31, 2004.

## Market Risk Disclosures

We are exposed to movements in base metal prices, primarily copper. Copper prices remained quite high in the first two quarters of 2005. Portions of this exposure are covered by passing the change in prices through to our customers. Beginning in 2005, we also entered into derivative contracts to hedge against further adverse movements in copper prices for a portion of our estimated 2005 exposure. We recorded hedge gains on matured copper contracts of an immaterial amount in the second quarter 2005.

For additional information regarding market risks, please refer to pages 26 and 27 of our annual report to shareholders for the period ended December 31, 2004.

## Outlook

Demand from portions of our larger markets has been weak in 2005, as evidenced by the new sales order entry rate being lower than sales over the first half of the year. Demand for defense applications was soft in the second quarter and the outlook for the balance of the year is also soft as defense funds are being diverted from the tactical applications that utilize our materials in order to support the current military operations in the Middle East. We believe that the actual growth rate in the over-all telecommunications and computer market is greater than what we are experiencing and we believe that this inconsistency may be due to an over-supply of our materials in downstream inventories. As this over-supply is worked off, we believe demand should improve. Demand from other markets, including magnetic and optical data storage, remains strong. We also continue to make progress in developing new products and applications; qualification of new materials or applications can be a time consuming process given the technical nature and complexity of the applications for our products, but the growth in these applications has had a positive influence on our sales. Looking forward, we believe that our sales in the third quarter, which in a given year are typically affected by industry and geographic slowdowns, will be in a range of $5 \%$ above or below sales in the third quarter of 2004 .

Margins and profitability may continue to be hampered somewhat to the extent that copper and other material costs remain high and that higher cost cannot be passed through to the customer or hedged at an acceptable level. In addition, the lower margins from the unfavorable change in product mix could potentially continue as well, as we continue to face stiff price competition in many of our markets. Other cost pressures, including energy, may continue to have a negative impact on margins and profitability. However, by improving manufacturing yields and efficiencies and implementing cost control measures and practices, we aim to minimize the impact of these pressures on our expense levels.

## Forward-Looking Statements

Portions of the narrative set forth in this document that are not statements of historical or current facts are forward-looking statements. Our actual future performance may materially differ from that contemplated

## Table of Contents

by the forward-looking statements as a result of a variety of factors. These factors include, in addition to those mentioned elsewhere herein:

- The global economy;
- The condition of the markets which we serve, whether defined geographically or by segment, with the major market segments being telecommunications and computer, automotive electronics, magnetic and optical data storage, aerospace and defense, industrial components and appliance;
- Changes in product mix and the financial condition of customers;
- Our success in developing and introducing new products and applications;
- Our success in implementing our strategic plans and the timely and successful completion of any capital projects;
- The availability of adequate lines of credit and the associated interest rates;
- Other financial factors, including cost and availability of materials, tax rates, exchange rates, pension costs, energy costs, regulatory compliance costs, and the cost and availability of insurance;
- The uncertainties related to the impact of war and terrorist activities;
- Changes in government regulatory requirements and the enactment of new legislation that impacts our obligations; and,
- The conclusion of pending litigation matters in accordance with our expectation that there will be no material adverse effects.


## Item 3. Quantitative and Qualitative Disclosure about Market Risk

For information regarding the Company's market risks, please refer to pages 26 and 27 of the Company's annual report to shareholders for the period ended December 31, 2004.

## Item 4. Controls and Procedures

We carried out an evaluation under the supervision and with participation of management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of July 1, 2005 pursuant to Rule 13a-15(b) under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective as of the evaluation date.

There have been no changes in our internal controls over financial reporting identified in connection with the evaluation required by Rule 13a-15 under the Securities Exchange Act of 1934, as amended, that occurred during the quarter ended July 1, 2005 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Management's assessment on our internal control over financial reporting is contained in the Report of Management on Internal Control over Financial Reporting on page 29 in our annual report to shareholders for the year ended December 31, 2004 and is incorporated herein by reference.

The Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting opining on management's assessment, included in the Report of Management on Internal Control over Financial Reporting, and opining on the effectiveness of our internal control over financial reporting is contained on page 29 in the annual report to shareholders for the year ended December 31, 2004 and is incorporated herein by reference.

## PART II OTHER INFORMATION

## Item 1. Legal Proceedings

The Company and our subsidiaries are subject, from time to time, to a variety of civil and administrative proceedings arising out of our normal operations, including, without limitation, product liability claims, health, safety and environmental claims and employment-related actions. Among such proceedings are the cases described below.

## Beryllium Claims

As of July 1, 2005, our subsidiary, Brush Wellman Inc., was a defendant in 16 proceedings in various state and federal courts brought by plaintiffs alleging that they have contracted, or have been placed at risk of contracting, chronic beryllium disease or other lung conditions as a result of exposure to beryllium. Plaintiffs in beryllium cases seek recovery under negligence and various other legal theories and seek compensatory and punitive damages, in many cases of an unspecified sum. Spouses of some plaintiffs claim loss of consortium.

During the second quarter of 2005, the number of beryllium cases remained unchanged from 16 (involving 61 plaintiffs) as of April 1, 2005 to 16 cases (involving 61 plaintiffs) as of July 1, 2005. During the second quarter, one third party case (involving two plaintiffs) was filed. One third party case (involving two plaintiffs) was voluntarily dismissed by the plaintiff. One third party case (involving one plaintiff) was settled; however, the Company is awaiting final court dismissal.

The 16 pending beryllium cases as of July 1,2005 fall into two categories: 12 cases involving third-party individual plaintiffs, with 20 individuals (and six spouses who have filed claims as part of their spouse's case and two children who have filed claims as part of their parent's case); and four purported class actions, involving 33 plaintiffs, as discussed more fully below. Claims brought by third party plaintiffs (typically employees of our customers or contractors) are generally covered by varying levels of insurance.

The first purported class action is Manuel Marin, et al. v. Brush Wellman Inc., filed in Superior Court of California, Los Angeles County, case number BC299055, on July 15, 2003. The named plaintiffs are Manuel Marin, Lisa Marin, Garfield Perry and Susan Perry. The defendants are Brush Wellman, Appanaitis Enterprises, Inc., and Doe Defendants 1 through 100. A First Amended Complaint was filed on September 15, 2004, naming five additional plaintiffs. The five additional named plaintiffs are Robert Thomas, Darnell White, Leonard Joffrion, James Jones and John Kesselring. The plaintiffs allege that they have been sensitized to beryllium while employed at the Boeing Company. The plaintiffs' wives claim loss of consortium. The plaintiffs purport to represent two classes of approximately 250 members each, one consisting of workers who worked at Boeing or its predecessors and are beryllium sensitized and the other consisting of their spouses. They have brought claims for negligence, strict liability - design defect, strict liability - failure to warn, fraudulent concealment, breach of implied warranties, and unfair business practices. The plaintiffs seek injunctive relief, medical monitoring, medical and health care provider reimbursement, attorneys' fees and costs, revocation of business license, and compensatory and punitive damages. Messrs. Marin, Perry, Thomas, White, Joffrion, Jones and Kesselring represent current and past employees of Boeing in California; and Ms. Marin and Ms. Perry are spouses. Defendant Appanaitis Enterprises, Inc. was dismissed on May 5, 2005.

The second purported class action is Neal Parker, et al. v. Brush Wellman Inc., filed in Superior Court of Fulton County, State of Georgia, case number 2004CV80827, on January 29, 2004. The case was removed to the U.S. District Court for the Northern District of Georgia, case number 04-CV-606, on March 4, 2004. The named plaintiffs are Neal Parker, Wilbert Carlton, Stephen King, Ray Burns, Deborah Watkins, Leonard Ponder, Barbara King and Patricia Burns. The defendants are Brush Wellman; Schmiede Machine and Tool Corporation; Thyssenkrupp Materials NA Inc., d/b/a Copper and Brass Sales; Axsys Technologies, Inc.; Alcoa, Inc.; McCann Aerospace Machining Corporation; Cobb Tool, Inc.; and Lockheed Martin Corporation. Messrs. Parker, Carlton, King and Burns and Ms. Watkins are current employees of Lockheed. Mr. Ponder is a retired employee, and Ms. King and Ms. Burns are family members. The plaintiffs have brought claims for negligence, strict liability, fraudulent concealment, civil conspiracy and punitive damages. The plaintiffs seek a

## Table of Contents

permanent injunction requiring the defendants to fund a court-supervised medical monitoring program, attorneys' fees and punitive damages. On March 29, 2005, the Court entered an order directing plaintiffs to amend their pleading to segregate out those plaintiffs who have endured only subclinical, cellular, and subcellular effects from those who have sustained actionable tort injuries, and that following such amendment, the Court will enter an order dismissing the claims asserted by the former subset of claimants; dismissing Count I of the complaint, which sought the creation of a medical monitoring fund; and dismissing the claims against defendant Axsys Technologies Inc. On April 20, 2005, the plaintiffs filed a Substituted Amended Complaint for Damages, contending that each of the eight named plaintiffs and the individuals listed on the attachment to the original Complaint, and each of the putative class members have sustained personal injuries; however, they allege that they identified five individuals whose injuries have manifested themselves such that they have been detected by physical examination and/or laboratory test.

The third purported class action is George Paz, et al. v. Brush Engineered Materials Inc., et al., filed in the U.S. District Court for the Southern District of Mississippi, case number 1:04CV597 on June 30, 2004. The named plaintiffs are George Paz, Barbara Faciane, Joe Lewis, Donald Jones, Ernest Bryan, Gregory Condiff, Karla Condiff, Odie Ladner, Henry Polk, Roy Tootle, William Stewart, Margaret Ann Harris, Judith Lemon, Theresa Ladner and Yolanda Paz. The defendants are Brush Engineered Materials Inc.; Brush Wellman Inc.; Wess-Del Inc.; and the Boeing Company. Plaintiffs seek the establishment of a medical monitoring trust fund as a result of their alleged exposure to products containing beryllium, attorneys' fees and expenses, and general and equitable relief. The plaintiffs purport to sue on behalf of a class of present or former Defense Contract Management Administration (DCMA) employees who conducted quality assurance work at Stennis Space Center and the Boeing Company at its facility in Canoga Park, California; present and former employees of Boeing at Stennis; and spouses and children of those individuals. Messrs. Paz and Lewis and Ms. Faciane represent current and former DCMA employees at Stennis. Mr. Jones represents DCMA employees at Canoga Park. Messrs. Bryan, Condiff, Ladner, Park, Polk, Tootle and Stewart and Ms. Condiff represent Boeing employees at Stennis. Ms. Harris, Ms. Lemon, Ms. Ladner and Ms. Paz are family members. The Company filed a Motion to Dismiss on September 28, 2004, which was granted and judgment was entered on January 11, 2005; however, the plaintiffs have filed an appeal.

The fourth purported class action is Gary Anthony v. Brush Wellman Inc., et al., filed in the Court of Common Pleas of Philadelphia County, Pennsylvania, case number 01718 on March 3, 2005. The case was removed to the U.S. District Court for the Eastern District of Pennsylvania, case number 05-CV-1202, on March 14, 2005. The only named plaintiff is Gary Anthony. The defendants are Brush Wellman Inc., Gary Kowalski, and Dickinson \& Associates Manufacturers Representatives. The plaintiff purports to sue on behalf of a class of current and former employees of the U.S. Gauge facility in Sellersville, Pennsylvania who have ever been exposed to beryllium for a period of at least one month while employed at U.S. Gauge. The plaintiff has brought claims for negligence. Plaintiff seeks the establishment of a medical monitoring trust fund, cost of publication of approved guidelines and procedures for medical screening and monitoring of the class, attorneys' fees and expenses.

## Other Claims

One of the Company's subsidiaries, Williams Advanced Materials, Inc. (WAM) is a party to patent litigation with Target Technology Company, LLC (Target). In first actions filed in April 2003 by WAM against Target in the U.S. District Court, Western District of New York, consolidated under case number 03-CV-0276A(SR), WAM has asked the court for a judgment declaring certain Target patents as invalid and/or unenforceable and awarding WAM damages in related cases. Target has counterclaimed alleging infringement and seeking a judgment for infringement, an injunction against further infringement and damages for past infringement. In September 2004, Target filed a separate action for patent infringement in U.S. District Court, Central District of California, case number SACV04-1083 DOC (MLGx), which action named as defendants, among others, WAM and WAM customers who purchase certain WAM alloys used in the production of DVDs. In the California action, Target alleges that the patent at issue, which is related to the patents at issue in the New York action, protects the use of certain silver alloys to make the semi-reflective layer in DVDs, and that in DVD-9s, a metal film is applied to the semi-reflective layer by a sputtering process,

## Table of Contents

and that raw material for the procedure is called a sputtering target. Target alleges that WAM manufactures and sells sputtering targets made of a silver alloy to DVD manufacturers with knowledge that these targets are used by its customers to manufacture the semi-reflective layer of a DVD-9. In that action, Target seeks judgment that its patent is valid and that it is being infringed by the defendants, an injunction permanently restraining the defendants, damages adequate to compensate plaintiff for the infringement, treble damages, and attorneys' fees and costs.

## Item 4. Submission of Matters to a Vote of Security Holders

(a) The Company's Annual Meeting of Shareholders for 2005 was held on May 3, 2005.
(b) At the Annual Meeting, three directors were elected to serve for a term of three years by the following vote:

|  | Shares Voted <br> "For" | Shares Voted <br> "Against" | Shares Voted <br> "Abstaining" | Shares <br> "Non-Voted", |
| :--- | :---: | :---: | :---: | :---: |
| Albert C. Bersticker | $15,534,487.572$ | $-0-$ | $2,119,472.462$ | $-0-$ |
| William G. Pryor | $15,716,647.014$ | $-0-$ | $1,937,313.020$ | $-0-$ |
| N. Mohan Reddy | $15,483,748.805$ | $-0-$ | $2,170,211.229$ | $-0-$ |

The following directors continued their term of office after the meeting: Gordon D. Harnett, Joseph P. Keithley, William B. Lawrence, William P. Madar, and William R. Robertson, John Sherwin, Jr.

## Item 6. Exhibits

(a) Exhibits

10(a) Amendment No. 2 to Brush Engineered Materials Inc. Key Employee Share Option Plan.
11 Statement re computation of per share earnings (filed as Exhibit 11 to Part I of this report).
31.1 Rule 13a-14(a) Certification
31.2 Rule 13a-14(a) Certification
32.1

Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

## 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.

BRUSH ENGINEERED MATERIALS INC.
Dated: August 3, 2005
/s/ John D. Grampa
John D. Grampa
Vice President Finance
and Chief Financial Officer

## AMENDMENT NO. 2 <br> TO <br> BRUSH ENGINEERED MATERIALS INC. KEY EMPLOYEE SHARE OPTION PLAN

Brush Engineered Materials, Inc., an Ohio corporation, hereby adopts this Amendment No. 2 to the Brush Engineered Materials Inc. Key Employee Share Option Plan (the "Plan"), pursuant to the transition rules set forth in IRS Notice 2005-1 with respect to Section 409A of the Internal Revenue Code of 1986, as amended.

## I.

All elective deferrals of compensation and non-elective deferrals relating to foregone matching contributions made under the Plan in connection with the grant of Options on September 30, 2004, and on December 31, 2004, and all Options granted under the Plan with respect to those deferrals are cancelled effective as of June 10, 2005. Each Participant who made any such a deferral or had such a deferral made on his behalf shall receive payment of the amount of such deferrals upon the cancellation, less applicable withholding taxes, and any such Participant shall have no further rights under the Options granted with respect to such deferrals. Notwithstanding the foregoing, a Participant who exercised any such Option shall not receive payment of the amount of his deferral with respect to the cancellation of the exercised Option.

## II.

No Options shall be issued under the Plan after December 31, 2004.
Executed at Cleveland, Ohio, this 10 th day of June, 2005.
BRUSH ENGINEERED MATERIALS INC.

By /s/ Daniel A. Skoch
Title: Senior Vice President Administration

And /s/ Michael C. Hasychak
Title: Vice President, Secretary and Treasurer

## BRUSH ENGINEERED MATERIALS INC. AND SUBSIDIARIES

## COMPUTATION OF PER SHARE EARNINGS

|  | Second Quarter Ended |  |  |  | First Half Ended |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | July 12005 |  | July 22004 |  | July 12005 |  | July 22004 |  |
| Basic: |  |  |  |  |  |  |  |  |
| Average shares outstanding |  | 19,224,298 |  | 16,704,568 |  | 19,210,887 |  | 16,661,099 |
| Net Income | \$ | 5,530,000 | \$ | 6,571,000 | \$ | 9,817,000 | \$ | 10,324,000 |
| Per share amount | \$ | 0.29 | \$ | 0.39 | \$ | 0.51 | \$ | 0.62 |
| Diluted: |  |  |  |  |  |  |  |  |
| Average shares outstanding |  | 19,224,298 |  | 16,704,568 |  | 19,210,887 |  | 16,661,099 |
| Dilutive stock securities based on the treasury stock method using average market price |  | 127,567 |  | 423,130 |  | 163,252 |  | 446,196 |
| Totals |  | 19,351,865 |  | 17,127,698 |  | 19,374,139 |  | 17,107,295 |
| Net Income | \$ | 5,530,000 | \$ | 6,571,000 | \$ | 9,817,000 | \$ | 10,324,000 |
| Per share amount | \$ | 0.29 | \$ | 0.38 | \$ | 0.51 | \$ | 0.60 |

## CERTIFICATIONS

I, Gordon D. Harnett, certify that:

1) I have reviewed this quarterly report on Form 10-Q of Brush Engineered Materials Inc. (the "Company");
2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4) The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and we have:
a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
c) evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
d) disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and
5) The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Dated: August 3, 2005
/s/ Gordon D. Harnett
Gordon D. Harnett
Chairman, Chief Executive Officer

## CERTIFICATIONS

I, John D. Grampa, certify that:

1) I have reviewed this quarterly report on Form 10-Q of Brush Engineered Materials Inc. (the "Company");
2) Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3) Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4) The Company's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and we have:
a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
c) evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
d) disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and
5) The Company's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Dated: August 3, 2005
/s/ John D. Grampa
John D. Grampa
Vice President Finance and Chief Financial Officer

> Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, in connection with the fling of the Quarterly Report on Form 10-Q of Brush Engineered Materials Inc. (the "Company") for the quarter ended July 1, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), each of the undersigned officers of the Company certifies, that, to such officer's knowledge:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78 m or 780 (d)), and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods expressed in the Report.

Dated: August 3, 2005
/s/ Gordon D. Harnett
Gordon D. Harnett
Chairman of the Board and Chief Executive Officer
/s/ John D. Grampa
John D. Grampa
Vice President Finance and Chief Financial Officer

