

KLA TENCOR CORP
Form 10-Q
January 28, 2011
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

☒ **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended: December 31, 2010

or

☐ **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 000-09992

KLA-Tencor Corporation

(Exact name of registrant as specified in its charter)

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Delaware
(State or other jurisdiction of
incorporation or organization)

04-2564110
(I.R.S. Employer

Identification No.)

One Technology Drive

Milpitas, California

95035

(Address of principal executive offices)

(Zip Code)

(408) 875-3000

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒

Accelerated filer ☐

Non-accelerated filer ☐
(Do not check if a smaller
reporting company)

Smaller reporting company ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

As of January 13, 2011, there were 167,221,198 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

Table of Contents

INDEX

	Page Number
<u>PART I</u>	
<u>FINANCIAL INFORMATION</u>	
Item 1	
Financial Statements (Unaudited)	
<u>Condensed Consolidated Balance Sheets as of December 31, 2010 and June 30, 2010</u>	3
<u>Condensed Consolidated Statements of Operations for the Three Months and Six Months Ended December 31, 2010 and 2009</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended December 31, 2010 and 2009</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	28
Item 3	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	40
Item 4	
<u>Controls and Procedures</u>	41
<u>PART II</u>	
<u>OTHER INFORMATION</u>	
Item 1	
<u>Legal Proceedings</u>	41
Item 1A	
<u>Risk Factors</u>	41
Item 2	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	51
Item 3	
<u>Defaults upon Senior Securities</u>	51
Item 4	
<u>(Removed and Reserved)</u>	51
Item 5	
<u>Other Information</u>	51
Item 6	
<u>Exhibits</u>	52
<u>SIGNATURES</u>	53
<u>EXHIBIT INDEX</u>	54

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****KLA-TENCOR CORPORATION****Condensed Consolidated Balance Sheets**

(Unaudited)

<i>(In thousands)</i>	December 31, 2010	June 30, 2010
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 596,104	\$ 529,918
Marketable securities	1,040,296	1,004,126
Accounts receivable, net	531,453	440,125
Inventories, net	504,697	401,730
Deferred income taxes	333,410	328,522
Other current assets	120,351	131,044
Total current assets	3,126,311	2,835,465
Land, property and equipment, net	249,468	236,752
Goodwill	328,147	328,006
Purchased intangibles, net	101,900	117,336
Other non-current assets	362,635	389,497
Total assets	\$ 4,168,461	\$ 3,907,056
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 123,166	\$ 107,938
Deferred system profit	241,494	204,764
Unearned revenue	33,193	37,026
Other current liabilities	396,084	422,059
Total current liabilities	793,937	771,787
Non-current liabilities:		
Long-term debt	746,018	745,747
Income tax payable	62,329	53,492
Unearned revenue	28,383	20,354
Other non-current liabilities	71,560	69,065
Total liabilities	1,702,227	1,660,445
Commitments and contingencies (Note 12 and Note 13)		
Stockholders' equity:		
Common stock and capital in excess of par value	972,870	921,460
Retained earnings	1,506,747	1,356,454
Accumulated other comprehensive income (loss)	(13,383)	(31,303)
Total stockholders' equity	2,466,234	2,246,611

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Total liabilities and stockholders' equity	\$ 4,168,461	\$ 3,907,056
--	--------------	--------------

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of Contents**KLA-TENCOR CORPORATION****Condensed Consolidated Statements of Operations**

(Unaudited)

<i>(In thousands, except per share data)</i>	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Revenues:				
Product	\$ 627,857	\$ 314,946	\$ 1,178,466	\$ 544,197
Service	138,470	125,409	270,203	238,845
Total revenues	766,327	440,355	1,448,669	783,042
Costs and operating expenses:				
Costs of revenues	311,398	207,286	575,367	379,178
Engineering, research and development	94,897	83,301	189,617	161,510
Selling, general and administrative	91,166	102,673	179,203	180,309
Total costs and operating expenses	497,461	393,260	944,187	720,997
Income from operations	268,866	47,095	504,482	62,045
Interest income and other, net	(4,182)	4,463	(2,957)	25,762
Interest expense	13,493	13,542	27,022	26,999
Income before income taxes	251,191	38,016	474,503	60,808
Provision for income taxes	65,699	16,222	134,815	18,609
Net income	\$ 185,492	\$ 21,794	\$ 339,688	\$ 42,199
Net income per share:				
Basic	\$ 1.11	\$ 0.13	\$ 2.03	\$ 0.25
Diluted	\$ 1.09	\$ 0.13	\$ 2.00	\$ 0.24
Cash dividend paid per share	\$ 0.25	\$ 0.15	\$ 0.50	\$ 0.30
Weighted average number of shares:				
Basic	166,886	171,408	167,052	171,053
Diluted	169,513	173,808	169,685	173,292

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of Contents**KLA-TENCOR CORPORATION****Condensed Consolidated Statements of Cash Flows**

(Unaudited)

	Six months ended December 31,	
<i>(In thousands)</i>	2010	2009
Cash flows from operating activities:		
Net income	\$ 339,688	\$ 42,199
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	42,436	46,374
Asset impairment charges	6,800	10,592
Gain on sale of real estate assets	(1,372)	(2,984)
Non-cash stock-based compensation expense	43,644	41,054
Tax charge from equity awards		(5,133)
Net gain on sale of marketable securities and other investments	(1,477)	(2,874)
Changes in assets and liabilities, net of assets acquired and liabilities assumed in business combinations:		
Increase in accounts receivable, net	(79,232)	(83,843)
Decrease (increase) in inventories	(103,160)	24,350
Decrease (increase) in other assets	(27,267)	55,182
Increase in accounts payable	14,680	23,616
Increase in deferred system profit	36,730	51,758
Increase in other liabilities	17,983	36,559
Net cash provided by operating activities	289,453	236,850
Cash flows from investing activities:		
Capital expenditures, net	(22,715)	(14,370)
Proceeds from sale of assets	18,185	5,878
Purchase of available-for-sale securities	(418,312)	(600,671)
Proceeds from sale and maturity of available-for-sale securities	363,327	404,387
Purchase of trading securities	(28,401)	(38,574)
Proceeds from sale of trading securities	44,528	46,621
Net cash used in investing activities	(43,388)	(196,729)
Cash flows from financing activities:		
Issuance of common stock	31,723	23,462
Tax withholding payments related to vested and released restricted stock units	(20,251)	(12,204)
Common stock repurchases	(119,173)	
Payment of dividends to stockholders	(83,594)	(51,292)
Net cash used in financing activities	(191,295)	(40,034)
Effect of exchange rate changes on cash and cash equivalents	11,416	6,390
Net increase in cash and cash equivalents	66,186	6,477
Cash and cash equivalents at beginning of period	529,918	524,967
Cash and cash equivalents at end of period	\$ 596,104	\$ 531,444

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Supplemental cash flow disclosures:

Income taxes paid (refund received), net	\$ 117,370	\$ (57,900)
Interest paid	\$ 26,447	\$ 26,330

See accompanying notes to condensed consolidated financial statements (unaudited).

Table of Contents

KLA-TENCOR CORPORATION

Notes to Condensed Consolidated Financial Statements

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

Basis of Presentation. The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation ("KLA-Tencor" or the Company) pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, Financial Statements and Supplementary Data included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2010, filed with the SEC on August 6, 2010.

The condensed consolidated financial statements include the accounts of KLA-Tencor and its majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

References in this Quarterly Report on Form 10-Q to authoritative guidance are to the Accounting Standards Codification issued by the Financial Accounting Standards Board ("FASB") in June 2009.

The results of operations for the three and six months ended December 31, 2010 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2011.

Certain reclassifications have been made to the prior year's Condensed Consolidated Balance Sheet and notes to conform to the current year presentation. The reclassifications had no effect on the Condensed Consolidated Statements of Operations or Cash Flows.

Management Estimates. The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

Recent Accounting Pronouncements

In December 2010, the FASB amended its guidance on goodwill and other intangible assets. The amendment modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if there are qualitative factors indicating that it is more likely than not that a goodwill impairment exists. The qualitative factors are consistent with the existing guidance which requires goodwill of a reporting unit to be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This amendment was effective for the Company's interim period ending December 31, 2010. The amendment did not have an impact on the Company's financial position, results of operations or cash flows.

In December 2010, the FASB amended its guidance on business combinations. Under the amended guidance, a public entity that presents comparative financial statements must disclose the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the prior annual reporting period. The amendment is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The amendment did not have an impact on the Company's financial position, results of operations or cash flows.

In April 2010, the FASB amended its guidance on share-based payment awards with an exercise price denominated in certain currencies. The amendment clarifies that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. This amendment becomes effective for the Company's interim period ending September 30, 2011. The Company does not expect the implementation to have an

Edgar Filing: KLA TENCOR CORP - Form 10-Q

impact on its financial position, results of operations or cash flows.

In January 2010, the FASB issued authoritative guidance for fair value measurements. This guidance now requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and also to describe the reasons for these transfers. This authoritative guidance also requires enhanced disclosure of activity in Level 3 fair value measurements. The guidance for Level 1 and Level 2 fair value measurements was effective for the Company's interim reporting period ended March 31, 2010. The implementation did not have an impact on the Company's financial position, results of operations or cash flows as it is disclosure-only in nature. The guidance for Level 3 fair value measurements disclosures becomes effective for the Company's interim reporting period ending September 30, 2011 and the Company does not expect that this guidance will have an impact on its financial position, results of operations or cash flows as it is disclosure-only in nature.

Table of Contents

Revenue Recognition for Certain Arrangements with Software Elements and/or Multiple Deliverables

In October 2009, the FASB amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry-specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple-deliverable revenue arrangements to:

provide updated guidance on how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and

require an entity to allocate revenue in an arrangement using estimated selling prices (ESP) of deliverables if it does not have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) of selling price. Valuation terms are defined as follows:

VSOE the price at which the Company sells the element in a separate stand-alone transaction.

TPE evidence from the Company or other companies of the value of a largely interchangeable element in a transaction.

ESP the Company's best estimate of the selling price of an element in a transaction.

The Company elected to early adopt this accounting guidance at the beginning of its second quarter of the fiscal year ended June 30, 2010 and applied the adoption retrospectively to the beginning of the fiscal year to apply the guidance to transactions originating or materially modified after June 30, 2009. The implementation resulted in additional qualitative disclosures that are included below but did not have a material impact on the Company's financial position, results of operations or cash flows.

This guidance does not generally change the units of accounting for the Company's revenue transactions. The Company typically recognizes revenue for system sales upon acceptance by the customer that the system has been installed and is operating according to predetermined specifications. Under certain circumstances, however, the Company recognizes revenue upon shipment, prior to acceptance by the customer. The portion of revenue associated with installation is deferred based on relative sales price and recognized upon completion of the installation. Spare parts revenue is recognized when the product has been shipped and risk of loss has passed to the customer, and collectability is reasonably assured. Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a contract, such as consulting and training revenue, is recognized when the related services are performed, and collectability is reasonably assured. The Company's arrangements generally do not include any provisions for cancellation, termination or refunds that would significantly impact recognized revenue.

The Company enters into revenue arrangements that may consist of multiple deliverables of its products and services where certain elements of a sales contract are not delivered and accepted in one reporting period.

In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. As a result, for substantially all of the arrangements with multiple deliverables pertaining to products and services, the Company uses VSOE or TPE to allocate the selling price to each deliverable. The Company determines TPE based on historical prices charged for products and services when sold on a stand-alone basis.

When the Company is unable to establish relative selling price using VSOE or TPE, the Company uses ESP in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

The Company regularly reviews relative selling prices and maintains internal controls over the establishment and updates of these estimates.

NOTE 2 FAIR VALUE MEASUREMENTS

The Company's financial assets are measured and recorded at fair value, except for equity investments in privately-held companies. These equity investments are generally accounted for under the cost method of accounting and are periodically assessed for other-than-temporary impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred. The Company's non-financial assets, such as goodwill, intangible assets, and property, plant and equipment, are recorded at cost and are assessed for impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred.

Fair Value Hierarchy. The authoritative guidance for fair value measurements establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below:

- Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.

Table of Contents

Level 2 Valuations based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities.

Level 3 Valuations based on inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.

All of the Company's financial instruments were classified within Level 1 or Level 2 of the fair value hierarchy at December 31, 2010, because they were valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of instruments valued based on quoted market prices in active markets include money market funds and U.S. Treasury securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

The types of instruments valued based on other observable inputs include U.S. agency securities, commercial paper, U.S. corporate bonds, municipal obligations and sovereign securities. The market inputs used to value these instruments generally consist of market yields, reported trades and broker/dealer quotes. Such instruments are generally classified within Level 2 of the fair value hierarchy.

The principal market in which the Company executes its foreign currency contracts is the institutional market in an over-the-counter environment with a relatively high level of price transparency. The market participants usually are large commercial banks. The Company's foreign currency contracts' valuation inputs are based on quoted prices and quoted pricing intervals from public data sources and do not involve management judgment. These contracts are typically classified within Level 2 of the fair value hierarchy.

The types of instruments valued based on unobservable inputs include the auction rate securities that were held by the Company as of and prior to June 30, 2010. Such instruments were generally classified within Level 3 of the fair value hierarchy. The Company estimated the fair value of these auction rate securities using a discounted cash flow model incorporating assumptions that market participants would use in their estimates of fair value. Some of these assumptions included estimates for interest rates, timing and amount of cash flows and expected holding periods of the auction rate securities.

Financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2010 were as follows:

		Quoted Prices in Active Markets for Identical Assets (Level 1)			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)		Total				
U.S. Treasuries	\$	60,706	\$	39,681	\$	21,025
U.S. Government agency securities		250,635		248,636		1,999
Municipal bonds		60,497				60,497
Corporate debt securities		621,883				621,883
Money market, bank deposits and other		401,010		401,010		
Sovereign securities		43,587		10,385		33,202
Total marketable securities and cash equivalents		1,438,318		699,712		738,606
Executive Deferred Savings Plan:						
Money market and other		720		720		
Mutual funds		124,873		96,337		28,536
Executive Deferred Savings Plan total		125,593		97,057		28,536
Derivative assets		2,313				2,313
Total financial assets	\$	1,566,224	\$	796,769	\$	769,455
						\$

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Derivative liabilities	\$	(4,584)	\$		\$	(4,584)	\$
Total financial liabilities	\$	(4,584)	\$		\$	(4,584)	\$

Table of Contents

Financial assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 were as follows:

		Quoted Prices in Active Markets for Identical Assets (Level 1)			Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)	Total					
U.S. Treasuries	\$ 42,293	\$	35,194	\$	7,099	
U.S. Government agency securities	250,280		243,144		7,136	
Municipal bonds	55,459				55,459	
Corporate debt securities	603,156				603,156	
Money market, bank deposits and other	373,081		373,070		11	
Sovereign securities	39,355		10,500		28,855	
Auction rate securities	16,825					16,825
Total marketable securities and cash equivalents	1,380,449		661,908		701,716	16,825
Executive Deferred Savings Plan:						
Money market and other	4		4			
Mutual funds	109,226		85,254		23,972	
Executive Deferred Savings Plan total	109,230		85,258		23,972	
Derivative assets	296				296	
Total financial assets	\$ 1,489,975	\$	747,166	\$	725,984	\$ 16,825
Derivative liabilities	\$ (5,824)	\$		\$	(5,824)	\$
Total financial liabilities	\$ (5,824)	\$		\$	(5,824)	\$

Table of Contents

Assets and liabilities measured at fair value on a recurring basis were presented on the Company's Condensed Consolidated Balance Sheet as of December 31, 2010 as follows:

(In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 398,022	\$ 374,573	\$ 23,449	\$
Marketable securities	1,040,296	325,139	715,157	
Other current assets	2,313		2,313	
Other non-current assets	125,593	97,057	28,536	
Total financial assets	\$ 1,566,224	\$ 796,769	\$ 769,455	\$
Other current liabilities	\$ (4,584)	\$	\$ (4,584)	\$
Total financial liabilities	\$ (4,584)	\$	\$ (4,584)	\$

Assets and liabilities measured at fair value on a recurring basis were presented on the Company's Condensed Consolidated Balance Sheet as of June 30, 2010 as follows:

(In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents	\$ 376,323	\$ 356,224	\$ 20,099	\$
Marketable securities	1,004,126	305,684	681,617	16,825
Other current assets	296		296	
Other non-current assets	109,230	85,258	23,972	
Total financial assets	\$ 1,489,975	\$ 747,166	\$ 725,984	\$ 16,825
Other current liabilities	\$ (5,824)	\$	\$ (5,824)	\$
Total financial liabilities	\$ (5,824)	\$	\$ (5,824)	\$

Changes in the Company's Level 3 securities for the three and six months ended December 31, 2010 and 2009 were as follows:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Beginning aggregate estimated fair value of Level 3 securities	\$	\$ 37,594	\$ 16,825	\$ 40,584
Total realized and unrealized gains				
Unrealized gain included in income		21		56
Net settlements		(5,250)	(16,825)	(8,275)
Ending aggregate estimated fair value of Level 3 securities	\$	\$ 32,365	\$	\$ 32,365

Table of Contents**NOTE 3 BALANCE SHEET COMPONENTS**

(In thousands)	December 31, 2010	June 30, 2010
Accounts receivable, net		
Accounts receivable, gross	\$ 553,533	\$ 471,999
Allowance for doubtful accounts	(22,080)	(31,874)
	\$ 531,453	\$ 440,125
Inventories, net		
Customer service parts	\$ 137,594	\$ 131,951
Raw materials	197,164	123,301
Work-in-process	120,430	95,641
Finished goods	49,509	50,837
	\$ 504,697	\$ 401,730
Other current assets		
Prepaid expenses	\$ 38,327	\$ 39,121
Income tax related receivables	53,487	47,934
Other current assets	28,537	43,989
	\$ 120,351	\$ 131,044
Land, property and equipment, net		
Land	\$ 41,952	\$ 41,807
Buildings and leasehold improvements	230,227	224,403
Machinery and equipment	456,054	443,351
Office furniture and fixtures	22,624	23,345
Construction in progress	4,828	2,603
	755,685	735,509
Less: accumulated depreciation and amortization	(506,217)	(498,757)
	\$ 249,468	\$ 236,752
Other non-current assets		
Long-term investments	\$ 143,347	\$ 132,829
Deferred tax assets long-term	208,631	244,927
Other	10,657	11,741
	\$ 362,635	\$ 389,497
Other current liabilities		
Warranty	\$ 30,892	\$ 21,109
Compensation and benefits	245,546	268,446
Income taxes payable	21,368	35,340
Interest payable	8,769	8,769
Accrued litigation costs	1,746	10,439
Other accrued expenses	87,763	77,956
	\$ 396,084	\$ 422,059

Table of Contents**NOTE 4 MARKETABLE SECURITIES**

The amortized costs and estimated fair value of marketable securities as of December 31, 2010 and June 30, 2010 are as follows:

As of December 31, 2010 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasuries	\$ 60,669	\$ 93	\$ (56)	\$ 60,706
U.S. Government agency securities	250,116	686	(167)	250,635
Municipal bonds	60,514	140	(157)	60,497
Corporate debt securities	617,599	4,875	(591)	621,883
Money market, bank deposits and other	401,010			401,010
Sovereign securities	43,328	272	(13)	43,587
Subtotal	1,433,236	6,066	(984)	1,438,318
Less: Cash equivalents	398,022			398,022
Marketable securities	\$ 1,035,214	\$ 6,066	\$ (984)	\$ 1,040,296

As of June 30, 2010 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasuries	\$ 42,182	\$ 112	\$ (1)	\$ 42,293
U.S. Government agency securities	249,182	1,108	(10)	250,280
Municipal bonds	55,171	368	(80)	55,459
Corporate debt securities	599,118	5,314	(1,276)	603,156
Money market, bank deposits and other	373,081			373,081
Sovereign securities	39,166	210	(21)	39,355
Auction rate securities	16,825			16,825
Subtotal	1,374,725	7,112	(1,388)	1,380,449
Less: Cash equivalents	376,316	7		376,323
Marketable securities	\$ 998,409	\$ 7,105	\$ (1,388)	\$ 1,004,126

KLA-Tencor's investment portfolio consists of both corporate and government securities that have a maximum maturity of three years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. All unrealized losses are due to changes in interest rates and bond yields. The Company has the ability to realize the full value of all of these investments upon maturity. The following table summarizes the estimated fair value and gross unrealized losses of the Company's investments, aggregated by investment instrument and length of time that the individual securities have been in an unrealized loss position as of December 31, 2010:

(In thousands)	Estimated Fair Value	Gross Unrealized Losses(1)
U.S. Treasuries	\$ 15,701	\$ (56)
U.S. Government agency securities	86,962	(167)
Municipal bonds	32,575	(157)
Corporate debt securities	151,322	(591)
Sovereign securities	10,063	(13)

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Total	\$ 296,623	\$ (984)
-------	------------	----------

- (1) Of the total gross unrealized losses, there were no amounts that have been in a continuous loss position for 12 months or more.

Table of Contents

The contractual maturities of securities classified as available-for-sale as of December 31, 2010, regardless of the consolidated balance sheet classification, are as follows:

(In thousands)	Amortized Cost	Estimated Fair Value
Due within one year	\$ 664,051	\$ 668,680
Due after one year through three years	371,163	371,616
	\$ 1,035,214	\$ 1,040,296

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Net realized gains for the three and six months ended December 31, 2010 were \$0.4 million and \$1.5 million, respectively.

During the fiscal years ended June 30, 2008, 2009 and 2010, the Company's investment portfolio included auction rate securities, which are investments with contractual maturities generally between 20 to 30 years. They are usually found in the form of municipal bonds, preferred stock, a pool of student loans, or collateralized debt obligations whose interest rates are reset. The reset typically occurs every seven to forty-nine days, through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par. The auction rate securities that were held by the Company were backed by student loans and were collateralized, insured and guaranteed by the United States Federal Department of Education. In addition, all auction rate securities that were held by the Company were rated by the major independent rating agencies as either AAA or Aaa. In February 2008, because sell orders exceeded buy orders, auctions failed for approximately \$48.2 million in par value of municipal auction rate securities that were then held by the Company. These failures were not believed to be a credit issue, but rather caused by a lack of liquidity. The funds associated with these failed auctions might not have been accessible until the issuer called the security, a successful auction occurred, a buyer was found outside of the auction process, or the security matured. By letter dated August 8, 2008, the Company received notification from UBS AG ("UBS"), in connection with a settlement entered into between UBS and certain regulatory agencies, offering to repurchase all of the Company's auction rate security holdings at par value. The Company formally accepted the settlement offer and entered into a repurchase agreement ("Agreement") with UBS on November 11, 2008 ("Acceptance Date"). By accepting the Agreement, the Company (1) received the right ("Put Option") to sell its auction rate securities at par value to UBS between June 30, 2010 and June 30, 2012 and (2) gave UBS the right to purchase the auction rate securities from the Company any time after the Acceptance Date as long as the Company receives the par value. The Put Option was exercised on June 30, 2010 to sell all \$16.8 million of the Company's remaining auction rate securities at par value and was subsequently settled in July 2010.

Executive Deferred Savings Plan

KLA-Tencor has a non-qualified deferred compensation plan whereby certain executives and non-employee directors may defer a portion of their compensation. Participants are credited with returns based on their allocation of their account balances among measurement funds. The Company controls the investment of these funds, and the participants remain general creditors of KLA-Tencor. Distributions from the plan commence the quarter following a participant's retirement or termination of employment. As of December 31, 2010, the Company had a deferred compensation plan related asset and liability of \$125.6 million and \$126.8 million, respectively, included as a component of other non-current assets and other current liabilities on the Condensed Consolidated Balance Sheet. As of June 30, 2010, the Company had a deferred compensation plan related asset and liability of \$109.2 million and \$110.0 million, respectively, included as a component of other non-current assets and other current liabilities on the Condensed Consolidated Balance Sheet.

Table of Contents**NOTE 5 GOODWILL AND PURCHASED INTANGIBLE ASSETS****Goodwill**

The following table presents goodwill balances and the movements during the six months ended December 31, 2010 and 2009:

(In thousands)	Six months ended December 31,	
	2010	2009
Gross beginning balance as of beginning of fiscal year	\$ 604,592	\$ 605,965
Accumulated impairment losses	(276,586)	(276,586)
Net beginning balance as of beginning of fiscal year	328,006	329,379
Net exchange differences	141	4,605
Net ending balance as of December 31	\$ 328,147	\$ 333,984

(In thousands)	As of	
	December 31, 2010	December 31, 2009
Gross goodwill balance	\$ 604,733	\$ 610,570
Accumulated impairment losses	(276,586)	(276,586)
Net goodwill balance	\$ 328,147	\$ 333,984

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. The Company completed its annual evaluation of the goodwill by reporting unit during the three months ended December 31, 2009 and 2010 and concluded that there was no impairment as of December 31, 2009 and 2010. As of December 31, 2009 and 2010, the Company's assessment of goodwill impairment indicated that the fair value of the Company's reporting units were substantially in excess of their estimated carrying values, and therefore goodwill in the reporting units was not impaired.

Fair value of a reporting unit is determined by using a weighted combination of two market-based approaches and an income approach, as this combination is deemed to be the most indicative of the Company's fair value in an orderly transaction between market participants and is consistent in principle with the methodology used for goodwill evaluation in the prior year. Under the market-based approach, the Company utilizes information regarding the Company as well as publicly available industry information to determine earnings multiples and sales multiples that are used to value the Company's reporting units. The Company assigns an equal weighting to the discounted cash flow. Under the income approach, the Company determines fair value based on estimated future cash flows of each reporting unit, discounted by an estimated weighted-average cost of capital, which reflects the overall level of inherent risk of a reporting unit and the rate of return an outside investor would expect to earn. Determining the fair value of a reporting unit is judgmental in nature and requires the use of significant estimates and assumptions, including revenue growth rates and operating margins, discount rates and future market conditions, among others.

Adjustments to goodwill during the three and six months ended December 31, 2010 and 2009 resulted primarily from foreign currency translation adjustments.

Table of Contents**Purchased Intangible Assets**

The components of purchased intangible assets as of December 31, 2010 and June 30, 2010 were as follows:

Category	Range of Useful Lives	As of December 31, 2010			As of June 30, 2010		
		Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount
Existing technology	4-7 years	\$ 134,561	\$ 85,234	\$ 49,327	\$ 133,066	\$ 75,524	\$ 57,542
Patents	6-13 years	57,648	37,403	20,245	57,648	34,217	23,431
Trade name / Trademark	4-10 years	19,893	12,099	7,794	19,893	11,130	8,763
Customer relationships	6-7 years	54,823	30,586	24,237	54,823	27,606	27,217
Other	0-1 year	16,199	15,902	297	16,200	15,817	383
Total		\$ 283,124	\$ 181,224	\$ 101,900	\$ 281,630	\$ 164,294	\$ 117,336

For the three months ended December 31, 2010 and 2009, amortization expense for other intangible assets was \$8.5 million and \$8.4 million, respectively. For the six months ended December 31, 2010 and 2009, amortization expense for other intangible assets was \$16.9 million and \$16.7 million, respectively. Based on the intangible assets recorded as of December 31, 2010, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated amortization expense is expected to be as follows:

Fiscal year ending June 30:	Amortization (in thousands)
2011 (remaining 6 months)	\$ 15,999
2012	30,230
2013	20,957
2014	15,537
2015	12,771
Thereafter	6,406
Total	\$ 101,900

NOTE 6 LONG-TERM DEBT

In April 2008, the Company issued \$750 million aggregate principal amount of 6.90% senior, unsecured long-term debt due in 2018 with an effective interest rate of 7.00%. The discount on the debt amounted to \$5.4 million and is being amortized over the life of the debt using the straight-line method as opposed to the interest method due to immateriality. Interest is payable semi-annually on November 1 and May 1. The debt indenture includes covenants that limit the Company's ability to grant liens on its facilities and to enter into sale and leaseback transactions, subject to significant allowances under which certain sale and leaseback transactions are not restricted. The Company was in compliance with all of its covenants as at December 31, 2010.

In certain circumstances involving a change of control followed by a downgrade of the rating of the Company's senior notes, the Company will be required to make an offer to repurchase the senior notes at a purchase price equal to 101% of the aggregate principal amount of the notes, plus accrued and unpaid interest. The Company's ability to repurchase the senior notes in such event may be limited by law, by the indenture associated with the senior notes, by the Company's then-available financial resources or by the terms of other agreements to which the Company may be party at such time. If the Company fails to repurchase the senior notes as required by the indenture, it would constitute an event of default under the indenture governing the senior notes which, in turn, may also constitute an event of default under other obligations.

Based on the trading prices of the debt at December 31, 2010 and June 30, 2010, the estimated fair value of the debt at December 31, 2010 and June 30, 2010 was \$829.1 million and \$834.4 million, respectively.

NOTE 7 STOCK-BASED COMPENSATION

Equity Incentive Program

Under the Company's current equity incentive program, the Company issues equity awards from its 2004 Equity Incentive Plan (the "2004 Plan"), which provides for the grant of options to purchase shares of its common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to its employees, consultants and members of its Board of Directors. The 2004 Plan permits the issuance of up to 32.0 million shares of common stock. Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date are counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto. During the six months ended December 31, 2010, 0.3 million restricted stock units were granted to senior management with performance-based and service-based vesting criteria.

Table of Contents

The following table summarizes the combined activity under the equity incentive plans for the indicated period:

(In thousands)	Available For Grant
Balances at June 30, 2010(1)	15,162
Restricted stock units granted(2)	(3,855)
Restricted stock units canceled(2)	142
Options canceled/expired/forfeited	889
Plan shares expired(3)	(838)
 Balances at December 31, 2010(1)	 11,500

- (1) Includes shares available for issuance under the 2004 Plan, as well as under the Company's 1998 Outside Director Option Plan (the "Outside Director Plan"), which only permits the issuance of stock options to the Company's non-employee directors. As of December 31, 2010, 1.6 million shares were available for grant under the Outside Director Plan.
- (2) The number of restricted stock units provided in this row reflects the application of the 1.8x multiple described above.
- (3) Represents the portion of shares listed as "Options canceled/expired/forfeited" above that were issued under the Company's equity incentive plans other than the 2004 Plan or the Outside Director Plan. Because the Company is only currently authorized to issue equity awards under the 2004 Plan and the Outside Director Plan, any equity awards that are canceled, expire or are forfeited under any other Company equity incentive plan do not result in additional shares being available to the Company for future grant.

Except for options granted to non-employee directors as part of their regular compensation package for service through the end of the first quarter of fiscal year 2008, the Company has granted only restricted stock units under its equity incentive program since September 2006. For the preceding several years until June 30, 2006, stock options were granted at the market price of the Company's common stock on the date of grant (except for the retroactively priced options which were granted primarily prior to the fiscal year ended June 30, 2002), generally with a vesting period of five years and an exercise period not to exceed seven years (ten years for options granted prior to July 1, 2005) from the date of issuance. Restricted stock units may be granted with varying criteria such as service-based and/or performance-based vesting.

Table of Contents

The fair value of stock-based awards is measured at the grant date and is recognized as expense over the employee's requisite service period. The fair value is determined using a Black-Scholes valuation model for stock options and for purchase rights under the Company's Employee Stock Purchase Plan and using the closing price of the Company's common stock on the grant date for restricted stock units.

The following table shows pre-tax stock-based compensation expense for the indicated periods:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Stock-based compensation expense by:				
Costs of revenues	\$ 3,439	\$ 3,325	\$ 7,607	\$ 6,613
Engineering, research and development	5,814	6,667	13,432	13,270
Selling, general and administrative	10,178	10,863	22,605	21,171
Total stock-based compensation expense	\$ 19,431	\$ 20,855	\$ 43,644	\$ 41,054

The following table shows stock-based compensation capitalized as inventory as of December 31, 2010 and June 30, 2010:

(In thousands)	December 31, 2010	June 30, 2010
Inventory	\$ 5,971	\$ 6,687

Stock Options

The following table summarizes the activity and weighted-average exercise price for stock options under all plans during the six months ended December 31, 2010:

Stock Options	Shares (In thousands)	Weighted-Average Exercise Price
Outstanding stock options as of June 30, 2010	11,358	\$ 43.72
Granted		\$
Exercised	(516)	\$ 30.16
Canceled/expired/forfeited	(889)	\$ 45.52
Outstanding stock options as of December 31, 2010	9,953	\$ 44.26
Vested and exercisable as of December 31, 2010	9,925	\$ 44.21

The Company has not issued any stock options since November 1, 2007. The weighted-average remaining contractual terms for total options outstanding under all plans and for total options vested and exercisable under all plans as of December 31, 2010 were each 2.5 years. The aggregate intrinsic values for total options outstanding under all plans and for total options vested and exercisable under all plans as of December 31, 2010 were each \$8.2 million.

The authoritative guidance on stock-based compensation permits companies to select the option-pricing model used to estimate the fair value of their stock-based compensation awards. The Black-Scholes option-pricing model requires the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. The expected stock price volatility assumption was based on market-based implied volatility from traded options on the Company's stock.

The following table shows total intrinsic value of options exercised, total cash received from employees as a result of employee stock option exercises, and tax benefits realized by the Company in connection with these stock option exercises for the indicated periods:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Total intrinsic value of options exercised	2,726	895	3,289	1,105
Total cash received from employees as a result of employee stock option exercises	12,594	11,661	15,547	14,577
Tax benefits realized by the Company in connection with these exercises	980	329	1,182	406

Table of Contents

As of December 31, 2010, the unrecognized stock-based compensation balance related to stock options was \$0.4 million and will be recognized over an estimated weighted-average amortization period of 0.7 years.

The Company settles employee stock option exercises with newly issued common shares except in certain tax jurisdictions where settling such exercises with treasury shares provides the Company or one of its subsidiaries with a tax benefit.

Restricted Stock Units

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value after estimated forfeitures for restricted stock units granted, vested and released, withheld for taxes, and forfeited during the six months ended December 31, 2010 and restricted stock units outstanding as of December 31, 2010 and June 30, 2010:

Restricted Stock Units	Shares (In thousands) (1)	Weighted-Average Grant Date Fair Value
Outstanding restricted stock units as of June 30, 2010	6,470	\$ 22.52
Granted	2,142	\$ 19.73
Vested and released	(1,258)	\$ 23.46
Withheld for taxes	(597)	\$ 23.73
Forfeited	(79)	\$ 21.40
Outstanding restricted stock units as of December 31, 2010	6,678	\$ 21.35

(1) Share numbers reflect actual shares subject to awarded restricted stock units. Under the terms of the 2004 Plan, each of the share numbers presented in this column is multiplied by 1.8 to calculate the impact on the share reserve under the 2004 Plan.

The restricted stock units granted by the Company since the beginning of the fiscal year ended June 30, 2007 generally vest in two equal installments on the second and fourth anniversaries of the date of grant. Prior to the fiscal year ended June 30, 2007, the restricted stock units granted by the Company generally vested in two equal installments over four or five years from the date of the grant. The value of the restricted stock units is based on the closing market price of the Company's common stock on the date of award. The restricted stock units have been awarded under the Company's 2004 Plan, and each unit will entitle the recipient to one share of common stock when the applicable vesting requirements for that unit are satisfied. However, for each share actually issued under the awarded restricted stock units, the share reserve under the 2004 Plan will be reduced by 1.8 shares, as provided under the terms of the 2004 Plan.

The following table shows the grant date fair value after estimated forfeitures, weighted-average grant date fair value per unit, and tax benefits realized by the Company in connection with vested and released restricted stock units for the three and six months ended December 31, 2010 and 2009:

	Three months ended December 31,		Six months ended December 31,	
(In thousands, except for weighted-average grant date fair value)	2010	2009	2010	2009
Grant date fair value after estimated forfeitures	\$ 1,543	\$ 921	\$ 42,248	\$ 63,391
Weighted-average grant date fair value per unit	\$ 27.22	\$ 26.31	\$ 19.73	\$ 22.21
Tax benefits realized by the Company in connection with vested and released restricted stock units	\$ 12,245	\$ 11,517	\$ 22,339	\$ 13,155

As of December 31, 2010, the unrecognized stock-based compensation expense balance related to restricted stock units was \$114.7 million and will be recognized over an estimated weighted-average amortization period of 2.6 years.

Employee Stock Purchase Plan

Edgar Filing: KLA TENCOR CORP - Form 10-Q

KLA-Tencor's Employee Stock Purchase Plan (ESPP) provides that eligible employees may contribute up to 10% of their eligible earnings toward the semi-annual purchase of KLA-Tencor's common stock. The ESPP is qualified under Section 423 of the Internal Revenue Code. The employee's purchase price is derived from a formula based on the closing price of the common stock on the first day of the offering period versus the closing price on the date of purchase (or, if not a trading day, on the immediately preceding trading day).

During the three months ended March 31, 2009, the Company's Board of Directors approved amendments to the ESPP as part of the Company's efforts to reduce operating expenses in response to the then-current economic conditions. Those amendments to the ESPP (a) eliminated the look-back feature (i.e., the reference to the fair market value of the Company's common stock at the commencement of the applicable six-month offering period) and (b) reduced the purchase price discount from 15% to 5%. These changes were effective July 1, 2009, such that the purchase price with respect to the six-month offering period that began on July 1, 2009 was 95% of the fair market value of the Company's common stock on the purchase date, December 31, 2009.

Table of Contents

During the quarter ended December 31, 2009, in response to improvements in the business conditions within the industries that the Company serves, the Company's Board of Directors approved amendments to the ESPP that (a) reinstated the six-month look-back feature and (b) increased the purchase price discount from 5% to 15%. These changes became effective January 1, 2010, such that the purchase price with respect to each offering period beginning on or after such date will be 85% of the lesser of (i) the fair market value of the Company's common stock at the commencement of the applicable six-month offering period or (ii) the fair market value of the Company's common stock on the purchase date.

The Company estimates the fair value of purchase rights under the ESPP using a Black-Scholes valuation model. The fair value of each purchase right under the ESPP was estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach with the following weighted-average assumptions:

	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Stock purchase plan:				
Expected stock price volatility	41%	(*)	41%	(*)
Risk-free interest rate	0.2%	(*)	0.2%	(*)
Dividend yield	3.68%	(*)	3.68%	(*)
Expected life of options (in years)	0.50	(*)	0.50	(*)

(*) There were no valuations recorded during the three and six months ended December 31, 2009. No compensation cost was recognized as the purchase price under the ESPP during that period was based solely on the market price of the shares at the purchase date and the discount on the purchase price was 5%.

The following table shows total cash received from employees for the issuance of shares under the ESPP, the number of shares purchased by employees through the ESPP, the tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP, and the weighted-average fair value per share:

	Three months ended December 31,		Six months ended December 31,	
(In thousands, except for weighted-average fair value)	2010	2009	2010	2009
Total cash received from employees for the issuance of shares under the ESPP	\$ 16,176	\$ 8,885	\$ 16,176	\$ 8,885
Number of shares purchased by employees through the ESPP	701	259	701	259
Tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP	\$ 115	\$ 154	\$ 471	\$ 867
Weighted-average fair value per share based on Black-Scholes model	\$ 6.53	\$	\$ 6.53	\$

The ESPP shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to issue under the ESPP during the forthcoming fiscal year. During the fiscal year ended June 30, 2010, a total of 2.0 million additional shares were reserved under the ESPP, and an additional 2.0 million shares have been reserved under the ESPP with respect to the fiscal year ending June 30, 2011. As of December 31, 2010, after giving effect to the ESPP purchase that occurred on that date, a total of 3.9 million shares were reserved and available for issuance under the ESPP.

Table of Contents**NOTE 8 STOCK REPURCHASE PROGRAM**

Since July 1997, the Board of Directors has authorized the Company to systematically repurchase in the open market up to 62.8 million shares of its common stock under a repurchase program. This program was put into place to reduce the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, and to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases will be made from time to time in the open market in compliance with applicable securities laws, including the Securities Exchange Act of 1934 and the rules promulgated thereunder such as Rule 10b-18. In October 2008, the Company suspended its stock repurchase program, and the Company subsequently restarted the program in February 2010. As of December 31, 2010, 1.7 million shares were available for repurchase under the Company's repurchase program.

Share repurchases for the three and six months ended December 31, 2010 and 2009 were as follows:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Number of shares of common stock repurchased	1,559		3,531	
Total cost of repurchases	\$ 57,938		\$ 117,261	

As of December 31, 2010, \$2.7 million of the above total cost of repurchase amount remained unpaid and is recorded in other current liabilities. The \$1.8 million which was accrued at September 30, 2010 was paid during the three months ended December 31, 2010.

NOTE 9 NET INCOME PER SHARE

Basic net income per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is calculated by using the weighted-average number of common shares outstanding during the period, increased to include the number of additional shares of common stock that would have been outstanding if the shares of common stock underlying the Company's outstanding dilutive stock options and restricted stock units had been issued. The dilutive effect of outstanding options and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. Under the treasury stock method, the amount the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares. The following table sets forth the computation of basic and diluted net income per share:

(In thousands, except per share amounts)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Numerator:				
Net income	\$ 185,492	\$ 21,794	\$ 339,688	\$ 42,199
Denominator:				
Weighted average shares outstanding, excluding unvested restricted stock units	166,886	171,408	167,052	171,053
Effect of dilutive options and restricted stock units	2,627	2,400	2,633	2,239
Denominator for diluted income per share	169,513	173,808	169,685	173,292
Basic earnings per share	\$ 1.11	\$ 0.13	\$ 2.03	\$ 0.25
Diluted earnings per share	\$ 1.09	\$ 0.13	\$ 2.00	\$ 0.24
Anti-dilutive securities excluded from the computation of diluted net income per share	8,622	10,948	9,602	12,483

The total amount of dividends paid during the three months ended December 31, 2010 and 2009 was \$41.8 million and \$25.7 million, respectively. The total amount of dividends paid during the six months ended December 31, 2010 and 2009 was \$83.6 million and \$51.3 million, respectively.

Table of Contents**NOTE 10 COMPREHENSIVE INCOME**

The components of comprehensive income, net of tax, are as follows:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Net income	\$ 185,492	\$ 21,794	\$ 339,688	\$ 42,199
Other comprehensive income (loss):				
Currency translation adjustments	4,455	(5,529)	17,978	3,561
Gain (loss) on cash flow hedging instruments, net	(639)	558	200	720
Change in unrecognized losses and transition obligation related to pension and post-retirement plans	91	19	171	37
Unrealized loss on investments	(2,179)	(1,648)	(428)	(75)
Other comprehensive income (loss)	1,728	(6,600)	17,921	4,243
Total comprehensive income	\$ 187,220	\$ 15,194	\$ 357,609	\$ 46,442

NOTE 11 INCOME TAXES

The following table provides details of income taxes:

(Dollar amounts in thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Income before income taxes	\$ 251,191	\$ 38,016	\$ 474,503	\$ 60,808
Provision for taxes	65,699	16,222	134,815	18,609
Effective tax rate	26.2%	42.7%	28.4%	30.6%

The Company's estimated annual effective tax rate for the year is approximately 29%.

The difference between the actual effective tax rate of 26.2% during the quarter and the estimated annual effective tax rate of 29% is primarily due to the tax impact of the following items during the three months ended December 31, 2010:

Tax expense was decreased by \$3.7 million due to windfalls from employee stock activity. A windfall arises when the tax deduction is more than book compensation. Windfalls are generally recorded as increases to capital in excess of par value. A shortfall arises when the tax deduction is less than book compensation. Shortfalls are recorded as decreases to capital in excess of par value to the extent that cumulative windfalls exceed cumulative shortfalls. Shortfalls in excess of cumulative windfalls are recorded as provision for income taxes. When there are shortfalls recorded as provision for income taxes during an earlier quarter, windfalls arising in subsequent quarters within the same fiscal year are recorded as a reduction to income taxes to the extent of the shortfalls recorded.

Tax expense was decreased by \$3.1 million related to a non-taxable increase in the assets held within the Company's Executive Deferred Savings Plan.

Tax expense was decreased by \$3.9 million related to the reinstatement of the U.S. Federal Research and Development Credit (the Federal R&D Credit), under The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which was signed into law on December 17, 2010.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Tax expense was higher as a percentage of income during the three months ended December 31, 2009 compared to the three months ended December 31, 2010 primarily due to an increase in tax expense of \$8.7 million resulting from shortfalls related to employee stock activity during the three months ended December 31, 2009. The shortfall expense during the three months ended December 31, 2009 had a significant impact on the Company's effective tax rate due to the lower level of income generated during the three months ended December 31, 2009.

Tax expense was higher as a percentage of income during the six months ended December 31, 2009 compared to the six months ended December 31, 2010 due to a decrease in tax expense of \$3.9 million resulting from the reinstatement of the Federal R&D Credit during the six months ended December 31, 2010 and an increase in tax expense of \$8.7 million resulting from shortfalls related to employee stock activity during the six months ended December 31, 2009.

In the normal course of business, the Company is subject to examination by taxing authorities throughout the world. The Company is under United States federal income tax examination for the fiscal years ended June 30, 2007 through June 30, 2009, which represents all years for which tax returns have been filed and the statute of limitations has not expired. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2006. The Company is also

Table of Contents

subject to examinations in major foreign jurisdictions, including Japan, Israel and Singapore, for all years beginning from the fiscal year ended June 30, 2006 and is currently under tax examinations in various other foreign tax jurisdictions. It is possible that certain examinations may be concluded in the next twelve months. The Company believes it is possible that it may recognize up to \$3.6 million of its existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of agreements with various foreign tax authorities.

NOTE 12 LITIGATION AND OTHER LEGAL MATTERS

Indemnification Obligations. Subject to certain limitations, the Company is obligated to indemnify its current and former directors, officers and employees with respect to certain litigation matters and investigations that arise in connection with their service to the Company. These obligations arise under the terms of its certificate of incorporation, its bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify generally means that the Company is required to pay or reimburse the individuals reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. The Company paid or reimbursed legal expenses incurred in connection with the investigation of its historical stock option practices and the related litigation and government inquiries by a number of its current and former directors, officers and employees. The Company is currently paying defense costs to one former officer and employee facing an SEC civil action to which the Company is not a party. Although the maximum potential amount of future payments the Company could be required to make under these agreements is theoretically unlimited, the Company believes the fair value of this liability, to the extent estimable, is appropriately considered within the reserve it has established for currently pending legal proceedings.

Other Legal Matters. The Company is named from time to time as a party to lawsuits in the normal course of its business. Actions filed against the Company include commercial, intellectual property, customer, and labor and employment related claims, including complaints of alleged wrongful termination and potential class action lawsuits regarding alleged violations of federal and state wage and hour and other laws. Litigation, in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of legal proceedings are difficult to predict, and the costs incurred in litigation can be substantial, regardless of outcome. The Company believes the amounts provided in its financial statements are adequate in light of the probable and estimated liabilities. However, because such matters are subject to many uncertainties, the ultimate outcomes are not predictable and there can be no assurances that the actual amounts required to satisfy alleged liabilities from the matters described above will not exceed the amounts reflected in its financial statements or will not have a material adverse effect on its results of operations, financial condition or cash flows.

NOTE 13 COMMITMENTS AND CONTINGENCIES

Factoring. KLA-Tencor has agreements with financial institutions to sell certain of its trade receivables and promissory notes from customers without recourse. The Company does not believe it is at risk for any material losses as a result of these agreements. In addition, from time to time the Company will discount without recourse letters of credit (LCs) received from customers in payment for goods.

The following table shows total receivables sold under factoring agreements, proceeds from sales of LCs and related discounting fees paid for the three and six months ended December 31, 2010 and 2009:

(In thousands)	Three months ended		Six months ended	
	December 31, 2010	December 31, 2009	December 31, 2010	December 31, 2009
Receivables sold under factoring agreements	\$ 96,586	\$ 39,818	\$ 156,611	\$ 70,019
Proceeds from sales of LCs	\$ 33,327	\$	\$ 84,263	\$ 10,630
Discounting fees paid on sales of LCs (1)	\$ 50	\$	\$ 155	\$ 123

(1) Discounting fees include bank fees and interest expense and were recorded in interest income and other, net.

Table of Contents

Facilities. KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was \$2.2 million and \$2.3 million for the three months ended December 31, 2010 and 2009, respectively. Rent expense was \$4.1 million and \$4.9 million for the six months ended December 31, 2010 and 2009, respectively.

The following is a schedule of expected operating lease payments (in thousands):

Fiscal year ended June 30,	Amount
2011 (remaining 6 months)	\$ 4,445
2012	6,636
2013	4,398
2014	2,912
2015	1,721
2016 and thereafter	4,273
Total minimum lease payments	\$ 24,385

Purchase Commitments. KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. KLA-Tencor's liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company's open inventory purchase commitments were \$289.2 million as of December 31, 2010 and are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

Guarantees. KLA-Tencor provides standard warranty coverage on its systems for 40 hours per week for twelve months, providing labor and parts necessary to repair the systems during the warranty period. The Company accounts for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. Utilizing actual service records, the Company calculates the average service hours and parts expense per system and applies the actual labor and overhead rates to determine the estimated warranty charge. The Company updates these estimated charges on a quarterly basis. The actual product performance and/or field expense profiles may differ, and in those cases the Company adjusts its warranty accruals accordingly.

The following table provides the changes in the product warranty accrual for the three and six months ended December 31, 2010 and 2009:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Beginning balance	\$ 25,556	\$ 15,052	\$ 21,109	\$ 18,213
Accruals for warranties issued during the period	12,306	5,994	21,792	10,727
Changes in liability related to pre-existing warranties	(1,307)	(654)	(1,148)	(2,579)
Settlements made during the period	(5,663)	(4,666)	(10,861)	(10,635)
Ending balance	\$ 30,892	\$ 15,726	\$ 30,892	\$ 15,726

Subject to certain limitations, KLA-Tencor indemnifies its current and former officers and directors for certain events or occurrences. Although the maximum potential amount of future payments the Company could be required to make under these agreements is theoretically unlimited, the Company believes the fair value of this liability, to the extent estimable, is appropriately considered within the reserve it has established for currently pending legal proceedings.

KLA-Tencor is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in connection with contracts and license agreements or the sale of assets, under which the Company customarily agrees to hold the other party harmless against losses arising from, or provides customers with other remedies to protect against, bodily injury or damage to personal property caused by the Company's products, non-compliance with the Company's product performance

Edgar Filing: KLA TENCOR CORP - Form 10-Q

specifications, infringement by the Company's products of third-party intellectual property rights and a breach of warranties, representations and covenants related to such matters as title to assets sold, validity of certain intellectual property rights, non-infringement of third-party rights, and certain income tax-related matters. In each of these circumstances, payment by the Company is typically subject to the other party making a claim to and cooperating with the Company pursuant to the procedures specified in the particular contract. This usually allows the Company to challenge the other party's claims or, in case of breach of intellectual property representations or covenants, to control the defense or settlement of any third-party claims brought against the other party. Further, the Company's obligations under these agreements may be limited in terms of amounts, activity (typically at the Company's option to replace or correct the products or terminate the agreement with a refund to the other party), and duration. In some instances, the Company may have recourse against third parties and/or insurance covering certain payments made by the Company.

Table of Contents

It is not possible to predict the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the unique facts and circumstances involved in each particular agreement. Historically, payments made by the Company under these agreements have not had a material effect on its business, financial condition, results of operations or cash flows.

The Company maintains guarantee arrangements available through various financial institutions for up to \$20.3 million, of which \$18.2 million had been issued as of December 31, 2010, primarily to fund guarantees to customs authorities for VAT and other operating requirements of the Company's subsidiaries in Europe and Asia.

NOTE 14 RESTRUCTURING CHARGES

The Company has undertaken a number of cost reduction activities, including workforce reductions, in an effort to lower its quarterly operating expense run rate. The program in the United States is accounted for in accordance with the authoritative guidance related to compensation for non-retirement post-employment benefits, whereas the programs in the international locations are accounted for in accordance with the authoritative guidance for contingencies. During the three months ended December 31, 2010, the Company recorded a \$1.1 million net restructuring charge, of which \$0.2 million was recorded to costs of revenues, \$0.1 million was recorded to engineering, research and development expense and \$0.8 million was recorded to selling, general and administrative expense. These charges represent the estimated minimum liability associated with expected termination benefits to be provided to employees after employment.

The following table shows the activity primarily related to severance and benefits expense for the three and six months ended December 31, 2010 and 2009:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Beginning balance	\$ 589	\$ 4,304	\$ 1,221	\$ 8,086
Restructuring costs	1,065	3,262	1,430	3,845
Adjustments	(8)	(149)	(30)	(685)
Cash payments	(771)	(2,839)	(1,746)	(6,668)
Ending balance	\$ 875	\$ 4,578	\$ 875	\$ 4,578

Substantially all of the remaining accrued restructuring balance as of December 31, 2010 related to the Company's workforce reductions is expected to be paid out by June 30, 2011.

NOTE 15 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

The authoritative guidance requires companies to recognize all derivative instruments and hedging activities, including foreign currency exchange contracts, as either assets or liabilities at fair value on the balance sheet. Changes in the fair value of derivatives that do not qualify for hedge treatment, as well as the ineffective portion of any hedges, are reflected in the Condensed Consolidated Statement of Operations. In accordance with the guidance, the Company designates foreign currency forward exchange contracts as cash flow hedges of certain forecasted foreign currency denominated sales and purchase transactions.

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to risks relating to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts and option contracts to hedge against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions, such as the Japanese yen, the euro and the Israeli shekel. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes. The Company routinely hedges its exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. These currency forward exchange contracts and options, designated as cash flow hedges, generally have maturities of less than 18 months. Cash flow hedges are evaluated for effectiveness monthly, based on changes in total fair value of the derivatives. If a financial counter-party to any of the Company's hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, the Company may experience material losses.

Table of Contents

For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gain or loss on the derivative is reported as a component of accumulated other comprehensive income (loss) (OCI) and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Changes in the fair value of currency forward exchange and option contracts due to changes in time value are excluded from the assessment of effectiveness. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

For derivative instruments that are not designated as accounting hedges, gains and losses are recognized in interest income and other, net. The majority of such derivatives are foreign currency forward contracts to hedge certain foreign currency denominated assets or liabilities. The gains and losses on these derivatives are largely offset by the changes in the fair value of the assets or liabilities being hedged.

Derivatives in Cash Flow Hedging Relationships: Foreign Exchange Contracts

The location and amounts of designated and non-designated derivative instruments' gains and losses in the condensed consolidated financial statements for the three and six months ended December 31, 2010 and 2009 are as follows:

	Location in Financial Statements Three months ended December 31, 2010					Three months ended December 31, 2009				
	Accumulated OCI	Revenues	Costs of revenues	Interest income and other, net	Total	Accumulated OCI	Revenues	Costs of revenues	Interest income and other, net	Total
Derivatives Designated as Hedging Instruments										
Loss in accumulated OCI on derivative (effective portion)	\$ (1,653)				\$ (1,653)	\$ (200)				\$ (200)
Gain (loss) reclassified from accumulated OCI into income (effective portion)		\$ (534)	\$ 312		\$ (222)		\$ (1,120)	\$ 24		\$ (1,096)
Gain recognized in income on derivative (ineffectiveness portion and amount excluded from effectiveness testing)				\$ 266	\$ 266				\$ 202	\$ 202
Derivatives Not Designated as Hedging Instruments										
Gain (loss) recognized in income				\$ (513)	\$ (513)				\$ 401	\$ 401

	Six months ended December 31, 2010					Six months ended December 31, 2009				
	Accumulated OCI	Revenues	Costs of revenues	Interest income and other, net	Total	Accumulated OCI	Revenues	Costs of revenues	Interest income and other, net	Total
Derivatives Designated as Hedging Instruments										
Loss in accumulated OCI on derivative (effective portion)	\$ (1,240)				\$ (1,240)	\$ (402)				\$ (402)
Gain (loss) reclassified from accumulated OCI into income		\$ (1,327)	\$ 170		\$ (1,157)		\$ (1,332)	\$ 24		\$ (1,308)

(effective portion)

Gain (loss) recognized in
income on derivative
(ineffectiveness portion and
amount excluded from
effectiveness testing)

\$ 147 \$ 147 \$ (319) \$ (319)

**Derivatives Not Designated
as Hedging Instruments**

Loss recognized in income

\$ (1,869) \$ (1,869) \$ (2,112) \$ (2,112)

Table of Contents

The U.S. dollar equivalent of all outstanding notional amounts of hedge contracts, with maximum maturity of 13 months, was as follows:

(In thousands)	As of December 31, 2010	As of June 30, 2010
Cash flow hedge contracts		
Purchase	\$ 12,620	\$ 15,835
Sell	(50,741)	(32,853)
Other foreign currency hedge contracts		
Purchase	83,156	82,535
Sell	(89,031)	(104,414)
Net	\$ (43,996)	\$ (38,897)

The location and fair value amounts of the Company's derivative instruments reported in its Condensed Consolidated Balance Sheets as of December 31, 2010 and June 30, 2010 were as follows:

(In thousands)	Balance Sheet Location	Asset Derivatives		Balance Sheet Location	Liability Derivatives	
		December 31, 2010	June 30, 2010		December 31, 2010	June 30, 2010
Derivatives designated as hedging instruments						
Foreign exchange contract	Other current assets	\$ 415	\$ 125	Other current liabilities	\$ 1,236	\$ 2,033
Total derivatives designated as hedging instruments		\$ 415	\$ 125		\$ 1,236	\$ 2,033
Derivatives not designated as hedging instruments						
Foreign exchange contract	Other current assets	\$ 1,898	\$ 171	Other current liabilities	\$ 3,348	\$ 3,791
Total derivatives not designated as hedging instruments		\$ 1,898	\$ 171		\$ 3,348	\$ 3,791
Total derivatives		\$ 2,313	\$ 296		\$ 4,584	\$ 5,824

The following table provides the balances and changes in accumulated other comprehensive income (loss) related to derivative instruments for the three and six months ended December 31, 2010 and 2009:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Beginning balance	\$ (646)	\$ (1,353)	\$ (1,994)	\$ (1,613)
Amount reclassified to income	222	1,096	1,157	1,558
Net change	(1,653)	(200)	(1,240)	(402)
Ending balance	\$ (2,077)	\$ (457)	\$ (2,077)	\$ (457)

NOTE 16 SALE OF REAL ESTATE

Edgar Filing: KLA TENCOR CORP - Form 10-Q

During the three months ended December 31, 2010, the Company completed the sale of remaining real estate properties in San Jose, California. The Company had recorded asset impairment charges of \$10.4 million, included in selling, general and administrative expenses, during the six months ended December 31, 2009. The real estate properties are non-financial assets subject to level 3 fair value measurement. The sale transaction, which closed on December 9, 2010, resulted in proceeds to the Company of \$18.2 million and a gain on sale of \$1.4 million as an offset to selling, general and administrative expenses.

Table of Contents**NOTE 17 RELATED PARTY TRANSACTIONS**

During the three and six months ended December 31, 2010 and 2009, the Company purchased from, or sold to, several entities, where one or more executive officers of the Company or members of the Company's Board of Directors, or their immediate family members, also serves as an executive officer or board member, including JDS Uniphase Corporation and Cisco Systems, Inc. For the three and six months ended December 31, 2010 and 2009, the following table provides the transactions with these parties (for the portion of such period that they were considered related):

(Dollar amounts in thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Total revenues	\$ 47	\$ 1,347	\$ 247	\$ 3,938
Total purchases	\$ 1,923	\$ 1,450	\$ 2,805	\$ 2,392

The Company had a receivable balance from these parties of \$0.1 million and \$2.0 million at December 31, 2010 and June 30, 2010, respectively. Management believes that such transactions are at arm's length and on similar terms as would have been obtained from unaffiliated third parties.

NOTE 18 SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

KLA-Tencor reports one reportable segment in accordance with the provisions of the authoritative guidance for segment reporting. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. KLA-Tencor's chief operating decision maker is the Chief Executive Officer.

KLA-Tencor is engaged primarily in designing, manufacturing, and marketing process control and yield management solutions for the semiconductor and related nanoelectronics industries. All operating units have been aggregated due to their inter-dependencies, commonality of long-term economic characteristics, products and services, the production processes, class of customer and distribution processes. The Company's service products are an extension of the system product portfolio and provide customers with spare parts and fab management services (including system preventive maintenance and optimization services) to improve yield, increase production uptime and throughput, and lower the cost of ownership. Since KLA-Tencor operates in one segment, all financial segment information can be found in the condensed consolidated financial statements.

KLA-Tencor's significant operations outside the United States include manufacturing facilities in Israel and Singapore, and sales, marketing and service offices in Western Europe, Japan and the Asia Pacific region. For geographical revenue reporting, revenues are attributed to the geographic location in which the customer is located. Long-lived assets consist primarily of net property and equipment and are attributed to the geographic region in which they are located.

The following is a summary of revenues by geographic region for the three and six months ended December 31, 2010 and 2009 (as a percentage of total revenues):

(Dollar amounts in thousands)	Three months ended December 31,				Six months ended December 31,			
	2010		2009		2010		2009	
Revenues:								
United States	\$ 149,843	20%	\$ 105,489	24%	\$ 236,362	16%	\$ 180,046	23%
Taiwan	233,081	30%	171,947	39%	421,622	29%	294,066	38%
Japan	59,813	8%	56,140	13%	153,701	11%	115,492	15%
Europe & Israel	60,491	8%	26,908	6%	99,737	7%	50,833	6%
Korea	123,154	16%	19,437	4%	285,245	20%	48,949	6%
Rest of Asia	139,945	18%	60,434	14%	252,002	17%	93,656	12%
Total	\$ 766,327	100%	\$ 440,355	100%	\$ 1,448,669	100%	\$ 783,042	100%

Table of Contents

The following is a summary of revenues by major products for the three and six months ended December 31, 2010 and 2009 (as a percentage of total revenues):

(Dollar amounts in thousands)	Three months ended December 31,				Six months ended December 31,			
	2010		2009		2010		2009	
Revenues:								
Defect inspection	\$ 506,360	66%	\$ 259,483	59%	\$ 916,473	63%	\$ 430,571	55%
Metrology	104,041	14%	54,080	12%	223,595	15%	98,758	13%
Service	138,470	18%	125,409	29%	270,203	19%	238,845	31%
Other	17,456	2%	1,383	0%	38,398	3%	14,868	2%
Total	\$ 766,327	100%	\$ 440,355	100%	\$ 1,448,669	100%	\$ 783,042	100%

For the three months ended December 31, 2010, three customers accounted for greater than 10% of total revenues. For the six months ended December 31, 2010, two customers accounted for greater than 10% of total revenues. For the three and six months ended December 31, 2009, two customers accounted for greater than 10% of total revenues. As of December 31, 2010 and June 30, 2010, two customers accounted for greater than 10% of net accounts receivable.

Long-lived assets by geographic region as of December 31, 2010 and June 30, 2010 were as follows:

(In thousands)	December 31, 2010	June 30, 2010
Long-lived assets:		
United States	\$ 134,645	\$ 174,033
Taiwan	843	714
Japan	4,353	3,985
Europe & Israel	128,111	127,474
Korea	2,879	3,482
Rest of Asia	53,875	56,141
Total	\$ 324,706	\$ 365,829

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward-looking statements. You can identify these and other forward-looking statements by the use of words such as may, will, could, would, should, expects, plans, anticipates, relies, believes, estimates, predicts, intends, potential, continue, thinks, seeks, or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Such forward-looking statements include, among others, forecasts of the future results of our operations; the percentage of spending that our customers allocate to process control; orders for our products and capital equipment generally; sales of semiconductors; the allocation of capital spending by our customers; growth of revenue in the semiconductor industry, the semiconductor capital equipment industry and our business; technological trends in the semiconductor industry; future developments or trends in the global capital and financial markets; our future product offerings and product features; the success and market acceptance of new products; timing of shipment of backlog; the future of our product shipments and our product and service revenues; our future gross margins; our future research and development expenses and selling, general and administrative expenses; our ability to successfully maintain cost discipline; international sales and operations; our ability to maintain or improve our existing competitive position; success of our product offerings; creation and funding of programs for research and development; attraction and retention of employees; results of our investment in leading edge technologies; the

Edgar Filing: KLA TENCOR CORP - Form 10-Q

effects of hedging transactions; the effect of the sale of trade receivables and promissory notes from customers; our future income tax rate; dividends; the completion of any acquisitions of third parties, or the technology or assets thereof; benefits received from any acquisitions and development of acquired technologies; sufficiency of our existing cash balance, investments and cash generated from operations to meet our operating and working capital requirements; and the adoption of new accounting pronouncements.

*Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in Part II, Item 1A, *Risk Factors* in this report as well as in Item 1, *Business* and Item 7, *Management's Discussion and Analysis of Financial Condition and Results of**

Table of Contents

Operations in our Annual Report on Form 10-K for the year ended June 30, 2010, filed with the Securities and Exchange Commission on August 6, 2010. You should carefully review these risks and also review the risks described in other documents we file from time to time with the Securities and Exchange Commission. You are cautioned not to place undue reliance on these forward-looking statements, and we expressly assume no obligation to update the forward-looking statements in this report after the date hereof.

CRITICAL ACCOUNTING ESTIMATES AND POLICIES

The preparation of our Condensed Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions in applying our accounting policies that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2010 describes the significant accounting policies and methods used in preparation of the Consolidated Financial Statements. We based these estimates and assumptions on historical experience, and evaluate them on an on-going basis to ensure that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed the Company's related disclosure in this Quarterly Report on Form 10-Q. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue Recognition

Inventories

Warranty

Allowance for Doubtful Accounts

Stock-Based Compensation

Contingencies and Litigation

Goodwill and Intangible Assets

Income Taxes

System revenues recognized without an acceptance from the customer were 35%, 26% and 22% of total revenues for the three months ended December 31, 2010, September 30, 2010 and December 31, 2009, respectively. The percentage of system revenues recognized without an acceptance from customers increased during the three months ended December 31, 2010 as compared to the three months ended September 30, 2010 and December 31, 2009, primarily due to higher shipments of tools that have already met the required acceptance criteria at those customer fabs.

There were no significant changes in our critical accounting estimates and policies during the three months ended December 31, 2010. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our fiscal year ended June 30, 2010 for a more complete discussion of our critical accounting policies and estimates.

Valuation of Goodwill and Intangible Assets

Edgar Filing: KLA TENCOR CORP - Form 10-Q

We assess goodwill for impairment annually as well as whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. We completed our annual evaluation of goodwill by reporting unit during the three months ended December 31, 2010 and 2009 and concluded that there was no impairment as of December 31, 2010 and 2009.

Table of Contents

Revenue Recognition for Certain Arrangements with Software Elements and/or Multiple Deliverables

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry-specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

provide updated guidance on how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and

require an entity to allocate revenue in an arrangement using estimated selling prices (ESP) of deliverables if it does not have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) of selling price. Valuation terms are defined as follows:

VSOE the price at which we sell the element in a separate stand-alone transaction.

TPE evidence from us or other companies of the value of a largely interchangeable element in a transaction.

ESP our best estimate of the selling price of an element in a transaction.

We elected to early adopt this accounting guidance at the beginning of the second quarter of our fiscal year ended June 30, 2010 and applied the adoption retrospectively to the beginning of the fiscal year to apply the guidance to transactions originating or materially modified after June 30, 2009. The implementation resulted in additional qualitative disclosures that are included below but did not have a material impact on our financial position, results of operations or cash flows.

This guidance does not generally change the units of accounting for our revenue transactions. We typically recognize revenue for system sales upon acceptance by the customer that the system has been installed and is operating according to predetermined specifications. Under certain circumstances, however, we recognize revenue upon shipment, prior to acceptance by the customer. The portion of revenue associated with installation is deferred based on relative sales price and recognized upon completion of the installation. Spare parts revenue is recognized when the product has been shipped and risk of loss has passed to the customer, and collectability is reasonably assured. Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a contract, such as consulting and training revenue, is recognized when the related services are performed, and collectability is reasonably assured. Our arrangements generally do not include any provisions for cancellation, termination or refunds that would significantly impact recognized revenue.

We enter into revenue arrangements that may consist of multiple deliverables of our products and services where certain elements of a sales contract are not delivered and accepted in one reporting period.

In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. As a result, for substantially all of the arrangements with multiple deliverables pertaining to products and services, we use VSOE or TPE to allocate the selling price to each deliverable. We determine TPE based on historical prices charged for products and services when sold on a stand-alone basis.

When we are unable to establish relative selling price using VSOE or TPE, we use ESP in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

We regularly review relative selling prices and maintain internal controls over the establishment and updates of these estimates.

Recent Accounting Pronouncements

In December 2010, the FASB amended its guidance on goodwill and other intangible assets. The amendment modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if there are qualitative factors indicating that it is more likely than not that a goodwill impairment exists. The qualitative factors are consistent with the existing guidance which requires goodwill of a reporting unit to be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This amendment was effective for our interim period ending December 31, 2010. The amendment did not have an impact on our financial position, results of operations or cash flows.

In December 2010, the FASB amended its guidance on business combinations. Under the amended guidance, a public entity that presents comparative financial statements must disclose the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the prior annual reporting period. The amendment is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The amendment did not have an impact on our financial position, results of operations or cash flows.

Table of Contents

In April 2010, the FASB amended its guidance on share-based payment awards with an exercise price denominated in certain currencies. The amendment clarifies that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. This amendment becomes effective for our interim period ending September 30, 2011. We do not expect the implementation to have an impact on our financial position, results of operations or cash flows.

In January 2010, the FASB issued authoritative guidance for fair value measurements. This guidance now requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and also to describe the reasons for these transfers. This authoritative guidance also requires enhanced disclosure of activity in Level 3 fair value measurements. The guidance for Level 1 and Level 2 fair value measurements was effective for our interim reporting period ended March 31, 2010. The implementation did not have an impact on our financial position, results of operations or cash flows as it is disclosure-only in nature. The guidance for Level 3 fair value measurements disclosures becomes effective for our interim reporting period ending September 30, 2011, and we do not expect that this guidance will have an impact on our financial position, results of operations or cash flows as it is disclosure-only in nature.

EXECUTIVE SUMMARY

KLA-Tencor Corporation is a leading supplier of process control and yield management solutions for the semiconductor and related nanoelectronics industries. Our comprehensive portfolio of products, services, software and expertise helps integrated circuit (IC or chip) manufacturers manage yield throughout the entire wafer fabrication process from research and development to final volume production. In addition to the semiconductor industry, our technologies serve a number of other industries, including light emitting diode (LED), data storage, photovoltaic, and general materials research and manufacturing.

Our products and services are used by virtually every major wafer, IC, reticle and disk manufacturer in the world. Our revenues are driven largely by capital spending by our customers who operate in one or more of several key semiconductor markets, including the memory, foundry and logic markets. Our customers purchase our products because of their need to drive advances in their process and product technologies, or to ramp up production to satisfy demand from their customers for chips used in a growing number of consumer electronics, communications, data processing, and industrial products. We believe that, over the long term, our customers will continue to invest in advanced technologies and new materials to enable smaller design rules and higher density applications, as well as to reduce cost. This in turn will drive increased adoption of process control equipment and service that reduce semiconductor defectivity and improve manufacturing yields.

As a supplier to the global semiconductor and semiconductor-related industries, we are subject to business cycles, the timing, length and volatility of which can be difficult to predict. The industries we serve have historically been cyclical due to sudden changes in overall market demand and manufacturing capacity. Our ability to predict future capacity-related capital spending by our customers is extremely limited, as such spending is very closely connected to the unpredictable business cycles within their industries. While our customer base, particularly in the semiconductor industry, historically has been, and is becoming increasingly concentrated, we expect our customers' capital spending on process control to increase over the long term. This increase is driven by the demand for more precise diagnostics capabilities to address new defects as a result of shrinking of device feature sizes, the transition to new materials, new device and circuit architecture, new lithography and other chip manufacturing challenges, and ongoing fab process innovation.

The demand for our products is ultimately affected by the profitability of our customers, which is driven by a number of factors including macroeconomic conditions, consumer and business demand for products that use their semiconductors, the successful development and introduction of new products and product applications, and the overall balance of manufacturing supply to customer demand in key market segments. While semiconductor content in consumer electronics, communications, data processing, and other industrial products continues to increase, the global economic weakness during the fiscal year ended June 30, 2009 adversely impacted many of our customers and consequently impacted the demand for our products. However, during the fiscal year ended June 30, 2010, economic conditions generally began to gradually improve, especially in some of the more rapidly developing economies in Asia. Demand for many technology-intensive products started to recover, and manufacturing capacity utilization in much of the semiconductor industry improved. As a result, several of our customers, particularly in the foundry market, began to increase their investments in manufacturing capacity and R&D, resulting in growing demand for our products and services throughout the year.

We continued to experience strong demand from our customers during the three months ended December 31, 2010, which, though lower than the preceding two quarters, was near historical highs. In response to this strong demand from our customers, we have been increasing our production volumes and customer support services. Our results for the three months ended December 31, 2010 reflect the sixth consecutive quarter of revenue growth.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

We cannot predict the duration and sustainability of these business conditions. We remain at risk of incurring inventory or other capacity related charges if current favorable business conditions do not continue.

Table of Contents

The following table sets forth some of the key quarterly unaudited financial information that we use to manage our business:

(In thousands, except net income per share)	Three months ended			Three months ended		
	December 31, 2010	September 30, 2010	June 30, 2010	March 31, 2010	December 31, 2009	September 30, 2009
Total revenues	\$ 766,327	\$ 682,342	\$ 559,419	\$ 478,299	\$ 440,355	\$ 342,687
Total costs and operating expenses	\$ 497,461	\$ 446,726	\$ 398,577	\$ 387,020	\$ 393,260	\$ 327,737
Gross margin	\$ 454,929	\$ 418,373	\$ 331,500	\$ 269,734	\$ 233,069	\$ 170,795
Income from operations	\$ 268,866	\$ 235,616	\$ 160,842	\$ 91,279	\$ 47,095	\$ 14,950
Net income	\$ 185,492	\$ 154,196	\$ 113,085	\$ 57,016	\$ 21,794	\$ 20,405
Net income per share:						
Basic (1)	\$ 1.11	\$ 0.92	\$ 0.67	\$ 0.33	\$ 0.13	\$ 0.12
Diluted (1)	\$ 1.09	\$ 0.91	\$ 0.66	\$ 0.33	\$ 0.13	\$ 0.12

- (1) Basic and diluted earnings per share are computed independently for each of the quarters presented based on the weighted average basic and fully diluted shares outstanding for each quarter. Therefore, the sum of quarterly basic and diluted per share information may not equal annual basic and diluted earnings per share.

RESULTS OF OPERATIONS**Revenues and Gross Margin**

(Dollar amounts in thousands)	Three months ended						
	December 31, 2010	September 30, 2010	December 31, 2009	Q2 FY11 vs. Q1 FY11		Q2 FY11 vs. Q2 FY10	
Revenues:							
Product	\$ 627,857	\$ 550,609	\$ 314,946	\$ 77,248	14%	\$ 312,911	99%
Service	\$ 138,470	\$ 131,733	\$ 125,409	\$ 6,737	5%	\$ 13,061	10%
Total revenues	\$ 766,327	\$ 682,342	\$ 440,355	\$ 83,985	12%	\$ 325,972	74%
Costs of revenues	\$ 311,398	\$ 263,969	\$ 207,286	\$ 47,429	18%	\$ 104,112	50%
Stock-based compensation expense included in costs of revenues	\$ 3,439	\$ 4,168	\$ 3,325	\$ (729)	-17%	\$ 114	3%
Gross margin percentage	59%	61%	53%				

(Dollar amounts in thousands)	Six months ended			
	December 31, 2010	December 31, 2009	Q2 FY10 YTD vs. Q2 FY09 YTD	
Revenues:				
Product	\$ 1,178,466	\$ 544,197	\$ 634,269	117%
Service	270,203	238,845	31,358	13%
Total revenues	\$ 1,448,669	\$ 783,042	\$ 665,627	85%
Costs of revenues	\$ 575,367	\$ 379,178	\$ 196,189	52%
Gross margin percentage	60%	52%		
Stock-based compensation expense included in costs of revenues	\$ 7,607	\$ 6,613	\$ 994	15%

Product revenues

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Product revenues increased during the three months ended December 31, 2010 from the three months ended September 30, 2010 as many of our customers maintained high levels of capital spending for both technology and capacity related investments, and as we recognized revenues during the three months ended December 31, 2010 from system orders received in current and prior periods. This increase was primarily the result of higher revenues derived from defect inspection equipment, as compared to the three months ended September 30, 2010.

Product revenues increased during the three and six months ended December 31, 2010 from the three and six months ended December 31, 2009 as our customers increased capital spending for both technology and capacity related investments of process control equipment, in response to anticipated semiconductor electronics end market demand. These factors contributed to an increase in the revenues that we recognized across each of our major products, as well as an increase in the number of tools that we sold, primarily defect inspection and metrology equipment, as compared to the three and six months ended December 31, 2009.

Table of Contents**Service revenues**

Service revenues are generated from maintenance service contracts, as well as billable time and material service calls made to our customers after the expiration of the warranty period. The amount of service revenues generated is generally a function of the number of post-warranty systems installed at our customers' sites and the utilization of those systems. Service revenues during the three months ended December 31, 2010 increased compared to the three months ended September 30, 2010 and December 31, 2009, and increased during the six months ended December 31, 2010 compared to the six months ended December 2009, in each case as a result of high factory utilization by our customers.

Revenues by region

Revenues by region for the periods indicated were as follows:

(Dollar amounts in thousands)	December 31, 2010		Three months ended September 30, 2010		December 31, 2009	
United States	\$ 149,843	20%	\$ 86,519	12%	\$ 105,489	24%
Taiwan	233,081	30%	188,541	28%	171,947	39%
Japan	59,813	8%	93,888	14%	56,140	13%
Europe & Israel	60,491	8%	39,246	6%	26,908	6%
Korea	123,154	16%	162,091	24%	19,437	4%
Rest of Asia	139,945	18%	112,057	16%	60,434	14%
Total	\$ 766,327	100%	\$ 682,342	100%	\$ 440,355	100%

A significant portion of our revenues continues to be generated in Asia, where a substantial portion of the world's semiconductor manufacturing capacity is located, and we expect that will continue to be the case.

Gross margin

Our gross margin fluctuates with revenue levels and product mix, and is affected by variations in costs related to manufacturing and servicing our products. Our customers maintained strong demand for new high value products, and we continued to benefit from significant volume efficiencies in manufacturing operations worldwide, ongoing effective cost management, and a lower overall manufacturing cost structure as a result of our globalization initiatives, all while generating higher revenue than during the prior quarter. While we continue to maintain a high gross margin percentage in comparison to historic levels, our gross margin decreased slightly during the three months ended December 31, 2010 compared to the three months ended September 30, 2010, primarily due to changes in product mix.

Our gross margin percentage significantly increased for the three and six months ended December 31, 2010 compared to the three and six months ended December 31, 2009 principally due to higher demand for our products, a more favorable product mix, significant volume efficiencies in manufacturing operations worldwide, continued effective cost management and a lower overall manufacturing cost structure as a result of our globalization initiatives during the three and six months ended December 31, 2010.

Engineering, Research and Development (R&D)

(Dollar amounts in thousands)	Three months ended			Q2 FY11 vs.		Q2 FY11 vs.	
	December 31, 2010	September 30, 2010	December 31, 2009	Q1 FY11		Q2 FY10	
R&D expenses	\$ 94,897	\$ 94,720	\$ 83,301	\$ 177	0%	\$ 11,596	14%
Stock-based compensation expense included in R&D expenses	\$ 5,814	\$ 7,618	\$ 6,667	\$ (1,804)	-24%	\$ (853)	-13%
R&D expenses as a percentage of total revenues	12%	14%	19%				

Edgar Filing: KLA TENCOR CORP - Form 10-Q

(Dollar amounts in thousands)	Six months ended		Q2 FY11 YTD vs. Q2 FY10 YTD	
	December 31, 2010	December 31, 2009		
R&D expenses	\$ 189,617	\$ 161,510	\$ 28,107	17%
Stock-based compensation expense included in R&D expenses	\$ 13,432	\$ 13,270	\$ 162	1%
R&D expenses as a percentage of total revenues	13%	21%		

Table of Contents

R&D expenses during the three months ended December 31, 2010 remained flat compared to the three months ended September 30, 2010 as an increase of 1.1 million in engineering material costs and consulting services was offset by a decrease of 1.0 million in employee-related expenses primarily due to lower stock-based compensation expense.

The increase in R&D expenses during the three months ended December 31, 2010 as compared to the three months ended December 31, 2009 was primarily due to an increase of \$6.4 million in engineering material costs, an increase of \$2.5 million in consulting services and an increase of \$4.3 million in employee-related expenses, partially offset by an increase of \$1.5 million in external funding from government grants.

R&D expenses during the six months ended December 31, 2010 increased as compared to the six months ended December 31, 2009 primarily due to an increase of \$12.1 million in engineering material costs, an increase of \$14.4 million in employee-related expenses from additional headcount and an increase of \$5.1 million in consulting services, partially offset by an increase of \$2.9 million in external funding from government grants.

R&D expenses include the benefit of \$3.3 million, \$2.8 million and \$1.8 million of external funding received during the three months ended December 31, 2010, September 30, 2010 and December 31, 2009, respectively, for certain strategic development programs from government grants.

Our future operating results will depend significantly on our ability to produce products and provide services that have a competitive advantage in our marketplace. To do this, we believe that we must continue to make substantial investments in our research and development. We remain committed to product development in new and emerging technologies as we address the yield challenges our customers face at future technology nodes.

Selling, General and Administrative (SG&A)

(Dollar amounts in thousands)	Three months ended			Q2 FY11 vs.		Q2 FY11 vs.	
	December 31, 2010	September 30, 2010	December 31, 2009	Q1 FY11		Q2 FY10	
SG&A expenses	\$ 91,166	\$ 88,037	\$ 102,673	\$ 3,129	4%	\$ (11,507)	-11%
Stock-based compensation expense included in SG&A expenses	\$ 10,178	\$ 12,427	\$ 10,863	\$ (2,249)	-18%	\$ (685)	-6%
SG&A expenses as a percentage of total revenues	12%	13%	23%				

(Dollar amounts in thousands)	Six months ended			Q2 FY11 YTD vs.	
	December 31, 2010	December 31, 2009		Q2 FY10 YTD	
SG&A expenses	\$ 179,203	\$ 180,309		\$ (1,106)	-1%
Stock-based compensation expense included in SG&A expenses	\$ 22,605	\$ 21,171		\$ 1,434	7%
SG&A expenses as a percentage of total revenues	12%	23%			

The increase in SG&A expenses during the three months ended December 31, 2010 as compared to the three months ended September 30, 2010 was primarily due to an increase of \$1.1 million in legal expenses for shareholder litigation relating to our historical stock option practices and an increase of \$2.2 million in employee-related compensation partially offset by a net gain of \$1.4 million from the sale of real estate assets recorded during the three months ended December 31, 2010.

The decrease in SG&A expenses during the three months ended December 31, 2010 as compared to the three months ended December 31, 2009 was primarily due to \$11.4 million of impairment charges recorded in the three months ended December 31, 2009 versus none recorded in the three months ended December 31, 2010, a decrease of \$6.0 million in litigation expenses for shareholder litigation relating to our historical stock option practices and a net gain of \$1.4 million from the sale of real estate assets recorded during the three months ended December 31, 2010, partially offset by an increase of \$8.1 million in employee-related expenses and an increase of \$1.1 million in consulting services.

The decrease in SG&A expenses during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009 is primarily due to decrease of \$11.2 million in litigation expenses, a decrease of \$11.4 million in impairment charges and a net gain of \$1.4 million from the sale of real estate assets, partially offset by an increase of \$23.7 million in employee-related expenses.

Impairment of Goodwill

During the three months ended December 31, 2009 and 2010, we performed our annual evaluation of goodwill by reporting unit, and concluded that there was no impairment as of December 31, 2009 and 2010. Our assessment indicated that the fair value of our reporting units was substantially in excess of their estimated carrying values, and therefore goodwill in the reporting units was not impaired as of December 31, 2009 and 2010.

Table of Contents**Restructuring Charges**

We have undertaken a number of cost reduction activities, including workforce reductions, in an effort to lower our quarterly operating expense run rate. The program in the United States is accounted for in accordance with the authoritative guidance related to compensation for nonretirement post-employment benefits, whereas the programs in the international locations are accounted for in accordance with the authoritative guidance for contingencies. During the three months ended December 31, 2010, we recorded a \$1.1 million net restructuring charge, of which \$0.2 million was recorded to costs of revenues, \$0.1 million was recorded to engineering, research and development expense and \$0.8 million was recorded to selling, general and administrative expense. This charge represents the estimated minimum liability associated with expected termination benefits to be provided to employees after employment.

The following table shows the activity primarily related to severance and benefits expense for the three and six months ended December 31, 2010 and 2009:

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Beginning balance	\$ 589	\$ 4,304	\$ 1,221	\$ 8,086
Restructuring costs	1,065	3,262	1,430	3,845
Adjustments	(8)	(149)	(30)	(685)
Cash payments	(771)	(2,839)	(1,746)	(6,668)
Ending balance	\$ 875	\$ 4,578	\$ 875	\$ 4,578

Substantially all of the remaining accrued restructuring balance as of December 31, 2010 related to our workforce reductions is expected to be paid out by June 30, 2011.

Interest Income and Other, Net and Interest Expense

(Dollar amounts in thousands)	December 31, 2010	Three months ended	
		September 30, 2010	December 31, 2009
Interest income and other, net	\$ (4,182)	\$ 1,225	\$ 4,463
Interest expense	\$ 13,493	\$ 13,529	\$ 13,542
Interest income and other, net as a percentage of total revenues	1%	0%	1%
Interest expense as a percentage of total revenues	2%	2%	3%

(Dollar amounts in thousands)	Six months ended	
	December 31, 2010	December 31, 2009
Interest income and other, net	\$ (2,957)	\$ 25,762
Interest expense	\$ 27,022	\$ 26,999
Interest income and other, net as a percentage of total revenues	0%	3%
Interest expense as a percentage of total revenues	2%	3%

Interest income and other, net is comprised primarily of interest income earned on our investment and cash portfolio, realized gains or losses on sales of marketable securities, gains or losses from revaluation of certain foreign currency denominated assets and liabilities as well as foreign currency contracts, and impairments associated with equity investments in privately-held companies. The decrease in interest income and other, net during the three months ended December 31, 2010 compared to the three months ended September 30, 2010 and December 31, 2009 was primarily due to an impairment charge of \$6.8 million recorded during the three months ended December 31, 2010 for equity investments in privately-held companies. The decrease in interest income and other, net during the six months ended December 31, 2010 compared to the six months ended December 31, 2009 was primarily attributable to reduced interest earnings due to the lower market interest rate environment and higher impairment charge related to equity investments in privately-held companies during the six months ended December 31, 2010, offset by the benefit recorded in the six months ended September 30, 2009 upon expiration of a statute of limitations relating to an uncertainty in our position with respect to a foreign transaction-based tax. No such benefit was recorded during the six months ended December 31, 2010.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Interest expense is primarily derived from the issuance of \$750 million aggregate principal amount of senior notes in the fourth quarter of the fiscal year ended June 30, 2008. Interest expense remained flat in the three months ended December 31, 2010 compared to the three months ended September 30, 2010 and December 31, 2009.

Table of Contents**Provision for Income Taxes**

The following table provides details of income taxes:

(Dollar amounts in thousands)	Three months ended December 31,		Six months ended December 31,	
	2010	2009	2010	2009
Income before income taxes	\$ 251,191	\$ 38,016	\$ 474,503	\$ 60,808
Provision for taxes	65,699	16,222	134,815	18,609
Effective tax rate	26.2%	42.7%	28.4%	30.6%

Our estimated annual effective tax rate for the year is approximately 29%.

The difference between the actual effective tax rate of 26.2% during the quarter and the estimated annual effective tax rate of 29% is primarily due to the tax impact of the following items during the three months ended December 31, 2010:

Tax expense was decreased by \$3.7 million due to windfalls from employee stock activity. A windfall arises when the tax deduction is more than book compensation. Windfalls are generally recorded as increases to capital in excess of par value. A shortfall arises when the tax deduction is less than book compensation. Shortfalls are recorded as decreases to capital in excess of par value to the extent that cumulative windfalls exceed cumulative shortfalls. Shortfalls in excess of cumulative windfalls are recorded as provision for income taxes. When there are shortfalls recorded as provision for income taxes during an earlier quarter, windfalls arising in subsequent quarters within the same fiscal year are recorded as a reduction to income taxes to the extent of the shortfalls recorded.

Tax expense was decreased by \$3.1 million related to a non-taxable increase in the assets held within our Executive Deferred Savings Plan.

Tax expense was decreased by \$3.9 million related to the reinstatement of the U.S. Federal Research and Development Credit (the Federal R&D Credit), under The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which was signed into law on December 17, 2010.

Tax expense was higher as a percentage of income during the three months ended December 31, 2009 compared to the three months ended December 31, 2010 primarily due to an increase in tax expense of \$8.7 million resulting from shortfalls related to employee stock activity during the three months ended December 31, 2009. The shortfall expense during the three months ended December 31, 2009 had a significant impact on our effective tax rate due to the lower level of income generated during the three months ended December 31, 2009.

Tax expense was higher as a percentage of income during the six months ended December 31, 2009 compared to the six months ended December 31, 2010 due to a decrease in tax expense of \$3.9 million resulting from the reinstatement of the Federal R&D Credit during the six months ended December 31, 2010 and an increase in tax expense of \$8.7 million resulting from shortfalls related to employee stock activity during the six months ended December 31, 2009.

Our future effective income tax rate depends on various factors, such as tax legislation, the geographic composition of our pre-tax income, the amount of our pre-tax income as business activity fluctuates, non-deductible expenses incurred in connection with acquisitions, research and development credits as a percentage of aggregate pre-tax income, non-taxable or non-deductible increases or decreases in the assets held within our Executive Deferred Savings Plan, the tax effects of employee stock activity and the effectiveness of our tax planning strategies.

In the normal course of business, we are subject to examination by taxing authorities throughout the world. We are under United States federal income tax examination for the fiscal years ended June 30, 2007 through June 30, 2009, which represents all years for which tax returns have been filed and the statute of limitations has not expired. We are subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2006. We are also subject to examinations in major foreign jurisdictions, including Japan, Israel and Singapore, for all years beginning from the fiscal year ended June 30, 2006 and is currently under tax examinations in various other foreign tax jurisdictions. It is possible that certain examinations may be concluded in the next twelve months. We believe it is possible that we may recognize up to \$3.6

Edgar Filing: KLA TENCOR CORP - Form 10-Q

million of our existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of agreements with various foreign tax authorities.

Table of Contents**LIQUIDITY AND CAPITAL RESOURCES**

(Dollar amounts in thousands)	December 31, 2010	June 30, 2010
Cash and cash equivalents	\$ 596,104	\$ 529,918
Marketable securities	1,040,296	1,004,126
Total cash, cash equivalents and marketable securities	\$ 1,636,400	\$ 1,534,044
Percentage of total assets	39%	39%

(In thousands)	December 31, 2010	Six months ended December 31, 2009
Cash flow:		
Net cash provided by operating activities	\$ 289,453	\$ 236,850
Net cash used in investing activities	(43,388)	(196,729)
Net cash used in financing activities	(191,295)	(40,034)
Effect of exchange rate changes on cash and cash equivalents	11,416	6,390
Net increase in cash and cash equivalents	\$ 66,186	\$ 6,477

At December 31, 2010, our cash, cash equivalents and marketable securities totaled \$1.6 billion, an increase of \$102 million from June 30, 2010. We generated \$289 million and \$237 million in cash from operations during the six months ended December 31, 2010 and 2009, respectively. We used \$43 million and \$197 million in cash from investing activities during the six months ended December 31, 2010 and 2009, respectively. We used \$191 million and \$40 million in cash for financing activities during the six months ended December 31, 2010 and 2009, respectively.

We have historically financed our operations through cash generated from operations. Net cash provided by operating activities during the six months ended December 31, 2010 increased compared to the six months ended December 31, 2009 from \$237 million to \$289 million primarily as a result of the following key factors:

An increase in cash collections by approximately \$681 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, due to higher sales volume, offset by

An increase in vendor payments by approximately \$316 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, to support a higher level of business activities,

An increase in payroll expenses by approximately \$123 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, mainly due to the bonus payment for fiscal year 2010, and

An increase in tax payments by approximately \$175 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, due to higher profitability.

Investing activities during the six months ended December 31, 2010 used net cash of \$43 million, as compared to using net cash of \$197 million during the six months ended December 31, 2009, and this change was primarily the result of the following factors:

An increase in the cash proceeds from the sale of assets of approximately \$13 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, primarily from the sale of the San Jose, California campus and

A decrease in the use of cash for purchases of available-for-sale and trading securities, net of sales and maturities, of approximately \$149 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009.

Net cash used in financing activities during the six months ended December 31, 2010 increased compared to the six months ended December 31, 2009 from \$40 million to \$191 million primarily as a result of our recently announced dividend increase and higher common stock repurchases. We repurchased \$117 million of our common stock during the six months ended December 30, 2010, as compared to no stock repurchases during the six months ended December 31, 2009.

During the three months ended December 31, 2010, our Board of Directors declared a dividend of \$0.25 per share of our outstanding common stock, which was paid on December 1, 2010 to our stockholders on record as of November 16, 2010. During the same period in fiscal year 2010, our Board of Directors declared and paid a quarterly cash dividend of \$0.15 per share. The total amount of dividends paid during the three months ended December 31, 2010 and 2009 was \$41.8 million and \$25.7 million, respectively. The total amount of dividends paid during the six months ended December 31, 2010 and 2009 was \$83.6 million and \$51.3 million, respectively.

Table of Contents

The following is a schedule summarizing our significant obligations to make future payments under contractual obligations as of December 31, 2010:

(In thousands)	Fiscal year ending June 30,							
	Total	2011 (2)	2012	2013	2014	2015	Thereafter	Other
Long-term debt obligations(1)	\$ 750,000	\$	\$	\$	\$	\$	\$ 750,000	
Interest expense associated with long-term debt obligations	379,498	25,875	51,750	51,750	51,750	51,750	146,623	
Purchase commitments	289,170	260,982	25,770	1,630	491	253	44	
Non-current income tax payable(3)	69,388							69,388
Operating leases	24,385	4,445	6,636	4,398	2,912	1,721	4,273	
Pension obligations	23,373	868	1,572	1,960	1,927	2,541	14,505	
Total contractual cash obligations	\$ 1,535,814	\$ 292,170	\$ 85,728	\$ 59,738	\$ 57,080	\$ 56,265	\$ 915,445	\$ 69,388

(1) In April 2008, we issued \$750 million aggregate principal amount of senior notes due in 2018.

(2) Remaining 6 months.

(3) Represents the non-current income tax payable obligation. We are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

We have agreements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, from time to time we will discount, without recourse, letters of credit (LCs) received from customers in payment of goods.

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs and related discounting fees paid for the three and six months ended December 31, 2010 and 2009:

(In thousands)	Three months ended		Six months ended	
	December 31, 2010	December 31, 2009	December 31, 2010	December 31, 2009
Receivables sold under factoring agreements	\$ 96,586	\$ 39,818	\$ 156,611	\$ 70,019
Proceeds from sales of LCs	\$ 33,327	\$	\$ 84,263	\$ 10,630
Discounting fees paid on sales of LCs (1)	\$ 50	\$	\$ 155	\$ 123

(1) Discounting fees include bank fees and interest expense and were recorded in interest income and other, net.

We maintain guarantee arrangements available through various financial institutions for up to \$20.3 million, of which \$18.2 million had been issued as of December 31, 2010 primarily to fund guarantees to customs authorities for VAT and other operating requirements of our subsidiaries in Europe and Asia.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply for key components. Our liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. Our open inventory purchase commitments were \$289.2 million as of December 31, 2010, and are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

We provide standard warranty coverage on our systems for 40 hours per week for twelve months, providing labor and parts necessary to repair the systems during the warranty period. We account for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. The actual product performance and/or field expense profiles may differ, and in those cases we adjust our warranty accruals accordingly. The difference between the estimated and actual warranty costs tends to be larger for new product introductions as there is limited historical product performance to estimate warranty expense; more

Edgar Filing: KLA TENCOR CORP - Form 10-Q

mature products with longer product performance histories tend to be more stable in our warranty charge estimates. Non-standard warranty coverage generally includes services incremental to the standard 40-hour per week coverage for twelve months. See Note 13, Commitments and Contingencies, to the Condensed Consolidated Financial Statements for a detailed description.

Table of Contents

Working capital increased to \$2.3 billion as of December 31, 2010, compared to \$2.1 billion as of June 30, 2010. As of December 31, 2010, our principal sources of liquidity consisted of \$1.6 billion of cash, cash equivalents, and marketable securities. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, we believe that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for at least the next twelve months.

During the fiscal years ended June 30, 2008, 2009 and 2010, our investment portfolio included auction rate securities, which are investments with contractual maturities generally between 20 to 30 years. They are usually found in the form of municipal bonds, preferred stock, a pool of student loans, or collateralized debt obligations whose interest rates are reset. The reset typically occurs every seven to forty-nine days, through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par. The auction rate securities that we held were backed by student loans and were collateralized, insured and guaranteed by the United States Federal Department of Education. In addition, all auction rate securities that we held were rated by the major independent rating agencies as either AAA or Aaa. In February 2008, auctions failed for approximately \$48.2 million in par value of municipal auction rate securities that we held because sell orders exceeded buy orders. These failures were not believed to be a credit issue, but rather caused by a lack of liquidity. The funds associated with these failed auctions might not have been accessible until the issuer called the security, a successful auction occurred, a buyer was found outside of the auction process, or the security matured.

By letter dated August 8, 2008, we received notification from UBS AG ("UBS"), in connection with a settlement entered into between UBS and certain regulatory agencies, offering to repurchase all of our auction rate security holdings at par value. We formally accepted the settlement offer and entered into a repurchase agreement ("Agreement") with UBS on November 11, 2008 ("Acceptance Date"). By accepting the Agreement, we (1) received the right ("Put Option") to sell our auction rate securities at par value to UBS between June 30, 2010 and June 30, 2012 and (2) gave UBS the right to purchase the auction rate securities from us any time after the Acceptance Date as long as we receive the par value. As of June 30, 2010, all of our auction rate securities had been sold and subsequently settled in July 2010.

In April 2008, we issued \$750 million aggregate principal amount of 6.90% senior, unsecured long-term debt due in 2018 with an effective interest rate of 7.00%. The discount on the debt amounted to \$5.4 million and is being amortized over the life of the debt using the straight-line method as opposed to the interest method due to immateriality. Interest is payable semi-annually on November 1 and May 1. The debt indenture includes covenants that limit our ability to grant liens on our facilities and to enter into sale and leaseback transactions, subject to significant allowances under which certain sale and leaseback transactions are not restricted. We were in compliance with all of our covenants as at December 31, 2010.

Our credit ratings and outlooks as of January 14, 2011 are summarized below.

Rating Agency	Rating	Outlook
Fitch	BBB	Stable
Moody's	Baa1	Stable
Standard & Poor's	BBB	Stable

Factors that can affect our credit ratings include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, and changes in our business strategy.

Table of Contents**Off-Balance Sheet Arrangements**

Under our foreign currency risk management strategy, we utilize derivative instruments to protect our interests from unanticipated fluctuations in earnings and cash flows caused by volatility in currency exchange rates. This financial exposure is monitored and managed as an integral part of our overall risk management program which focuses on the unpredictability of financial markets and seeks to reduce the potentially adverse effects that the volatility of these markets may have on our operating results. We continue our policy of hedging our current and forecasted foreign currency exposures with hedging instruments having tenors of up to 18 months. The outstanding hedge contracts, with maximum maturity of 13 months, were as follows:

(In thousands)	As of December 31, 2010	As of June 30, 2010
Cash flow hedge contracts		
Purchase	\$ 12,620	\$ 15,835
Sell	(50,741)	(32,853)
Other foreign currency hedge contracts		
Purchase	83,156	82,535
Sell	(89,031)	(104,414)
Net	\$ (43,996)	\$ (38,897)

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments, such as foreign currency hedges. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position as of December 31, 2010. Actual results may differ materially.

As of December 31, 2010, we had an investment portfolio of fixed income securities of \$1.0 billion, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of December 31, 2010, the fair value of the portfolio would have declined by \$1.1 million.

As of December 31, 2010, we had net forward contracts to purchase \$44.0 million in foreign currency in order to hedge currency exposures (see Note 15, Derivative Instruments and Hedging Activities, to the Condensed Consolidated Financial Statements for a detailed description). If we had entered into these contracts on December 31, 2010, the U.S. dollar equivalent would have been \$46.3 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by \$17.0 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on net income or cash flows.

In April 2008, we issued \$750 million aggregate principal amount of 6.90% senior unsecured notes due in 2018. The fair market value of long-term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall and decrease as interest rates rise. At December 31, 2010, the book value and the fair value of our fixed rate debt were \$746.0 million and \$829.1 million, respectively.

See Note 4, Marketable Securities, to the Condensed Consolidated Financial Statements in Part I, Item 1; Management's Discussion and Analysis of Financial Condition and Results of Operations, *Liquidity and Capital Resources*, in Part I, Item 2; and Risk Factors in Part II, Item 1A of this Quarterly Report on Form 10-Q for a description of recent market events that may affect the value of the investments in our portfolio that we held at December 31, 2010.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures and Related CEO and CFO Certifications

Evaluation of Disclosure Controls and Procedures

The Company conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in the Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) ("Disclosure Controls") as of the end of the period covered by this Quarterly Report on Form 10-Q (this "Report") required by Exchange Act Rules 13a-15(b) or 15d-15b. The controls evaluation was conducted under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"). Based on this evaluation, the CEO and CFO have concluded that as of the end of the period covered by this Report the Company's disclosure controls and procedures were effective at a reasonable assurance level.

Attached as exhibits to this Report are certifications of the CEO and CFO, which are required in accordance with Rule 13a-14 of the Exchange Act. This Controls and Procedures section includes the information concerning the controls evaluation referred to in the certifications, and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

Definition of Disclosure Controls

Disclosure Controls are controls and procedures designed to reasonably assure that information required to be disclosed in the Company's reports filed under the Exchange Act, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure Controls are also designed to reasonably assure that such information is accumulated and communicated to the Company's management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. The Company's Disclosure Controls include components of its internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of its financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the United States. To the extent that components of the Company's internal control over financial reporting are included within its Disclosure Controls, they are included in the scope of the Company's annual controls evaluation.

Limitations on the Effectiveness of Controls

The Company's management, including the CEO and CFO, does not expect that the Company's disclosure controls or internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

There have been no changes in our internal control over financial reporting during the three months ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth above under Note 12, "Litigation and Other Legal Matters," to the Condensed Consolidated Financial Statements in Item 1 of Part 1 is incorporated herein by reference.

ITEM 1A. RISK FACTORS

A description of factors that could materially affect our business, financial condition or operating results is provided below.

Risks Associated with Our Industry and Market Conditions

The semiconductor equipment industry is highly cyclical. The purchasing decisions of our customers are highly dependent on the economies of both the local markets in which they are located and the semiconductor industry worldwide. If we fail to respond to industry cycles, our business could be seriously harmed.

Table of Contents

The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. The cyclical nature of the primary industry in which we operate is largely a function of our customers' capital spending patterns and need for expanded manufacturing capacity, which in turn are affected by factors such as capacity utilization, consumer demand for products, inventory levels and our customers' access to capital. This cyclical nature affects our ability to accurately predict future revenue and, in some cases, future expense levels. In the current environment, our ability to accurately predict our future operating results is particularly limited.

During down cycles in our industry, the financial results of our customers may be negatively impacted, which could result not only in a decrease in, or cancellation or delay of, orders (which are generally subject to cancellation or delay by the customer with limited or no penalty) but also a weakening of their financial condition that could impair their ability to pay for our products or our ability to recognize revenue from certain customers. When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During periods of declining revenues, as was experienced during fiscal year 2009, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. If we fail to respond, or if our attempts to respond fail to accomplish our intended results, then our business could be seriously harmed. Furthermore, any workforce reductions and cost reduction actions that we adopt in response to down cycles may result in additional restructuring charges, disruptions in our operations and loss of key personnel. In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles. Each of these factors could adversely impact our operating results and financial condition.

In addition, the semiconductor equipment industry and other industries that we serve are constantly developing and changing over time. These changes currently, or in the future may, include the increasing cost of building and operating fabrication facilities and the impact of such increases on our customers' investment decisions; the variability of future growth rates in the semiconductor and related industries; the ever-increasing cost and complexity involved in the adoption by our customers of technology advances and the potential impact that may have on their rate of adoption; pricing trends in the end-markets for consumer electronics and other products, which places a growing emphasis on our customers' cost of ownership; overall changes in capital spending patterns by our customers; and demand by semiconductor manufacturers for shorter cycle times for developing, manufacturing and installing capital equipment. Further, many semiconductor manufacturers have recently experienced decreased profitability, causing them to enter into collaboration or sharing arrangements for capacity, cost or risk with other manufacturers, outsource manufacturing activities, focus only on specific markets or applications, or purchase less manufacturing equipment. Any of the changes described in this paragraph may, particularly during periods of challenging macroeconomic conditions, negatively affect our customers' rate of investment in capital equipment, which could result in downward pressure on our prices, customer orders, revenues and gross margins. If we do not successfully manage the risks resulting from any of these or other potential changes in our industries, our business, financial condition and operating results could be adversely impacted.

We are exposed to risks associated with a weakening in the condition of the financial markets and the global economy.

The severe tightening of the credit markets, turmoil in the financial markets and weakening of the global economy that were experienced during the fiscal year ended June 30, 2009 contributed to slowdowns in the industries in which we operate, which slowdowns could recur or worsen if economic conditions were to deteriorate again.

The markets for semiconductors, and therefore our business, are ultimately driven by the global demand for electronic devices by consumers and businesses. Economic uncertainty frequently leads to reduced consumer and business spending, which caused our customers to decrease, cancel or delay their equipment and service orders from us in the economic slowdown during fiscal year 2009. In addition, the tightening of credit markets and concerns regarding the availability of credit that accompanied that slowdown made it more difficult for our customers to raise capital, whether debt or equity, to finance their purchases of capital equipment, including the products we sell. Reduced demand, combined with delays in our customers' ability to obtain financing (or the unavailability of such financing), has at times in the past several years adversely affected our product and service sales and revenues and therefore has harmed our business and operating results, and our operating results and financial condition may again be adversely impacted if economic conditions decline from their current levels.

In addition, a decline in the condition of the global financial markets could adversely impact the market values or liquidity of our investments. Our investment portfolio includes corporate and government securities, money market funds and other types of debt and equity investments. Although we believe our portfolio continues to be comprised of sound investments due to the quality and (where applicable) credit ratings and government guarantees of the underlying investments, a decline in the capital and financial markets would adversely impact the market values of our investments and their liquidity. If the market value of such investments were to decline, or if we were to have to sell some of our investments under illiquid market conditions, we may be required to recognize an impairment charge on such investments or a loss on such sales, either of which could have an adverse effect on our financial condition and operating results.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

If we are unable to timely and appropriately adapt to changes resulting from difficult macroeconomic conditions, our business, financial condition or results of operations may be materially and adversely affected.

Table of Contents

Our future performance depends, in part, upon our ability to continue to compete successfully worldwide.

Our industry includes large manufacturers with substantial resources to support customers worldwide. Some of our competitors are diversified companies with greater financial resources and more extensive research, engineering, manufacturing, marketing, and customer service and support capabilities than we possess. We face competition from companies whose strategy is to provide a broad array of products and services, some of which compete with the products and services that we offer. These competitors may bundle their products in a manner that may discourage customers from purchasing our products, including pricing such competitive tools significantly below our product offerings. In addition, we face competition from smaller emerging semiconductor equipment companies whose strategy is to provide a portion of the products and services that we offer, using innovative technology to sell products into specialized markets. The strength of our competitive positions in many of our existing markets is largely due to our leading technology, which is the result of continuing significant investments in product research and development. However, we may enter new markets, whether through acquisitions or new internal product development, in which competition is based primarily on product pricing, not technological superiority. Further, some new growth markets that emerge may not require leading technologies. Loss of competitive position in any of the markets we serve, or an inability to sell our products on favorable commercial terms in new markets we may enter, could negatively affect our prices, customer orders, revenues, gross margins and market share, any of which would negatively affect our operating results and financial condition.

We are exposed to risks associated with a highly concentrated customer base.

Our customer base, particularly in the semiconductor industry, historically has been, and is becoming increasingly, highly concentrated. In this environment, orders from a relatively limited number of manufacturers have accounted for, and are expected to continue to account for, a substantial portion of our sales. In addition, the mix and type of customers, and sales to any single customer, may vary significantly from quarter to quarter and from year to year. If customers do not place orders, or they delay or cancel orders, we may not be able to replace the business. Furthermore, because our products are configured to customer specifications, any changes, delays or cancellations of orders may result in significant, non-recoverable costs. As a result of the consolidation within our customer base, the customers that survive that consolidation represent a greater portion of our sales. Those surviving customers may have more aggressive policies regarding engaging alternative, second-source suppliers for the products we serve and, in addition, may seek, and on occasion receive, pricing, payment, intellectual property-related, or other commercial terms that are less favorable to us. Any of these changes could negatively impact our prices, customer orders, revenues and gross margins. Also, certain customers have undergone significant ownership changes, experienced management changes or have outsourced manufacturing activities, any of which may result in additional complexities in managing customer relationships and transactions. As a result of the challenging economic environment during fiscal year 2009, we were (and in some cases continue to be) exposed to additional risks related to the continued financial viability of certain of our customers. To the extent our customers experience liquidity issues, we may be required to incur additional bad debt expense with respect to receivables owed to us by those customers. In addition, customers with liquidity issues may be forced to discontinue operations or may be acquired by one of our customers, and in either case such event would have the effect of further consolidating our customer base. Any of these factors could have a material adverse effect on our business, financial condition and operating results.

Risks Related to Our Business

If we do not develop and introduce new products and technologies in a timely manner in response to changing market conditions or customer requirements, our business could be seriously harmed.

Success in the semiconductor equipment industry depends, in part, on continual improvement of existing technologies and rapid innovation of new solutions. For example, the size of semiconductor devices continues to shrink, and the industry is currently transitioning to the use of new materials and innovative fab processes. While we expect these trends will increase our customers' reliance on diagnostic products such as ours, we cannot be sure that these trends will directly improve our business. These and other evolving customer needs require us to respond with continued development programs and to cut back or discontinue older programs, which may no longer have industry-wide support. Technical innovations are inherently complex and require long development cycles and appropriate staffing of highly qualified employees. Our competitive advantage and future business success depend on our ability to accurately predict evolving industry standards, to develop and introduce new products that successfully address changing customer needs, to win market acceptance of these new products and to manufacture these new products in a timely and cost-effective manner.

In this environment, we must continue to make significant investments in research and development in order to enhance the performance, features and functionality of our products, to keep pace with competitive products and to satisfy customer demands. Substantial research and development costs typically are incurred before we confirm the technical feasibility and commercial viability of a new product, and not all development activities result in commercially viable products. There can be no assurance that revenues from future products or product enhancements will be sufficient to recover the development costs associated with such products or enhancements. In addition, we cannot be sure that these products or enhancements will receive market acceptance or that we will be able to sell these products at prices that are favorable to

Edgar Filing: KLA TENCOR CORP - Form 10-Q

us. Our business will be seriously harmed if we are unable to sell our products at favorable prices or if the market in which we operate does not accept our products.

Table of Contents

Our business would be harmed if we do not receive parts sufficient in number and performance to meet our production requirements and product specification in a timely and cost-effective manner.

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers to supply these materials. We generally do not have guaranteed supply arrangements with our suppliers. Because of the variability and uniqueness of customers' orders, we do not maintain an extensive inventory of materials for manufacturing. We seek to minimize the risk of production and service interruptions and/or shortages of key parts by selecting and qualifying alternative suppliers for key parts, monitoring the financial stability of key suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, key parts may be available only from a single supplier or a limited group of suppliers. Also, key parts we obtain from some of our suppliers incorporate the suppliers' proprietary intellectual property; in those cases we are increasingly reliant on third parties for high-performance, high-technology components, which reduces the amount of control we have over the availability and protection of the technology and intellectual property that is used in our products. In addition, if certain of our key suppliers experience liquidity issues and are forced to discontinue operations, which is a heightened risk during economic downturns, that would affect their ability to deliver parts and could result in delays for our products. Our operating results and business may be adversely impacted if we are unable to obtain parts to meet our production requirements and product specifications, or if we are only able to do so on unfavorable terms.

Disruption of our manufacturing facilities or other operations, or in the operations of our customers, due to earthquake, flood, other natural catastrophic events, health epidemics or terrorism could result in cancellation of orders, delays in deliveries or other business activities, or loss of customers and could seriously harm our business.

We have significant manufacturing operations in the United States, Singapore, Israel, Belgium and Germany. In addition, our business is international in nature, with our sales, service and administrative personnel and our customers located in numerous countries throughout the world. Operations at our manufacturing facilities and our assembly subcontractors, as well as our other operations and those of our customers, are subject to disruption for a variety of reasons, including work stoppages, acts of war, terrorism, health epidemics, fire, earthquake, volcanic eruptions, energy shortages, flooding or other natural disasters. Such disruption could cause delays in, among other things, shipments of products to our customers, our ability to perform services requested by our customers, or the installation and acceptance of our products at customer sites. We cannot ensure that alternate means of conducting our operations (whether through alternate production capacity or service providers or otherwise) would be available if a major disruption were to occur or that, if such alternate means were available, they could be obtained on favorable terms.

As part of our cost-cutting actions, we have consolidated several operating facilities. Our California operations are now primarily centralized in our Milpitas facility. The consolidation of our California operations into a single campus could further concentrate the risks related to any of the disruptive events described in the preceding paragraph, such as acts of war or terrorism, earthquakes, fires or other natural disasters, if any such event were to impact our Milpitas facility.

We outsource a number of services to third-party service providers, which decreases our control over the performance of these functions. Disruptions or delays at our third-party service providers could adversely impact our operations.

We outsource a number of services, including our transportation and logistics management of spare parts and certain accounting functions, to domestic and overseas third-party service providers. While outsourcing arrangements may lower our cost of operations, they also reduce our direct control over the services rendered. It is uncertain what effect such diminished control will have on the quality or quantity of products delivered or services rendered, on our ability to quickly respond to changing market conditions, or on our ability to ensure compliance with all applicable domestic and foreign laws and regulations. Disruptions or delays at our third-party service providers due to events such as regional economic, business, environmental or political events, information technology system failures or military actions could adversely impact our operations and our ability to ship products, manage our product inventory or record and report financial and management information on a timely and accurate basis.

Our success is dependent in part on our technology and other proprietary rights. If we are unable to maintain our lead or protect our proprietary technology, we may lose valuable assets.

Our success is dependent in part on our technology and other proprietary rights. We own various United States and international patents and have additional pending patent applications relating to some of our products and technologies. The process of seeking patent protection is lengthy and expensive, and we cannot be certain that pending or future applications will actually result in issued patents or that issued patents will be of sufficient scope or strength to provide meaningful protection or commercial advantage to us. Other companies and individuals, including our larger competitors, may develop technologies and obtain patents relating to our business that are similar or superior to our technology or may design around the patents we own, adversely affecting our business. In addition, we at times engage in collaborative technology development efforts with our customers and suppliers, and these collaborations may constitute a key component of certain of our

Edgar Filing: KLA TENCOR CORP - Form 10-Q

ongoing technology and product research and development projects. The termination of any such collaboration, or delays caused by disputes or other unanticipated challenges that may arise in connection with any such collaboration, could significantly impair our research and development efforts, which could have a material adverse impact on our business and operations.

Table of Contents

We also maintain trademarks on certain of our products and services and claim copyright protection for certain proprietary software and documentation. However, we can give no assurance that our trademarks and copyrights will be upheld or successfully deter infringement by third parties.

While patent, copyright and trademark protection for our intellectual property is important, we believe our future success in highly dynamic markets is most dependent upon the technical competence and creative skills of our personnel. We attempt to protect our trade secrets and other proprietary information through confidentiality and other agreements with our customers, suppliers, employees and consultants and through other security measures. We also maintain exclusive and non-exclusive licenses with third parties for strategic technology used in certain products. However, these employees, consultants and third parties may breach these agreements, and we may not have adequate remedies for wrongdoing. In addition, the laws of certain territories in which we develop, manufacture or sell our products may not protect our intellectual property rights to the same extent as do the laws of the United States. In any event, the extent to which we can protect our trade secrets through the use of confidentiality agreements is limited, and our success will depend to a significant extent on our ability to innovate ahead of our competitors.

We might be involved in intellectual property disputes or other intellectual property infringement claims that may be costly to resolve, prevent us from selling or using the challenged technology and seriously harm our operating results and financial condition.

As is typical in the semiconductor equipment industry, from time to time we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which they believe cover certain of our products, processes, technologies or information. In addition, we occasionally receive notification from customers who believe that we owe them indemnification or other obligations related to intellectual property claims made against such customers by third parties. Litigation tends to be expensive and requires significant management time and attention and could have a negative effect on our results of operations or business if we lose or have to settle a case on significantly adverse terms. Our customary practice is to evaluate such infringement assertions and to consider whether to seek licenses where appropriate. However, we cannot ensure that licenses can be obtained or, if obtained, will be on acceptable terms or that costly litigation or other administrative proceedings will not occur. The inability to obtain necessary licenses or other rights on reasonable terms, or the instigation of litigation or other administrative proceedings, could seriously harm our operating results and financial condition.

We depend on key personnel to manage our business effectively, and if we are unable to attract, retain and motivate our key employees, our sales and product development could be harmed.

Our employees are vital to our success, and our key management, engineering and other employees are difficult to replace. We generally do not have employment contracts with our key employees. Further, we do not maintain key person life insurance on any of our employees. The expansion of high technology companies worldwide has increased demand and competition for qualified personnel. If we are unable to retain key personnel, or if we are not able to attract, assimilate or retain additional highly qualified employees to meet our needs in the future, our business and operations could be harmed.

If we fail to operate our business in accordance with our business plan, our operating results, business and stock price may be significantly and adversely impacted.

We attempt to operate our business in accordance with a business plan that is established annually, revised frequently (generally quarterly), and reviewed by management even more frequently (at least monthly). Our business plan is developed based on a number of factors, many of which require estimates and assumptions, such as our expectations of the economic environment, future business levels, our customers' willingness and ability to place orders, lead-times, and future revenue and cash flow. Our budgeted operating expenses, for example, are based in part on our future revenue expectations. However, our ability to achieve our anticipated revenue levels is a function of numerous factors, including the volatile and cyclical nature of our industry, customer order cancellations, macroeconomic changes, operational matters regarding particular agreements, our ability to manage customer deliveries and resources for the installation and acceptance of our products (for products where customer acceptance is required before we can recognize revenue from such sales), our ability to manage delays or accelerations by customers in taking deliveries and the acceptance of our products (for products where customer acceptance is required before we can recognize revenue from such sales), our ability to operate our business and sales processes effectively, and a number of the other risk factors set forth in this Item 1A.

Because our expenses are in most cases relatively fixed in the short term, any revenue shortfall below expectations could have an immediate and significant adverse effect on our operating results. Similarly, if we fail to manage our expenses effectively or otherwise fail to maintain rigorous cost controls, we could experience greater than anticipated expenses during an operating period, which would also negatively affect our results of operations. If we fail to operate our business consistent with our business plan, our operating results in any period may be significantly and adversely impacted. Such an outcome could cause customers, suppliers or investors to view us as less stable, or could cause us to fail to meet financial analysts' revenue or earnings estimates, any of which could have a material adverse impact on our business, financial condition or stock price.

Table of Contents

Acquisitions are an important element of our strategy but, because of the uncertainties involved, we may not find suitable acquisition candidates and we may not be able to successfully integrate and manage acquired businesses. We are also exposed to risks in connection with strategic alliances into which we may enter.

In addition to our efforts to develop new technologies from internal sources, part of our growth strategy is to pursue acquisitions and acquire new technologies from external sources. As part of this effort, we may make acquisitions of, or significant investments in, businesses with complementary products, services and/or technologies. There can be no assurance that we will find suitable acquisition candidates or that acquisitions we complete will be successful. In addition, we may use equity to finance future acquisitions, which would increase our number of shares outstanding and be dilutive to current stockholders.

If we are unable to successfully integrate and manage acquired businesses or if acquired businesses perform poorly, then our business and financial results may suffer. It is possible that the businesses we have acquired, as well as businesses that we may acquire in the future, may perform worse than expected or prove to be more difficult to integrate and manage than expected. In addition, we may lose key employees of the acquired companies. As a result, risks associated with acquisition transactions may give rise to a material adverse effect on our business and financial results for a number of reasons, including:

we may have to devote unanticipated financial and management resources to acquired businesses;

the combination of businesses may cause the loss of key personnel or an interruption of, or loss of momentum in, the activities of our company and/or the acquired business;

we may not be able to realize expected operating efficiencies or product integration benefits from our acquisitions;

we may experience challenges in entering into new market segments for which we have not previously manufactured and sold products;

we may face difficulties in coordinating geographically separated organizations, systems and facilities;

the customers, distributors, suppliers, employees and others with whom the companies we acquire have business dealings may have a potentially adverse reaction to the acquisition;

we may have to write-off goodwill or other intangible assets; and

we may incur unforeseen obligations or liabilities in connection with acquisitions.

At times, we may also enter into strategic alliances with customers, suppliers or other business partners with respect to development of technology and intellectual property. These alliances typically require significant investments of capital and exchange of proprietary, highly sensitive information. The success of these alliances depends on various factors over which we may have limited or no control and requires ongoing and effective cooperation with our strategic partners. Mergers and acquisitions and strategic alliances are inherently subject to significant risks, and the inability to effectively manage these risks could materially and adversely affect our business, financial condition and operating results.

Compliance with federal securities laws, rules and regulations, as well as NASDAQ requirements, is becoming increasingly complex, and the significant attention and expense we must devote to those areas may have an adverse impact on our business.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Federal securities laws, rules and regulations, as well as NASDAQ rules and regulations, require companies to maintain extensive corporate governance measures, impose comprehensive reporting and disclosure requirements, set strict independence and financial expertise standards for audit and other committee members and impose civil and criminal penalties for companies and their chief executive officers, chief financial officers and directors for securities law violations. These laws, rules and regulations have increased, and in the future are expected to continue to increase, the scope, complexity and cost of our corporate governance, reporting and disclosure practices, which could harm our results of operations and divert management's attention from business operations.

We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war. If international political instability continues or increases, our business and results of operations could be harmed.

The threat of terrorism targeted at the regions of the world in which we do business increases the uncertainty in our markets. Any act of terrorism which affects the economy or the semiconductor industry could adversely affect our business. Increased international political instability in various parts of the world, disruption in air transportation and further enhanced security measures as a result of terrorist attacks may hinder our ability to do business and may increase our costs of operations. Such continuing instability could cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. This same instability could have the same effects on our suppliers and their ability to timely deliver their products. If international political instability continues or increases, our business and results of operations could be harmed. We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war.

Table of Contents

We self insure certain risks including earthquake risk. If one or more of the uninsured events occurs, we could suffer major financial loss.

We purchase insurance to help mitigate the economic impact of certain insurable risks; however, certain other risks are uninsurable or are insurable only at significant cost or cannot be mitigated with insurance. An earthquake could significantly disrupt our manufacturing operations, a significant portion of which are conducted in California, an area highly susceptible to earthquakes. It could also significantly delay our research and engineering efforts on new products, much of which is also conducted in California. We take steps to minimize the damage that would be caused by an earthquake, but there is no certainty that our efforts will prove successful in the event of an earthquake. We self insure earthquake risks because we believe this is a prudent financial decision based on our large cash reserves and the high cost and limited coverage available in the earthquake insurance market. Certain other risks are also self-insured either based on a similar cost-benefit analysis, or based on the unavailability of insurance. If one or more of the uninsured events occurs, we could suffer major financial loss.

A change in accounting standards or practices or a change in existing taxation rules or practices (or changes in interpretations or applications of such standards, practices or rules) can have a significant effect on our reported results and may even affect reporting of transactions completed before the change is effective.

New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation rules have occurred and may occur in the future. Changes to (or revised interpretations or applications of) existing tax or accounting rules or the questioning of current or past practices may adversely affect our reported financial results or the way we conduct our business.

For example, the adoption of the authoritative guidance for stock-based compensation, which required us to measure all employee stock-based compensation awards using a fair value method beginning in fiscal year 2006 and record such expense in our consolidated financial statements, has had a material impact on our consolidated financial statements, as reported under accounting principles generally accepted in the United States of America.

A change in our effective tax rate can have a significant adverse impact on our business.

A number of factors may adversely impact our future effective tax rates, such as the jurisdictions in which our profits are determined to be earned and taxed; the resolution of issues arising from tax audits with various tax authorities; changes in the valuation of our deferred tax assets and liabilities; adjustments to estimated taxes upon finalization of various tax returns; increases in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with acquisitions; changes in available tax credits; changes in stock-based compensation expense; changes in tax laws or the interpretation of such tax laws (for example, proposals for fundamental U.S. international tax reform, such as the proposal by President Obama's Administration, if enacted); changes in generally accepted accounting principles; and the repatriation of non-U.S. earnings for which we have not previously provided for U.S. taxes. A change in our effective tax rate can adversely impact our results from operations.

We are exposed to various risks related to the legal, regulatory and tax environments in which we perform our operations and conduct our business.

We are subject to various risks related to compliance with new, existing, different, inconsistent or even conflicting laws, rules and regulations enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply, including environmental, safety, antitrust and export control regulations. For example, we are or may become subject to existing or future environmental and safety regulations (including those related to climate change) in connection with our global business operations, including regulations related to the development, manufacture and use of our products, recycling and disposal of materials used in our products or in producing our products, the operation of our facilities, and the use of our real property. Our failure or inability to comply with existing or future laws, rules or regulations, or changes to existing laws, rules or regulations, including changes that result in inconsistent or conflicting laws, rules or regulations, in the countries in which we operate could result in violations of contractual or regulatory obligations that may adversely affect our operating results, financial condition and our ability to conduct our business.

In addition, we may from time to time be involved in legal proceedings or claims regarding employment, contracts, product performance, product liability, antitrust, environmental regulations, securities, unfair competition and other matters (in addition to proceedings and claims related to intellectual property matters, which are separately discussed elsewhere in this Item 1A). These legal proceedings and claims, regardless of their merit, may be time-consuming and expensive to prosecute or defend, divert management's attention and resources, and/or inhibit our ability to sell our products. There can be no assurance regarding the outcome of current or future legal proceedings or claims, which could adversely affect our operating results, financial condition and our ability to operate our business.

Table of Contents

We are also exposed to additional risks related to our receipt of external funding for certain strategic development programs from various governments and government agencies, both domestically and internationally. Governments and government agencies typically have the right to terminate funding programs at any time in their sole discretion, so there is no assurance that these sources of external funding will continue to be available to us in the future. In addition, under the terms of these government grants, the applicable granting agency typically has the right to audit the costs that we incur, directly and indirectly, in connection with such programs. Any such audit could result in modifications to, or even termination of, the applicable government funding program. For example, if an audit were to identify any costs as being improperly allocated to the applicable program, those costs would not be reimbursed, and any such costs that had already been reimbursed would have to be refunded. We do not know the outcome of any future audits. Any adverse finding resulting from any such audit could lead to penalties (financial or otherwise), termination of funding programs, suspension of payments, fines and suspension or prohibition from receiving future government funding from the applicable government or government agency, any of which could adversely impact our operating results, financial condition and our ability to operate our business.

Furthermore, we are subject to tax audits in various jurisdictions, and such jurisdictions may assess additional income or other taxes against us. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material adverse effect on our operating results or cash flows in the period or periods for which that determination is made.

A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We are exposed to numerous risks as a result of the international nature of our business and operations.

A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We expect that these conditions will continue in the foreseeable future. Managing global operations and sites located throughout the world presents challenges associated with, among other things, cultural diversity and organizational alignment. Moreover, each region in the global semiconductor equipment market exhibits unique characteristics that can cause capital equipment investment patterns to vary significantly from period to period. Periodic local or international economic downturns, trade balance issues, tariffs or other trade barriers (including those applied to our products or to parts and supplies that we purchase), political instability, legal or regulatory changes or terrorism in regions where we have operations or where we do business, along with fluctuations in interest and currency exchange rates, could negatively affect our business and results of operations. Although we attempt to manage near-term currency risks through the use of hedging instruments, there can be no assurance that such efforts will be adequate.

We are exposed to foreign currency exchange rate fluctuations; although we hedge certain currency risks, we may still be adversely affected by changes in foreign currency exchange rates or declining economic conditions in these countries.

We have some exposure to fluctuations in foreign currency exchange rates, primarily the Euro and the Japanese Yen. We have international subsidiaries that operate and sell our products globally. In addition, an increasing proportion of our manufacturing activities are conducted outside of the United States, and many of the costs associated with such activities are denominated in foreign currencies. We routinely hedge our exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations, but these hedges may be inadequate to protect us from currency exchange rate fluctuations. To the extent that these hedges are inadequate, or if there are significant currency exchange rate fluctuations in currencies for which we do not have hedges in place, our reported financial results or the way we conduct our business could be adversely affected. Furthermore, if a financial counter-party to our hedges experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, we may experience material financial losses.

We are exposed to risks related to our financial arrangements with respect to receivables factoring and banking arrangements.

We enter into factoring arrangements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, we maintain bank accounts with several domestic and foreign financial institutions, any of which may prove not to be financially viable. If we were to stop entering into these factoring arrangements, our operating results, financial condition and cash flows could be adversely impacted by delays or failures in collecting trade receivables. However, by entering into these arrangements, and by engaging these financial institutions for banking services, we are exposed to additional risks. If any of these financial institutions experiences financial difficulties or is otherwise unable to honor the terms of our factoring or deposit arrangements, we may experience material financial losses due to the failure of such arrangements or a lack of access to our funds, any of which could have an adverse impact upon our operating results, financial condition and cash flows.

In addition, pursuant to the terms of certain of our agreements regarding sales of our trade receivables, we may be required to repurchase the trade receivables from the financial institutions party to such agreements in the event of a dispute between us and the applicable customer regarding the customer's obligation to pay the underlying trade receivable. Such a mandatory repurchase could have an adverse impact on our

cash flows for the period in which the repurchase takes place.

Table of Contents

There are risks associated with our outstanding indebtedness.

As of December 31, 2010, we had \$750 million aggregate principal amount of outstanding indebtedness represented by our senior notes that will mature in 2018, and we may incur additional indebtedness in the future. Our ability to pay interest and repay the principal for our indebtedness is dependent upon our ability to manage our business operations and the other risk factors discussed in this section. There can be no assurance that we will be able to manage any of these risks successfully.

In addition, changes by any rating agency to our outlook or credit rating could negatively affect the value and liquidity of both our debt and equity securities. Factors that can affect our credit rating include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, and changes in our business strategy.

In certain circumstances involving a change of control followed by a downgrade of the rating of our senior notes, we will be required to make an offer to repurchase the senior notes at a purchase price equal to 101% of the aggregate principal amount of the notes repurchased, plus accrued and unpaid interest. We cannot make any assurance that we will have sufficient financial resources at such time or will be able to arrange financing to pay the repurchase price of the senior notes. Our ability to repurchase the senior notes in such event may be limited by law, by the indenture associated with the senior notes, or by the terms of other agreements to which we may be party at such time. If we fail to repurchase the senior notes as required by the indenture, it would constitute an event of default under the indenture governing the senior notes which, in turn, may also constitute an event of default under other of our obligations.

There can be no assurance that we will continue to declare cash dividends at all or in any particular amounts.

Our Board of Directors first instituted a quarterly dividend during the fiscal year ended June 30, 2005. Since that time, we have announced two increases in the amount of our quarterly dividend level. We intend to continue to pay quarterly dividends subject to capital availability and periodic determinations by our Board of Directors that cash dividends are in the best interest of our stockholders and are in compliance with all laws and agreements applicable to the declaration and payment of cash dividends by us. Future dividends may be affected by, among other factors: our views on potential future capital requirements for investments in acquisitions and the funding of our research and development; legal risks; stock repurchase programs; changes in federal and state income tax laws or corporate laws; and changes to our business model. Our dividend payments may change from time to time, and we cannot provide assurance that we will continue to declare dividends at all or in any particular amounts. A reduction in our dividend payments could have a negative effect on our stock price.

We are exposed to fluctuations in the market values of our portfolio investments and in interest rates; impairment of our investments could harm our earnings. In addition, we and our stockholders are exposed to risks related to the volatility of the market for our common stock.

Our investment portfolio consists of both corporate and government securities that have a maximum effective maturity of 10 years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. We have the ability to realize the full value of all these investments upon maturity. Unrealized losses are due to changes in interest rates and bond yields.

In addition, the market price for our common stock is volatile and has fluctuated significantly during recent years. The trading price of our common stock could continue to be highly volatile and fluctuate widely in response to various factors, including without limitation conditions in the semiconductor industry and other industries in which we operate, fluctuations in the global economy or capital markets, our operating results or other performance metrics, or adverse consequences experienced by us as a result of any of the risks described elsewhere in this Item 1A. Volatility in the market price of our common stock could cause an investor in our common stock to experience a loss on the value of their investment in us and could also adversely impact our ability to raise capital through the sale of our common stock or to use our common stock as consideration to acquire other companies.

We have recorded significant restructuring, inventory write-off and asset impairment charges in the past and may do so again in the future, which could have a material negative impact on our business.

During the fiscal year ended June 30, 2009, we recorded material restructuring charges of \$38.7 million related to our global workforce reduction, large excess inventory write-offs of \$85.6 million, and material impairment charges of \$446.7 million related to our goodwill and purchased intangible assets. If we were to encounter challenging economic conditions once again, we may implement additional cost reduction actions, which would require us to take additional, potentially material, restructuring charges related to, among other things, employee terminations or exit costs. We may also be required to write off additional inventory if our product build plans or usage of service inventory decline, and such additional write-offs could constitute material charges.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

As noted above, we recorded a material charge during the fiscal year ended June 30, 2009 related to the impairment of our goodwill and purchased intangible assets. Goodwill represents the excess of costs over the net fair value of net assets acquired in a business combination. Goodwill is not amortized, but is instead tested for impairment at least annually in accordance with

Table of Contents

authoritative guidance for goodwill. Purchased intangible assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment in accordance with authoritative guidance for long-lived assets. The valuation of goodwill and intangible assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. A substantial decline in our stock price, or any other adverse change in market conditions, particularly if such change has the effect of changing one of the critical assumptions or estimates we used to calculate the amount of such impairment charge, could result in a change to the estimation of fair value that could result in an additional impairment charge.

Any such additional material charges, whether related to restructuring or goodwill or purchased intangible asset impairment, may have a material negative impact on our operating results and related financial statements.

We are exposed to risks related to our commercial terms and conditions, including our indemnification of third parties, as well as the performance of our products.

Although our standard commercial documentation sets forth the terms and conditions that we intend to apply to commercial transactions with our business partners, counterparties to such transactions may not explicitly agree to our terms and conditions. In situations where we engage in business with a third party without an explicit master agreement regarding the applicable terms and conditions, or where the commercial documentation applicable to the transaction is subject to varying interpretations, we may have disputes with those third parties regarding the applicable terms and conditions of our business relationship with them. Such disputes could lead to a deterioration of our commercial relationship with those parties, costly and time-consuming litigation, or additional concessions or obligations being offered by us to resolve such disputes, or could impact our revenue or cost recognition. Any of these outcomes could materially and adversely affect our business, financial condition and results of operations.

In addition, in our commercial agreements, from time to time in the normal course of business we indemnify third parties with whom we enter into contractual relationships, including customers and lessors, with respect to certain matters. We have agreed, under certain conditions, to hold these third parties harmless against specified losses, such as those arising from a breach of representations or covenants, other third party claims that our products when used for their intended purposes infringe the intellectual property rights of such other third parties, or other claims made against certain parties. We may be compelled to enter into or accrue for probable settlements of alleged indemnification obligations or subject to potential liability arising from our customers' involvements in legal disputes. In addition, notwithstanding the provisions related to limitations on our liability that we seek to include in our business agreements, the counter-parties to such agreements may dispute our interpretation or application of such provisions, and a court of law may not interpret or apply such provisions in our favor, any of which could result in an obligation for us to pay material damages to third parties and engage in costly legal proceedings. It is difficult to determine the maximum potential amount of liability under any indemnification obligations, whether or not asserted, due to our limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in any particular claim. Our business, financial condition and results of operations in a reported fiscal period could be materially adversely affected if we expend significant amounts in defending or settling any purported claims, regardless of their merit or outcomes.

We are also exposed to potential costs associated with unexpected product performance issues. Our products and production processes are extremely complex and thus could contain unexpected product defects, especially when products are first introduced. Unexpected product performance issues could result in significant costs being incurred by us, including increased service or warranty costs, providing product replacements for (or modifications to) defective products, litigation related to defective products, product recalls, or product write-offs or disposal costs. These costs could be substantial and could have an adverse impact upon our business, financial condition and operating results. In addition, our reputation with our customers could be damaged as a result of such product defects, which could reduce demand for our products and negatively impact our business.

We rely upon certain critical information systems for our daily business operation. Our inability to use or access these information systems at critical points in time could unfavorably impact the timeliness and efficiency of our business operations.

Our global operations are linked by information systems, including telecommunications, the internet, our corporate intranet, network communications, email and various computer hardware and software applications. Despite our implementation of network security measures, our tools and servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems and tools located at customer sites, or could be subject to system failures or malfunctions for other reasons. System failures or malfunctioning, such as difficulties with our customer relationship management (CRM) system, could disrupt our operations and our ability to timely and accurately process and report key components of our financial results. In addition, any disruptions or difficulties that may occur in connection with our enterprise resource planning (ERP) system or other systems (whether in connection with the regular operation of such systems or as a result of the integration of our acquired businesses into such systems) could adversely affect our ability to complete important business processes, such as the evaluation of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. Any such event could have an adverse effect on our business, operating results and financial condition.

Table of Contents

We are subject to the risks of additional government actions in the event we were to breach the terms of any settlement arrangement into which we have entered.

In connection with the settlement of certain government actions and other legal proceedings related to our historical stock option practices, we have explicitly agreed as a condition to such settlements that we will comply with certain laws, such as the books and records provisions of the federal securities laws. If we were to violate any such law, we might not only be subject to the significant penalties applicable to such violation, but our past settlements may also be impacted by such violation, which could give rise to additional government actions or other legal proceedings. Any such additional actions or proceedings may require us to expend significant management time and incur significant accounting, legal and other expenses, and may divert attention and resources from the operation of our business. These expenditures and diversions, as well as an adverse resolution of any such action or proceeding, could have a material adverse effect on our business, financial condition and results of operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Equity Repurchase Plans

The following is a summary of stock repurchases for the three months ended December 31, 2010: ⁽¹⁾

Period	Total Number of Shares Purchased (2)	Average Price Paid per Share	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (3)
October 1, 2010 to October 31, 2010	535,481	\$ 35.31	2,698,770
November 1, 2010 to November 30, 2010	517,898	\$ 36.80	2,180,872
December 1, 2010 to December 31, 2010	505,500	\$ 39.50	1,675,372
Total	1,558,879	\$ 37.17	

- (1) In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase up to 17.8 million shares of its common stock in the open market. This plan was put into place to reduce the dilution from our employee benefit and incentive plans, such as our stock option and employee stock purchase plans, and to return excess cash to our stockholders. The Board of Directors has authorized the Company to repurchase additional shares of its common stock under the repurchase program in February 2005 (up to 10.0 million shares), February 2007 (up to 10.0 million shares), August 2007 (up to 10.0 million shares) and June 2008 (up to 15.0 million shares), in each case in addition to the originally authorized 17.8 million shares described in the first sentence of this footnote.
- (2) All shares were purchased pursuant to the publicly announced repurchase programs described in footnote 1 above.
- (3) The stock repurchase programs have no expiration date. Future repurchases of the Company's common stock under the Company's repurchase programs may be effected through various different repurchase transaction structures, including isolated open market transactions or systematic repurchase plans.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

None.

Table of Contents

ITEM 6. EXHIBITS

10.46	2010 Executive Severance Plan *
31.1	Certification of Chief Executive Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C Section 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Document
101.PRE	XBRL Taxonomy Definition Presentation Document

* Denotes a management contract, plan or arrangement

Table of Contents

SIGNATURES

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

	KLA-Tencor Corporation (Registrant)
January 27, 2011 (Date)	/s/ RICHARD P. WALLACE Richard P. Wallace President and Chief Executive Officer (Principal Executive Officer)
January 27, 2011 (Date)	/s/ MARK P. DENTINGER Mark P. Dentinger Executive Vice President and Chief Financial Officer (Principal Financial Officer)
January 27, 2011 (Date)	/s/ VIRENDRA A. KIRLOSKAR Virendra A. Kirloskar Senior Vice President and Chief Accounting Officer (Principal Accounting Officer)

Table of Contents

KLA-TENCOR CORPORATION

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference		
		Form	File Number	Exhibit Number
10.46	2010 Executive Severance Plan*			
31.1	Certification of Chief Executive Officer under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934			
31.2	Certification of Chief Financial Officer under Rule 13a-14(a) /15d-14(a) of the Securities Exchange Act of 1934			
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350			
101.INS	XBRL Instance Document			
101.SCH	XBRL Taxonomy Extension Schema Document			
101.CAL	XBRL Taxonomy Extension Calculation Document			
101.DEF	XBRL Taxonomy Extension Definition Document			
101.LAB	XBRL Taxonomy Extension Label Document			
101.PRE	XBRL Taxonomy Extension Presentation Document			

* Denotes a management contract, plan or arrangement