KLA TENCOR CORP
Form 10-Q
January 27, 2012
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)

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

For the quarterly period ended December 31, 2011

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)

Delaware	04-2564110
(State or other jurisdiction of incorporation or organization)	(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 x No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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 x	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 x

As of January 12, 2012, there were 166,732,846 shares of the registrant's Common Stock, $0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
KLA-TENCOR CORPORATION
Condensed Consolidated Balance Sheets
(Unaudited)

(In thousands)	December 31, 2011	June 30, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$824,986	$711,329
Marketable securities	1,351,659	1,327,206
Accounts receivable, net	544,098	583,270
Inventories, net	639,641	575,730
Deferred income taxes	296,206	331,397
Other current assets	92,469	147,078
Total current assets	3,749,059	3,676,010
Land, property and equipment, net	267,629	257,358
Goodwill	327,813	328,156
Purchased intangibles, net	70,218	85,902
Other non-current assets	286,269	328,095
Total assets	$4,700,988	$4,675,521
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$129,064	$142,945
Deferred system profit	190,718	192,338
Unearned revenue	48,165	44,264
Other current liabilities	462,033	499,314
Total current liabilities	829,980	878,861
Non-current liabilities:		
Long-term debt	746,561	746,290
Income tax payable	38,736	78,337
Unearned revenue	36,881	34,905
Other non-current liabilities	80,358	76,235
Total liabilities	1,732,516	1,814,628
Commitments and contingencies (Note 12 and Note 13)		
Stockholders' equity:		
Common stock and capital in excess of par value	1,050,788	1,010,659
Retained earnings	1,928,396	1,852,633
Accumulated other comprehensive income (loss)	(10,712)	(2,399)
Total stockholders' equity	2,968,472	2,860,893
Total liabilities and stockholders' equity	$4,700,988	$4,675,521

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

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KLA-TENCOR CORPORATION
Condensed Consolidated Statements of Operations
(Unaudited)

(In thousands, except per share data)	Three months ended December 31, 2011	Three months ended December 31, 2010	Six months ended December 31, 2011	Six months ended December 31, 2010
Revenues:				
Product	$500,659	$627,857	$1,150,915	$1,178,466
Service	141,823	138,470	288,043	270,203
Total revenues	642,482	766,327	1,438,958	1,448,669
Costs and operating expenses:				
Costs of revenues	272,855	311,398	613,204	575,367
Engineering, research and development	116,363	94,897	224,125	189,617
Selling, general and administrative	93,801	91,166	187,877	179,203
Total costs and operating expenses	483,019	497,461	1,025,206	944,187
Income from operations	159,463	268,866	413,752	504,482
Interest income and other, net	740	(4,182)	7,606	(2,957)
Interest expense	13,296	13,493	27,189	27,022
Income before income taxes	146,907	251,191	394,169	474,503
Provision for income taxes	36,110	65,699	91,377	134,815
Net income	$110,797	$185,492	$302,792	$339,688
Net income per share:				
Basic	$0.67	$1.11	$1.82	$2.03
Diluted	$0.66	$1.09	$1.78	$2.00
Cash dividends declared per share	$0.35	$0.25	$0.70	$0.50
Weighted average number of shares:				
Basic	166,343	166,886	166,513	167,052
Diluted	169,103	169,513	169,650	169,685

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

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KLA-TENCOR CORPORATION
Condensed Consolidated Statements of Cash Flows
(Unaudited)

(In thousands)	Six months ended December 31, 2011	2010
Cash flows from operating activities:		
Net income	$302,792	$339,688
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	46,451	42,436
Asset impairment charges	1,378	6,800
Gain on sale of real estate assets	—	(1,372)
Non-cash stock-based compensation expense	40,142	43,644
Net gain on sale of marketable securities and other investments	(556)	(1,477)
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable, net	45,408	(79,232)
Increase in inventories, net	(76,841)	(103,160)
Decrease (increase) in other assets	61,819	(27,267)
Increase (decrease) in accounts payable	(13,978)	14,680
Increase (decrease) in deferred system profit	(1,620)	36,730
Increase in other liabilities	1,222	17,983
Net cash provided by operating activities	406,217	289,453
Cash flows from investing activities:		
Capital expenditures, net	(27,046)	(22,715)
Proceeds from sale of assets	2,228	18,185
Purchase of available-for-sale securities	(591,088)	(418,312)
Proceeds from sale and maturity of available-for-sale securities	556,167	363,327
Purchase of trading securities	(35,438)	(28,401)
Proceeds from sale of trading securities	34,529	44,528
Net cash used in investing activities	(60,648)	(43,388)
Cash flows from financing activities:		
Issuance of common stock	49,098	31,723
Tax withholding payments related to vested and released restricted stock units	(29,474)	(20,251)
Common stock repurchases	(129,972)	(119,173)
Payment of dividends to stockholders	(116,561)	(83,594)
Net cash used in financing activities	(226,909)	(191,295)
Effect of exchange rate changes on cash and cash equivalents	(5,003)	11,416
Net increase in cash and cash equivalents	113,657	66,186
Cash and cash equivalents at beginning of period	711,329	529,918
Cash and cash equivalents at end of period	$824,986	$596,104
Supplemental cash flow disclosures:		
Income taxes paid, net	$7,645	$117,370
Interest paid	$27,515	$26,447

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

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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, 2011, filed with the SEC on August 5, 2011.

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.

The results of operations for the three and six months ended December 31, 2011 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, 2012.

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.

Revenue Recognition. KLA-Tencor recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectability is reasonably assured. 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 selling price and recognized upon completion of the installation. Spare parts revenue is recognized when the product has been shipped, 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 also allows for multiple element revenue arrangements in cases where certain elements of a sales arrangement are not delivered and accepted in one reporting period. In such cases, the Company defers the relative fair value of each undelivered element until that element is delivered to the customer. To be considered a separate element, the product or service in question must represent a separate unit of accounting, which means that such product or service must fulfill the following criteria: (a) the delivered item(s) has value to the customer on a stand-alone basis; and (b) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. If the arrangement does not meet all of the above criteria, the entire amount of the sales contract is deferred until all elements are accepted by the customer.

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 vendor-specific objective evidence ("VSOE") or third-party evidence ("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.

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When the Company is unable to establish relative selling price using VSOE or TPE, the Company uses estimated selling price ("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 to be sold on a stand-alone basis. ESP could potentially be used for new or customized products.

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

Recent Accounting Pronouncements. In December 2011, the International Accounting Standards Board (“IASB”) and the Financial Accounting Standards Board (“FASB”) issued common disclosure requirements that are intended to enhance comparability between financial statements prepared on the basis of U.S. Generally Accepted Accounting Principles (“U.S. GAAP”) and those prepared in accordance with International Financial Reporting Standards (“IFRS”). IFRS is a comprehensive series of accounting standards published by the IASB. The requirement is relevant to companies that have financial instruments and derivative instruments that are either offset in the balance sheet (presented on a net basis) or subject to an enforceable master netting arrangement or similar arrangement. The requirement does not change the existing offsetting eligibility criteria or the permitted balance sheet presentation for those instruments that meet the eligibility criteria. However, once this disclosure requirement becomes effective, companies will also be required to disclose information about financial instruments and derivative instruments that have been offset and related arrangements and to provide both net (offset amounts) and gross information in the notes to the financial statements for relevant assets and liabilities that are offset. The disclosure requirement becomes effective retrospectively in the first quarter of the Company's fiscal year ending June 30, 2014. The Company does not expect that the requirement will have an impact on its financial position, results of operations or cash flows as it is disclosure only in nature.

In September 2011, the FASB amended its guidance through the issuance of a revised accounting standard intended to simplify testing goodwill for impairment. The amendments allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. An entity will no longer be required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. Prior to the amendment, entities were required to test goodwill for impairment, on at least an annual basis, by first comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit is calculated as being less than its carrying amount, then the second step of the quantitative test is to be performed to measure the amount of impairment loss, if any. The amendment becomes effective for annual and interim goodwill impairment tests performed for the Company's fiscal year ending June 30, 2013. Early adoption is permitted, and the Company elected to early adopt this accounting guidance at the beginning of the three months ended December 31, 2011 (see Note 5, “Goodwill and Purchased Intangible Assets,” for a detailed description).

In June 2011, the FASB amended its guidance on the presentation of comprehensive income. Under the amended guidance, an entity has the option to present comprehensive income in either one continuous statement or two consecutive financial statements. A single statement must present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income. In a two-statement approach, an entity must present the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The entity is also required to present on the face of its financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The option under current guidance that permits the presentation of components of other comprehensive income as part of the statement of changes in stockholders' equity has been eliminated. In December 2011, the FASB further amended its guidance to defer changes related to the presentation of reclassification adjustments indefinitely as a result of concerns raised by stakeholders that the new presentation requirements would be difficult for preparers and add unnecessary complexity to financial statements. The amendment (other than the portion regarding the presentation of reclassification adjustments which, as noted above, has been deferred indefinitely) becomes effective during the first quarter of the Company's fiscal year ending

June 30, 2013. Early adoption is permitted. The amendment will impact the presentation of the financial statements but will not impact the Company's financial position, results of operations or cash flows.

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In May 2011, the FASB amended its guidance to converge fair value measurement and disclosure guidance about fair value measurement under U.S. GAAP with IFRS. The amendment changes the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendment to result in a change in the application of the requirements in the current authoritative guidance. The amendment becomes effective prospectively for the Company's interim reporting period ending March 31, 2012. Early application is not permitted. The Company does not expect the amendment to have a material impact on its financial position, results of operations or cash flows.

NOTE 2 – FAIR VALUE MEASUREMENTS

The Company’s financial assets and liabilities 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 land, property 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.
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 as of December 31, 2011, 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 certain U.S. Government agency securities, U.S. Treasury securities and sovereign 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 commercial paper, corporate debt securities, municipal securities and certain U.S. Government agency securities, U.S. Treasury securities 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 included the auction rate securities that were held by the Company as of and prior to June 30, 2010. Such instruments were 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.

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Financial assets (excluding cash held in operating accounts and time deposits) and liabilities measured at fair value on a recurring basis as of the date indicated below were presented on the Company's Condensed Consolidated Balance Sheet as follows:

As of December 31, 2011 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
Corporate debt securities	$5,000	$—	$5,000
Money market and other	591,032	591,032	—
Marketable securities:			
U.S. Treasury securities	71,302	67,302	4,000
U.S. Government agency securities	449,356	449,356	—
Municipal securities	41,473	—	41,473
Corporate debt securities	716,707	—	716,707
Sovereign securities	36,181	18,443	17,738
Total cash equivalents and marketable securities(1)	1,911,051	1,126,133	784,918
Other current assets:			
Derivative assets	789	—	789
Other non-current assets:			
Executive Deferred Savings Plan:			
Money market and other	3,467	3,467	—
Mutual funds	118,556	93,895	24,661
Executive Deferred Savings Plan total	122,023	97,362	24,661
Total financial assets(1)	$2,033,863	$1,223,495	$810,368
Other current liabilities:			
Derivative liabilities	$(2,329)	$—	$(2,329)
Total financial liabilities	$(2,329)	$—	$(2,329)

(1) Excludes cash of $192.4 million held in operating accounts and time deposits of $73.2 million as of December 31, 2011.

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Financial assets (excluding cash held in operating accounts and time deposits) and liabilities measured at fair value on a recurring basis as of the date indicated below were presented on the Company's Condensed Consolidated Balance Sheet as follows:

As of June 30, 2011 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
U.S. Treasury securities	$4,400	$—	$4,400
U.S. Government agency securities	6,010	6,010	—
Corporate debt securities	21,982	—	21,982
Money market and other	481,770	481,770	—
Marketable securities:			
U.S. Treasury securities	54,496	52,396	2,100
U.S. Government agency securities	314,173	314,173	—
Municipal securities	38,957	—	38,957
Corporate debt securities	853,403	—	853,403
Sovereign securities	32,086	14,696	17,390
Total cash equivalents and marketable securities(1)	1,807,277	869,045	938,232
Other current assets:			
Derivative assets	1,970	—	1,970
Other non-current assets:			
Executive Deferred Savings Plan:			
Money market and other	1,806	1,806	—
Mutual funds	126,227	95,971	30,256
Executive Deferred Savings Plan total	128,033	97,777	30,256
Total financial assets(1)	$1,937,280	$966,822	$970,458
Other current liabilities:			
Derivative liabilities	$(2,127)	$—	$(2,127)
Total financial liabilities	$(2,127)	$—	$(2,127)

(1) Excludes cash of $165.9 million held in operating accounts and time deposits of $65.4 million as of June 30, 2011.

Changes in the Company's Level 3 securities for the indicated periods were as follows:

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2011	2010	2011	2010
Beginning aggregate fair value of Level 3 securities	$—	$—	$—	$16,825
Net settlements	—	—	—	(16,825)
Ending aggregate fair value of Level 3 securities	$—	$—	$—	$—

During the fiscal year ended June 30, 2010 (and in prior fiscal years), the Company's investment portfolio included auction rate securities, which were investments with contractual maturities generally between 20 to 30 years. 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. 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 with UBS on November 11, 2008. On June 30, 2010, UBS repurchased the Company's $16.8 million of then-remaining auction rate securities at par value, and the repurchase was subsequently settled in July 2010.

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NOTE 3 – BALANCE SHEET COMPONENTS

(In thousands)	As of December 31, 2011	As of June 30, 2011
Accounts receivable, net:		
Accounts receivable, gross	$566,299	$605,376
Allowance for doubtful accounts	(22,201)	(22,106)
	$544,098	$583,270
Inventories, net:		
Customer service parts	$172,349	$148,466
Raw materials	212,862	235,605
Work-in-process	195,532	131,804
Finished goods	58,898	59,855
	$639,641	$575,730
Other current assets:		
Prepaid expenses	$56,789	$61,796
Income tax related receivables	11,538	59,774
Other current assets	24,142	25,508
	$92,469	$147,078
Land, property and equipment, net:		
Land	$41,418	$41,956
Buildings and leasehold improvements	237,191	234,173
Machinery and equipment	466,092	447,772
Office furniture and fixtures	21,666	19,645
Construction in process	7,810	6,979
	774,177	750,525
Less: accumulated depreciation and amortization	(506,548)	(493,167)
	$267,629	$257,358
Other non-current assets:		
Executive Deferred Savings Plan(1)	$122,023	$128,033
Deferred tax assets – long-term	140,168	173,788
Other	24,078	26,274
	$286,269	$328,095
Other current liabilities:		
Warranty	$43,476	$41,528
Executive Deferred Savings Plan(1)	121,612	128,088
Compensation and benefits	127,981	186,761
Income taxes payable	20,078	16,364
Interest payable	8,769	8,769
Accrued litigation costs	2,000	4,824
Other accrued expenses	138,117	112,980
	$462,033	$499,314

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(1) 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, except in cases where such distributions are required to be delayed in order to avoid a prohibited distribution under Internal Revenue Code Section 409A. As of December 31, 2011, the Company had a deferred compensation plan related asset and liability included as a component of other non-current assets and other current liabilities on its Condensed Consolidated Balance Sheet.

NOTE 4 – MARKETABLE SECURITIES

The amortized cost and fair value of marketable securities as of the dates indicated below were as follows:

As of December 31, 2011 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$71,098	$207	$(3)	$71,302
U.S. Government agency securities	448,963	692	(299)	449,356
Municipal securities	41,286	188	(1)	41,473
Corporate debt securities	719,442	3,464	(1,199)	721,707
Money market and other	591,032	—	—	591,032
Sovereign securities	36,167	73	(59)	36,181
Subtotal	1,907,988	4,624	(1,561)	1,911,051
Add: Time deposits(1)	73,193	—	—	73,193
Less: Cash equivalents	632,585	—	—	632,585
Marketable securities	$1,348,596	$4,624	$(1,561)	$1,351,659

As of June 30, 2011 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$58,754	$165	$(23)	$58,896
U.S. Government agency securities	319,375	931	(123)	320,183
Municipal securities	38,688	275	(6)	38,957
Corporate debt securities	870,591	5,162	(368)	875,385
Money market and other	481,770	—	—	481,770
Sovereign securities	31,932	179	(25)	32,086
Subtotal	1,801,110	6,712	(545)	1,807,277
Add: Time deposits(1)	65,402	—	—	65,402
Less: Cash equivalents	545,475	—	(2)	545,473
Marketable securities	$1,321,037	$6,712	$(543)	$1,327,206

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(1) Time deposits excluded from fair value measurements.

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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 market interest rates, bond yields and/or credit ratings. The Company has the ability to realize the full value of all of these investments upon maturity. The following table summarizes the fair value and gross unrealized losses of the Company’s investments that were in an unrealized loss position as of the date indicated below:

As of December 31, 2011 (In thousands)	Fair Value	Gross Unrealized Losses(1)
U.S. Treasury securities	$23,995	$(3)
U.S. Government agency securities	209,146	(299)
Municipal securities	3,626	(1)
Corporate debt securities	214,565	(1,199)
Sovereign securities	14,110	(59)
Total	$465,442	$(1,561)

(1) Of the total gross unrealized losses, there were no amounts that, as of December 31, 2011, had been in a continuous loss position for 12 months or more.

The contractual maturities of securities classified as available-for-sale, regardless of their classification on the Company's Condensed Consolidated Balance Sheet, as of the date indicated below were as follows:

As of December 31, 2011 (In thousands)	Amortized Cost	Fair Value
Due within one year	$327,355	$328,390
Due after one year through three years	1,021,241	1,023,269
	$1,348,596	$1,351,659

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 losses on the Company's investments for the three months ended December 31, 2011 were $0.1 million. Net realized gains on the Company's investments for the three months ended December 31, 2010 were $0.4 million. Net realized gains on the Company's investments for the six months ended December 31, 2011 and 2010 were $0.6 million and $1.5 million, respectively.

NOTE 5 – GOODWILL AND PURCHASED INTANGIBLE ASSETS

Goodwill

The following table presents goodwill balances as of the dates indicated below:

(In thousands)	As of December 31, 2011	As of June 30, 2011
Gross goodwill balance	$604,399	$604,742
Accumulated impairment losses	(276,586)	(276,586)
Net goodwill balance	$327,813	$328,156

The changes in the gross goodwill balance since June 30, 2011 resulted primarily from foreign currency translation adjustments.

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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. In September 2011, the FASB amended its guidance to simplify testing goodwill for impairment. The amended guidance allows an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. If an entity determines that as a result of the qualitative assessment that it is more likely than not (> 50% likelihood) that the fair value of a reporting unit is less than its carrying amount, then the quantitative test is required. Otherwise, no further testing is required. The Company elected to early adopt this accounting guidance at the beginning of the three months ended December 31, 2011.

The Company has four reporting units: Defect Inspection, Metrology, Service and Other. As of December 31, 2011, the entire goodwill balance resided in the Defect Inspection reporting unit.

The fair value of each of the Company's reporting units was substantially in excess of its estimated carrying amount as of the most recent quantitative analysis of goodwill impairment performed in the three months ended December 31, 2010. There have been no triggering events or changes in circumstances since that quantitative analysis to indicate that the fair value of any of the Company's reporting units would be less than its carrying amount.

The Company performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2011 during the three months ended December 31, 2011 and concluded that it was more likely than not that the fair value of each of the reporting units exceeded its carrying amount. In assessing the qualitative factors, the Company considered the impact of these key factors: change in industry and competitive environment, market capitalization, stock price, earnings multiples, budgeted-to-actual revenue performance from prior year, gross margin and cash flow from operating activities. As such, it was not necessary to perform the two-step goodwill impairment test at this time. Based on the Company's assessment, goodwill in the reporting units was not impaired as of December 31, 2011 or 2010.

Purchased Intangible Assets

The components of purchased intangible assets as of the dates indicated below were as follows:

(In thousands)		As of December 31, 2011			As of June 30, 2011		
Category	Range of Useful Lives	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	$102,705	$31,856	$134,561	$94,172	$40,389
Patents	6-13 years	57,648	43,778	13,870	57,648	40,591	17,057
Trade name/Trademark	4-10 years	19,893	13,678	6,215	19,893	12,907	6,986
Customer relationships	6-7 years	54,823	36,546	18,277	54,823	33,565	21,258
Other	0-1 year	16,200	16,200	—	16,200	15,988	212
Total		$283,125	$212,907	$70,218	$283,125	$197,223	$85,902

For the three months ended December 31, 2011 and 2010, amortization expense for other intangible assets was $7.7 million and $8.5 million, respectively. For the six months ended December 31, 2011 and 2010, amortization expense for other intangible assets was $15.7 million and $16.9 million, respectively. Based on the intangible assets recorded as of December 31, 2011, 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)
2012 (remaining 6 months)	$14,588
2013	20,914
2014	15,537
2015	12,771
2016	5,582

2017 and thereafter	826
Total	$70,218

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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 of December 31, 2011.

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 on the applicable dates, the fair value of the debt as of December 31, 2011 and June 30, 2011 was $870.5 million and $863.5 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.

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

(In thousands)	Available For Grant
Balances as of June 30, 2011(1)	11,554
Restricted stock units granted(2)(3)	(3,981)
Restricted stock units canceled(2)	267
Options canceled/expired/forfeited	668
Plan shares expired(4)	(623)
Balances as of December 31, 2011(1)	7,885

(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 members of the Board of Directors. As of December 31, 2011, 1.7 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) Includes 0.2 million restricted stock units granted to senior management during the six months ended December 31, 2011 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2011, it had not yet been

determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based and service-based criteria are fully satisfied.

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(4) 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 plans do not result in additional shares being available to the Company for future grant.

Except for options granted to non-employee Board members 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 September 30, 2006, stock options were granted at the market price of the Company's common stock on the date of grant (except for the previously disclosed 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.

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 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,	
	2011	2010	2011	2010
Stock-based compensation expense by:				
Costs of revenues	$3,671	$3,439	$7,509	$7,607
Engineering, research and development	5,756	5,814	11,577	13,432
Selling, general and administrative	10,219	10,178	21,056	22,605
Total stock-based compensation expense	$19,646	$19,431	$40,142	$43,644

The following table shows stock-based compensation capitalized as inventory as of the dates indicated below:

(In thousands)	As of December 31, 2011	As of June 30, 2011
Inventory	$7,453	$6,701

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, 2011:

Stock Options	Shares (In thousands)	Weighted-Average Exercise Price
Outstanding stock options as of June 30, 2011	7,675	$ 45.38
Granted	—	$ —
Exercised	(820)	$ 36.48
Canceled/expired/forfeited	(668)	$ 45.59
Outstanding stock options as of December 31, 2011	6,187	$ 46.54
Vested and exercisable as of December 31, 2011	6,185	$ 46.54

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, 2011 were each 1.74 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, 2011 were each $22.0 million.

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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 assumptions, including the option's expected life and the expected price volatility of the underlying stock. The expected stock price volatility assumption was based on the market-based implied volatility from traded options of the Company's common stock.

The following table shows the 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, 2011	Three months ended December 31, 2010	Six months ended December 31, 2011	Six months ended December 31, 2010
Total intrinsic value of options exercised	$3,809	$2,726	$6,569	$3,289
Total cash received from employees as a result of employee stock option exercises	$20,201	$12,594	$29,903	$15,547
Tax benefits realized in connection with these exercises	$1,224	$980	$2,163	$1,182

As of December 31, 2011, the unrecognized stock-based compensation balance related to stock options was immaterial.

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, 2011 and restricted stock units outstanding as of December 31, 2011 and June 30, 2011:

Restricted Stock Units	Shares (In thousands) (1)	Weighted-Average Grant Date Fair Value
Outstanding restricted stock units as of June 30, 2011	6,540	$ 21.28
Granted(2)	2,212	$ 25.67
Vested and released	(1,387)	$ 24.62
Withheld for taxes	(706)	$ 24.48
Forfeited	(148)	$ 21.26
Outstanding restricted stock units as of December 31, 2011(2)	6,511	$ 21.71

(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.

(2) Includes 0.2 million restricted stock units granted to senior management during the six months ended December 31, 2011 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2011, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units, if all applicable performance-based and service-based criteria are fully satisfied.

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.

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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 indicated periods:

(In thousands, except for weighted-average grant date fair value)	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Grant date fair value after estimated forfeitures	$2,139	$1,543	$56,776	$42,248
Weighted-average grant date fair value per unit	$36.87	$27.22	$25.67	$19.73
Tax benefits realized in connection with vested and released restricted stock units	$11,463	$12,245	$28,236	$22,339

As of December 31, 2011, the unrecognized stock-based compensation expense balance related to restricted stock units was $126.5 million and will be recognized over an estimated weighted-average amortization period of 2.6 years.

Employee Stock Purchase Plan

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).

Effective January 1, 2010, the offering period (or length of the look-back period) under the ESPP has a duration of six months, and the purchase price with respect to each offering period beginning on or after such date is, until otherwise amended, equal to 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,	
	2011	2010	2011	2010
Stock purchase plan:				
Expected stock price volatility	32.7 %	41.0 %	32.7 %	41.0 %
Risk-free interest rate	0.1 %	0.2 %	0.1 %	0.2 %
Dividend yield	3.4 %	3.7 %	3.4 %	3.7 %
Expected life of options (in years)	0.50	0.50	0.50	0.50

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 for the indicated periods:

(In thousands, except for weighted-average fair value per share)	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Total cash received from employees for the issuance of shares under the ESPP	$19,195	$16,176	$19,195	$16,176
Number of shares purchased by employees through the ESPP	545	701	545	701
Tax benefits realized in connection with the disqualifying dispositions of shares purchased under the ESPP	$368	$115	$843	$471
Weighted-average fair value per share based on Black-Scholes model	$9.16	$6.53	$9.16	$6.53

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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 be issued under the ESPP during the forthcoming fiscal year. During the fiscal year ended June 30, 2011, a total of 2.0 million additional shares were reserved under the ESPP. To date, no additional shares have been reserved under the ESPP with respect to the fiscal year ending June 30, 2012. As of December 31, 2011, a total of 2.9 million shares were reserved and available for issuance under the ESPP.

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 72.8 million shares of its common stock under a repurchase program, including 10.0 million shares authorized in February 2011. 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. As of December 31, 2011, 5.9 million shares were available for repurchase under the Company's repurchase program.

Share repurchases for the indicated periods were as follows:

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2011	2010	2011	2010
Number of shares of common stock repurchased	1,396	1,559	3,159	3,531
Total cost of repurchases	$63,106	$57,938	$130,088	$117,261

As of December 31, 2011, $2.8 million of the total cost of repurchases set forth above remained unpaid and was recorded in other current liabilities. The $3.3 million which was accrued as of September 30, 2011 was paid during the three months ended December 31, 2011.

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 net income 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 net income 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,	
	2011	2010	2011	2010
Numerator:				
Net income	$110,797	$185,492	$302,792	$339,688
Denominator:				
Weighted-average shares-basic, excluding unvested restricted stock units	166,343	166,886	166,513	167,052
Effect of dilutive options and restricted stock units	2,760	2,627	3,137	2,633
Weighted-average shares-diluted	169,103	169,513	169,650	169,685
Basic net income per share	$0.67	$1.11	$1.82	$2.03
Diluted net income per share	$0.66	$1.09	$1.78	$2.00
Anti-dilutive securities excluded from the computation of diluted net income per share	3,610	8,622	4,338	9,602

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The total amount of dividends paid during the three months ended December 31, 2011 and 2010 was $58.1 million and $41.8 million, respectively. The total amount of dividends paid during the six months ended December 31, 2011 and 2010 was $116.6 million and $83.6 million, respectively.

NOTE 10 – COMPREHENSIVE INCOME

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2011	2010	2011	2010
Net income	$110,797	$185,492	$302,792	$339,688
Other comprehensive income (loss):				
Currency translation adjustments	(4,540)	4,455	(6,327)	17,978
Gains (losses) on cash flow hedging instruments	309	(639)	(316)	200
Change in unrecognized losses and transition obligation related to pension and post-retirement plans	139	91	241	171
Unrealized gains (losses) on investments	345	(2,179)	(1,911)	(428)
Other comprehensive income (loss)	(3,747)	1,728	(8,313)	17,921
Total comprehensive income	$107,050	$187,220	$294,479	$357,609

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,	
	2011	2010	2011	2010
Income before income taxes	$146,907	$251,191	$394,169	$474,503
Provision for taxes	$36,110	$65,699	$91,377	$134,815
Effective tax rate	24.6%	26.2%	23.2%	28.4%

The Company's estimated annual effective tax rate for the fiscal year ending June 30, 2012 is approximately 23.0%. The difference between the actual effective tax rate of 24.6% during the quarter and the estimated annual effective tax rate of 23.0% is primarily due to the tax impact of the following items during the three months ended December 31, 2011:

- Tax expense was increased by $5.1 million due to shortfalls from employee stock activity. A shortfall arises when the tax deduction is less than book compensation. Windfalls are recorded as increases to capital in excess of par value. 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.
- Tax expense was decreased by $2.7 million due to a non-taxable increase in the value of the assets held within the Company's Executive Deferred Savings Plan.

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Tax expense was lower as a percentage of income during the three months ended December 31, 2011 compared to the three months ended December 31, 2010 primarily due to:

- A decrease in tax expense of $3.0 million during the three months ended December 31, 2011 related to state income taxes as a result of the adoption of California budget legislation, signed on February 20, 2009, which allows a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011; and
- A decrease in tax expense of $7.1 million during the three months ended December 31, 2011 related to an increase in the proportion of the Company's earnings generated in jurisdictions with tax rates lower than the U.S. statutory tax rate; partially offset by
- An increase in tax expense of $8.8 million during the three months ended December 31, 2011 related to shortfalls from employee stock activity. The Company incurred a tax expense of $5.1 million due to shortfalls from employee stock activity during the three months ended December 31, 2011 compared to a tax benefit of $3.7 million due to windfalls from employee stock activity during the three months ended December 31, 2010.

Tax expense was lower as a percentage of income during the six months ended December 31, 2011 compared to the six months ended December 31, 2010 primarily due to:

- A tax benefit of $18.3 million recognized during the six months ended December 31, 2011 resulting from a decrease in the Company's unrecognized tax benefits due to the settlement of a U.S. federal income tax examination;
- A tax benefit of $18.0 million recognized during the six months ended December 31, 2011 resulting from a decrease in reserves for uncertain tax positions taken in prior years;
- A decrease in tax expense of $7.7 million during the six months ended December 31, 2011 related to state income taxes as a result of the adoption of California budget legislation, signed on February 20, 2009, which allows a taxpayer to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011; and
- A decrease in tax expense of $18.7 million during the six months ended December 31, 2011 related to an increase in the proportion of the Company's earnings generated in jurisdictions with tax rates lower than the U.S. statutory tax rate; partially offset by
- An increase in tax expense of $23.6 million during the six months ended December 31, 2011 related to a migration of a portion of the Company's manufacturing to Singapore; and
- An increase in tax expense of $9.0 million during the six months ended December 31, 2011 related to a non-deductible decrease in the value of the assets held within the Company's Executive Deferred Savings Plan. The Company incurred a tax expense of $2.5 million due to a non-deductible decrease in the value of the assets held within the Company's Executive Deferred Savings Plan during the six months ended December 31, 2011 compared to a tax benefit of $6.5 million due to a non-taxable increase in the value of the assets held within the Company's Executive Deferred Savings Plan during the six months ended December 31, 2010.

In the normal course of business, the Company is subject to examination by tax authorities throughout the world. The Company is subject to U.S. federal income tax examination for all years beginning from the fiscal year ended June 30, 2010. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2007. The Company is also subject to examinations in other major foreign jurisdictions, including Singapore, for all years beginning from the fiscal year ended June 30, 2007. 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 $2.4 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 examinations with various tax authorities.

NOTE 12 – LITIGATION AND OTHER LEGAL MATTERS

Indemnification Obligations. As a result of the Company's indemnification obligations in connection with the litigation and government inquiries related to the Company's historical stock option practices, the Company has been paying defense costs for one former officer and employee facing an SEC civil action to which the Company is not a party. That former officer and the SEC have settled the civil action. As a result, during the three months ended December 31, 2011, the Company and the former officer entered into an agreement that releases each other from liabilities stemming from the former officer's employment with the Company and materially concludes the Company's indemnification obligations to the former officer. The terms of that release agreement have been appropriately considered within the reserve the Company has established for currently pending legal proceedings.

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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 condensed consolidated 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 the Company's condensed consolidated 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, the Company periodically sells certain letters of credit (“LCs”), without recourse, received from customers in payment for goods.

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs for the indicated periods:

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2011	2010	2011	2010
Receivables sold under factoring agreements	$81,606	$96,586	$250,330	$156,611
Proceeds from sales of LCs	$—	$33,327	$4,510	$84,263

Factoring and LC fees for the sale of certain trade receivables were recorded in interest income and other, net and were not material for the periods presented.

Facilities. KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was $2.2 million for both the three months ended December 31, 2011 and 2010. Rent expense was $4.5 million and $4.1 million for the six months ended December 31, 2011 and 2010, respectively.

The following is a schedule of expected operating lease payments:

Fiscal year ending June 30,	Amount (In thousands)
2012 (remaining 6 months)	$4,347
2013	7,156
2014	4,483
2015	2,216
2016	1,991
2017 and thereafter	3,180
Total minimum lease payments	$23,373

Purchase Commitments. KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. The Company’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 approximately $319.2 million as of December 31, 2011 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.

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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 indicated periods:

(In thousands)	Three months ended December 31, 2011	Three months ended December 31, 2010	Six months ended December 31, 2011	Six months ended December 31, 2010
Beginning balance	$43,603	$25,556	$41,528	$21,109
Accruals for warranties issued during the period	10,110	12,306	21,402	21,792
Changes in liability related to pre-existing warranties	540	(1,307)	2,930	(1,148)
Settlements made during the period	(10,777)	(5,663)	(22,384)	(10,861)
Ending balance	$43,476	$30,892	$43,476	$30,892

The Company maintains guarantee arrangements available through various financial institutions for up to $20.4 million, of which $18.4 million had been issued as of December 31, 2011, primarily to fund guarantees to customs authorities for value-added tax ("VAT") and other operating requirements of the Company’s subsidiaries in Europe and Asia.

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 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.

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.

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.

NOTE 14 – 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 and option contracts as cash flow hedges of certain forecasted foreign currency denominated sales and purchase transactions.

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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 counterparty 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.

For derivative instruments that are designated and qualify as cash flow hedges, the effective portion of the gains or losses 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 Company uses 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 locations and amounts of designated and non-designated derivative instruments' gains and losses reported in the condensed consolidated financial statements for the indicated periods are as follows:

		Three months ended December 31,		Six months ended December 31,	
(In thousands)	Location in Financial Statements	2011	2010	2011	2010
Derivatives designated as hedging instruments					
Losses in accumulated OCI on derivatives (effective portion)	Accumulated OCI	$(223)	$(1,653)	$(1,417)	$(1,240)
Gains (losses) reclassified from accumulated OCI into income (effective portion):	Revenues	$(689)	$(534)	$(973)	$(1,327)
	Costs of revenues	(13)	312	48	170
	Total losses reclassified from accumulated OCI into income (effective portion)	$(702)	$(222)	$(925)	$(1,157)
Gains recognized in income on derivatives (ineffective portion and amount excluded from effectiveness testing)	Interest income and other, net	$57	$266	$99	$147
Derivatives not designated as hedging instruments					
Gains (losses) recognized in income	Interest income and other, net	$758	$(513)	$(11,810)	$(1,869)

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

(In thousands)	As of December 31, 2011	As of June 30, 2011
Cash flow hedge contracts		
Purchase	$8,950	$3,381
Sell	$38,039	$30,133
Other foreign currency hedge contracts		
Purchase	$145,593	$174,499
Sell	$181,670	$216,738

The location and fair value amounts of the Company's derivative instruments reported in its Condensed Consolidated Balance Sheets as of the dates indicated below were as follows:

	Asset Derivatives			Liability Derivatives		
	Balance Sheet Location	As of December 31, 2011	As of June 30, 2011	Balance Sheet Location	As of December 31, 2011	As of June 30, 2011
(In thousands)		Fair Value			Fair Value	
Derivatives designated as hedging instruments						
Foreign exchange contracts	Other current assets	$367	$145	Other current liabilities	$334	$475
Total derivatives designated as hedging instruments		$367	$145		$334	$475
Derivatives not designated as hedging instruments						
Foreign exchange contracts	Other current assets	$422	$1,825	Other current liabilities	$1,995	$1,652
Total derivatives not designated as hedging instruments		$422	$1,825		$1,995	$1,652
Total derivatives		$789	$1,970		$2,329	$2,127

The following table provides the balances and changes in accumulated other comprehensive income (loss) related to derivative instruments for the indicated periods:

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2011	2010	2011	2010
Beginning balance	$(959)	$(646)	$12	$(1,994)
Amount reclassified to income	702	222	925	1,157
Net change	(223)	(1,653)	(1,417)	(1,240)
Ending balance	$(480)	$(2,077)	$(480)	$(2,077)

NOTE 15 – SALE OF REAL ESTATE

During the three months ended December 31, 2010, the Company completed the sale of remaining real estate properties in San Jose, California. 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 recorded as an offset to selling, general and administrative expenses.

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NOTE 16 – RELATED PARTY TRANSACTIONS

During the three and six months ended December 31, 2011 and 2010, 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. The following table provides the transactions with these parties for the indicated periods (for the portion of such period that they were considered related):

(In thousands)	Three months ended December 31,		Six months ended December 31,	
	2011	2010	2011	2010
Total revenues	$88	$47	$125	$247
Total purchases	$2,179	$1,923	$4,271	$2,805

The Company's receivable balance from these parties was immaterial as of December 31, 2011 and was $0.2 million as of June 30, 2011. Management believes that such transactions are at arm's length and on similar terms as would have been obtained from unaffiliated third parties.

NOTE 17 – 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.

The Company 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 the Company operates in one segment, all financial segment information required by the authoritative guidance can be found in the condensed consolidated financial statements.

The Company'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 regions. 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 indicated periods (as a percentage of total revenues):

(Dollar amounts in thousands)	Three months ended December 31,						Six months ended December 31,					
	2011			2010			2011			2010		
Revenues:												
United States	$160,484	25	%	$149,843	20	%	$358,727	25	%	$236,362	16	%
Taiwan	169,015	26	%	233,081	30	%	392,305	27	%	421,622	29	%
Japan	110,321	17	%	59,813	8	%	245,136	17	%	153,701	11	%
Europe & Israel	69,270	11	%	60,491	8	%	162,266	11	%	99,737	7	%
Korea	61,979	10	%	123,154	16	%	141,577	10	%	285,245	20	%
Rest of Asia	71,413	11	%	139,945	18	%	138,947	10	%	252,002	17	%
Total	$642,482	100	%	$766,327	100	%	$1,438,958	100	%	$1,448,669	100	%

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The following is a summary of revenues by major products for the indicated periods (as a percentage of total revenues):

(Dollar amounts in thousands)	Three months ended December 31, 2011			2010			Six months ended December 31, 2011			2010		
Revenues:												
Defect inspection	$343,463	53	%	$506,360	66	%	$787,096	55	%	$916,473	63	%
Metrology	131,746	21	%	104,041	14	%	313,758	22	%	223,595	15	%
Service	141,823	22	%	138,470	18	%	288,043	20	%	270,203	19	%
Other	25,450	4	%	17,456	2	%	50,061	3	%	38,398	3	%
Total	$642,482	100	%	$766,327	100	%	$1,438,958	100	%	$1,448,669	100	%

Two customers each accounted for greater than 10% of total revenues for the three months ended December 31, 2011 and 2010. Three customers accounted for greater than 10% of total revenues for the six months ended December 31, 2011. Two customers accounted for greater than 10% of total revenues for the six months ended December 31, 2010. Two customers each accounted for greater than 10% of net accounts receivable as of December 31, 2011 and June 30, 2011.

Long-lived assets by geographic region as of the dates indicated below were as follows:

(In thousands)	As of December 31, 2011	As of June 30, 2011
Long-lived assets:		
United States	$207,639	$202,520
Taiwan	813	803
Japan	4,172	4,256
Europe & Israel	84,221	90,163
Korea	2,575	2,804
Rest of Asia	48,426	53,106
Total	$347,846	$353,652

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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,” “predict “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 effects of hedging transactions; the effect of the sale of trade receivables and promissory notes from customers; our future income tax rate; future payments of dividends to our stockholders; 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 Operations” in our Annual Report on Form 10-K for the year ended June 30, 2011, filed with the Securities and Exchange Commission on August 5, 2011. 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.

EXECUTIVE SUMMARY

KLA-Tencor Corporation is a leading supplier of process control and yield management solutions for the semiconductor and related nanoelectronics industries. Our broad portfolio of products and services primarily supports integrated circuit (“IC” or “chip”) manufacturers throughout the semiconductor fabrication process, from research and development to final volume production. We provide leading-edge equipment, software and support that enable IC manufacturers to identify, resolve and manage significant advanced technology manufacturing process challenges and obtain higher finished product yields at lower overall cost. In addition to serving the semiconductor industry, we also provide a range of technology solutions to a number of other high technology industries, including the light emitting diode (“LED”), data storage and photovoltaic industries, as well as general materials research.

Our products and services are used by the vast majority of bare wafer, IC, lithography reticle ("reticle" or "mask") and disk manufacturers in the world. Our equipment, services and expertise are used by our customers to measure and control nanometric-level manufacturing processes, and to detect, analyze and resolve critical product defects that arise in that environment. Our revenues are driven largely by our customers' spending on capital equipment and related maintenance services necessary to support key transitions in their underlying product technologies, or to increase their production volumes in response to market demand. Our semiconductor customers generally operate in one or more of the three major semiconductor markets -- memory, foundry and logic. All three of these markets are characterized by rapid technological changes and sudden shifts in end-user demand, which influence the level and pattern of our customers' spending on our products and services. Although capital spending in all three semiconductor markets has historically been very cyclical, the demand for more advanced and lower cost chips used in a growing number of consumer electronics, communications, data processing, and industrial products has resulted in favorable long-term revenue growth rates for our process control and yield management solutions.

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As a supplier to the global semiconductor and semiconductor-related industries, we are subject to the cyclical capital spending that characterizes these industries. The timing, length and volatility of capacity-oriented capital spending cycles of our customers are unpredictable. In addition, our customer base continues to become more highly concentrated over time, thereby increasing the potential impact of a sudden change in capital spending by a major customer on our revenues and profitability.

The growing use of increasingly sophisticated semiconductor devices in communications, consumer electronics, data processing, and automotive and aerospace products, combined with a somewhat improved economic environment, particularly in Asia, caused many of our customers to invest in additional semiconductor manufacturing capabilities and capacity during the fiscal year ended June 30, 2011. These investments included process control and yield management equipment and services, which had a significant favorable impact on our revenues, compared to the prior fiscal year.

During the three months ended December 31, 2011, our revenues and earnings declined sequentially in response to the reduction of customer orders of process control equipment in the previous quarter. During the quarter ended December 31, 2011, our customers increased their orders of process control equipment investments, and we anticipate our revenues and earnings to increase in the next quarter as we increase deliveries to meet the higher level of customer demand for our 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. We expect that this in turn will drive long term increased adoption of process control equipment and services that reduce semiconductor defectivity and improve manufacturing yields, leaving the longer term drivers underlying growth in our industry intact.

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 December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011	December 31, 2010	September 30, 2010
Total revenues	$642,482	$ 796,476	$892,439	$834,059	$ 766,327	$ 682,342
Total costs and operating expenses	$483,019	$ 542,187	$548,370	$522,280	$ 497,461	$ 446,726
Gross margin	$369,627	$ 456,127	$536,259	$506,363	$ 454,929	$ 418,373
Income from operations	$159,463	$ 254,289	$344,069	$311,779	$ 268,866	$ 235,616
Net income	$110,797	$ 191,995	$245,017	$209,783	$ 185,492	$ 154,196
Net income per share:						
Basic (1)	$0.67	$ 1.15	$1.46	$1.25	$ 1.11	$ 0.92
Diluted (1)	$0.66	$ 1.13	$1.43	$1.22	$ 1.09	$ 0.91

(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.

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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, 2011 describes the significant accounting policies and methods used in preparation of the Consolidated Financial Statements. We base 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 our 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

There were no significant changes in our critical accounting estimates and policies during the three months ended December 31, 2011. 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, 2011 for a more complete discussion of our critical accounting policies and estimates.

Valuation of Goodwill and Intangible Assets

We have four reporting units: Defect Inspection, Metrology, Service and Other. As of December 31, 2011, the entire goodwill balance resided in the Defect Inspection reporting unit.

The fair value of each of our reporting units was substantially in excess of its estimated carrying amount as of the most recent quantitative analysis of goodwill impairment performed in the three months ended December 31, 2010. There have been no triggering events or changes in circumstances since that quantitative analysis to indicate that the fair value of any of our reporting units would be less than its carrying amount.

We performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2011 during the three months ended December 31, 2011 and concluded that it was more likely than not that the fair value of each of our reporting units exceeded its carrying amount. In assessing the qualitative factors, we considered the impact of these key factors: change in industry and competitive environment, market capitalization, stock price, earnings multiples, budgeted-to-actual revenue performance from prior year, gross margin and cash flow from operating activities. As such, it was not necessary to perform the two-step goodwill impairment test at this time.

Our next annual evaluation of the goodwill by reporting unit will be performed during the three months ending December 31, 2012. If we were to encounter challenging economic conditions, such as a decline in our operating results, an unfavorable industry or macroeconomic environment, a substantial decline in our stock price, or any other adverse change in market conditions, we may be required to perform the two-step quantitative goodwill impairment analysis. In addition, if such conditions have the effect of changing one of the critical assumptions or estimates we use to calculate the value of our goodwill or intangible assets, we may be required to record goodwill and/or intangible asset impairment charges in future periods, whether in connection with our next annual impairment assessment in the second quarter of fiscal year 2013 or prior to that, if any triggering event occurs outside of the quarter during which the annual goodwill impairment assessment is performed. It is not possible at this time to determine if any such future impairment charge would result or, if it does, whether such charge would be material to our results of operations.

Revenue Recognition

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectability is reasonably assured. We enter into arrangements that may consist of multiple deliverables of our products and services where certain elements of the sales arrangement are not delivered and accepted in one reporting period. Judgment is required to properly identify the accounting units of the multiple deliverable transactions and to determine the manner in which revenue should be allocated among the accounting units. Additionally, judgment is required to interpret various commercial terms and to determine when all criteria of revenue recognition have been met in order for revenue recognition to occur in the appropriate accounting period. While changes in the allocation of the estimated sales price between the accounting units will not affect the amount of total revenue recognized for a particular arrangement, any material changes in these allocations could impact the timing of revenue recognition, which could have a material effect on our financial position and results of operations.

Recent Accounting Pronouncements

In December 2011, the International Accounting Standards Board ("IASB") and the Financial Accounting Standards Board ("FASB") issued common disclosure requirements that are intended to enhance comparability between financial statements prepared on the basis of U.S. Generally Accepted Accounting Principles ("U.S. GAAP") and those prepared in accordance with International Financial Reporting Standards ("IFRS"). IFRS is a comprehensive series of accounting standards published by the IASB. The requirement is relevant to companies that have financial instruments and derivative instruments that are either offset in the balance sheet (presented on a net basis) or subject to an enforceable master netting arrangement or similar arrangement. The requirement does not change the existing offsetting eligibility criteria or the permitted balance sheet presentation for those instruments that meet the eligibility criteria. However, once this disclosure requirement becomes effective, companies will also be required to disclose information about financial instruments and derivative instruments that have been offset and related arrangements and to provide both net (offset amounts) and gross information in the notes to the financial statements for relevant assets and liabilities that are offset. The disclosure requirement becomes effective retrospectively in the first quarter of our fiscal year ending June 30, 2014. We do not expect that the requirement will have an impact on our financial position, results of operations or cash flows as it is disclosure only in nature.

In September 2011, the FASB amended its guidance through the issuance of a revised accounting standard intended to simplify testing goodwill for impairment. The amendments allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. An entity will no longer be required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. Prior to the amendment, entities were required to test goodwill for impairment, on at least an annual basis, by first comparing the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit is calculated as being less than its carrying amount, then the second step of the quantitative test is to be performed to measure the amount of impairment loss, if any. The amendment becomes effective for annual and interim goodwill impairment tests performed for our fiscal year ending June 30, 2013. Early adoption is permitted, and we elected to early adopt this accounting guidance at the beginning of the three months ended December 31, 2011 (see 5, “Goodwill and Purchased Intangible Assets,” to the Condensed Consolidated Financial Statements for a detailed description).

In June 2011, the FASB amended its guidance on the presentation of comprehensive income. Under the amended guidance, an entity has the option to present comprehensive income in either one continuous statement or two consecutive financial statements. A single statement must present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income, and a total for comprehensive income. In a two-statement approach, an entity must present the components of net income and total net income in the first statement. That statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The entity is also required to present on the face of its financial statements reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement(s) where the components of net income and the components of other comprehensive income are presented. The option under current guidance that permits the presentation of components of other comprehensive income as part of the statement of changes in stockholders' equity has been eliminated. In December 2011, the FASB further amended its guidance to defer changes related to the presentation of reclassification adjustments indefinitely as a result of concerns raised by stakeholders that the new presentation requirements would be difficult for preparers and add unnecessary complexity to financial statements. The amendment (other than the portion regarding the presentation of reclassification adjustments which, as noted above, has been deferred indefinitely) becomes effective during the first quarter of our fiscal year ending June 30, 2013. Early adoption is permitted. The amendment will impact the presentation of the financial statements but will not have an impact on our financial position, results of operations or cash flows.

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In May 2011, the FASB amended its guidance, to converge fair value measurement and disclosure guidance about fair value measurement under U.S. GAAP with IFRS. The amendment changes the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. For many of the requirements, the FASB does not intend for the amendment to result in a change in the application of the requirements in the current authoritative guidance. The amendment becomes effective prospectively for our interim reporting period ending March 31, 2012. Early application is not permitted. We do not expect the amendment to have a material impact on our financial position, results of operations or cash flows.

RESULTS OF OPERATIONS

Revenues and Gross Margin

(Dollar amounts in thousands)	Three months ended December 31, 2011	September 30, 2011	December 31, 2010	Q2 FY12 vs. Q1 FY12		Q2 FY12 vs. Q2 FY11	
Revenues:							
Product	$500,659	$ 650,256	$ 627,857	$(149,597)	(23)%	$(127,198)	(20