

KLA TENCOR CORP  
Form 10-Q  
October 29, 2010  
Table of Contents

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

**FORM 10-Q**

(Mark One)

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the quarterly period ended: September 30, 2010

or

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-09992

**KLA-Tencor Corporation**

(Exact name of registrant as specified in its charter)

Edgar Filing: KLA TENCOR CORP - Form 10-Q

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**04-2564110**  
(I.R.S. Employer  
Identification No.)

**One Technology Drive**

**Milpitas, California**

**95035**

(Address of principal executive offices)

(Zip Code)

**(408) 875-3000**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

As of October 13, 2010, there were 167,064,459 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

**Table of Contents**

**INDEX**

|   | <b>Page<br/>Number</b> |
|---|------------------------|
| <b><u>PART I</u></b>  |                        |
| <b><u>FINANCIAL INFORMATION</u></b>   |                        |
| Item 1  |                        |
| Financial Statements (Unaudited)  |                        |
| <u>Condensed Consolidated Balance Sheets as of September 30, 2010 and June 30, 2010</u>                       | 3                      |
| <u>Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2010 and 2009</u> | 4                      |
| <u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended September 30, 2010 and 2009</u> | 5                      |
| <u>Notes to Condensed Consolidated Financial Statements</u>   | 6                      |
| Item 2  |                        |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                  | 28                     |
| Item 3  |                        |
| <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | 39                     |
| Item 4  |                        |
| <u>Controls and Procedures</u>  | 40                     |
| <b><u>PART II</u></b>   |                        |
| <b><u>OTHER INFORMATION</u></b>   |                        |
| Item 1  |                        |
| <u>Legal Proceedings</u>  | 41                     |
| Item 1A   |                        |
| <u>Risk Factors</u>   | 41                     |
| Item 2  |                        |
| <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 50                     |
| Item 3  |                        |
| <u>Defaults upon Senior Securities</u>  | 51                     |
| Item 4  |                        |
| <u>(Removed and Reserved)</u>   | 51                     |
| Item 5  |                        |
| <u>Other Information</u>  | 51                     |
| Item 6  |                        |
| <u>Exhibits</u>   | 52                     |
| <b><u>SIGNATURES</u></b>  | 53                     |
| <b><u>EXHIBIT INDEX</u></b>   | 54                     |

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

(Unaudited)

| <i>(In thousands)</i>                               | <b>September 30,<br/>2010</b> | <b>June 30,<br/>2010</b> |
|---|-------------------------------|--------------------------|
| <b>ASSETS</b>                                       |                               |                          |
| Current assets:                                     |                               |                          |
| Cash and cash equivalents                           | \$ 538,384                    | \$ 529,918               |
| Marketable securities                               | 980,608                       | 1,004,126                |
| Accounts receivable, net                            | 500,022                       | 440,125                  |
| Inventories, net                                    | 464,242                       | 401,730                  |
| Deferred income taxes                               | 317,240                       | 328,522                  |
| Other current assets                                | 132,865                       | 131,044                  |
| <b>Total current assets</b>                         | <b>2,933,361</b>              | <b>2,835,465</b>         |
| Land, property and equipment, net                   | 247,380                       | 236,752                  |
| Goodwill  | 328,126                       | 328,006                  |
| Purchased intangibles, net                          | 108,908                       | 117,336                  |
| Other non-current assets                            | 385,090                       | 389,497                  |
| <b>Total assets</b>                                 | <b>\$ 4,002,865</b>           | <b>\$ 3,907,056</b>      |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>          |                               |                          |
| Current liabilities:                                |                               |                          |
| Accounts payable                                    | \$ 138,226                    | \$ 107,938               |
| Deferred system profit                              | 201,663                       | 204,764                  |
| Unearned revenue                                    | 33,518                        | 37,026                   |
| Other current liabilities                           | 390,211                       | 422,059                  |
| <b>Total current liabilities</b>                    | <b>763,618</b>                | <b>771,787</b>           |
| Non-current liabilities:                            |                               |                          |
| Long-term debt                                      | 745,882                       | 745,747                  |
| Income tax payable                                  | 57,500                        | 53,492                   |
| Unearned revenue                                    | 21,124                        | 20,354                   |
| Other non-current liabilities                       | 73,484                        | 69,065                   |
| <b>Total liabilities</b>                            | <b>1,661,608</b>              | <b>1,660,445</b>         |
| Commitments and contingencies (Note 12 and Note 13) |                               |                          |
| Stockholders' equity:                               |                               |                          |
| Common stock and capital in excess of par value     | 953,437                       | 921,460                  |
| Retained earnings                                   | 1,402,931                     | 1,356,454                |

Edgar Filing: KLA TENCOR CORP - Form 10-Q

|   |              |              |
|---|--------------|--------------|
| Accumulated other comprehensive income (loss) | (15,111)     | (31,303)     |
| Total stockholders' equity                    | 2,341,257    | 2,246,611    |
| Total liabilities and stockholders' equity    | \$ 4,002,865 | \$ 3,907,056 |

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

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

(Unaudited)

| <i>(In thousands, except per share data)</i> | <b>Three months ended<br/>September 30,</b> |                  |
|--|---|------------------|
|  | <b>2010</b>                                 | <b>2009</b>      |
| <b>Revenues:</b>                             |   |                  |
| Product                                      | \$ 550,609                                  | \$ 229,251       |
| Service                                      | 131,733                                     | 113,436          |
| <b>Total revenues</b>                        | <b>682,342</b>                              | <b>342,687</b>   |
| <b>Costs and operating expenses:</b>         |   |                  |
| Costs of revenues                            | 263,969                                     | 171,892          |
| Engineering, research and development        | 94,720                                      | 78,209           |
| Selling, general and administrative          | 88,037                                      | 77,636           |
| <b>Total costs and operating expenses</b>    | <b>446,726</b>                              | <b>327,737</b>   |
| Income from operations                       | 235,616                                     | 14,950           |
| Interest income and other, net               | 1,225                                       | 21,299           |
| Interest expense                             | 13,529                                      | 13,457           |
| <b>Income before income taxes</b>            | <b>223,312</b>                              | <b>22,792</b>    |
| Provision for income taxes                   | 69,116                                      | 2,387            |
| <b>Net income</b>                            | <b>\$ 154,196</b>                           | <b>\$ 20,405</b> |
| <b>Net income per share:</b>                 |   |                  |
| Basic  | \$ 0.92                                     | \$ 0.12          |
| Diluted                                      | \$ 0.91                                     | \$ 0.12          |
| <b>Cash dividend paid per share</b>          | <b>\$ 0.25</b>                              | <b>\$ 0.15</b>   |
| <b>Weighted average number of shares:</b>    |   |                  |
| Basic  | 167,187                                     | 170,698          |
| Diluted                                      | 169,839                                     | 172,718          |

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

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

(Unaudited)

| <i>(In thousands)</i>  | <b>Three months ended<br/>September 30,</b> |                 |
|--|---|-----------------|
|  | <b>2010</b>                                 | <b>2009</b>     |
| <b>Cash flows from operating activities:</b>   |   |                 |
| Net income   | \$ 154,196                                  | \$ 20,405       |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |   |                 |
| Depreciation and amortization  | 20,783                                      | 23,134          |
| Gain on sale of real estate assets   |   | (2,824)         |
| Non-cash stock-based compensation  | 24,213                                      | 20,199          |
| Tax charge from equity awards  |   | (5,133)         |
| Net gain on sale of marketable securities and other investments                          | (1,047)                                     | (1,292)         |
| <b>Changes in assets and liabilities:</b>  |   |                 |
| Increase in accounts receivable, net   | (50,342)                                    | (28,279)        |
| Decrease (increase) in inventories   | (63,450)                                    | 26,971          |
| Decrease (increase) in other assets  | 10,870                                      | (46,368)        |
| Increase in accounts payable   | 30,096                                      | 11,288          |
| Increase (decrease) in deferred system profit  | (3,101)                                     | 18,902          |
| Increase (decrease) in other liabilities   | (26,690)                                    | 36,246          |
| <b>Net cash provided by operating activities</b>   | <b>95,528</b>                               | <b>73,249</b>   |
| <b>Cash flows from investing activities:</b>   |   |                 |
| Capital expenditures, net  | (11,163)                                    | (3,635)         |
| Purchase of available-for-sale securities  | (228,951)                                   | (263,646)       |
| Proceeds from sale and maturity of available-for-sale securities                         | 239,650                                     | 221,588         |
| Purchase of trading securities   | (16,004)                                    | (23,573)        |
| Proceeds from sale of trading securities   | 30,623                                      | 29,145          |
| <b>Net cash provided by (used in) investing activities</b>                               | <b>14,155</b>                               | <b>(40,121)</b> |
| <b>Cash flows from financing activities:</b>   |   |                 |
| Issuance of common stock   | 2,953                                       | 2,917           |
| Tax withholding payments related to vested and released restricted stock units           | (9,517)                                     | (1,833)         |
| Common stock repurchases   | (62,156)                                    |                 |
| Payment of dividends to stockholders   | (41,785)                                    | (25,606)        |
| <b>Net cash used in financing activities</b>   | <b>(110,505)</b>                            | <b>(24,522)</b> |
| Effect of exchange rate changes on cash and cash equivalents                             | 9,288                                       | 7,266           |
| <b>Net increase in cash and cash equivalents</b>   | <b>8,466</b>                                | <b>15,872</b>   |
| Cash and cash equivalents at beginning of period   | 529,918                                     | 524,967         |

Edgar Filing: KLA TENCOR CORP - Form 10-Q

|  |            |            |
|--|------------|------------|
| Cash and cash equivalents at end of period | \$ 538,384 | \$ 540,839 |
| Supplemental cash flow disclosures:        |            |            |
| Income taxes paid, net                     | \$ 46,060  | \$ 10,591  |
| Interest paid                              | \$ 352     | \$ 246     |

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



**Table of Contents**

**KLA-TENCOR CORPORATION**

**Notes to Condensed Consolidated Financial Statements**

(Unaudited)

**NOTE 1 BASIS OF PRESENTATION**

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

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

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

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

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

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

**Recent Accounting Pronouncements**

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

In April 2010, the FASB amended the authoritative guidance addressing accounting for arrangements in which a vendor satisfies its performance obligations over time, with all or a portion of the consideration contingent on future events, referred to as "milestones." The scope of the new guidance is limited to milestones in arrangements that involve research or development activities, such as achieving a specific result from the research or development efforts. The amendment provides guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. A vendor can recognize consideration that is contingent upon achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone meets all criteria to be considered substantive. A vendor that is affected by the amendments is required to provide a description of the overall arrangement, a description of each milestone and related contingent consideration, a determination of whether each milestone is considered substantive, the factors that the entity considered in determining whether the milestone or milestones are substantive, and the amount of consideration recognized during the period for the milestone or milestones. This amendment is effective for the Company's interim period ended September 30, 2010. The amendment did not have an impact

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

on the Company's financial position, results of operations or cash flows.

In February 2010, the SEC issued a policy statement and staff work plan regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards (IFRS). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board. Under the proposed timeline set forth by the SEC, the Company could be required in fiscal year 2015 to prepare financial statements in accordance with IFRS, and the SEC is expected to make a determination in 2011 regarding the mandatory adoption of IFRS. The Company is currently assessing the impact that this potential change would have on its consolidated financial statements, and it will continue to monitor the development of the potential implementation of IFRS.

---

**Table of Contents**

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

In June 2009, the FASB issued authoritative guidance for consolidations that changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This guidance is effective for the Company's interim reporting period ended September 30, 2010. The adoption did not have an impact on the Company's financial position, results of operations or cash flows.

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

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

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

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

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

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

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

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

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

In terms of the timing and pattern of revenue recognition, the new accounting guidance for revenue recognition is not expected to have a significant effect on revenues in periods after the initial adoption when applied to multiple element arrangements based on current sales strategies.

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

For transactions entered into through June 30, 2009, the Company primarily recognized revenue based on the guidance in Staff Accounting Bulletin No. 104. During the period, for the majority of the Company's arrangements involving multiple deliverables, the entire amount of the sales contract was allocated to each respective element based on its relative selling price, using fair value. In the limited circumstances when the Company was not able to determine fair value for the deliverables in the arrangement, but was able to obtain fair value for the undelivered elements, revenue was allocated using the residual method. Under the residual method, the amount of revenue allocated to delivered elements equaled the total arrangement consideration less the aggregate selling price of any undelivered elements, and no revenue was recognized until all elements without fair value had been delivered. If fair value of any undelivered elements did not exist, the entire amount of the sales contract was deferred until all elements were accepted by the customer.

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

---

**Table of Contents**

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

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

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

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

**NOTE 2 FAIR VALUE MEASUREMENTS**

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

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

- Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.
- 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 are classified within Level 1 or Level 2 of the fair value hierarchy at September 30, 2010 because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The types of instruments valued based on quoted market prices in active markets include money market funds and U.S. Treasury securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

The types of instruments valued based on other observable inputs include U.S. agency securities, commercial paper, U.S. corporate bonds and municipal obligations. 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.

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

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

**Table of Contents**

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

| (In thousands)                                   | Total        | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets (Level<br>1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|--|--------------|--|---|---|
| U.S. Treasuries                                  | \$ 32,940    | \$ 31,990  | \$ 950  |   |
| U.S. Government agency securities                | 256,981      | 249,220  | 7,761   |   |
| Municipal bonds                                  | 59,217       |  | 59,217  |   |
| Corporate debt securities                        | 561,959      |  | 561,959   |   |
| Money market, bank deposits and other            | 311,129      | 308,405  | 2,724   |   |
| Sovereign securities                             | 45,650       | 10,465   | 35,185  |   |
| Equity securities                                | 1,812        | 1,812  |   |   |
| Total marketable securities and cash equivalents | 1,269,688    | 601,892  | 667,796   |   |
| Executive Deferred Savings Plan ( EDSP ):        |              |  |   |   |
| Money market and other                           | 1,751        | 1,751  |   |   |
| Mutual funds                                     | 118,463      | 91,886   | 26,577  |   |
| Executive Deferred Savings Plan total            | 120,214      | 93,637   | 26,577  |   |
| Derivative assets                                | 3,482        |  | 3,482   |   |
| Total financial assets                           | \$ 1,393,384 | \$ 695,529   | \$ 697,855  | \$  |
| Derivative liabilities                           | \$ (3,603)   | \$   | \$ (3,603)  | \$  |
| Total financial liabilities                      | \$ (3,603)   | \$   | \$ (3,603)  | \$  |

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

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

Edgar Filing: KLA TENCOR CORP - Form 10-Q

|                                       |              |            |            |           |
|---------------------------------------|--------------|------------|------------|-----------|
| Executive Deferred Savings Plan total | 109,230      | 85,258     | 23,972     |           |
| Derivative assets                     | 296          |            | 296        |           |
| Total financial assets                | \$ 1,489,975 | \$ 747,166 | \$ 725,984 | \$ 16,825 |
| Derivative liabilities                | \$ (5,824)   | \$         | \$ (5,824) | \$        |
| Total financial liabilities           | \$ (5,824)   | \$         | \$ (5,824) | \$        |



**Table of Contents**

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

| (In thousands)                     | Total               | Quoted Prices in<br>Active<br>Markets<br>for Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
|------------------------------------|---------------------|---|--|---|
| Cash equivalents                   | \$ 289,080          | \$ 288,480  | \$ 600   | \$  |
| Marketable securities              | 980,608             | 313,412   | 667,196  |   |
| Other current assets               | 3,482               |   | 3,482  |   |
| Other non-current assets           | 120,214             | 93,637  | 26,577   |   |
| <b>Total financial assets</b>      | <b>\$ 1,393,384</b> | <b>\$ 695,529</b>   | <b>\$ 697,855</b>                                      | <b>\$</b>                                       |
| Other current liabilities          | \$ (3,603)          | \$  | \$ (3,603)   | \$  |
| <b>Total financial liabilities</b> | <b>\$ (3,603)</b>   | <b>\$</b>   | <b>\$ (3,603)</b>                                      | <b>\$</b>                                       |

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

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

Changes in our Level 3 securities for the three months ended September 30, 2010 and 2009 were as follows:

|  | Three months ended<br>September 30, |           |
|--|-------------------------------------|-----------|
|  | 2010                                | 2009      |
| Beginning aggregate estimated fair value of Level 3 securities | \$ 16,825                           | \$ 40,584 |
| Total realized and unrealized gains                            |                                     |           |
| Unrealized gain included in other comprehensive income         |                                     |           |

Edgar Filing: KLA TENCOR CORP - Form 10-Q

|   |          |           |
|---|----------|-----------|
| Unrealized gain included in income                          |          | 35        |
| Net settlements   | (16,825) | (3,025)   |
| Ending aggregate estimated fair value of Level 3 securities | \$       | \$ 37,594 |

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

| (In thousands)                    | September 30,<br>2010 | June 30,<br>2010 |
|-----------------------------------|-----------------------|------------------|
| Accounts receivable, net          |                       |                  |
| Accounts receivable, gross        | \$ 522,078            | \$ 471,999       |
| Allowance for doubtful accounts   | (22,056)              | (31,874)         |
|                                   | \$ 500,022            | \$ 440,125       |
| Inventories, net                  |                       |                  |
| Customer service parts            | \$ 134,301            | \$ 131,951       |
| Raw materials                     | 177,785               | 123,301          |
| Work-in-process                   | 109,336               | 95,641           |
| Finished goods                    | 42,820                | 50,837           |
|                                   | \$ 464,242            | \$ 401,730       |
| Other current assets              |                       |                  |
| Prepaid expenses                  | \$ 38,511             | \$ 39,121        |
| Income tax related receivables    | 47,934                | 47,934           |
| Other current assets              | 46,420                | 43,989           |
|                                   | \$ 132,865            | \$ 131,044       |
| Land, property and equipment, net |                       |                  |
| Land                              | \$ 41,840             | \$ 41,807        |
| Buildings and improvements        | 122,638               | 122,467          |
| Machinery and equipment           | 452,812               | 443,351          |
| Office furniture and fixtures     | 22,839                | 23,345           |
| Leasehold improvements            | 102,246               | 101,936          |
| Construction in progress          | 6,641                 | 2,603            |
|                                   | 749,016               | 735,509          |
| Less: accumulated depreciation    | (501,636)             | (498,757)        |
|                                   | \$ 247,380            | \$ 236,752       |
| Other non-current assets          |                       |                  |
| Long-term investments             | \$ 144,489            | \$ 132,829       |
| Deferred tax assets long-term     | 229,514               | 244,927          |
| Other                             | 11,087                | 11,741           |
|                                   | \$ 385,090            | \$ 389,497       |
| Other current liabilities         |                       |                  |
| Warranty                          | \$ 25,556             | \$ 21,109        |
| Compensation and benefits         | 231,288               | 268,446          |
| Income taxes payable              | 30,520                | 35,340           |
| Interest payable                  | 21,706                | 8,769            |
| Accrued litigation costs          | 1,632                 | 10,439           |

Edgar Filing: KLA TENCOR CORP - Form 10-Q

|                        |            |            |
|------------------------|------------|------------|
| Other accrued expenses | 79,509     | 77,956     |
|                        | \$ 390,211 | \$ 422,059 |

**Table of Contents****NOTE 4 MARKETABLE SECURITIES**

The amortized costs and estimated fair values of marketable securities as of September 30, 2010 and June 30, 2010 are as follows:

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|--|-------------------|------------------------------|-------------------------------|-------------------------|
| <b>As of September 30, 2010 (In thousands)</b> |                   |                              |                               |                         |
| U.S. Treasuries                                | \$ 32,724         | \$ 216                       | \$                            | \$ 32,940               |
| U.S. Government agency securities              | 255,940           | 1,061                        | (20)                          | 256,981                 |
| Municipal bonds                                | 58,853            | 379                          | (15)                          | 59,217                  |
| Corporate debt securities                      | 555,320           | 6,656                        | (17)                          | 561,959                 |
| Money market, bank deposits and other          | 311,129           |                              |                               | 311,129                 |
| Sovereign securities                           | 45,247            | 417                          | (14)                          | 45,650                  |
| Equity securities                              | 1,937             |                              | (125)                         | 1,812                   |
| Subtotal                                       | 1,261,151         | 8,729                        | (191)                         | 1,269,688               |
| Less: Cash equivalents                         | 289,080           |                              |                               | 289,080                 |
| Marketable securities                          | \$ 972,070        | \$ 8,729                     | \$ (191)                      | \$ 980,608              |
| <b>As of June 30, 2010 (In thousands)</b>      |                   |                              |                               |                         |
| U.S. Treasuries                                | \$ 42,182         | \$ 112                       | \$ (1)                        | \$ 42,293               |
| U.S. Government agency securities              | 249,182           | 1,108                        | (10)                          | 250,280                 |
| Municipal bonds                                | 55,171            | 368                          | (80)                          | 55,459                  |
| Corporate debt securities                      | 599,118           | 5,314                        | (1,276)                       | 603,156                 |
| Money market, bank deposits and other          | 373,081           |                              |                               | 373,081                 |
| Sovereign securities                           | 39,166            | 210                          | (21)                          | 39,355                  |
| Auction rate securities                        | 16,825            |                              |                               | 16,825                  |
| Subtotal                                       | 1,374,725         | 7,112                        | (1,388)                       | 1,380,449               |
| Less: Cash equivalents                         | 376,316           | 7                            |                               | 376,323                 |
| Marketable securities                          | \$ 998,409        | \$ 7,105                     | \$ (1,388)                    | \$ 1,004,126            |

KLA-Tencor's investment portfolio consists of both corporate and government securities that have a maximum maturity of three years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. All unrealized losses are due to changes in interest rates and bond yields. The Company has the ability to realize the full value of all these investments upon maturity. The following table summarizes the estimated fair value and gross unrealized losses of the Company's investments, aggregated by investment instrument and length of time that the individual securities have been in an unrealized loss position as of September 30, 2010:

| (In thousands) | Estimated<br>Fair Value | Gross<br>Unrealized<br>Losses(1) |
|----------------|-------------------------|----------------------------------|
|----------------|-------------------------|----------------------------------|

Edgar Filing: KLA TENCOR CORP - Form 10-Q

|                                   |           |          |
|-----------------------------------|-----------|----------|
| U.S. Government agency securities | \$ 39,200 | \$ (20)  |
| Municipal bonds                   | 5,255     | (15)     |
| Corporate debt securities         | 13,193    | (17)     |
| Sovereign securities              | 9,700     | (14)     |
| Equity securities                 | 1,812     | (125)    |
| Total                             | \$ 69,160 | \$ (191) |

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

**Table of Contents**

The contractual maturities of securities classified as available-for-sale as of September 30, 2010, regardless of the consolidated balance sheet classification, are as follows:

| (In thousands)                         | Amortized<br>Cost | Estimated<br>Fair<br>Value |
|--|-------------------|----------------------------|
| Due within one year                    | \$ 201,411        | \$ 202,336                 |
| Due after one year through three years | 770,659           | 778,272                    |
|  | \$ 972,070        | \$ 980,608                 |

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 gain for the three months ended September 30, 2010 was approximately \$1.0 million.

During the fiscal years ended June 30 2008, 2009 and 2010, the Company's investment portfolio included auction rate securities, which are investments with contractual maturities generally between 20 to 30 years. They are usually found in the form of municipal bonds, preferred stock, a pool of student loans, or collateralized debt obligations whose interest rates are reset. The reset typically occurs every seven to forty-nine days, through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par. The auction rate securities that were held by the Company were backed by student loans and were collateralized, insured and guaranteed by the United States Federal Department of Education. In addition, all auction rate securities that were held by the Company were rated by the major independent rating agencies as either AAA or Aaa. In February 2008, because sell orders exceeded buy orders, auctions failed for approximately \$48.2 million in par value of municipal auction rate securities that were then held by the Company. These failures were not believed to be a credit issue, but rather caused by a lack of liquidity. The funds associated with these failed auctions might not have been accessible until the issuer called the security, a successful auction occurred, a buyer was found outside of the auction process, or the security matured. By letter dated August 8, 2008, the Company received notification from UBS AG ( UBS ), in connection with a settlement entered into between UBS and certain regulatory agencies, offering to repurchase all of the Company's auction rate security holdings at par value. The Company formally accepted the settlement offer and entered into a repurchase agreement ( Agreement ) with UBS on November 11, 2008 ( Acceptance Date ). By accepting the Agreement, the Company (1) received the right ( Put Option ) to sell its auction rate securities at par value to UBS between June 30, 2010 and June 30, 2012 and (2) gave UBS the right to purchase the auction rate securities from the Company any time after the Acceptance Date as long as the Company receives the par value. As of June 30, 2009, the Company had \$40.7 million par value of auction rate securities. During the fiscal year ended June 30, 2010, \$23.9 million of the auction rate securities were called at par by the issuers. The Put Option was exercised on June 30, 2010 to sell the remaining auction rate securities of \$16.8 million at par value and was subsequently settled in July 2010.

**Executive Deferred Savings Plan**

KLA-Tencor has a non-qualified deferred compensation plan whereby certain executives and non-employee directors may defer a portion of their compensation. Participants are credited with returns based on their allocation of their account balances among measurement funds. The Company controls the investment of these funds, and the participants remain general creditors of KLA-Tencor. Distributions from the plan commence the quarter following a participant's retirement or termination of employment. As of September 30, 2010, the Company had a deferred compensation plan related asset and liability of \$120.2 million and \$121.0 million, respectively, included as a component of other non-current assets and current liabilities on the Condensed Consolidated Balance Sheet, respectively. As of June 30, 2010, the Company had a deferred compensation plan related asset and liability of \$109.2 million and \$110.0 million, respectively, included as a component of other non-current assets and other current liabilities on the Condensed Consolidated Balance Sheet, respectively.

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

The following table presents goodwill balances and the movements during the three months ended September 30, 2010 and 2009:

| (In thousands)   | Three months ended September 30, |            |
|--|----------------------------------|------------|
|  | 2010                             | 2009       |
| Gross beginning balance as of beginning of fiscal year | \$ 604,592                       | \$ 605,965 |
| Accumulated impairment losses                          | (276,586)                        | (276,586)  |
| Net beginning balance as of beginning of fiscal year   | 328,006                          | 329,379    |
| Net exchange differences                               | 120                              | 8,939      |
| Net ending balance as of September 30                  | \$ 328,126                       | \$ 338,318 |

  

| (In thousands)                | As of<br>September 30, 2010 | As of<br>September 30, 2009 |
|-------------------------------|-----------------------------|-----------------------------|
| Gross goodwill balance        | \$ 604,712                  | \$ 614,904                  |
| Accumulated impairment losses | (276,586)                   | (276,586)                   |
| Net goodwill balance          | \$ 328,126                  | \$ 338,318                  |

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. The Company completed its annual evaluation of the goodwill by reporting unit during the three months ended December 31, 2009 and concluded that there was no impairment. As of December 31, 2009, the Company's assessment of goodwill impairment indicated that the fair values of the Company's reporting units were substantially in excess of their estimated carrying values and therefore goodwill in the reporting units was not impaired. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to the impairment test performed in the second quarter of the fiscal year ended June 30, 2010. The next annual evaluation of the goodwill by reporting unit will be performed in the second quarter of the fiscal year ending June 30, 2011.

Adjustments to goodwill during the three months ended September 30, 2010 and 2009 resulted primarily from foreign currency translation adjustments.

**Purchased Intangible Assets**

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

| (Dollar amounts in thousands) | Range of<br>Useful<br>Lives | As of September 30, 2010    |                             |               | As of June 30, 2010         |                             |               |
|-------------------------------|-----------------------------|-----------------------------|-----------------------------|---------------|-----------------------------|-----------------------------|---------------|
|                               |                             | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Amount |
| Existing technology           | 4-7 years                   | \$ 133,066                  | \$ 80,342                   | \$ 52,724     | \$ 133,066                  | \$ 75,524                   | \$ 57,542     |
| Patents                       | 6-13 years                  | 57,648                      | 35,810                      | 21,838        | 57,648                      | 34,217                      | 23,431        |
| Trade name / Trademark        | 4-10 years                  | 19,893                      | 11,615                      | 8,278         | 19,893                      | 11,130                      | 8,763         |



Edgar Filing: KLA TENCOR CORP - Form 10-Q

|                        |           |            |            |            |            |            |            |
|------------------------|-----------|------------|------------|------------|------------|------------|------------|
| Customer relationships | 6-7 years | 54,823     | 29,096     | 25,727     | 54,823     | 27,606     | 27,217     |
| Other                  | 0-1 year  | 16,200     | 15,859     | 341        | 16,200     | 15,817     | 383        |
| Total                  |           | \$ 281,630 | \$ 172,722 | \$ 108,908 | \$ 281,630 | \$ 164,294 | \$ 117,336 |

**Table of Contents**

For the three months ended September 30, 2010 and 2009, amortization expense for other intangible assets was \$8.4 million and \$8.3 million, respectively. Based on the intangible assets recorded as of September 30, 2010, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated amortization expense is expected to be as follows:

| Fiscal year ending June 30: | Amortization<br>(in thousands) |
|-----------------------------|--------------------------------|
| 2011 (remaining 9 months)   | \$ 24,277                      |
| 2012                        | 29,931                         |
| 2013                        | 20,658                         |
| 2014                        | 15,238                         |
| 2015                        | 12,472                         |
| Thereafter                  | 6,332                          |
| <b>Total</b>                | <b>\$ 108,908</b>              |

**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 September 30, 2010.

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

Based on the trading prices of the debt at September 30, 2010 and June 30, 2010, the estimated fair value of the debt at September 30, 2010 and June 30, 2010 were \$848.3 million and \$834.4 million, respectively.

**NOTE 7 STOCK-BASED COMPENSATION****Equity Incentive Program**

Under the Company's current equity incentive program, the Company issues equity awards from its 2004 Equity Incentive Plan (the "2004 Plan"), which provides for the grant of options to purchase shares of its common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to its employees, consultants and members of its Board of Directors. The 2004 Plan was approved by the Company's stockholders on October 18, 2004 and permits the issuance of up to 32.0 million shares of common stock, including 11.0 million shares approved by the Company's stockholders on November 4, 2009. As of September 30, 2010, 9.9 million shares were available for grant under the 2004 Plan. Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date are counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto. During the three months ended September 30, 2010, approximately 0.3 million restricted stock units were granted to senior management with performance-based and service-based vesting criteria.

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

| <b>(In thousands)</b>                 | <b>Available<br/>For Grant</b> |
|---------------------------------------|--------------------------------|
| Balances at June 30, 2010(1)          | 15,162                         |
| Restricted stock units granted(2)     | (3,753)                        |
| Restricted stock units canceled(2)    | 64                             |
| Options canceled/expired/forfeited    | 810                            |
| Plan shares expired(3)                | (773)                          |
| <br>Balances at September 30, 2010(1) | <br>11,510                     |

**Table of Contents**

- (1) Includes shares available for issuance under the 2004 Plan, as well as under the Company's 1998 Outside Director Option Plan (the "Outside Director Plan"), which only permits the issuance of stock options to the Company's non-employee directors. As of September 30, 2010, approximately 1.6 million shares were available for grant under the Outside Director Plan.
- (2) 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 number of restricted stock units provided in this row reflects the application of that 1.8x multiple.
- (3) Represents the portion of shares listed as "Options canceled/expired/forfeited" above that were issued under the Company's equity incentive plans other than the 2004 Plan or the Outside Director Plan. Because the Company is only currently authorized to issue equity awards under the 2004 Plan and the Outside Director Plan, any equity awards that are canceled, expire or are forfeited under any other Company equity incentive plan do not result in additional shares being available to the Company for future grant.

Except for options granted to non-employee directors as part of their regular compensation package for service through the end of the first quarter of fiscal year 2008, the Company has granted only restricted stock units under its equity incentive program since September 2006. For the preceding several years until June 30, 2006, stock options were granted at the market price of the Company's common stock on the date of grant (except for the retroactively priced options which were granted primarily prior to the fiscal year ended June 30, 2002), 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 stock options and for purchase rights under the Company's Employee Stock Purchase Plan and using the closing price of the Company's common stock on the grant date for restricted stock units.

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

| (In thousands)                        | Three months ended<br>September 30, |                  |
|---------------------------------------|-------------------------------------|------------------|
|                                       | 2010                                | 2009             |
| Stock-based compensation expense by:  |                                     |                  |
| Costs of revenues                     | \$ 4,168                            | \$ 3,288         |
| Engineering, research and development | 7,618                               | 6,603            |
| Selling, general and administrative   | 12,427                              | 10,308           |
| <b>Total stock-based compensation</b> | <b>\$ 24,213</b>                    | <b>\$ 20,199</b> |

**Stock Options**

The following table summarizes the activity and weighted-average exercise price for stock options under all plans for the three months ended September 30, 2010:

| Stock Options   | Shares<br>(In thousands) | Weighted-Average<br>Exercise Price |
|---|--------------------------|------------------------------------|
| Outstanding stock options as of June 30, 2010             | 11,358                   | \$ 43.72                           |
| Granted   |                          | \$                                 |
| Exercised   | (105)                    | \$ 28.02                           |
| Cancelled/expired/forfeited                               | (810)                    | \$ 45.88                           |
| <b>Outstanding stock options as of September 30, 2010</b> | <b>10,443</b>            | <b>\$ 43.71</b>                    |

Edgar Filing: KLA TENCOR CORP - Form 10-Q

|   |        |    |       |
|---|--------|----|-------|
| Vested and exercisable as of September 30, 2010 | 10,387 | \$ | 43.65 |
|---|--------|----|-------|

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 September 30, 2010 were each 2.7 years. The aggregate intrinsic values for total options outstanding under all plans and for total options vested and exercisable under all plans as of September 30, 2010 were each \$5.7 million.

**Table of Contents**

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

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

| (In thousands)  | Three months ended<br>September 30, |          |
|---|-------------------------------------|----------|
|   | 2010                                | 2009     |
| Total intrinsic value of options exercised  | \$ 563                              | \$ 210   |
| Total cash received from employees as a result of employee stock option exercises | \$ 2,953                            | \$ 2,917 |
| Tax benefits realized in connection with these stock option exercises             | \$ 202                              | \$ 77    |

As of September 30, 2010, the unrecognized stock-based compensation balance related to stock options was \$0.8 million and will be recognized over an estimated weighted-average amortization period of 0.7 years.

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

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

| (In thousands) | September 30,<br>2010 | June 30,<br>2010 |
|----------------|-----------------------|------------------|
| Inventory      | \$ 7,378              | \$ 6,687         |

**Restricted Stock Units**

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value for restricted stock units granted, vested and released, traded for taxes, and forfeited during the three months ended September 30, 2010 and restricted stock units outstanding as of September 30, 2010 and June 30, 2010:

| Restricted Stock Units                                      | Shares             | Weighted-Average         |
|---|--------------------|--------------------------|
|   | (In thousands) (1) | Grant Date<br>Fair Value |
| Outstanding restricted stock units as of June 30, 2010      | 6,470              | \$ 22.52                 |
| Granted   | 2,085              | \$ 19.52                 |
| Vested and released   | (615)              | \$ 30.59                 |
| Traded for taxes  | (304)              | \$ 30.62                 |
| Forfeited   | (36)               | \$ 21.73                 |
| Outstanding restricted stock units as of September 30, 2010 | 7,600              | \$ 20.72                 |

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

(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 are multiplied by 1.8 to calculate their impact on the share reserve under the 2004 Plan. The restricted stock units granted by the Company since the beginning of the fiscal year ended June 30, 2007 generally vest in two equal installments on the second and fourth anniversaries of the date of grant. Prior to the fiscal year ended June 30, 2007, the restricted stock units granted by the Company generally vested in two equal installments over four or five years from the anniversary 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.

**Table of Contents**

The following table shows the grant-date fair value after estimated forfeitures, weighted-average grant date fair value per unit, and tax benefits realized by the Company in connection with vested and released restricted stock units for the three months ended September 30, 2010 and 2009:

| (In thousands, except for weighted-average grant date fair value)                   | Three months ended<br>September 30, |           |
|---|-------------------------------------|-----------|
|   | 2010                                | 2009      |
| Grant-date fair value after estimated forfeitures                                   | \$ 40,705                           | \$ 62,470 |
| Weighted-average grant date fair value per unit                                     | \$ 19.52                            | \$ 22.16  |
| Tax benefits realized in connection with vested and released restricted stock units | \$ 10,094                           | \$ 1,638  |

As of September 30, 2010, the unrecognized stock-based compensation balance related to restricted stock units was \$125.1 million and will be recognized over an estimated weighted-average amortization period of 2.7 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 fair market value of the common stock at the time of enrollment into the offering period versus the fair market value on the date of purchase.

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

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

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

| Stock purchase plan:                | Three months ended<br>September 30, |      |
|-------------------------------------|-------------------------------------|------|
|                                     | 2010                                | 2009 |
| Expected stock price volatility     | 41%                                 | (*)  |
| Risk-free interest rate             | 0.20%                               | (*)  |
| Dividend yield                      | 3.68%                               | (*)  |
| Expected life of options (in years) | 0.50                                | (*)  |



Edgar Filing: KLA TENCOR CORP - Form 10-Q

- (\*) There were no valuations recorded during the three months ended September 30, 2009. No compensation cost was recognized as the purchase price was based solely on the market price of the shares at the purchase date and the discount on the purchase price was 5%.

**Table of Contents**

In connection with disqualifying dispositions of shares purchased under the ESPP, the Company realized tax benefits as follows during the three months ended September 30, 2010 and 2009:

| (In thousands)   | Three months ended<br>September 30, |        |
|--|-------------------------------------|--------|
|  | 2010                                | 2009   |
| Tax benefits realized in connection with disqualifying dispositions of ESPP shares | \$ 356                              | \$ 713 |

The ESPP shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to issue under the ESPP during the forthcoming fiscal year. During the fiscal year ended June 30, 2010, a total of 2.0 million additional shares were reserved under the ESPP, and an additional 2.0 million shares were reserved under the ESPP with respect to fiscal year 2011 during the three months ended September 30, 2010. As of September 30, 2010, a total of 4.6 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 62.8 million shares of its common stock under a repurchase program. This program was put into place to reduce the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, and to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases will be made from time to time in the open market in compliance with applicable securities laws, including the Securities Exchange Act of 1934 and the rules promulgated there under such as Rule 10b-18. In October 2008, the Company suspended its stock repurchase program, and the Company subsequently restarted the program in February 2010. At September 30, 2010, 3.2 million shares were available for repurchase under the Company's repurchase program.

Share repurchases for the three months ended September 30, 2010 and 2009 were as follows:

| (In thousands)                               | Three months ended<br>September 30, |      |
|--|-------------------------------------|------|
|  | 2010                                | 2009 |
| Number of shares of common stock repurchased | 1,972                               |      |
| Total cost of repurchases                    | \$ 59,323                           |      |

At September 30, 2010, \$1.8 million of the above total cost of repurchase amount remained unpaid and is recorded in other current liabilities. The \$4.6 million which was accrued at June 30, 2010 was paid during the three months ended September 30, 2010.

**NOTE 9 NET INCOME PER SHARE**

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

Edgar Filing: KLA TENCOR CORP - Form 10-Q

| (In thousands, except per share data)  | Three months ended |                       |
|--|--------------------|-----------------------|
|  | 2010               | September 30,<br>2009 |
| Numerator:   |                    |                       |
| Net income   | \$ 154,196         | \$ 20,405             |
| Denominator:   |                    |                       |
| Weighted-average shares outstanding, excluding unvested restricted stock units         | 167,187            | 170,698               |
| Effect of dilutive options and restricted stock  | 2,652              | 2,020                 |
| Denominator for diluted earnings per share   | 169,839            | 172,718               |
| Basic earnings per share   | \$ 0.92            | \$ 0.12               |
| Diluted earnings per share   | \$ 0.91            | \$ 0.12               |
| Anti-dilutive securities excluded from the computation of diluted net income per share | 10,340             | 12,242                |

**Table of Contents**

The total amounts of dividends paid during the three months ended September 30, 2010 and 2009 were \$41.8 million and \$25.6 million, respectively.

**NOTE 10 COMPREHENSIVE INCOME**

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

| (In thousands)   | Three months ended<br>September 30, |           |
|--|-------------------------------------|-----------|
|  | 2010                                | 2009      |
| Net income   | \$ 154,196                          | \$ 20,405 |
| Other comprehensive income:  |                                     |           |
| Currency translation adjustments   | 13,522                              | 9,089     |
| Gain on cash flow hedging instruments, net   | 840                                 | 162       |
| Change in unrecognized losses and transition obligation related to pension and post retirement plans | 80                                  | 18        |
| Unrealized gain on investments, net  | 1,750                               | 1,573     |
| Other comprehensive income   | \$ 16,192                           | \$ 10,842 |
| Total comprehensive income   | \$ 170,388                          | \$ 31,247 |

**NOTE 11 INCOME TAXES**

The following table provides details of income taxes:

| (Dollar amounts in thousands) | Three months ended<br>September 30, |           |
|-------------------------------|-------------------------------------|-----------|
|                               | 2010                                | 2009      |
| Income before income taxes    | \$ 223,312                          | \$ 22,792 |
| Provision for taxes           | 69,116                              | 2,387     |
| Effective tax rate            | 31.0%                               | 10.5%     |

The Company's estimated effective tax rate for the year is approximately 30%.

The difference between the actual effective tax rate during the quarter and the estimated annual effective tax rate is due to the tax impact of the following during the three months ended September 30, 2010:

Tax expense was increased by \$9.1 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 \$3.4 million by a non-taxable increase in the assets held within the Company's Executive Deferred Savings Plan and by \$2.9 million due to the tax effect of inter-company dividends.

Tax expense was lower as a percentage of income during the three months ended September 30, 2009 compared to the three months ended September 30, 2010 primarily due to a decrease in tax expense of \$4.1 million resulting from a non-taxable increase in the assets held within the Company's Executive Deferred Savings Plan during the three months ended September 30, 2009. This decrease in tax expense during the three

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

months ended September 30, 2009 had a significant impact on the Company's effective tax rate due to the lower level of income generated during the quarter.

On October 8, 2010, the California legislature approved the 2010-2011 budget bills, which included various income tax provisions, including suspending utilization of net operating loss carry forwards. The Company does not expect a material impact to the effective tax rate from the income tax provisions in the bills.

**Table of Contents**

In the normal course of business, the Company is subject to examination by taxing authorities throughout the world. The Company is under United States federal income tax examination for the fiscal years ended June 30, 2007 through June 30, 2009, which represents all years for which tax returns have been filed and the statute of limitations has not expired. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2006. The Company is also subject to examinations in major foreign jurisdictions, including Japan, Israel and Singapore, for all years beginning from the fiscal year ended June 30, 2006 and is currently under tax examinations in various other foreign tax jurisdictions. It is possible that certain examinations may be concluded in the next twelve months. The Company believes it is possible that it may recognize up to \$3.6 million of its existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of agreements with various foreign tax authorities.

**NOTE 12 LITIGATION AND OTHER LEGAL MATTERS**

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

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

**NOTE 13 COMMITMENTS AND CONTINGENCIES**

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

The following table shows total receivables sold under factoring agreements, proceeds from sales of LCs and related discounting fees paid for the three months ended September 30, 2010 and 2009:

| (In thousands)                              | Three months ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2010 | September 30,<br>2009 |
| Receivables sold under factoring agreements | \$ 60,025             | \$ 30,201             |
| Proceeds from sales of LCs                  | \$ 50,831             | \$ 10,507             |
| Discounting fees paid on sales of LCs (1)   | \$ 105                | \$ 123                |

Edgar Filing: KLA TENCOR CORP - Form 10-Q

- (1) Discounting fees were equivalent to interest expense and were recorded in interest income and other, net.

**Table of Contents**

**Facilities.** KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was approximately \$2.0 million and \$2.6 million for the three months ended September 30, 2010 and 2009, respectively.

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

| Fiscal year ended June 30,          | Amount           |
|-------------------------------------|------------------|
| 2011 (remaining 9 months)           | \$ 6,890         |
| 2012                                | 6,596            |
| 2013                                | 4,386            |
| 2014                                | 3,013            |
| 2015                                | 1,846            |
| 2016 and thereafter                 | 5,054            |
| <b>Total minimum lease payments</b> | <b>\$ 27,785</b> |

**Purchase Commitments.** KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. KLA-Tencor's liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company's open inventory purchase commitments were approximately \$355.6 million as of September 30, 2010 and are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

**Guarantees.** KLA-Tencor provides standard warranty coverage on its systems for 40 hours per week for twelve months, providing labor and parts necessary to repair the systems during the warranty period. KLA-Tencor 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, KLA-Tencor calculates the average service hours and parts expense per system and applies the actual labor and overhead rates to determine the estimated warranty charge. KLA-Tencor updates these estimated charges on a quarterly basis. The actual product performance and/or field expense profiles may differ, and in those cases KLA-Tencor adjusts its warranty accruals accordingly.

The following table provides the changes in the product warranty accrual for the three months ended September 30, 2010 and 2009:

| (In thousands)  | Three months ended<br>September 30, |                  |
|---|-------------------------------------|------------------|
|   | 2010                                | 2009             |
| Beginning balance                                       | \$ 21,109                           | \$ 18,213        |
| Accruals for warranties issued during the period        | 9,486                               | 4,733            |
| Changes in liability related to pre-existing warranties | 159                                 | (1,925)          |
| Settlements made during the period                      | (5,198)                             | (5,969)          |
| <b>Ending balance</b>                                   | <b>\$ 25,556</b>                    | <b>\$ 15,052</b> |

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



## Edgar Filing: KLA TENCOR CORP - Form 10-Q

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.

**Table of Contents**

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

The Company maintains guarantee arrangements available through various financial institutions for \$26.2 million, of which \$18.8 million have been issued primarily to fund guarantees to customs authorities for VAT and other operating requirements of the Company's subsidiaries in Europe and Asia as of September 30, 2010.

**NOTE 14 RESTRUCTURING CHARGES**

In March 2009, the Company announced a plan to further reduce its global workforce by approximately 10%, which followed the Company's announcement in November 2008 of a global workforce reduction of approximately 15%. The Company has undertaken a number of cost reduction activities, including these workforce reductions, in an effort to lower its quarterly operating expense run rate. The program in the United States is accounted for in accordance with the authoritative guidance related to compensation for non-retirement post-employment benefits, whereas the programs in the international locations are accounted for in accordance with the authoritative guidance for contingencies. During the three months ended September 30, 2010, the Company recorded a \$0.3 million net restructuring charge, of which \$0.1 million was recorded to costs of revenues and \$0.2 million was recorded to selling, general and administrative expense. These charges represent the estimated minimum liability associated with expected termination benefits to be provided to employees after employment.

The following table shows the activity primarily related to severance and benefits expense for the three months ended September 30, 2010 and 2009:

| (In thousands)      | Three months ended<br>September 30,<br>2010 | Three months ended<br>September 30,<br>2009 |
|---------------------|---|---|
| Beginning balance   | \$ 1,221                                    | \$ 8,086                                    |
| Restructuring costs | 365   | 583   |
| Adjustments         | (22)  | (536)                                       |
| Cash payments       | (975)                                       | (4,099)                                     |
| Ending balance      | \$ 589                                      | \$ 4,034                                    |

Substantially all of the remaining accrued restructuring balance related to the Company's workforce reductions is expected to be paid out by the end of calendar year 2010.

**NOTE 15 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

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

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to risks relating to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts and option contracts to hedge against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions such as the Japanese yen, the euro and the Israeli shekel. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes. The Company routinely hedges its exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. These currency forward exchange contracts and

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

options, designated as cash flow hedges, generally have maturities of less than 18 months. Cash flow hedges are evaluated for effectiveness monthly, based on changes in total fair value of the derivatives. If a financial counter-party to any of the Company's hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, the Company may experience material losses.

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

**Table of Contents**

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

**Derivatives in Cash Flow Hedging Relationships: Foreign Exchange Contracts**

The location and amounts of designated and non-designated derivative instruments gains and losses in the condensed consolidated financial statements for the three months ended September 30, 2010 and 2009 are as follows:

| (In thousands)  | Location in Financial Statements      |          |                   |                                |            |                                       |          |                   |                                |            |
|---|---------------------------------------|----------|-------------------|--------------------------------|------------|---------------------------------------|----------|-------------------|--------------------------------|------------|
|   | Three months ended September 30, 2010 |          |                   |                                |            | Three months ended September 30, 2009 |          |                   |                                |            |
|   | Accumulated OCI                       | Revenues | Costs of revenues | Interest income and other, net | Total      | Accumulated OCI                       | Revenues | Costs of revenues | Interest income and other, net | Total      |
| <b>Derivatives Designated as Hedging Instruments</b>  |                                       |          |                   |                                |            |                                       |          |                   |                                |            |
| Gain (loss) in accumulated OCI on derivative (effective portion)  | \$ 414                                |          |                   |                                | \$ 414     | \$ (202)                              |          |                   |                                | \$ (202)   |
| Loss reclassified from accumulated OCI into income (effective portion)  |                                       | \$ (793) | \$ (142)          |                                | \$ (935)   |                                       | \$ (462) |                   |                                | \$ (462)   |
| Gain (loss) recognized in income on derivative (ineffectiveness portion and amount excluded from effectiveness testing) |                                       |          |                   | \$ (119)                       | \$ (119)   |                                       |          |                   | \$ (521)                       | \$ (521)   |
| <b>Derivatives Not Designated as Hedging Instruments</b>  |                                       |          |                   |                                |            |                                       |          |                   |                                |            |
| Gain (loss) recognized in income  |                                       |          |                   | \$ (1,356)                     | \$ (1,356) |                                       |          |                   | \$ (2,513)                     | \$ (2,513) |

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

| (In thousands)                                | As of September 30, 2010 | As of June 30, 2010 |
|---|--------------------------|---------------------|
| <b>Cash flow hedge contracts</b>              |                          |                     |
| Purchase                                      | \$ 14,551                | \$ 15,835           |
| Sell  | (68,792)                 | (32,853)            |
| <b>Other foreign currency hedge contracts</b> |                          |                     |
| Purchase                                      | 81,323                   | 82,535              |
| Sell  | (64,885)                 | (104,414)           |
| Net   | \$ (37,803)              | \$ (38,897)         |

**Table of Contents**

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

| (In thousands)   | Balance Sheet Location | Asset Derivatives  |               | Balance Sheet Location    | Liability Derivatives |               |
|--|------------------------|--------------------|---------------|---------------------------|-----------------------|---------------|
|  |                        | September 30, 2010 | June 30, 2010 |                           | September 30, 2010    | June 30, 2010 |
|  |                        | Fair Value         | Fair Value    |                           | Fair Value            | Fair Value    |
| <b>Derivatives designated as hedging instruments</b>           |                        |                    |               |                           |                       |               |
| Foreign exchange contract                                      | Other current assets   | \$ 1,089           | \$ 125        | Other current liabilities | \$ 1,355              | \$ 2,033      |
| <b>Total derivatives designated as hedging instruments</b>     |                        | \$ 1,089           | \$ 125        |                           | \$ 1,355              | \$ 2,033      |
| <b>Derivatives not designated as hedging instruments</b>       |                        |                    |               |                           |                       |               |
| Foreign exchange contract                                      | Other current assets   | \$ 2,393           | \$ 171        | Other current liabilities | \$ 2,248              | \$ 3,791      |
| <b>Total derivatives not designated as hedging instruments</b> |                        | 2,393              | 171           |                           | \$ 2,248              | \$ 3,791      |
| <b>Total derivatives</b>                                       |                        | \$ 3,482           | \$ 296        |                           | \$ 3,603              | \$ 5,824      |

The following table provides the balances and changes in the accumulated other comprehensive income (loss) related to derivative instruments for the three months ended September 30, 2010 and 2009:

| (In thousands)                | Three months ended |                    |
|-------------------------------|--------------------|--------------------|
|                               | September 30, 2010 | September 30, 2009 |
| Beginning balance             | \$ (1,995)         | \$ (1,613)         |
| Amount reclassified to income | 935                | 462                |
| Net change                    | 414                | (202)              |
| Ending balance                | \$ (646)           | \$ (1,353)         |

**NOTE 16 RELATED PARTY TRANSACTIONS**

During the three months ended September 30, 2010 and 2009, the Company purchased from, or sold to, several entities, where one or more 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, Cisco Systems, Inc., and National Semiconductor Corp. For the three months ended September 30, 2010 and 2009, the following table provides the transactions with these parties (for the portion of such period that they were considered related):

| (In thousands)  | Three months ended |                    |
|-----------------|--------------------|--------------------|
|                 | September 30, 2010 | September 30, 2009 |
| Total revenues  | \$ (200)           | \$ (2,591)         |
| Total purchases | 882                | 942                |

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

The Company had a receivable balance from these parties of approximately \$0.1 million and \$2.0 million at September 30, 2010 and 2009, respectively. Management believes that such transactions are at arm's length and on similar terms as would have been obtained from unaffiliated third parties.

**Table of Contents****NOTE 17 SEGMENT REPORTING AND GEOGRAPHIC INFORMATION**

KLA-Tencor reports one reportable segment in accordance with 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 Company's Chief Executive Officer.

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

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

The following is a summary of revenues by geographic region for the three months ended September 30, 2010 and 2009:

| (Dollar amounts in thousands) | Three months ended<br>September 30, |      |            |      |
|-------------------------------|-------------------------------------|------|------------|------|
|                               | 2010                                |      | 2009       |      |
| Revenues:                     |                                     |      |            |      |
| United States                 | \$ 86,519                           | 12%  | \$ 74,557  | 22%  |
| Taiwan                        | 188,541                             | 28%  | 122,119    | 36%  |
| Japan                         | 93,888                              | 14%  | 59,352     | 17%  |
| Europe & Israel               | 39,246                              | 6%   | 23,925     | 7%   |
| Korea                         | 162,091                             | 24%  | 29,512     | 8%   |
| Rest of Asia Pacific          | 112,057                             | 16%  | 33,222     | 10%  |
| Total                         | \$ 682,342                          | 100% | \$ 342,687 | 100% |

The following is a summary of revenues by major products for the three months ended September 30, 2010 and 2009 (as a percentage of total revenues):

| (Dollar amounts in thousands) | Three months ended<br>September 30, |      |            |      |
|-------------------------------|-------------------------------------|------|------------|------|
|                               | 2010                                |      | 2009       |      |
| Revenues:                     |                                     |      |            |      |
| Defect inspection             | \$ 413,081                          | 60%  | \$ 171,746 | 50%  |
| Metrology                     | 119,705                             | 18%  | 45,336     | 13%  |
| Service                       | 129,242                             | 19%  | 112,188    | 33%  |
| Other                         | 20,314                              | 3%   | 13,417     | 4%   |
| Total                         | \$ 682,342                          | 100% | \$ 342,687 | 100% |





**Table of Contents**

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

| <b>(In thousands)</b> | <b>September 30, 2010</b> | <b>June 30, 2010</b> |
|-----------------------|---------------------------|----------------------|
| Long-lived assets:    |                           |                      |
| United States         | \$ 177,193                | \$ 174,033           |
| Taiwan                | 766                       | 714                  |
| Japan                 | 4,125                     | 3,985                |
| Europe & Israel       | 127,063                   | 127,474              |
| Korea                 | 3,100                     | 3,482                |
| Rest of Asia Pacific  | 55,126                    | 56,141               |
| <br>Total             | <br>\$ 367,375            | <br>\$ 365,829       |

For the three months ended September 30, 2010, two customers each accounted for greater than 10% of total revenues. For the three months ended September 30, 2009, two customers each accounted for greater than 10% of total revenues. As of September 30, 2010, three customers each accounted for greater than 10% of net accounts receivable. As of June 30, 2010, two customers each accounted for more than 10% of net accounts receivable.

---

**Table of Contents****ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

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

*Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in Part II, Item 1A, Risk Factors in this report as well as in Item 1, Business and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended June 2010, filed with the Securities and Exchange Commission on August 6, 2010. You should carefully review these risks and also review the risks described in other documents we file from time to time with the Securities and Exchange Commission. You are cautioned not to place undue reliance on these forward-looking statements, and we expressly assume no obligation to update the forward-looking statements in this report after the date hereof.*

**CRITICAL ACCOUNTING ESTIMATES AND POLICIES**

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

Revenue Recognition

Inventories

Warranty

Allowance for Doubtful Accounts

Stock-Based Compensation

Contingencies and Litigation

Goodwill and Intangible Assets

Income Taxes

---

**Table of Contents**

System revenues recognized without a written acceptance from the customer were approximately 26%, 30% and 17% of total revenues for the three months ended September 30, 2010, June 30, 2010 and September 30, 2009, respectively. The percentage of system revenues recognized without a written acceptance from the customer for the three months ended September 30, 2010 has decreased compared to the three months ended June 30, 2010 primarily due to lower shipments of tools that have already met the required acceptance criteria at those customer fabs. The percentage of system revenues recognized without a written acceptance from the customer for the three months ended September 30, 2010 has increased compared to the three months ended September 30, 2009 primarily due to higher shipments of tools that have already met the required acceptance criteria at those customer fabs.

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

**Valuation of Goodwill and Intangible Assets**

We assess goodwill for impairment annually as well as whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Long-lived intangible assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable.

We completed our annual evaluation of goodwill by reporting unit during the three months ended December 31, 2009 and concluded that there was no impairment.

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

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

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

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

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

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

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

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

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

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

For transactions entered into through June 30, 2009, we primarily recognized revenue based upon the guidance in Staff Accounting Bulletin No. 104. During the period, for the majority of our arrangements involving multiple deliverables, the entire amount of the sales contract was allocated to each respective element based on its relative selling price, using fair value. In the limited circumstances when we were not able to determine fair value for the deliverables in the arrangement, but were able to obtain fair value for the undelivered elements, revenue was allocated using the residual method. Under the residual method, the amount of revenue allocated to delivered elements equaled the total arrangement consideration less the aggregate selling price of any undelivered elements, and no revenue was recognized until all elements without fair value had been delivered. If fair value of any undelivered elements did not exist, the entire amount of the sales contract was deferred until all elements were accepted by the customer.

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

---

## **Table of Contents**

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

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

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

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

In terms of the timing and pattern of revenue recognition, the new accounting guidance for revenue recognition is not expected to have a significant effect on revenues in periods after the initial adoption when applied to multiple element arrangements based on current sales strategies.

### **Adoption of Fair Value Measurement**

We adopted authoritative guidance for fair value measurements as of the beginning of fiscal year 2009. In February 2008, the FASB issued a provision that allowed companies to elect a one-year delay in applying the fair value measurements guidance to certain fair value measurements, primarily related to non-financial assets and liabilities. We elected the delayed adoption date for our non-financial assets and liabilities impacted by the guidance. This guidance defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles and enhances disclosures about fair value measurements. Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The adoption of the guidance relating to the fair value measurement of non-financial assets and liabilities on July 1, 2009 did not have a material impact on our condensed consolidated results of operations or financial condition. See Note 2, Fair Value Measurements, to the Condensed Consolidated Financial Statements.

Concurrently with the adoption of the fair value measurement and disclosure provisions, we adopted authoritative guidance that permits entities to elect, at specified election dates, to measure eligible financial instruments at fair value. See Note 2, Fair Value Measurements, to the Condensed Consolidated Financial Statements.

### **Recent Accounting Pronouncements**

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

In April 2010, the FASB amended the authoritative guidance addressing accounting for arrangements in which a vendor satisfies its performance obligations over time, with all or a portion of the consideration contingent on future events, referred to as milestones. The scope of the new guidance is limited to milestones in arrangements that involve research or development activities, such as achieving a specific result from the research or development efforts. The amendment provides guidance on the criteria that should be met for determining whether the milestone method of revenue recognition is appropriate. A vendor can recognize consideration that is contingent upon achievement of a milestone in its entirety as revenue in the period in which the milestone is achieved only if the milestone meets all criteria to be considered substantive. A vendor that is affected by the amendments is required to provide a description of the overall arrangement, a description of each milestone and related contingent consideration, a determination of whether each milestone is considered substantive, the factors that the entity considered in determining whether the milestone or milestones are substantive, and the amount of consideration recognized during the period for the milestone or milestones. The amended guidance is effective for our interim period ended September 30, 2010. We currently do not hold such derivatives.

The amendment did not have an on our financial position, results of operations or cash flows.

## **Table of Contents**

In February 2010, the SEC issued a policy statement and staff work plan regarding the potential use by U.S. issuers of financial statements prepared in accordance with International Financial Reporting Standards ( IFRS ). IFRS is a comprehensive series of accounting standards published by the International Accounting Standards Board. Under the proposed timeline set forth by the SEC, we could be required in fiscal year 2015 to prepare financial statements in accordance with IFRS, and the SEC is expected to make a determination in 2011 regarding the mandatory adoption of IFRS. We are currently assessing the impact that this potential change would have on our consolidated financial statements, and we will continue to monitor the development of the potential implementation of IFRS.

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

In June 2009, the FASB issued authoritative guidance for consolidations that changes how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This guidance is effective for our interim reporting period ended September 30, 2010. The adoption did not have an impact on our financial position, results of operations or cash flows.

## **EXECUTIVE SUMMARY**

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

Our products and services are used by the vast majority of wafer, IC, reticle and disk manufacturers in the world. Our revenues are driven largely by capital spending by our customers who operate in one or more of several key semiconductor markets, including the memory, foundry and logic markets. Our customers purchase our products either in response to the need to drive advances in process technologies or to ramp up production to satisfy demand from industries such as communication, data processing, consumer electronics, automotive and aerospace. 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 reduced cost, which in turn will drive increased adoption of process control to reduce defectivity.

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

The demand for our products is generally affected by the profitability of our customers, which is driven by capacity and market supply for their products as well as the willingness and ability of our customers to invest in new technologies. The increase in the semiconductor content in communication, data processing, consumer electronics, automotive and aerospace products combined with the improving global economic environment over the past year favorably impacted our customers and consequently accelerated the demand for our products. As our customers accelerate capital investments, we have increased production volumes to support customer demand. However, we cannot predict the duration and sustainability of the improved business conditions. As we increase production volumes and make commitments to increase our capacity in anticipation of improved business conditions, we remain at risk of incurring inventory related and other restructuring charges if the current business conditions deteriorate.



## Edgar Filing: KLA TENCOR CORP - Form 10-Q

Our results for the three months ended September 30, 2010 reflected the fifth consecutive quarter of revenue, net income and diluted earnings per share growth as we increased production to meet the high volume of orders placed by customers in recent quarters. We also achieved high levels of gross and operating margins in the quarter, a result of strong new product acceptance and continued strict cost discipline.

**Table of Contents**

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

| (In thousands, except net income per share) | Three months ended    |                  | Three months ended |                      |                       |
|---|-----------------------|------------------|--------------------|----------------------|-----------------------|
|   | September 30,<br>2010 | June 30,<br>2010 | March 31,<br>2010  | December 31,<br>2009 | September 30,<br>2009 |
| Total revenues                              | \$ 682,342            | \$ 559,419       | \$ 478,299         | \$ 440,355           | \$ 342,687            |
| Total costs and operating expenses          | \$ 446,726            | \$ 398,577       | \$ 387,020         | \$ 393,260           | \$ 327,737            |
| Gross margin                                | \$ 421,579            | \$ 331,500       | \$ 269,734         | \$ 233,069           | \$ 170,795            |
| Income from operations                      | \$ 235,616            | \$ 160,842       | \$ 91,279          | \$ 47,095            | \$ 14,950             |
| Net income                                  | \$ 154,196            | \$ 113,085       | \$ 57,016          | \$ 21,794            | \$ 20,405             |
| Net income per share:                       |                       |                  |                    |                      |                       |
| Basic (1)                                   | \$ 0.92               | \$ 0.67          | \$ 0.33            | \$ 0.13              | \$ 0.12               |
| Diluted (1)                                 | \$ 0.91               | \$ 0.66          | \$ 0.33            | \$ 0.13              | \$ 0.12               |

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

**RESULTS OF OPERATIONS****Revenues and Gross Margin**

| (Dollar amounts in thousands)                                  | Three months ended    |                  |                       | Q1 FY11 vs. |     | Q1 FY11 vs. |      |
|--|-----------------------|------------------|-----------------------|-------------|-----|-------------|------|
|  | September 30,<br>2010 | June 30,<br>2010 | September 30,<br>2009 | Q4 FY10     |     | Q1 FY10     |      |
| Revenues:  |                       |                  |                       |             |     |             |      |
| Product  | \$ 550,609            | \$ 430,286       | \$ 229,251            | \$ 120,323  | 28% | \$ 321,358  | 140% |
| Service  | \$ 131,733            | \$ 129,133       | \$ 113,436            | \$ 2,600    | 2%  | \$ 18,297   | 16%  |
| Total revenues   | \$ 682,342            | \$ 559,419       | \$ 342,687            | \$ 122,923  | 22% | \$ 339,655  | 99%  |
| Costs of revenues  | \$ 263,969            | \$ 227,919       | \$ 171,892            | \$ 36,051   | 16% | \$ 92,077   | 54%  |
| Stock-based compensation expense included in costs of revenues | \$ 4,168              | \$ 3,869         | \$ 3,288              | \$ 299      | 8%  | \$ 880      | 27%  |
| Gross margin percentage  | 61%                   | 60%              | 50%                   |             |     |             |      |

**Product revenues**

Product revenues increased during the three months ended September 30, 2010 from the three months ended September 30, 2009 as our customers increased capital spending for both technology and capacity related investments of process control equipment, in response to anticipated semiconductor electronics end market demand. These factors contributed to an increase in the revenues that we recognized across our major products, particularly from wafer defect inspection and reticle inspection equipment, as well as an increase in the number of tools that we sold, primarily wafer defect inspection and metrology equipment, as compared to the three months ended September 30, 2009.

Product revenues increased during the three months ended September 30, 2010 from the three months ended June 30, 2010 as our customers maintained high levels of capital spending for both technology and capacity related investments, and as we recognized revenues during the three months ended September 30, 2010 from system orders received in prior periods.

**Service revenues**

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

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

**Table of Contents****Revenues by region**

Revenues by region for the periods indicated were as follows:

| (Dollar amounts in thousands) | Three months ended |             |                   |             |                    |             |
|-------------------------------|--------------------|-------------|-------------------|-------------|--------------------|-------------|
|                               | September 30, 2010 |             | June 30, 2010     |             | September 30, 2009 |             |
| United States                 | \$ 86,519          | 12%         | \$ 58,877         | 11%         | \$ 74,557          | 22%         |
| Taiwan                        | 188,541            | 28%         | 217,694           | 39%         | 122,119            | 36%         |
| Japan                         | 93,888             | 14%         | 72,588            | 13%         | 59,352             | 17%         |
| Europe & Israel               | 39,246             | 6%          | 31,778            | 6%          | 23,925             | 7%          |
| Korea                         | 162,091            | 24%         | 52,997            | 9%          | 29,512             | 8%          |
| Rest of Asia Pacific          | 112,057            | 16%         | 125,485           | 22%         | 33,222             | 10%         |
| <b>Total</b>                  | <b>\$ 682,342</b>  | <b>100%</b> | <b>\$ 559,419</b> | <b>100%</b> | <b>\$ 342,687</b>  | <b>100%</b> |

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

**Gross margin**

Our gross margin fluctuates with revenue levels and product mix, and is affected by variations in costs related to manufacturing and servicing our products. Gross margin percentage increased slightly during the three months ended September 30, 2010 compared to the three months ended June 30, 2010 as our customers maintained strong demands for new high value products, and we continued to benefit from a favorable product mix, significant volume efficiencies in manufacturing operations worldwide, ongoing cost control measures, and a lower overall manufacturing cost structure as a result of our globalization initiatives, all while generating higher revenue than during the prior quarter.

Our gross margin percentage significantly increased for the three months ended September 30, 2010 compared to the three months ended September 30, 2009 principally due to stronger demand for our products, a more favorable product mix, significant volume efficiencies in manufacturing operations worldwide, continued cost control measures, a lower overall manufacturing cost structure as a result of our globalization initiatives and lower inventory obsolescence during the three months ended September 30, 2010, partially offset by an increase in employee-related expenses.

**Engineering, Research and Development ( R&D )**

| (Dollar amounts in thousands)                             | Three months ended |               |                    | Q1 FY11 vs. |     | Q1 FY11 vs. |     |
|---|--------------------|---------------|--------------------|-------------|-----|-------------|-----|
|   | September 30, 2010 | June 30, 2010 | September 30, 2009 | Q4 FY10     | 14% | Q1 FY10     | 21% |
| R&D expenses  | \$ 94,720          | \$ 83,309     | \$ 78,209          | \$ 11,411   | 14% | \$ 16,511   | 21% |
| Stock-based compensation expense included in R&D expenses | \$ 7,618           | \$ 7,176      | \$ 6,603           | \$ 442      | 6%  | \$ 1,015    | 15% |
| R&D expenses as a percentage of total revenues            | 14%                | 15%           | 23%                |             |     |             |     |

R&D expenses during the three months ended September 30, 2010 increased compared to the three months ended June 30, 2010 primarily due to increases in employee-related expenses and engineering material costs, while also reflecting the impact of a decrease in external funding from government grants. During the three months ended September 30, 2010, we increased engineering headcount and continued to be aggressive in our R&D efforts for next generation development programs. The following are expenses that were recorded in the three months ended September 30, 2010 compared to the three months ended June 30, 2010:

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

\$57.0 million for employee-related expenses, compared to \$53.8 million during the three months ended June 30, 2010,

\$27.2 million for engineering material costs, compared to \$22.5 million in the three months ended June 30, 2010, and

\$2.8 million of benefit to R&D expense from external funding, compared to \$6.0 million during the three months ended June 30, 2010.

**Table of Contents**

R&D expenses during the three months ended September 30, 2010 increased compared to the three months ended September 30, 2009 due to a combination of additional headcount, consultants, engineering material costs, and higher bonus accrual rates. The following are expenses that were recorded in the three months ended September 30, 2010 compared to the three months ended September 30, 2009:

\$57.0 million for employee-related expenses, compared to \$47.7 million during the three months ended September 30, 2009,

\$27.2 million for engineering material costs, compared to \$19.9 million in the three months ended September 30, 2009,

\$8.3 million for outside services such as consulting and legal, compared to \$5.7 million during the three months ended September 30, 2009, and

\$2.8 million of benefit to R&D expense from external funding, compared to \$1.4 million during the three months ended September 30, 2009.

R&D expenses include the benefit of \$2.8 million, 6.0 million and \$1.4 million of external funding received during the three months ended September 30, 2010, June 30, 2010 and September 30, 2009, respectively, for certain strategic development programs from government grants.

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

**Selling, General and Administrative ( SG&A )**

| (Dollar amounts in thousands)                              | Three months ended    |                  |                       | Q1 FY11 vs. |    | Q1 FY11 vs. |     |
|--|-----------------------|------------------|-----------------------|-------------|----|-------------|-----|
|  | September 30,<br>2010 | June 30,<br>2010 | September 30,<br>2009 | Q4 FY10     | 1% | Q1 FY10     | 13% |
| SG&A expenses  | \$ 88,037             | \$ 87,349        | \$ 77,636             | \$ 688      | 1% | \$ 10,041   | 13% |
| Stock-based compensation expense included in SG&A expenses | \$ 12,427             | \$ 12,414        | \$ 10,308             | \$ 13       | 0% | \$ 2,119    | 21% |
| SG&A expenses as a percentage of total revenues            | 13%                   | 16%              | 23%                   |             |    |             |     |

SG&A expenses during the three months ended September 30, 2010 were higher compared to the three months ended June 30, 2010 primarily due to increases in employee-related expenses associated with higher headcount, litigation expenses, and reduction in the recovery of bad debt expenses, offset by impairment expenses of real estate assets. The following are expenses that were recorded in the three months ended September 30, 2010 compared to the three months ended June 30, 2010:

\$93.0 million for employee-related expenses, compared to \$87.6 million in the three months ended June 30, 2010,

No impairment expenses of real estate assets, compared to \$4.5 million during the three months ended June 30, 2010,

\$2.1 million for legal expenses related to various litigation matters, compared to \$0.3 million during the three months ended June 30, 2010, and

\$0.6 million of bad debt recovery, compared to \$2.9 million during the three months ended June 30, 2010.

SG&A expenses during the three months ended September 30, 2010 were higher compared to the three months ended September 30, 2009 primarily due to increases in the bonus accrual rate as a result of improved economic conditions. This was partially offset by a decrease in litigation expenses related to the shareholder litigation relating to our historical stock option practices. The following are expenses that were recorded in the three months ended September 30, 2010 compared to the three months ended September 2009:

\$93.0 million for employee-related expenses, compared to \$66.6 million in the three months ended September 30, 2009, and

\$2.1 million for litigation expenses, compared to \$8.5 million during the three months ended September 30, 2009.

**Restructuring Charges**

In March 2009, we announced a plan to further reduce our global workforce by approximately 10%, which followed our announcement in November 2008 of a global workforce reduction of approximately 15%. We have undertaken a number of cost reduction activities, including these workforce reductions, in an effort to lower our quarterly operating expense run rate. The program in the United States is accounted for in accordance with the authoritative guidance related to compensation for nonretirement postemployment benefits, whereas the programs in the international locations are accounted for in accordance with the authoritative guidance for contingencies.

**Table of Contents**

The following table shows the activity primarily related to severance and benefits expense for the three months ended September 30, 2010 and 2009:

| (In thousands)      | Three months ended<br>September 30,<br>2010 | Three months ended<br>September 30,<br>2009 |
|---------------------|---|---|
| Beginning balance   | \$ 1,221                                    | \$ 8,086                                    |
| Restructuring costs | 365   | 583   |
| Adjustments         | (22)  | (536)                                       |
| Cash payments       | (975)                                       | (4,099)                                     |
| Ending balance      | \$ 589                                      | \$ 4,034                                    |

Substantially all of the remaining accrued restructuring balance related to the Company's workforce reductions is expected to be paid out by the end of calendar year 2010.

**Interest Income and Other, Net and Interest Expense**

| (Dollar amounts in thousands)                                    | September 30, 2010 | Three months ended<br>June 30, 2010 | September 30, 2009 |
|--|--------------------|-------------------------------------|--------------------|
| Interest income and other, net                                   | \$ 1,225           | \$ 2,686                            | \$ 21,299          |
| Interest expense   | \$ 13,529          | \$ 13,426                           | \$ 13,457          |
| Interest income and other, net as a percentage of total revenues | 0.18%              | 0.48%                               | 6.22%              |
| Interest expense as a percentage of total revenues               | 1.98%              | 2.40%                               | 3.93%              |

Interest income and other, net is comprised primarily of interest income earned on our investment and cash portfolio, realized gains or losses on sales of marketable securities, as well as gains or losses recorded upon settlement of certain foreign currency contracts. The decrease in interest income and other, net during the three months ended September 30, 2010 compared to the three months ended June 30, 2010 was primarily attributable to an increase in foreign exchange loss due to the revaluation of certain foreign currency denominated assets during the three months ended September 30, 2010. The decrease in interest income and other, net during the three months ended September 30, 2010 compared to September 30, 2009 was primarily due to a benefit of \$15.9 million that we recorded during the three months ended September 30, 2009 upon expiration of a statute of limitations relating to an uncertainty in our position with respect to a foreign transaction-based tax.

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

**Provision for Income Taxes**

The following table provides details of income taxes:

| (Dollar amounts in thousands) | September 30, 2010 | Three months ended<br>June 30, 2010 | September 30, 2009 |
|-------------------------------|--------------------|-------------------------------------|--------------------|
| Income before income taxes    | \$ 223,312         | \$ 150,102                          | \$ 22,792          |
| Provision for taxes           | \$ 69,116          | \$ 37,017                           | \$ 2,387           |
| Effective tax rate            | 31.0%              | 24.7%                               | 10.5%              |

The Company's estimated effective tax rate for the year is approximately 30%.



## Edgar Filing: KLA TENCOR CORP - Form 10-Q

The difference between the actual effective tax rate during the quarter and the estimated annual effective tax rate is due to the tax impact of the following during the three months ending September 30, 2010:

Tax expense was increased by \$9.1 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.

**Table of Contents**

Tax expense was decreased by \$3.4 million by a non-taxable increase in the assets held within our Executive Deferred Savings Plan and by \$2.9 million due to the tax effect of inter-company dividends.

Tax expense was lower as a percentage of income during the three months ended September 30, 2009 compared to the three months ended September 30, 2010 primarily due to a decrease in tax expense of \$4.1 million resulting from a non-taxable increase in the assets held within our Executive Deferred Savings Plan during the three months ended September 30, 2009. This decrease in tax expense during the three months ended September 30, 2009 had a significant impact on our effective tax rate due to the lower level of income generated during the quarter.

Tax expense was lower as a percentage of income during the three months ended June 30, 2010 compared with the three months ended September 30, 2010 primarily due to an increase of earnings in jurisdictions with tax rates lower than the U.S. statutory tax rate during the three months ended June 30, 2010.

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

On October 8, 2010, the California legislature approved the 2010-2011 budget bills, which included various income tax provisions, including suspending utilization of net operating loss carry forwards. We do not expect a material impact to the effective tax rate from the income tax provisions in the bills.

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

**LIQUIDITY AND CAPITAL RESOURCES**

| <b>(Dollar amounts in thousands)</b>                          | <b>September 30, 2010</b> | <b>June 30, 2010</b>      |
|---|---------------------------|---------------------------|
| Cash and cash equivalents                                     | \$ 538,384                | \$ 529,918                |
| Marketable securities   | 980,608                   | 1,004,126                 |
| <b>Total cash, cash equivalents and marketable securities</b> | <b>\$ 1,518,992</b>       | <b>\$ 1,534,044</b>       |
| Percentage of total assets                                    | 38%                       | 39%                       |
|   | <b>Three months ended</b> |                           |
|   | <b>September</b>          | <b>September 30, 2009</b> |
|   | <b>30, 2010</b>           | <b>September 30, 2009</b> |
| Cash flow:  |                           |                           |
| Net cash provided by operating activities                     | \$ 95,528                 | \$ 73,249                 |
| Net cash provided by (used in) investing activities           | 14,155                    | (40,121)                  |
| Net cash used in financing activities                         | (110,505)                 | (24,522)                  |
| Effect of exchange rate changes on cash and cash equivalents  | 9,288                     | 7,266                     |
| Net increase in cash and cash equivalents                     | \$ 8,466                  | \$ 15,872                 |

At September 30, 2010, our cash, cash equivalents and marketable securities totaled \$1.5 billion, a decrease of \$15.1 million from the value at June 30, 2010. We generated \$95.5 million in cash from operations and \$14.2 million from investing activities during the three months ended

Edgar Filing: KLA TENCOR CORP - Form 10-Q

September 30, 2010. We used \$110.5 million in cash for financing activities during the three months ended September 30, 2010.

**Table of Contents**

We have historically financed our operations through cash generated from operations. Net cash provided by operating activities during the three months ended September 30, 2010 increased compared to the three months ended September 30, 2009 from \$73.2 million to \$95.5 million primarily as a result of the following key factors:

An increase in cash collections by approximately \$304 million during the three months ended September 30, 2010 as compared to the three months ended September 30, 2009, due to higher sales volume, offset by

An increase in vendor payments by approximately \$141 million during the three months ended September 30, 2010 as compared to the three months ended September 30, 2009, to support a higher level of business activities,

An increase in payroll expenses by approximately \$96 million during the three months ended September 30, 2010 as compared to the three months ended September 30, 2009, mainly due to the bonus payment for fiscal year 2010, and

An increase in tax payments by approximately \$39 million during the three months ended September 30, 2010 as compared to the three months ended September 30, 2009, due to higher profitability.

Investing activities during the three months ended September 30, 2010 generated net cash of \$14.2 million, as compared to using net cash of \$40.1 million during the three months ended September 30, 2009, and this change was primarily the result of the following factors:

An increase in the proceeds from sales and maturities of available-for-sale and trading securities, net of purchases, of approximately \$62 million, offset by

An increase in capital expenditures of approximately \$8 million.

Net cash used in financing activities during the three months ended September 30, 2010 increased compared to the three months ended September 30, 2009 from \$24.5 million to \$110.5 million as a result of our recently announced dividend increase and higher common stock repurchases. We repurchased \$62.2 million of our common stock during the three months ended September 30, 2010, as compared to no stock repurchases during the three months ended September 30, 2009.

During the three months ended September 30, 2010, our Board of Directors declared a dividend of \$0.25 per share of our outstanding common stock, which was paid on September 1, 2010 to our stockholders on record as of August 16, 2010. During the same period in fiscal year 2010, our Board of Directors declared and paid a quarterly cash dividend of \$0.15 per share. The total amount of dividends paid during the three months ended September 30, 2010 and 2009 were \$41.8 million and \$25.6 million, respectively.

The following is a schedule summarizing our significant obligations to make future payments under contractual obligations as of September 30, 2010:

| (In thousands)  | Total      | Fiscal year ending June 30, |        |        |        |        | Thereafter | Other  |
|---|------------|-----------------------------|--------|--------|--------|--------|------------|--------|
|   |            | 2011(2)                     | 2012   | 2013   | 2014   | 2015   |            |        |
| Long-term debt obligations(1)                               | \$ 750,000 | \$                          | \$     | \$     | \$     | \$     | \$ 750,000 |        |
| Interest expense associated with long-term debt obligations | 392,438    | 38,813                      | 51,750 | 51,750 | 51,750 | 51,750 | 146,625    |        |
| Purchase commitments  | 355,639    | 349,383                     | 4,442  | 1,026  | 491    | 253    | 44         |        |
| Non-current income tax payable(3)                           | 63,820     |                             |        |        |        |        |            | 63,820 |

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

|   |                     |                   |                  |                  |                  |                  |                   |                  |
|---|---------------------|-------------------|------------------|------------------|------------------|------------------|-------------------|------------------|
| Operating leases                          | 27,785              | 6,890             | 6,596            | 4,386            | 3,013            | 1,846            | 5,054             |                  |
| Pension obligations                       | 23,806              | 1,301             | 1,572            | 1,960            | 1,927            | 2,541            | 14,505            |                  |
| <b>Total contractual cash obligations</b> | <b>\$ 1,613,488</b> | <b>\$ 396,387</b> | <b>\$ 64,360</b> | <b>\$ 59,122</b> | <b>\$ 57,181</b> | <b>\$ 56,390</b> | <b>\$ 916,228</b> | <b>\$ 63,820</b> |

- (1) In April 2008, we issued \$750 million aggregate principal amount of senior notes due in 2018.
- (2) Remaining 9 months.
- (3) Represents the non-current income tax payable obligation. We are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

**Table of Contents**

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

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs and related discounting fees paid for the three months ended September 30, 2010 and 2009:

| (In thousands)                              | Three months ended    |                       |
|---|-----------------------|-----------------------|
|   | September 30,<br>2010 | September 30,<br>2009 |
| Receivables sold under factoring agreements | \$ 60,025             | \$ 30,201             |
| Proceeds from sales of LCs                  | \$ 50,831             | \$ 10,507             |
| Discounting fees paid on sales of LCs (1)   | \$ 105                | \$ 123                |

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

We maintain guarantee arrangements available through various financial institutions for \$26.2 million, of which \$18.8 million have been issued primarily to fund guarantees to customs authorities for VAT and other operating requirements of our subsidiaries in Europe and Asia as of September 30, 2010.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply chain for key components. Our liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. Our open inventory purchase commitments were approximately \$355.6 million as of September 30, 2010, most of which is 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 change in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

We provide standard warranty coverage on our systems for 40 hours per week for twelve months, providing labor and parts necessary to repair the systems during the warranty period. We account for the estimated warranty cost as a charge to cost of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. The actual product performance and/or field expense profiles may differ, and in those cases we adjust our warranty accruals accordingly. The difference between the estimated and actual warranty costs tends to be larger for new product introductions as there is limited historical product performance to estimate warranty expense; more mature products with longer product performance histories tend to be more stable in our warranty charge estimates. Non-standard warranty coverage generally includes services incremental to the standard 40-hour per week coverage for twelve months. See Note 13, Commitments and Contingencies, to the Condensed Consolidated Financial Statements for a detailed description.

Working capital increased to \$2.2 billion as of September 30, 2010, compared to \$2.1 billion as of June 30, 2010. As of September 30, 2010, our principal sources of liquidity consisted of \$1.5 billion of cash, cash equivalents, and marketable securities. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, we believe that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for at least the next twelve months.

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

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

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

**Table of Contents**

In April 2008, we issued \$750 million aggregate principal amount of 6.90% senior, unsecured long-term debt due in 2018 with an effective interest rate of 7.00%. The discount on the debt amounted to \$5.4 million and is being amortized over the life of the debt using the straight-line method as opposed to the interest method due to immateriality. Interest is payable semi-annually on November 1 and May 1. The debt indenture includes covenants that limit our ability to grant liens on our facilities and to enter into sale and leaseback transactions, subject to significant allowances under which certain sale and leaseback transactions are not restricted. We are in compliance with all of our covenants as at September 30, 2010.

Our credit ratings and outlooks as of October 11, 2010 are summarized below.

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

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

**Off-Balance Sheet Arrangements**

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

| (In thousands)                         | As of<br>September 30, 2010 | As of<br>June 30, 2010 |
|--|-----------------------------|------------------------|
| Cash flow hedge contracts              |                             |                        |
| Purchase                               | \$ 14,551                   | \$ 15,835              |
| Sell                                   | (68,792)                    | (32,853)               |
| Other foreign currency hedge contracts |                             |                        |
| Purchase                               | 81,323                      | 82,535                 |
| Sell                                   | (64,885)                    | (104,414)              |
| Net                                    | \$ (37,803)                 | \$ (38,897)            |

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments, such as foreign currency hedges. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position as of September 30, 2010. Actual results may differ materially.

As of September 30, 2010, we had an investment portfolio of fixed income securities of \$980.6 million, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of September 30, 2010, the fair value of the portfolio would decline by \$1.0 million.



## Edgar Filing: KLA TENCOR CORP - Form 10-Q

As of September 30, 2010, we had net forward contracts to sell \$37.8 million in foreign currency in order to hedge certain currency exposures (detail of these contracts is included in Note 15, Derivative Instruments and Hedging Activities, to the Condensed Consolidated Financial Statements for a detailed description). If we had entered into these contracts on September 30, 2010, the U.S. dollar equivalent would have been \$37.9 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by \$19.7 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that, as a result of the hedging of certain of our foreign currency exposure, changes in the most relevant foreign currency exchange rates should have no material impact on our income or cash flows.

---

## **Table of Contents**

In April 2008, we issued \$750 million aggregate principal amount of 6.90% senior unsecured notes due in 2018. The fair market value of long-term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall and decrease as interest rates rise. At September 30, 2010, the book value and the fair value of our fixed rate debt were \$745.9 million and \$848.3 million, respectively.

### **ITEM 4. CONTROLS AND PROCEDURES**

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

##### *Evaluation of Disclosure Controls and Procedures*

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

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

##### *Definition of Disclosure Controls*

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

##### *Limitations on the Effectiveness of Controls*

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

There have been no changes in our internal control over financial reporting during the three months ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



---

**Table of Contents**

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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

**ITEM 1A. RISK FACTORS**

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

**Risks Associated with Our Industry and Market Conditions**

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

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

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

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

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

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

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

---

**Table of Contents**

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

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

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

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

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

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

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

**Risks Related to Our Business**

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

---

**Table of Contents**

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

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

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

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

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

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

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



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

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

## **Table of Contents**

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

Our success is dependent in part on our technology and other proprietary rights. We own various United States and international patents and have additional pending patent applications relating to some of our products and technologies. The process of seeking patent protection is lengthy and expensive, and we cannot be certain that pending or future applications will actually result in issued patents or that issued patents will be of sufficient scope or strength to provide meaningful protection or commercial advantage to us. Other companies and individuals, including our larger competitors, may develop technologies and obtain patents relating to our business that are similar or superior to our technology or may design around the patents we own, adversely affecting our business. In addition, we at times engage in collaborative technology development efforts with our customers and suppliers, and these collaborations may constitute a key component of certain of our ongoing technology and product research and development projects. The termination of any such collaboration, or delays caused by disputes or other unanticipated challenges that may arise in connection with any such collaboration, could significantly impair our research and development efforts, which could have a material adverse impact on our business and operations.

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

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

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

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

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

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

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

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

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

## Table of Contents

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

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

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

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

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

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

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

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

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

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

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

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

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

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

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

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

---

**Table of Contents**

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

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

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

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

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

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

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

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

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

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

We are subject to various risks related to compliance with new, existing, different, inconsistent or even conflicting laws, rules and regulations enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply, including environmental, safety, antitrust and export control regulations. For example, we are or may become subject to existing or future environmental and safety regulations (including those related to climate change) in connection with our global business operations, including regulations

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

related to the development, manufacture and use of our products, recycling and disposal of materials used in our products or in producing our products, the operation of our facilities, and the use of our real property. Our failure or inability to comply with existing or future laws, rules or regulations, or changes to existing laws, rules or regulations, including changes that result in inconsistent or conflicting laws, rules or regulations, in the countries in which we operate could result in violations of contractual or regulatory obligations that may adversely affect our operating results, financial condition and our ability to conduct our business.

---

**Table of Contents**

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

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

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

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

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

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

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



---

**Table of Contents**

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

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

***There are risks associated with our outstanding indebtedness.***

As of September 30, 2010, we had \$750 million aggregate principal amount of outstanding indebtedness represented by our senior notes that will mature in 2018, and we may incur additional indebtedness in the future. Our ability to pay interest and repay the principal for our indebtedness is dependent upon our ability to manage our business operations and the other risk factors discussed in this section. There can be no assurance that we will be able to manage any of these risks successfully.

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

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

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

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

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

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

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

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

investment in us and could also adversely impact our ability to raise capital through the sale of our common stock or to use our common stock as consideration to acquire other companies.

---

**Table of Contents**

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

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

As noted above, we recorded a material charge during the fiscal year ended June 30, 2009 related to the impairment of our goodwill and purchased intangible assets. Goodwill represents the excess of costs over the net fair value of net assets acquired in a business combination. Goodwill is not amortized, but is instead tested for impairment at least annually in accordance with authoritative guidance for goodwill. Purchased intangible assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment in accordance with authoritative guidance for long-lived assets. The valuation of goodwill and intangible assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. A substantial decline in our stock price, or any other adverse change in market conditions, particularly if such change has the effect of changing one of the critical assumptions or estimates we used to calculate the amount of such impairment charge, could result in a change to the estimation of fair value that could result in an additional impairment charge.

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

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

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

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

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

addition, our reputation with our customers could be damaged as a result of such product defects, which could reduce demand for our products and negatively impact our business.

**Table of Contents**

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

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

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

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

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS****Recent Sales of Unregistered Securities**

On March 15, 2010 we entered into a Stipulation of Settlement with respect to the derivative lawsuits related to the Company's historical stock option practices. In connection with such settlement, which was approved by the U.S. District Court for the Northern District of California on May 26, 2010, we became obligated as of June 28, 2010 (the effective date of the settlement, per the terms of the Stipulation) to, among other things, issued \$8 million in shares of our common stock to plaintiffs' counsel within ten business days following such effective date. On July 12, 2010, without using an underwriter, we issued 263,106 shares of our common stock to plaintiffs' counsel in connection with such settlement, with the number of shares determined by dividing \$8 million by the average daily closing price of our common stock for the ten trading days immediately preceding June 28, 2010. Because the U.S. District Court approved the terms of the settlement, which included the issuance of these securities, the securities were issued pursuant to the exemption from registration provided by Section 3(a)(10) of the Securities Act of 1933, as amended.

**Equity Repurchase Plans**

The following is a summary of stock repurchases for the three months ended September 30, 2010: <sup>(1)</sup>

| Period                        | Total Number of Shares Purchased (2) | Average Price Paid per Share | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (3) |
|-------------------------------|--------------------------------------|------------------------------|--|
| July 1, 2010 to July 31, 2010 | 1,105,000                            | \$ 29.70                     | 4,101,000  |

## Edgar Filing: KLA TENCOR CORP - Form 10-Q

|   |                  |           |              |           |
|---|------------------|-----------|--------------|-----------|
| August 1, 2010 to August 31, 2010       | 459,852          | \$        | 30.22        | 3,641,148 |
| September 1, 2010 to September 30, 2010 | 406,897          | \$        | 30.98        | 3,234,251 |
| <b>Total</b>                            | <b>1,971,749</b> | <b>\$</b> | <b>30.09</b> |           |

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

**Table of Contents**

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**  
None.

**ITEM 4. (REMOVED AND RESERVED)**

**ITEM 5. OTHER INFORMATION**  
None.

**Table of Contents**

**ITEM 6. EXHIBITS**

- 10.45 Fiscal Year 2011 Performance Bonus Plan \* +
- 31.1 Certification of Chief Executive Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
- 31.2 Certification of Chief Financial Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C Section 1350.

\* Denotes a management contract, plan or arrangement.

+ Confidential treatment has been requested as to a portion of this exhibit.



**Table of Contents**

**SIGNATURES**

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

|                            |  |
|----------------------------|--|
|                            | <b>KLA-Tencor Corporation</b><br>(Registrant)  |
| October 28, 2010<br>(Date) | /s/ RICHARD P. WALLACE<br>Richard P. Wallace<br><br>President and Chief Executive Officer<br><br>(Principal Executive Officer)                     |
| October 28, 2010<br>(Date) | /s/ MARK P. DENTINGER<br>Mark P. Dentinger<br><br>Executive Vice President and Chief Financial Officer<br><br>(Principal Financial Officer)        |
| October 28, 2010<br>(Date) | /s/ VIRENDRA A. KIRLOSKAR<br>Virendra A. Kirloskar<br><br>Senior Vice President and Chief Accounting Officer<br><br>(Principal Accounting Officer) |

**Table of Contents**

**KLA-TENCOR CORPORATION**

**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>   | <b>Form</b> | <b>Incorporated by Reference</b> |                           | <b>Filing<br/>Date</b> |
|---------------------------|--|-------------|----------------------------------|---------------------------|------------------------|
|                           |  |             | <b>File<br/>No.</b>              | <b>Exhibit<br/>Number</b> |                        |
| 10.45                     | Fiscal Year 2011 Performance Bonus Plan * +  |             |                                  |                           |                        |
| 31.1                      | Certification of Chief Executive Officer under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 |             |                                  |                           |                        |
| 31.2                      | Certification of Chief Financial Officer under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934 |             |                                  |                           |                        |
| 32                        | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350        |             |                                  |                           |                        |

\* Denotes a management contract, plan or arrangement.

+ Confidential treatment has been requested as to a portion of this exhibit.