

KLA TENCOR CORP
Form 10-Q
January 28, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

or

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

Commission File Number 000-09992

KLA-Tencor Corporation

(Exact name of registrant as specified in its charter)

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

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

(Unaudited)

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

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Total liabilities and stockholders' equity

\$ 4,168,461 \$ 3,907,056

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

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

(Unaudited)

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

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

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

(Unaudited)

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

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Supplemental cash flow disclosures:

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

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

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KLA-TENCOR CORPORATION

Notes to Condensed Consolidated Financial Statements

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

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

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

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

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

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

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

Recent Accounting Pronouncements

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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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.

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

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

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

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

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

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

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

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

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

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

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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 Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (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:				
Money market and other	4	4		
Mutual funds	109,226	85,254	23,972	
 Executive Deferred Savings Plan total	 109,230	 85,258	 23,972	
Derivative assets	296		296	
Total financial assets	\$ 1,489,975	\$ 747,166	\$ 725,984	\$ 16,825
Derivative liabilities	\$ (5,824)	\$	\$ (5,824)	\$
Total financial liabilities	\$ (5,824)	\$	\$ (5,824)	\$

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

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

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

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

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

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

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

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

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

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

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

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

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Total	\$ 296,623	\$ (984)
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- (1) Of the total gross unrealized losses, there were no amounts that have been in a continuous loss position for 12 months or more.

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

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

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

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

Executive Deferred Savings Plan

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

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

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

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

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

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

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

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

Table of Contents**Purchased Intangible Assets**

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

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

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

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

NOTE 6 LONG-TERM DEBT

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

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

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

NOTE 7 STOCK-BASED COMPENSATION

Equity Incentive Program

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

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

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

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

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

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

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

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

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

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

Stock Options

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

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

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

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

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

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

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

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

Restricted Stock Units

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

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

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

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

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

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

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

Employee Stock Purchase Plan

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

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 9 NET INCOME PER SHARE

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

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

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

Table of Contents**NOTE 10 COMPREHENSIVE INCOME**

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

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

NOTE 11 INCOME TAXES

The following table provides details of income taxes:

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

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

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

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

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

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

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

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

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

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

NOTE 12 LITIGATION AND OTHER LEGAL MATTERS

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

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

NOTE 13 COMMITMENTS AND CONTINGENCIES

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

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

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

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

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

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

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

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

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

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

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

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

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

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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.

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

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

NOTE 14 RESTRUCTURING CHARGES

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

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

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

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

NOTE 15 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

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

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

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

Derivatives in Cash Flow Hedging Relationships: Foreign Exchange Contracts

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

(In thousands)	Location in Financial Statements Three months ended December 31, 2010					Three months ended December 31, 2009				
	Accumulated OCI	Revenues	Costs of revenues	Interest income and other, net	Total	Accumulated OCI	Revenues	Costs of revenues	Interest income and other, net	Total
Derivatives Designated as Hedging Instruments										
Loss in accumulated OCI on derivative (effective portion)	\$ (1,653)				\$ (1,653)	\$ (200)				\$ (200)
Gain (loss) reclassified from accumulated OCI into income (effective portion)		\$ (534)	\$ 312		\$ (222)		\$ (1,120)	\$ 24		\$ (1,096)
Gain recognized in income on derivative (ineffectiveness portion and amount excluded from effectiveness testing)				\$ 266	\$ 266				\$ 202	\$ 202
Derivatives Not Designated as Hedging Instruments										
Gain (loss) recognized in income				\$ (513)	\$ (513)				\$ 401	\$ 401
Derivatives Designated as Hedging Instruments										
Derivatives Designated as Hedging Instruments										
Loss in accumulated OCI on derivative (effective portion)	\$ (1,240)				\$ (1,240)	\$ (402)				\$ (402)
Gain (loss) reclassified from accumulated OCI into income		\$ (1,327)	\$ 170		\$ (1,157)		\$ (1,332)	\$ 24		\$ (1,308)

(effective portion)

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

\$ 147 \$ **147**

\$ (319) \$