KLA TENCOR CORP
Form 10-Q
October 29, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **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)

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

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

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

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

KLA-TENCOR CORPORATION

Condensed Consolidated Balance Sheets

(Unaudited)

(In thousands)	September 30, 2010	June 30, 2010
ASSETS		
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
Total current assets	2,933,361	2,835,465
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
Total assets	$ 4,002,865	$ 3,907,056
LIABILITIES AND STOCKHOLDERS EQUITY		
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
Total current liabilities	763,618	771,787
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
Total liabilities	1,661,608	1,660,445
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

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).

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Operations

(Unaudited)

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

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

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Three months ended September 30, 2010	2009
Cash flows from operating activities:		
Net income	$ 154,196	$ 20,405
Adjustments to reconcile net income to net cash provided by operating activities:		
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)
Changes in assets and liabilities:		
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
Net cash provided by operating activities	95,528	73,249
Cash flows from investing activities:		
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
Net cash provided by (used in) investing activities	14,155	(40,121)
Cash flows from financing activities:		
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)
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
Cash and cash equivalents at beginning of period	529,918	524,967

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).

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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 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 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.

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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.

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.

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.

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.

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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 Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (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 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 (EDSP):				
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 September 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	$ 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	
Total financial assets	$ 1,393,384	$ 695,529	$ 697,855	$
Other current liabilities	$ (3,603)	$	$ (3,603)	$
Total financial liabilities	$ (3,603)	$	$ (3,603)	$

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

	Three months ended 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		

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

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NOTE 3 BALANCE SHEET COMPONENTS

(In thousands)		September 30, 2010		June 30, 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

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

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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:

As of September 30, 2010 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
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

As of June 30, 2010 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated 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 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 Fair Value	Gross Unrealized Losses(1)

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.

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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 Cost	Estimated Fair 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.

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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:

	Three months ended September 30,	
(In thousands)	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 September 30, 2010	As of 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)		As of September 30, 2010			As of June 30, 2010		
Category	Range of Useful Lives	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net 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

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

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 (in thousands)
2011 (remaining 9 months)	$ 24,277
2012	29,931
2013	20,658
2014	15,238
2015	12,472
Thereafter	6,332
Total	$ 108,908

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:

(In thousands)	**Available For Grant**
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)
Balances at September 30, 2010(1)	11,510

(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 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
Total stock-based compensation	$ 24,213	$ 20,199

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 (In thousands)	Weighted-Average 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
Outstanding stock options as of September 30, 2010	10,443	$ 43.71

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.

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The authoritative guidance on stock-based compensation permits companies to select the option-pricing model used to estimate the fair value of their stock-based compensation awards. The Black-Scholes option-pricing model requires the input of 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 September 30, 2010	Three months ended September 30, 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, 2010	June 30, 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 (In thousands) (1)	Weighted-Average Grant Date 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

(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.

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

	Three months ended September 30,	
(In thousands, except for weighted-average grant date fair value)	**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:

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

(*) 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%.

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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 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 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:

(In thousands, except per share data)	**Three months ended September 30, 2010**	**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

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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 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 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 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.

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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:

	Three months ended	
(In thousands)	**September 30, 2010**	**September 30, 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.

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
Total minimum lease payments	$ 27,785

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:

	Three months ended September 30,	
(In thousands)	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)
Ending balance	$ 25,556	$ 15,052

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.

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.

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 September 30, 2010	Three months ended September 30, 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 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.

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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:

	Location in Financial Statements									
	Three months ended September 30, 2010					Three months ended September 30, 2009				
(In thousands)	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										
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)**
Derivatives Not Designated as Hedging Instruments										
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
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)

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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:

	Asset Derivatives			Liability Derivatives		
		September 30, 2010	June 30, 2010		September 30, 2010	June 30, 2010
(In thousands)	Balance Sheet Location	Fair Value		Balance Sheet Location	Fair Value	
Derivatives designated as hedging instruments						
Foreign exchange contract	Other current assets	$ 1,089	$ 125	Other current liabilities	$ 1,355	$ 2,033
Total derivatives designated as hedging instruments		$ 1,089	$ 125		$ 1,355	$ 2,033
Derivatives not designated as hedging instruments						
Foreign exchange contract	Other current assets	$ 2,393	$ 171	Other current liabilities	$ 2,248	$ 3,791
Total derivatives not designated as hedging instruments		2,393	171		$ 2,248	$ 3,791
Total derivatives		$ 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	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	2009
Total revenues	$ (200)	$ (2,591)
Total purchases	882	942

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.

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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:

	Three months ended September 30,			
(Dollar amounts in thousands)	**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):

	Three months ended September 30,			
(Dollar amounts in thousands)	**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%

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

(In thousands)	September 30, 2010	June 30, 2010
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
Total	$ 367,375	$ 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.

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

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward-looking statements. You can identify these and other forward-looking statements by the use of words such as may, will, could, would, should, expects, plans, anticipates, relies, believes, estimates, 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