

KLA TENCOR CORP  
Form 10-Q  
April 28, 2008

**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: March 31, 2008

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 0-09992

**KLA-Tencor Corporation**

(Exact name of registrant as specified in its charter)

Edgar Filing: KLA TENCOR CORP - Form 10-Q

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

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

**One Technology Drive**

**Milpitas, California**

**95035**

(Address of principal executive offices)

(Zip Code)

**(408) 875-3000**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant 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. (Check one):

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of April 17, 2008 there were 170,061,282 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

---

**INDEX**

	<b>Page Number</b>
<b><u>PART I</u></b>	
<b><u>FINANCIAL INFORMATION</u></b>	
Item 1	
Financial Statements (Unaudited)	
<u>Condensed Consolidated Balance Sheets as of March 31, 2008 and June 30, 2007</u>	3
<u>Condensed Consolidated Statements of Operations for the Three Months and Nine Months Ended March 31, 2008 and 2007</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Nine Months Ended March 31, 2008 and 2007</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	23
Item 3	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	36
Item 4	
<u>Controls and Procedures</u>	37
<b><u>PART II</u></b>	
<b><u>OTHER INFORMATION</u></b>	
Item 1	
<u>Legal Proceedings</u>	38
Item 1A	
<u>Risk Factors</u>	38
Item 2	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	45
Item 3	
<u>Defaults upon Senior Securities</u>	45
Item 4	
<u>Submission of Matters to a Vote of Security Holders</u>	45
Item 5	
<u>Other Information</u>	45
Item 6	
<u>Exhibits</u>	45
<b><u>SIGNATURES</u></b>	46
<b><u>EXHIBIT INDEX</u></b>	47

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

## KLA-TENCOR CORPORATION

## Condensed Consolidated Balance Sheets

<i>(In thousands)</i>	March 31, 2008 (unaudited)	June 30, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 563,482	\$ 722,511
Restricted cash	619,895	
Marketable securities	84,392	988,118
Accounts receivable, net	573,284	581,500
Inventories	443,710	535,370
Deferred income taxes	356,323	339,133
Other current assets	135,616	86,139
<b>Total current assets</b>	<b>2,776,702</b>	<b>3,252,771</b>
Land, property and equipment, net	341,186	382,240
Marketable securities	46,803	
Goodwill	315,617	311,856
Purchased intangibles, net	144,937	175,432
Other long-term assets	485,760	500,950
<b>Total assets</b>	<b>\$ 4,111,005</b>	<b>\$ 4,623,249</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 101,239	\$ 92,165
Deferred system profit	188,300	201,747
Unearned revenue	52,216	52,304
Other current liabilities	642,143	659,346
<b>Total current liabilities</b>	<b>983,898</b>	<b>1,005,562</b>
Non-current liabilities:		
Income tax payable	58,921	
Unearned revenue	41,885	46,950
Other non-current liabilities	37,211	20,695
<b>Total liabilities</b>	<b>1,121,915</b>	<b>1,073,207</b>
Commitments and contingencies (Notes 12 and 13) Stockholders' equity:		
Common stock and capital in excess of par value	700,028	967,886
Retained earnings	2,257,049	2,570,751
Accumulated other comprehensive income	32,013	11,405
<b>Total stockholders' equity</b>	<b>2,989,090</b>	<b>3,550,042</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 4,111,005</b>	<b>\$ 4,623,249</b>

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



## KLA-TENCOR CORPORATION

## Condensed Consolidated Statements of Operations

(Unaudited)

<i>(In thousands except per share data)</i>	Three months ended March 31,		Nine months ended March 31,	
	2008	2007	2008	2007
<b>Revenues:</b>				
Product	\$ 476,274	\$ 607,390	\$ 1,568,155	\$ 1,682,619
Service	125,945	108,818	362,867	312,222
Total revenues	602,219	716,208	1,931,022	1,994,841
<b>Costs and operating expenses:</b>				
Costs of revenues	285,650	306,751	876,548	874,642
Engineering, research and development	96,646	106,265	293,503	313,659
Selling, general and administrative	94,723	120,537	365,006	391,536
Total costs and operating expenses	477,019	533,553	1,535,057	1,579,837
Income from operations	125,200	182,655	395,965	415,004
Interest income and other, net	36,009	20,817	66,752	65,931
Income before income taxes and minority interest	161,209	203,472	462,717	480,935
Provision for income taxes	50,229	48,546	179,644	101,551
Income before minority interest	110,980	154,926	283,073	379,384
Minority interest		(141)		1,372
Net income	\$ 110,980	\$ 154,785	\$ 283,073	\$ 380,756
<b>Net income per share:</b>				
Basic	\$ 0.62	\$ 0.78	\$ 1.55	\$ 1.91
Diluted	\$ 0.61	\$ 0.76	\$ 1.52	\$ 1.87
<b>Weighted average number of shares:</b>				
Basic	178,112	197,930	182,397	199,053
Diluted	180,617	203,474	186,303	203,976

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

## KLA-TENCOR CORPORATION

## Condensed Consolidated Statements of Cash Flows

(Unaudited)

<i>(In thousands)</i>	Nine months ended March 31,	
	2008	2007
Cash flows from operating activities:		
Net income	\$ 283,073	\$ 380,756
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	79,907	73,152
Impairment charges	6,163	56,830
Gain on sale of real estate assets	(17,683)	
Non-cash, stock-based compensation	77,189	73,241
Tax benefit from employee stock options	11,573	2,298
Excess tax benefit from stock-based compensation	(7,545)	(3,822)
Minority interest		(1,372)
Net (gain) loss on sale of marketable securities and other investments	(20,806)	1,175
Changes in assets and liabilities:		
Accounts receivable, net	56,228	(39,737)
Inventories	87,109	(31,675)
Other assets	(21,239)	(13,103)
Accounts payable	12,892	(10,998)
Deferred system profit	(13,447)	(8,910)
Other liabilities	(53,613)	(22,619)
Net cash provided by operating activities	479,801	455,216
Cash flows from investing activities:		
Restricted cash	(581,540)	
Acquisitions of businesses, net of cash received	(5,491)	(439,190)
Capital expenditures, net	(47,694)	(54,641)
Proceeds from sale of real estate assets	63,290	
Purchase of available-for-sale securities	(723,312)	(2,912,361)
Proceeds from sale of available-for-sale securities	1,560,720	2,955,029
Proceeds from maturity of available-for-sale securities	16,865	173,203
Net cash provided by (used in) investing activities	282,838	(277,960)
Cash flows from financing activities:		
Issuance of common stock	131,028	122,796
Common stock repurchases	(989,660)	(763,582)
Payment of dividends to stockholders	(82,167)	(72,020)
Excess tax benefit from stock-based compensation	7,545	3,822
Net cash used in financing activities	(933,254)	(708,984)
Effect of exchange rate changes on cash and cash equivalents	11,586	6,953
Net decrease in cash and cash equivalents	(159,029)	(524,775)
Cash and cash equivalents at beginning of period	722,511	1,129,191
Cash and cash equivalents at end of period	\$ 563,482	\$ 604,416

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Supplemental cash flow disclosures:

Income taxes paid, net	\$ 190,608	\$ 162,525
Interest paid	\$ 2,778	\$ 1,514

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



**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 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, 2007, filed with the SEC on August 20, 2007.

The condensed consolidated financial statements include the accounts of KLA-Tencor and its majority-owned subsidiaries. All significant intercompany balances and transactions have been eliminated. The Company has included the results of operations of acquired companies from the date of acquisition.

The results of operations for the three- and nine-month periods ended March 31, 2008 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, 2008.

**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.

**Reclassifications.** The Company has reclassified certain prior period balances to conform to the current year presentation. These reclassifications did not impact any prior amounts of reported total assets, total liabilities, stockholders' equity, results of operations or cash flows.

**Recent Accounting Pronouncements.** In March 2008, the Financial Accounting Standards Board ( "FASB" ) issued Statement of Financial Accounting Standards ( "SFAS" ) No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of SFAS No. 133*. This statement changes the disclosure requirements for derivative instruments and hedging activities. SFAS No. 161 requires the Company to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for the Company's interim period beginning January 1, 2009. The Company is currently evaluating the impact of the implementation of SFAS No. 161 on its consolidated financial position, results of operations and cash flows.

In February 2008, the FASB adopted FASB Staff Position SFAS No. 157-2 - *Effective Date of FASB Statement No. 157* - delaying the effective date of SFAS No. 157 for one year for all non financial assets and non financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company is currently evaluating the impact of the implementation of SFAS No. 157 on its consolidated financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations*. SFAS No. 141(R) retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. SFAS No. 141(R) defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest at their fair values as of the acquisition date. In addition, SFAS No. 141(R) requires expensing of acquisition-related and restructure-related costs, remeasurement of earn-out provisions at fair value, measurement of equity securities issued for purchase at the date of close of the transaction and non-expensing of in-process research and development related intangibles. SFAS No. 141(R) is effective for the Company's business combinations for which the acquisition date is on or after July 1, 2009. The Company is currently evaluating the impact of the implementation of SFAS No. 141(R) on its consolidated financial position, results of operations and cash flows.

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

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51*. This Statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. It requires

consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. This Statement establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation. SFAS No. 160 is effective for the Company's fiscal year beginning July 1, 2009. The Company is currently evaluating the impact of the implementation of SFAS No. 160 on its consolidated financial position, results of operations and cash flows.

In June 2007, the FASB ratified Emerging Issues Task Force (EITF) Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities*. This issue provides that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. EITF Issue No. 07-3 is effective for the Company's fiscal year beginning July 1, 2008. The adoption of EITF Issue No. 07-3 is not expected to have a material impact on the Company's consolidated financial position, results of operations and cash flows.

## NOTE 2 RESTRICTED CASH

During the three months ended March 31, 2008, as required by applicable Belgian regulations, the Company funded a restricted cash account in connection with the Company's proposed acquisition of ICOS Vision Systems Corporation NV (ICOS) containing the aggregate cash consideration of \$392.3 million that may be payable for all securities of ICOS upon successful completion of the offer. The transaction is expected to close in the three months ending June 30, 2008. Please refer to Note 5 Business Combinations for additional information related to the proposed acquisition of ICOS. As of March 31, 2008, the fair value of the restricted cash balance in that account was \$619.9 million, which includes \$38.4 million of gain resulting from exchange rate fluctuation. The cash will be restricted until the termination of the offer, if unsuccessful, or the closing of the acquisition.

## NOTE 3 MARKETABLE SECURITIES

(In thousands)	March 31, 2008	June 30, 2007
Short-term marketable securities:		
U.S. Government agency securities	\$	\$ 3,043
Municipal bonds	77,249	841,427
Corporate debt securities		3,500
Corporate equity securities		283
Money market bank deposits and other	896,391	538,275
Auction rate securities		156,450
	973,640	1,542,978
Less: Amounts included in cash equivalents and restricted cash	(889,248)	(554,860)
Total short-term marketable securities	\$ 84,392	\$ 988,118
Long-term marketable securities:		
Auction rate securities	\$ 46,803	\$
Total long-term marketable securities	\$ 46,803	\$

Our investment portfolio includes 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, and a pool of student loans or collateralized debt obligations whose interest rates are reset, typically 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 held by us are backed by student loans and are collateralized, insured and guaranteed by the United States Federal Department of Education. In addition, all auction rate securities held by us are rated by the major independent rating agencies as either AAA or Aaa. Beginning in February 2008, auctions failed for approximately \$48.2 million in par value of municipal auction rate securities we held because sell orders exceeded buy orders. These failures are not believed to be a credit issue, but rather are caused by a lack of liquidity. The funds associated with these failed auctions may not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures. As a result, we have classified these securities with failed auctions as long-term assets in our consolidated balance sheet. Although we believe our securities continue to represent sound investments, we may be forced to sell some of our auction rate securities portfolio under illiquid market conditions, which could result in our recognizing a loss on such sales. During the three months ended March 31, 2008, the Company recorded a temporary impairment charge of \$0.9

Edgar Filing: KLA TENCOR CORP - Form 10-Q

million (net of tax of \$0.5 million), calculated using a discounted cash flow model, in accumulated other comprehensive income, a component of stockholders' equity. The balance of the long-term marketable securities at March 31, 2008 was \$46.8 million.

**NOTE 4 BALANCE SHEET COMPONENTS**

(In thousands)	March 31, 2008	June 30, 2007
Accounts receivable, net		
Accounts receivable, gross	\$ 585,389	\$ 593,229
Allowance for doubtful accounts	(12,105)	(11,729)
	\$ 573,284	\$ 581,500
<b>Inventories</b>		
Customer service parts	\$ 176,505	\$ 175,763
Raw materials	127,041	155,846
Work-in-process	69,298	105,254
Finished goods and demonstration equipment	70,866	98,507
	\$ 443,710	\$ 535,370
<b>Land, property and equipment, net</b>		
Land	\$ 67,759	\$ 84,456
Buildings and improvements	136,955	151,466
Machinery and equipment	433,277	419,840
Office furniture and fixtures	35,248	37,919
Leasehold improvements	147,867	141,236
Construction in process	8,198	17,191
	829,304	852,108
Less: Accumulated depreciation and amortization	(488,118)	(469,868)
	\$ 341,186	\$ 382,240
<b>Other assets</b>		
Long-term investments	\$ 169,596	\$ 179,725
Deferred tax assets long-term	306,106	309,487
Other	10,058	11,738
	\$ 485,760	\$ 500,950
<b>Other current liabilities</b>		
Warranty and retrofit	\$ 52,220	\$ 66,669
Compensation and benefits	284,084	314,046
Income taxes payable	24,992	85,993
Accrued litigation costs	73,629	13,577
Other accrued expenses	207,218	179,061
	\$ 642,143	\$ 659,346

**NOTE 5 BUSINESS COMBINATIONS**

On February 21, 2008, the Company announced an agreement under which the Company agreed to make a tender offer to acquire ICOS in a cash transaction valued at \$36.50 per share. ICOS is a leading supplier of packaging and interconnect inspection solutions for the semiconductor industry and is a leader in the inspection of photovoltaic solar technologies and LED lighting products. Upon successful completion of the offer, the Company will pay cash consideration of up to \$392.3 million for all securities of ICOS. The transaction is expected to close in the three months ending June 30, 2008.

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

During the three months ended March 31, 2007, the Company acquired SensArray Corporation ( SensArray ), a designer and producer of sensors that are embedded in wafers to collect information on the performance of tools used in the semiconductor manufacturing process, for \$34.1 million in cash. The operating results of SensArray have been included in the Company s consolidated financial statements effective as of the acquisition date.

During the three months ended March 31, 2007, the Company acquired OnWafer Technologies, Inc. ( OnWafer ), a developer of specialized metrology substrates that provide high precision time-sequence measurements that show a wafer s response to tools used in the semiconductor manufacturing process, for \$20.9 million in cash. The operating results of OnWafer have been included in the Company s consolidated financial statements effective as of the acquisition date.

During the three months ended December 31, 2006, the Company completed its acquisition of all of the shares of ADE Corporation ( ADE ), a supplier of semiconductor process control solutions, for \$491.1 million. With the acquisition, the Company gained entry into the wafer metrology market, expanded into a broader range of products and services, and gained access to ADE's workforce and intellectual property portfolio. The operating results of ADE have been included in the Company's consolidated financial statements effective as of the acquisition date.

The following table summarizes the aggregate fair value of the net assets acquired in conjunction with the SensArray, OnWafer, and ADE acquisitions:

(In thousands)	Purchase Price Allocation
Cash	\$ 105,880
Current assets	86,810
Intangibles:	
Existing technology	73,040
Patents	30,200
Trade name / Trademarks	13,210
Customer relationships	34,070
In-Process R&D	4,600
Other intangible assets	8,520
Noncurrent assets	16,673
Goodwill	257,917
Liabilities assumed (1)	(84,813)
	\$ 546,107
Cash consideration	\$ 545,098
Value of options assumed	1,009
Total consideration	\$ 546,107

(1) \$6.6 million of accrued restructuring created as a result of the acquisitions has been included in liabilities assumed.

#### NOTE 6 GOODWILL AND OTHER INTANGIBLE ASSETS

##### Goodwill

The following table presents goodwill balances and movements during the nine months ended March 31, 2008:

(In thousands)	Amount
As of June 30, 2007	\$ 311,856
Adjustments	3,761
As of March 31, 2008	\$ 315,617

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 carrying value of goodwill was allocated to KLA-Tencor's reporting units pursuant to SFAS No. 142, *Goodwill and Other Intangible Assets*. In accordance with SFAS No. 142, KLA-Tencor completed its annual evaluation of goodwill by reporting unit during the quarter ended December 31, 2007 and concluded that there was no impairment as of December 31, 2007. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to the impairment test performed in the quarter ended December 31, 2007. Adjustments to goodwill during the nine months ended March 31, 2008 resulted primarily from revisions to purchase price allocations related to entities that were acquired in the fiscal year ended June 30, 2007.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

**Purchased Intangible Assets**

The components of purchased intangible assets as of March 31, 2008 and June 30, 2007 were as follows:

(in thousands)	Range of Useful Lives	As of March 31, 2008			As of June 30, 2007		
		Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Existing technology	4-7 years	\$ 97,205	\$ 28,974	\$ 68,231	\$ 96,534	\$ 14,152	\$ 82,382
Patents	6-13 years	39,301	15,499	23,802	38,997	8,114	30,883
Trade name / Trademark	4-10 years	20,835	4,528	16,307	20,835	2,086	18,749
Customer relationships	6-7 years	44,870	8,935	35,935	44,870	3,591	41,279
Other	0-1 year	10,835	10,173	662	10,695	8,556	2,139
Total		\$ 213,046	\$ 68,109	\$ 144,937	\$ 211,931	\$ 36,499	\$ 175,432



Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. During the three months ended December 31, 2007, the Company discontinued certain products acquired during the fiscal year ended June 30, 2007. Accordingly, the Company determined that based on estimated cash flows, the carrying amount of certain related intangible assets, primarily existing technology and patents, exceeded fair value by \$6.2 million. An impairment charge of \$6.2 million was recorded during the three months ended December 31, 2007, of which \$5.9 million was recorded to costs of revenues and \$0.3 million to engineering, research and development costs.

For the three months ended March 31, 2008 and 2007, amortization expense for purchased intangible assets was \$8.5 million and \$11.0 million, respectively. For the nine months ended March 31, 2008 and 2007, amortization expense for other intangible assets was \$25.4 million and \$21.6 million, respectively. Based on the intangible assets recorded as of March 31, 2008, 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)
2008 (remaining 3 months)	\$ 7,959
2009	30,893
2010	30,793
2011	29,786
2012	26,698
Thereafter	18,808
<b>Total</b>	<b>\$ 144,937</b>

#### NOTE 7 STOCK-BASED COMPENSATION

KLA-Tencor applies the provisions of SFAS No. 123(R), *Share-Based Payment*. SFAS No. 123(R) establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee's requisite service period.

The following table shows pre-tax stock-based compensation expense for the three and nine months ended March 31, 2008 and 2007:

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2008	2007	2008	2007
Stock-based compensation expense:				
Costs of revenues	\$ 5,670	\$ 6,629	\$ 16,623	\$ 23,218
Engineering, research and development	8,052	11,036	23,753	33,984
Selling, general and administrative	12,133	11,604	36,814	25,182
<b>Total stock-based compensation</b>	<b>\$ 25,855</b>	<b>\$ 29,269</b>	<b>\$ 77,190</b>	<b>\$ 82,384</b>

As of March 31, 2008, the unrecognized stock-based compensation balance was \$167.9 million.

#### Stock Options

The following table shows the number of options granted and grant-date fair value after estimated forfeitures for the three and nine months ended March 31, 2008 and 2007:

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2008	2007	2008	2007
Number of options granted		67	24	294

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Grant-date fair value after estimated forfeitures	\$	\$	242	426	\$ 2,188
---	----	----	-----	-----	----------

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

As of March 31, 2008, the unrecognized stock-based compensation balance related to stock options was \$62.4 million and will be recognized over an estimated weighted average amortization period of 1.9 years.

The following table shows stock-based compensation capitalized as inventory and deferred system profit as of March 31, 2008 and June 30, 2007:

(In thousands)	March 31, 2008	June 30, 2007
Inventory	\$ 6,023	\$ 6,229
Deferred system profit	\$ 1,012	\$ 1,386

### Valuation Assumptions

The Company estimates the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS No. 123(R), as clarified by SEC Staff Accounting Bulletin (SAB) No. 107, *Share-Based Payment*. The fair value of each option grant is 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		Nine months ended	
	March 31, 2008	2007	March 31, 2008	2007
<b>Stock option plan:</b>				
Expected stock price volatility	(*)	32%	34%	34%
Risk free interest rate	(*)	4.7%	4.4%	5.0%
Dividend yield	(*)	1.0%	1.0%	1.1%
Expected life of options (in years)	(*)	4.4	4.7	4.4
<b>Stock purchase plan:</b>				
Expected stock price volatility	33%	35%	33%	35%
Risk free interest rate	3.6%	5.0%	4.2%	5.0%
Dividend yield	1.3%	1.0%	1.1%	1.1%
Expected life of options (in years)	1.3	1.3	1.3	1.3

(\*) There were no stock options issued during the three months ended March 31, 2008.

SFAS No. 123(R) requires the use of option-pricing models that were not developed for use in valuing employee stock options. The Black-Scholes option-pricing model was applied for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option's expected life and the expected price volatility of the underlying stock. The expected stock price volatility assumption was determined using the implied volatility of the Company's common stock. The Company's computation of expected volatility is based on market-based implied volatility from traded options on the Company's stock. The Company believes that implied volatility is more reflective of market conditions and a better indicator of expected volatility than a blended volatility.

### Equity Incentive Program

The Company's equity incentive program is a broad-based, long-term retention program that is intended to attract and retain key employees, and align stockholder and employee interests. The equity incentive program consists of two plans: one under which non-employee directors may be granted options to purchase shares of the Company's stock, and another in which non-employee directors, officers, key employees, consultants and all other employees may be granted options to purchase shares of the Company's stock, restricted stock units and other types of equity awards. For the past several years until June 30, 2006, stock options were generally granted at the market price of the Company's common stock on the date of grant, 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 time-based or performance-based vesting. Substantially all of the Company's employees that meet established performance goals and qualify as key employees participate in its main equity incentive plan. Since July 1, 2006, the Company has granted only restricted stock units under its equity incentive program, except for options granted to non-employee directors, which were part of their regular compensation package for service through the end of the first quarter of fiscal year 2008 but are no longer a component thereof.



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

The 2004 Equity Incentive Plan (the "2004 Plan") provides for the grant of options to purchase shares of the Company's 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. Since the adoption of the 2004 Plan, no further grants are permitted under the 1982 Stock Option Plan or 2000 Nonstatutory Stock Option Plan. On November 15, 2007, the stockholders approved an amendment to the 2004 Plan to, among other things, increase the number of shares of the Company's common stock reserved for issuance under the 2004 Plan by 8.5 million shares. The 2004 Plan permits the issuance of up to 21.0 million shares of common stock, of which 7.4 million shares were available for grant as of March 31, 2008. 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 shall be counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto. Total options outstanding under all plans as of March 31, 2008 were 16.5 million. During the nine months ended March 31, 2008, approximately 0.5 million restricted stock units were granted to senior management with performance-based vesting.

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

(In thousands except for Weighted-Average Exercise Price)	Available For Grant	Options Outstanding	Weighted- Average Exercise Price
Balances at June 30, 2007	3,317	19,585	\$ 42.28
Plan shares expired			
Options granted	(24)	24	\$ 54.81
Restricted stock units granted(1)	(3,837)		
Restricted stock units canceled(1)	635		
Shares added to plans	8,500		
Options canceled/expired/forfeited	327	(327)	\$ 46.67
Options exercised		(2,820)	\$ 38.77
Balances at March 31, 2008(2)	8,918	16,462	\$ 42.36

(1) 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 shall be counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto.

(2) The 2004 Plan is the only equity incentive plan under which the Company is currently authorized to issue restricted stock units. As of March 31, 2008, there were 7.4 million shares available for grant under the 2004 Plan, which amount is equivalent to 4.1 million restricted stock units available for grant after giving effect to the provision in the 2004 Plan that provides that restricted stock unit awards shall be counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto.

The weighted-average grant date fair value of options, as determined under SFAS No. 123(R), granted during the nine months ended March 31, 2008 and 2007 was \$17.95 and \$13.66 per share, respectively. As of March 31, 2008, 12.7 million options were exercisable with a weighted-average exercise price of \$41.67 per share and weighted-average remaining contractual term of 4.4 years. The aggregate intrinsic value for the options exercisable as of March 31, 2008 was \$87.6 million.

The total intrinsic value of options exercised during the nine months ended March 31, 2008 and 2007 was \$56.1 million and \$52.5 million, respectively. The total cash received from employees as a result of employee stock option exercises during the nine months ended March 31, 2008 and 2007 was approximately \$109.7 million and \$112.0 million, respectively. In connection with these exercises, the tax benefits realized by the Company for the nine months ended March 31, 2008 and 2007 were \$27.5 million and \$18.4 million, respectively. The \$27.5 million includes \$7.9 million of tax benefit realized by the Company for the cash bonuses paid during the three months ended March 31, 2008 related to 409A affected options.

### Restricted Stock Units

The following table shows the number of restricted stock units granted and grant-date fair value for the three and nine months ended March 31, 2008 and 2007:

Edgar Filing: KLA TENCOR CORP - Form 10-Q

(In thousands)	Three months ended		Nine months ended	
	March 31,		March 31,	
	2008	2007	2008	2007
Number of restricted stock units granted	29	172	2,132	2,770
Grant-date fair value	\$ 713	\$ 6,395	\$ 62,377	\$ 89,876

Beginning in the fiscal year ended June 30, 2007, the restricted stock units 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 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 was based on the closing market price of the Company's common stock on the date of award. The restricted stock units were awarded under the 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 units, the share reserve under the 2004 Plan will be reduced by 1.8 shares, as provided under the terms of the 2004 Plan.

As of March 31, 2008, the unrecognized stock-based compensation balance related to restricted stock units was \$105.5 million and will be recognized over an estimated weighted-average amortization period of 2.8 years. Additionally, the number of restricted stock units outstanding as of March 31, 2008 was 5.2 million.

#### **Employee Stock Purchase Plan**

KLA-Tencor's Amended and Restated 1997 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. Offering periods are generally two years in length. On September 28, 2006, the ESPP was temporarily suspended due to the ongoing stock option investigation and was not reactivated until February 2007, and accordingly there were no shares purchased under the ESPP during the three and six months ended December 31, 2006. A cash payment of approximately \$4.6 million in lieu of the estimated financial benefit of participating in the ESPP was provided during the three months ended March 31, 2007 to employees below the Vice President level who had been active participants in the ESPP before it was temporarily suspended. After the filing on January 29, 2007 of the Company's Annual Report on Form 10-K for the year ended June 30, 2006 and its Quarterly Report on Form 10-Q for the quarter ended September 30, 2006, approximately 0.3 million shares were purchased under the ESPP on February 1, 2007. Total cash received from employees for the issuance of shares under the ESPP was approximately \$10.8 million during the nine months ended March 31, 2007. No shares were purchased under the ESPP during the three months ended March 31, 2008, and 0.6 million shares were purchased under the ESPP during the nine months ended March 31, 2008. In connection with the ESPP, the Company realized tax benefits of \$1.5 million and \$0.9 million for the nine months ended March 31, 2008 and March 31, 2007, respectively.

The number of shares available for issuance under the ESPP is replenished annually, typically on the first day of each fiscal year, by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. As of March 31, 2008, a total of 1.5 million shares were reserved and available for issuance under the ESPP.

#### **Former Chief Executive Officer Agreement and Termination**

During November 2005, the Company announced that effective January 1, 2006, Kenneth L. Schroeder would cease to be its Chief Executive Officer and would thereafter be employed as a Senior Advisor. The Company and Mr. Schroeder also revised his prior agreement with the Company and defined the salary, bonus payout and equity award vesting during the period of his employment as a Senior Advisor. Effective January 1, 2006, the Company determined that all service conditions associated with certain prior equity awards under the terms of the revised agreement with Mr. Schroeder had been satisfied; and accordingly, the Company recorded at that time an additional non-cash, stock-based compensation charge of approximately \$9.8 million relating to these equity awards. The above mentioned charge is included as a component of Selling, General and Administrative (SG&A) expense during fiscal 2006.

On October 16, 2006, following the Special Committee investigation of the Company's historical stock option practices, the Company terminated all aspects of Mr. Schroeder's employment relationship and agreement with the Company. As a result, vesting of Mr. Schroeder's then outstanding stock options and restricted stock awards immediately ceased, and the 0.9 million unvested option shares and 0.1 million unvested restricted stock award shares held by Mr. Schroeder at the time of termination were canceled. Accordingly, in the second quarter of fiscal 2007, the Company reversed \$20.3 million of the non-cash, stock-based compensation charges in accordance with paragraphs 19 and 43 of SFAS No. 123(R), because Mr. Schroeder would no longer be able to fulfill his service obligations. The \$20.3 million reversal related to the charges that had been recorded in prior periods related to unvested option shares and restricted stock award shares.

In December 2006, the Company canceled 0.6 million vested option shares held by Mr. Schroeder as of the time of termination, representing those shares that had been retroactively priced or otherwise improperly granted. In accordance with paragraph 57 of SFAS No. 123(R), previously recognized stock-based compensation expense related to these awards was not reversed upon cancellation.

**IRC Section 409A Affected Options**

Because virtually all holders of retroactively priced options that had been issued by the Company were not involved in or aware of the retroactive pricing, the Company took certain actions to deal with the adverse tax consequences that may have been incurred by the holders of retroactively priced options. The adverse tax consequences were that retroactively priced stock options vesting after December 31, 2004 ( 409A Affected Options ) subject the option holder to a penalty tax under IRC Section 409A (and, as applicable, similar penalty taxes under California and other state tax laws). One such action by the Company involved offering to amend the 409A Affected Options to increase the exercise price to the market price on the actual grant date or, if lower, the market price at the time of the amendment, in exchange for cash bonus payments to the option holders that were paid in January 2008 in an amount equal to the aggregate increase in exercise prices of the amended 409A Affected Options held by such option holders. The amended options would not be subject to taxation under IRC Section 409A. Under IRS regulations, these option amendments had to be completed by December 31, 2006 for anyone who was an executive officer when he or she received 409A Affected Options; the amendments for non-officers could not be offered until after the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2006 and Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 were filed and did not need to be completed until December 31, 2007. During the fiscal year ended June 30, 2007, the Company accrued approximately \$20.2 million for the cash bonuses payable to non-executive holders of the amended options to compensate them for the resulting increase in their option exercise prices. The \$20.2 million of cash bonuses were paid in January 2008. The amount of these bonuses would be effectively repaid to the Company if and when the options are exercised and the increased exercise price is paid. However, there is no assurance that the options will be exercised, and the employees will retain the bonuses under all circumstances. In order to compensate certain option holders whose employment terminated or who had already exercised 409A Affected Options for the additional taxes they would incur under IRC Section 409A (and, as applicable, similar state tax laws), the Company also recorded approximately \$12.9 million during the nine months ended March 31, 2007 and no such charges during the nine months ended March 31, 2008.

Three of the Company's option holders were subject to the December 31, 2006 deadline described above. Accordingly, in December 2006, the Company offered to amend the 409A Affected Options held by Richard P. Wallace, the Company's Chief Executive Officer, and two former executive officers to increase the exercise price so that their 409A Affected Options would not subject the option holders to a penalty tax under IRC Section 409A. All three individuals accepted the Company's offer. In addition, the Company agreed to pay each of the three individuals a cash bonus in January 2008 equal to the aggregate increase in the exercise prices for his amended options. For Mr. Wallace, the amount of this bonus was \$0.4 million. To account for these actions, the Company recorded a charge of \$0.3 million, net of amount reclassified from capital in excess of par, during the nine months ended March 31, 2007. The cash bonus was paid in January 2008.

In addition, in the three months ended December 31, 2007, the Company agreed to amend 409A Affected Options held by two other executives and, in connection with those amendments, agreed to pay cash bonuses in January 2008 to those two executives equal to the aggregate increase in the exercise prices for such 409A Affected Options. Accordingly, the Company accrued \$0.2 million during the three months ended December 31, 2007. These cash bonuses were paid in January 2008.

With respect to certain former officers whose options were canceled or re-priced by the Company following the Special Committee investigation, no bonuses of the type described above will be paid.

**NOTE 8 STOCK REPURCHASE PROGRAM**

In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. Since the inception of the repurchase program in 1997 through March 31, 2008 the Board of Directors had authorized KLA-Tencor to repurchase a total of 47.8 million shares. The Company's systematic buyback program was temporarily suspended in May 2006, and resumed in February 2007. The Company accounts for repurchased common stock under the cost method and includes such treasury stock as a component of its stockholders' equity. During the three and nine months ended March 31, 2008, the common stock repurchases of \$175.9 million and \$993.0 million, respectively, reduced capital in excess of par and retained earnings. At March 31, 2008, \$3.3 million of the above repurchase payment amount remained unpaid and is recorded in other current liabilities.

In February 2007, the Company entered into an Accelerated Share Repurchase program ( ASR ) with a third-party investment bank and prepaid \$750.0 million to repurchase its common stock. The program had two separate components. The first component was the purchase of shares, and the second component is the forward contract indexed to the Company's own common stock. The purchase price per share of the common stock repurchased through the ASR was determined and adjusted based on a discount to the volume-weighted average price of the Company's common stock during a period following the execution of the ASR agreement, subject to a maximum price per share. The exact number of shares repurchased pursuant to the ASR was determined based on such adjusted price. The ASR completed during the fourth quarter of fiscal year 2007. Under the ASR, the Company repurchased 14.0 million shares of the Company's common stock at an average price of \$53.52 per share of which 12.0 million shares were delivered to the Company during the three months ended March 31, 2007.





Edgar Filing: KLA TENCOR CORP - Form 10-Q

The payment of \$750.0 million was included in the cash flows from financing activities in the Company's Condensed Consolidated Statement of Cash Flows. The shares received were multiplied by the closing stock price on the date of receipt to determine the cost of repurchase. The entire \$750.0 million was recorded in the stockholders' equity section of its Condensed Consolidated Balance Sheet. The Company decreases its shares outstanding as shares are physically received under the Company's repurchase program, including the ASR.

Share repurchases for the three and nine months ended March 31, 2008 were as follows:

(In thousands)	Three months ended March 31, 2008	Nine months ended March 31, 2008
Number of shares of common stock repurchased	4,210	18,566
Total cost of repurchase	\$ 175,945	\$ 993,035

**NOTE 9 EARNINGS PER SHARE**

Basic earnings 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 potentially dilutive shares of common stock 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, which includes consideration of stock-based compensation required by SFAS No. 123(R) and SFAS No. 128, *Earnings Per Share*. The following table sets forth the computation of basic and diluted earnings per share:

(In thousands, except per share amounts)	Three months ended March 31,		Nine months ended March 31,	
	2008	2007	2008	2007
<b>Numerator:</b>				
Net income	\$ 110,980	\$ 154,785	\$ 283,073	\$ 380,756
<b>Denominator:</b>				
Weighted average shares outstanding, excluding unvested restricted stock units	178,112	197,930	182,397	199,053
Effect of dilutive options and restricted stock units (1)	2,505	5,544	3,906	4,923
Denominator for diluted earnings per share	180,617	203,474	186,303	203,976
Basic earnings per share	\$ 0.62	\$ 0.78	\$ 1.55	\$ 1.91
Diluted earnings per share	\$ 0.61	\$ 0.76	\$ 1.52	\$ 1.87

(1) 12.9 million potentially dilutive securities are excluded from the computation of diluted earnings per share for the three months ended March 31, 2008 because their effect would have been anti-dilutive.

During the three months ended March 31, 2008, the Company's Board of Directors authorized a quarterly cash dividend of \$0.15 per share, which was paid on March 3, 2008 to stockholders of record as of the close of business on February 25, 2008. The total amount of dividends paid during the three and nine months ended March 31, 2008 was \$26.6 million and \$82.2 million, respectively. During the three months ended March 31, 2007, the Company declared and paid a quarterly cash dividend of \$0.12 per share. The total amount of dividends paid during the three and nine months ended March 31, 2007 was \$23.9 million and \$72.0 million, respectively.

**NOTE 10 COMPREHENSIVE INCOME**

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

(In thousands)

Edgar Filing: KLA TENCOR CORP - Form 10-Q

	Three months ended		Nine months ended	
	March 31,		March 31,	
	2008	2007	2008	2007
Net income	\$ 110,980	\$ 154,785	\$ 283,073	\$ 380,756
Other comprehensive income (loss):				
Currency translation adjustments	16,891	1,290	39,881	4,036
Gain (loss) on cash flow hedging instruments, net	(9,585)	(2,281)	(20,354)	3,046
Change in unrecognized losses and transition obligation related to pension and post retirement plans	51		106	
Unrealized gains (losses) on investments (1)	(3,864)	(388)	976	3,930
Other comprehensive income (loss)	\$ 3,493	\$ (1,379)	\$ 20,609	11,012
Total comprehensive income	\$ 114,473	\$ 153,406	\$ 303,682	391,768

(1) Taxes (benefits) included in unrealized gains (losses) on investments

**NOTE 11 INCOME TAXES**

The Company recorded a provision of \$50.2 million and \$179.6 million for the three and nine months ended March 31, 2008, respectively, which represent effective tax rates of 31.1% and 38.8%, respectively. The increase in the effective tax rate for the nine months ended March 31, 2008 over the fiscal year ended June 30, 2007 was primarily due to the immediate impact of \$46.6 million of incremental U.S. tax expense associated with the implementation of the Company's global manufacturing strategy during the three months ended September 30, 2007. The incremental U.S. tax expense was a result of an inter-company licensing agreement related to the migration of a portion of the Company's manufacturing activities to Singapore. In addition, there was an increase in the effective tax rate for the nine months ended March 31, 2008 compared to the year ended June 30, 2007 due to decreases in the tax benefits related to the decrease of tax exempt interest as a percentage of pre-tax income, and the expiration of the research and development credit and the extraterritorial income exclusion, partially offset by an increase in income earned outside the United States subject to lower tax rates than the statutory tax rate.

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* — an interpretation of FASB *Statement No. 109* (FIN 48), on July 1, 2007. FIN 48 contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, *Accounting for Income Taxes*. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement.

As a result of the adoption of FIN 48, the Company increased the liability for net unrecognized tax benefits by \$8.4 million, and accounted for the increase as a cumulative effect of change in accounting principle that resulted in a reduction of retained earnings of \$8.4 million at July 1, 2007. The Company has historically classified accruals for tax uncertainties in current taxes payable. Upon adoption of FIN 48, the Company has reclassified taxes payable of \$62.1 million from current to non-current liability. In addition, as a result of the adoption of FIN 48, at March 31, 2008, long-term liabilities increased by \$24.4 million; non-current deferred tax assets increased by \$17.3 million; and goodwill related to acquisitions decreased by \$1.3 million.

As of the adoption date of FIN 48, the Company had gross tax effected unrecognized tax benefits of approximately \$77.2 million, of which \$72.5 million, if recognized, would affect the effective tax rate, while the remaining \$4.7 million would reduce acquisition related goodwill. The change in the uncertain tax benefits for the three and nine months ended March 31, 2008 was a decrease of approximately \$10.3 million and \$2.1 million, respectively, related to various tax positions including the filing of an amended federal income tax return for the year ended June 30, 2005. The Company anticipates an increase of approximately \$2.4 million to the unrecognized tax benefits during the remainder of the year ending June 30, 2008, related to various tax positions. The Company has included the effects of these items in current estimates of the forecasted tax provision for the year ending June 30, 2008. The Company will reexamine the tax provision and the effect of estimated unrecognized tax benefits on the Company's financial position at each reporting period.

The Company's policy is to include interest and penalties related to unrecognized tax benefits within interest income and other, net. As of the adoption date of FIN 48, the Company had accrued interest and penalties related to unrecognized tax benefits of approximately \$12.9 million. The accrued interest and penalties on unrecognized tax benefits decreased by approximately \$2.0 million and increased by \$0.1 million for the three and nine months ended March 31, 2008, respectively, to \$13.0 million as of March 31, 2008.

The Company conducts business globally, and, as a result, the Company and one or more of its subsidiaries file income tax returns in various jurisdictions throughout the world, including with the United States federal government, various U.S. states and foreign jurisdictions. In the normal course of business, the Company is subject to examination by taxing authorities throughout the world. The Company is not under federal income tax examination at this time, except for an Internal Revenue Service audit covering calendar year 2006 related to the Company's historical stock option practices. The Company remains subject to federal income tax examination for all years from the year ended June 30, 2005. The Company is subject to state income tax examinations for all years from the year ended June 30, 2002. The Company is also subject to examinations in major foreign jurisdictions, including Israel and Singapore, for all years from the year ended June 30, 2002 and is currently under tax examinations in various foreign tax jurisdictions.

**NOTE 12 LITIGATION AND OTHER LEGAL MATTERS**

**Government Inquiries and SEC Settlement Relating to Historical Stock Option Practices.** On May 23, 2006, the Company received a subpoena from the United States Attorney's Office ( USAO ) requesting information relating to the Company's past stock option grants and related accounting matters. Also on May 23, 2006, the Company received a letter from the SEC making an informal inquiry and request for information on the same subject matters. The Company learned on February 2, 2007 that the SEC had opened a formal investigation into these matters. The Company cooperated fully with the SEC investigation. On July 25, 2007, the Company announced that it had reached a settlement with the SEC by consenting to the entry of a permanent injunction against future violations of the reporting, books and records, and internal controls provisions of the federal securities laws. The settlement resolves completely the SEC investigation into the Company's historical stock option granting practices. KLA-Tencor was not charged by the SEC with fraud, nor was the Company required to pay any civil penalty, fine or money

damages as part of the settlement.

The Company is cooperating fully with the USAO's continuing inquiry and intends to continue to do so. This inquiry may require the Company to expend significant management time and incur significant legal and other expenses, and could result in criminal actions seeking, among other things, injunctions against the Company and the payment of significant fines and penalties by the Company, which may adversely affect its results of operations and cash flow.

The Company has also responded to inquiries from the U.S. Department of Labor, which is conducting an examination of the Company's 401(k) Savings Plan prompted by the Company's stock option issues. The Company is cooperating fully with this examination and intends to continue to do so. Further, the Internal Revenue Service is conducting an audit covering calendar year 2006 related to the Company's historical stock option practices.

The Company cannot predict how long it will take, or how much more time and resources will be required, to resolve these government inquiries, nor can it predict the outcome of these inquiries. Also, there can be no assurance that other inquiries, investigations or actions will not be started by other United States federal or state regulatory agencies or by foreign governmental agencies.

**Shareholder Derivative Litigation Relating to Historical Stock Option Practices.** Beginning on May 22, 2006, several persons and entities identifying themselves as shareholders of KLA-Tencor filed derivative actions purporting to assert claims on behalf of and in the name of the Company against various of the Company's current and former directors and officers relating to its accounting for stock options issued from 1994 to the present. The complaints in these actions allege that the individual defendants breached their fiduciary duties and other obligations to the Company and violated state and federal securities laws in connection with the Company's historical stock option granting process, its accounting for past stock options, and historical sales of stock by the individual defendants. Three substantially similar actions are pending, one in the U.S. District Court for the Northern District of California (which consists of three separate lawsuits consolidated in one action, hereafter the "Federal Action"); one in the California Superior Court for Santa Clara County; and one in the Delaware Chancery Court.

The plaintiffs in the derivative actions have asserted claims for violations of Sections 10(b) (including Rule 10b-5 thereunder), 14(a), and 20(a) of the Securities Exchange Act of 1934, unjust enrichment, breach of fiduciary duty and aiding and abetting such breach, negligence, misappropriation of information, abuse of control, gross mismanagement, waste of corporate assets, breach of contract, constructive fraud, rescission, and violations of California Corporations Code section 25402, as well as a claim for an accounting of all stock option grants made to the named defendants. KLA-Tencor is named as a nominal defendant in these actions. On behalf of KLA-Tencor, the plaintiffs seek unspecified monetary and other relief against the named defendants. The plaintiffs are James Ziolkowski, Mark Ziering, Alaska Electrical Pension Fund, Jeffrey Rabin and Benjamin Langford. The individual named defendants are current directors and officers Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Jeffrey L. Hall, Stephen P. Kaufman, John H. Kispert, Lida Urbanek and Richard P. Wallace; and former directors and officers Robert J. Boehlke, Leo Chamberlain, Gary E. Dickerson, Richard J. Elkus, Jr., Dennis J. Fortino, Kenneth Levy, Michael E. Marks, Stuart J. Nichols, Arthur P. Schnitzer, Kenneth L. Schroeder and Jon D. Tompkins. Current director David C. Wang and former director Dean O. Morton were originally named as defendants in one of the derivative actions filed in the U.S. District Court for the Northern District of California, but were dropped as named defendants as of December 22, 2006 upon the filing of a consolidated complaint in that action.

The derivative actions are at a preliminary stage. The defendants are not yet required to respond to the complaints in the actions pending in California, and the defendants have moved to dismiss or stay the action pending in Delaware. The Company's Board of Directors has appointed a Special Litigation Committee ("SLC") composed solely of independent directors to conduct an independent investigation of the claims asserted in the derivative actions and to determine the Company's position with respect to those claims. On March 25, 2008, the SLC filed a motion to terminate the Federal Action and to approve certain settlements with individuals as identified below.

During the three months ended March 31, 2008, the Company, acting through the SLC, entered into settlement agreements with each of Gary E. Dickerson, Kenneth Levy and Jon D. Tompkins related to the claims brought against such individuals in connection with the derivative actions. The SLC also entered into an agreement in principle with Kenneth Schroeder related to the claims brought against him in connection with the derivative actions. Each of these agreements is subject to court approval. The agreements, individually and in the aggregate, do not involve amounts that are material to the Company. As of March 31, 2008, the Company has not recorded the gain contingency arising from the settlement agreements discussed above as the gain is not certain. The Company will record any gain upon receiving applicable court approval.

In addition, during the three months ended March 31, 2008, the Company entered into an agreement in principle with Kenneth Schroeder to resolve all claims arising from his employment agreement and departure from the Company. The terms of this agreement in principle are subject to documentation in a final agreement.

**Shareholder Class Action Litigation Relating to Historical Stock Option Practices.** KLA-Tencor and various of its current and former directors and officers were named as defendants in a putative securities class action filed on June 29, 2006 in the U.S. District Court for the Northern District of California. Two similar actions were filed later in the same court, and all three cases have been consolidated into one action (the Northern District Litigation). The consolidated complaint alleges claims under Section 10(b) and Rule 10b-5 thereunder, Section 14(a), Section 20(a), and Section 20A of the Securities Exchange Act of 1934 as a result of the Company's past stock option grants and related accounting and reporting, and seek unspecified monetary damages and other relief. The plaintiffs seek to represent a class consisting of purchasers of KLA-Tencor stock between June 30, 2001 and May 22, 2006 who allegedly suffered losses as a result of material misrepresentations in KLA-Tencor's SEC filings and public statements during that period. The lead plaintiffs, who seek to represent the class, are the Police and Fire Retirement System of the City of Detroit, the Louisiana Municipal Police Employees' Retirement System, and the City of Philadelphia Board of Pensions and Retirement. The defendants are KLA-Tencor, Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Gary E. Dickerson, Richard J. Elkus, Jr., Jeffrey L. Hall, Stephen P. Kaufman, John H. Kispert, Kenneth Levy, Michael E. Marks, Stuart J. Nichols, Kenneth L. Schroeder, Jon D. Tompkins, Lida Urbanek and Richard P. Wallace. This litigation is at an early stage. Discovery has not commenced, and the court has not yet determined whether the plaintiffs may sue on behalf of any class of purchasers. The Company and all other defendants filed motions to dismiss these cases in June 2007, which are now pending before the Court. However, the Company's motions to dismiss have been taken off calendar due to the agreement in principle between the Company and plaintiffs to settle the litigation, as described below.

In December 2007, the Company reached an agreement in principle for the settlement of the Northern District Litigation. Under the terms of a memorandum of understanding entered into in January 2008 confirming such agreement in principle, the Company will be required to make a payment of \$65.0 million to the settlement class. The settlement, which is subject to a final agreement and court approval, will provide a full release of KLA-Tencor and the other named defendants in connection with the allegation raised in the lawsuit. Accordingly, as the liability had been incurred at December 31, 2007 and it could be reasonably estimated, an amount of \$65.0 million was accrued by a charge to SG&A expenses during the three months ended December 31, 2007.

As part of a derivative lawsuit filed in the Delaware Chancery Court on July 21, 2006 (described above), a plaintiff claiming to be a KLA-Tencor shareholder also asserted a separate putative class action claim against the Company and certain of its current and former directors and officers alleging that shareholders incurred damage due to purported dilution of KLA-Tencor common stock resulting from historical stock option granting practices. The Company has moved to dismiss this claim.

Another plaintiff, Chris Crimi, filed a putative class action complaint in the Superior Court of the State of California for the County of Santa Clara on September 4, 2007 against the Company and certain of its current and former directors and officers. The plaintiff seeks to represent a class consisting of persons who held KLA-Tencor common stock between September 20, 2002 and September 27, 2006, alleges causes of action for breach of fiduciary duty and rescission based on alleged misstatements and omissions in the Company's SEC filings concerning the Company's past stock option grants, and seeks unspecified damages based upon purported dilution of the Company's stock, injunctive relief, and rescission. The named defendants, in addition to the Company, are Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Richard J. Elkus, Jr., Stephen P. Kaufman, Kenneth Levy, Michael E. Marks, Dean O. Morton, Kenneth L. Schroeder, Jon D. Tompkins, and Richard P. Wallace. This litigation is at an early stage, and discovery has not yet begun. The Company filed a motion to stay the case pending the resolution of other option-related litigation, as well as a demurrer asking the court to dismiss the case on the ground that the claims have no merit. On February 29, 2008, the Court sustained the Company's demurrer and granted leave to file an amended complaint. Plaintiff filed an amended complaint reasserting the foregoing claims and adding a claim under section 1507 of the California Corporations Code on or about April 1, 2008. The Company intends to vigorously defend this litigation.

The Company cannot predict the outcome of the shareholder class action cases (described above), and it cannot estimate the likelihood or potential dollar amount of any adverse results, other than the Northern District Litigation. However, an unfavorable outcome in any of these cases could have a material adverse impact upon the financial position, results of operations or cash flows for the period in which the outcome occurs and in future periods.

**Indemnification Obligations.** Subject to certain limitations, the Company is obligated to indemnify its current and former directors, officers and employees in connection with the investigation of the Company's historical stock option practices and the related litigation and ongoing government inquiries. These obligations arise under the terms of the Company's 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 is currently paying or reimbursing legal expenses being incurred in connection with these matters by a number of its current and former directors, officers and employees. 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.





**Other Legal Matters.** The Company is named from time to time as a party to lawsuits in the normal course of its business. 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.

### 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 and proceeds from sales of LCs and related discounting fees paid for the three and nine months ended March 31, 2008 and 2007:

(In thousands)	Three months ended		Nine months ended	
	March 31, 2008	March 31, 2007	March 31, 2008	March 31, 2007
Receivables sold under factoring agreements	\$ 62,850	\$ 53,036	\$ 218,262	\$ 197,640
Proceeds from sales of LCs	\$ 20,596	\$ 4,302	\$ 38,125	\$ 43,014
Discounting fees paid on sales of LCs (1)	\$ 149	\$ 47	\$ 226	\$ 545

(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 operating leases, which qualify for operating lease accounting treatment under SFAS No. 13, *Accounting for Leases*, and, as such, these facilities are not included on the Company's Condensed Consolidated Balance Sheet. Rent expense was approximately \$3.4 million and \$2.4 million for the three months ended March 31, 2008 and 2007, respectively. Rent expense was approximately \$9.4 million and \$7.0 million for the nine months ended March 31, 2008 and 2007, respectively.

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

Fiscal year ending June 30,	Amount
2008 (remaining 3 months)	\$ 3,022
2009	10,008
2010	7,088
2011	5,192
2012	2,552
2013 and thereafter	9,874
<b>Total minimum lease payments</b>	<b>\$ 37,736</b>

**Purchase Commitments.** KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. KLA-Tencor's liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company's open inventory purchase commitments were approximately \$150.6 million as of March 31, 2008 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 change 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 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 periodically. The actual product performance and/or field expense profiles may differ, and in those cases KLA-Tencor adjusts warranty accruals accordingly.



The following table provides the changes in the product warranty accrual for the three and nine months ended March 31, 2008 and 2007:

(In thousands)	Three months ended March 31,		Nine months ended March 31,	
	2008	2007	2008	2007
Beginning balance	\$ 46,828	\$ 48,390	\$ 52,838	\$ 45,642
Accruals for warranties issued during the period	9,666	14,788	35,124	43,737
Changes in liability related to pre-existing warranties	116	(1,578)	(1,749)	(6,368)
Settlements made during the period	(13,786)	(11,982)	(43,389)	(33,393)
Ending balance	\$ 42,824	\$ 49,618	\$ 42,824	\$ 49,618

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 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 of \$28.7 million in various locations to fund customs guarantees for VAT and letter of credit needs of its subsidiaries in Europe and Asia. Approximately \$22.6 million was outstanding under these arrangements as of March 31, 2008.

#### NOTE 14 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts and options to hedge against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes.

During the three months ended March 31, 2008, as required by applicable Belgian regulations, the Company funded a restricted cash account in the amount of 392.3 million in connection with the Company's proposed acquisition of ICOS. Concurrently, the Company entered into a foreign exchange contract to sell the same amount at a forward date of July 15, 2008. In addition, in order to hedge the economic risk of the acquisition, the Company also entered into a foreign exchange Euro call option contract with a notional amount of 320.0 million and an expiry date of July 15, 2008. The Company made a payment of \$10.1 million during the three months ended March 31, 2008 for the option premium. In accordance with SFAS No. 133, both the forward contract to sell 392.3 million and the call option contract are marked to market at the end of each reporting period. As of March 31, 2008, the fair value of the call option contract was \$21.1 million, which was included as part of other current assets, with \$11.0 million of gain included in interest income and other, net. The unrealized loss on the forward exchange contract of \$37.5 million as a result of the mark to market was offset by the \$38.4 million gain on the revaluation of the restricted cash account with the net impact included in interest income and other, net.



The outstanding hedge contracts, with maximum maturity of 13 months, as of March 31, 2008 and June 30, 2007 were as follows:

(In thousands)	As of March 31, 2008	As of June 30, 2007
Cash flow hedge contracts		
Purchase	\$ 6,448	\$ 4,651
Sell	(196,253)	(242,942)
Other foreign currency hedge contracts		
Purchase	653,012	126,992
Sell	(847,681)	(265,378)
Net outstanding hedge contracts	\$ (384,474)	\$ (376,677)

#### NOTE 15 SALE AND IMPAIRMENT OF REAL ESTATE ASSETS

During the nine months ended March 31, 2007, as part of the Company's long-term business plan, the Company decided to sell certain real estate properties owned by the Company in San Jose, California and Livermore, California. Based on the valuation of these assets using relevant market indicators such as range of estimated selling prices, the Company recorded an asset impairment charge of approximately \$56.8 million, which was included in SG&A expenses during the nine months ended March 31, 2007. During the three months ended December 31, 2007, the Company completed the sale of real estate properties in Livermore, California and recognized a gain of \$9.0 million as an offset to SG&A expenses.

During the three months ended March 31, 2008, the Company entered into an agreement for the sale and leaseback of certain buildings located in San Jose, California. The sale transaction, which closed on March 26, 2008, resulted in proceeds to the Company of \$28.8 million and a gain on sale of \$13.2 million. Under the agreement, the Company leases back the buildings for periods ranging from 3 months to 39 months. Rent will be a total of \$0.4 million during the three months ending June 30, 2008 and \$1.1 million, \$1.7 million and \$1.8 million during the fiscal years ending June 30, 2009, 2010 and 2011, respectively. Under the provisions of SFAS No. 13, *Accounting for Leases*, the Company immediately recognized \$8.5 million of the gain, which represents the portion of the gain in excess of the present value of the minimum lease payments, and deferred the remaining gain of \$4.7 million, which will be amortized ratably in proportion to rent expense over the 39-month term of the lease. The Company is recognizing the rent expense related to rental payments on a straight line basis over the term of the lease.

In addition, during the three months ended March 31, 2008, the Company entered into an agreement to sell certain real estate located in Chennai, India. The sale is expected to be completed in the fourth quarter of fiscal year 2008. Accordingly, these assets with a net book value of \$5.8 million are held for sale at March 31, 2008.

#### NOTE 16 RELATED PARTY TRANSACTIONS

During the three months ended March 31, 2008 or 2007, or both, the Company purchased from, or sold to, JDS Uniphase Corporation, Freescale Semiconductor, Inc., National Semiconductor Corp., STMicroelectronics, NV and Oracle Corporation, at the time when one or more members of the Company's Board of Directors also served as an executive officer or board member of the other party.

For the three months ended March 31, 2008 and 2007, the Company's total revenues from transactions with these parties from the period that they were considered related were approximately \$11.9 million and \$16.1 million, respectively. For the nine months ended March 31, 2008 and 2007, the Company's total revenues from transactions with these parties from the period that they were considered related were approximately \$32.5 million and \$53.6 million, respectively.

In addition, for the three months ended March 31, 2008 and 2007 the Company's total purchases from transactions with these parties from the period that they were considered related were approximately \$3.3 million and \$2.3 million, respectively. For the nine months ended March 31, 2008 and 2007 the Company's total purchases from transactions with these parties from the period that they were considered related were approximately \$7.1 million and \$5.8 million, respectively.

The Company had a receivable balance from these parties of approximately \$13.7 million and \$7.2 million at March 31, 2008 and June 30, 2007, respectively. Management believes that such transactions are at arms length and on similar terms as would have been obtained from unaffiliated third parties.

#### NOTE 17 SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

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

KLA-Tencor reports one reportable segment in accordance with the provisions of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. 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 makers are its Chief Executive Officer and the Chief Operating Officer.

Edgar Filing: KLA TENCOR CORP - Form 10-Q

KLA-Tencor is engaged primarily in designing, manufacturing, and marketing process control and yield management solutions for the semiconductor and related microelectronics 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 SFAS No. 131 can be found in the condensed consolidated financial statements.

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

The following is a summary of revenues by geographic region for the three and nine months ended March 31, 2008 and 2007:

(Dollar amounts in thousands)	Three months ended				Nine months ended			
	March 31,		March 31,		March 31,		March 31,	
	2008	2007	2008	2007	2008	2007	2008	2007
Revenues:								
United States	\$ 108,725	18%	\$ 198,479	28%	\$ 346,313	18%	494,497	25%
Taiwan	105,770	18%	143,949	20%	471,370	24%	407,559	20%
Japan	141,591	23%	173,362	24%	497,004	26%	415,826	21%
Europe & Israel	80,000	13%	82,341	12%	242,913	12%	204,310	10%
Korea	100,106	17%	51,976	7%	185,638	10%	213,232	11%
Asia Pacific	66,027	11%	66,101	9%	187,784	10%	259,417	13%
Total	\$ 602,219	100%	\$ 716,208	100%	\$ 1,931,022	100%	\$ 1,994,841	100%

Long-lived assets by geographic region as of March 31, 2008 and June 30, 2007 were as follows:

(In thousands)	March 31, 2008	June 30, 2007
Long-lived assets:		
United States	\$ 250,283	\$ 321,146
Taiwan	1,756	1,720
Japan	6,921	6,821
Europe & Israel	11,891	11,466
Korea	5,649	6,524
Asia Pacific	74,744	46,301
Total	\$ 351,244	\$ 393,978

The following is a summary of revenues by major products for the three months ended March 31, 2008 and 2007 (as a percentage of total revenue):

Revenues:	Three months ended		Nine months ended	
	March 31,	March 31,	March 31,	March 31,
	2008	2007	2008	2007
Defect inspection	53%	62%	57%	62%
Metrology	24%	21%	21%	18%
Service	21%	14%	19%	15%
Other	2%	3%	3%	5%

Total	100%	100%	100%	100%
-------	------	------	------	------



In each of the three and nine months ended March 31, 2008 and March 31, 2007, no customer accounted for greater than 10% of revenue. As of March 31, 2008, one customer accounted for approximately 10% of net accounts receivable. As of June 30, 2007, no customer accounted for greater than 10% of net accounts receivable.

## **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; the future impact of the restatement of our historical financial statements, shareholder litigation and related matters arising from the discovery that we had retroactively priced stock options (primarily from July 1, 1997 to June 30, 2002) and had not accounted for them correctly; 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 selling, general and administrative expenses; international sales and operations; maintenance of our competitive advantage; 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, including the anticipated timing of the completion of our proposed acquisition of ICOS Vision Systems Corporation NV and the anticipated benefits realizable to us from such acquisition, 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 Item 1A, Risk Factors of Part II of this report as well as in Item 1, Business and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended June 30, 2007, filed with the Securities and Exchange Commission on August 20, 2007. You should carefully review these risks and also review the risks described in this document and the 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 of the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007 describes the significant accounting policies and methods used in preparation of the Consolidated Financial Statements. We based these estimates and assumptions on historical experience, and evaluate them on an on-going basis to ensure that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed our related disclosure in this Quarterly Report on Form 10-Q. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

Revenue Recognition

Inventories

Warranty

Allowance for Doubtful Accounts

Stock-Based Compensation

Contingencies and Litigation

Goodwill and Intangible Assets

Income Taxes

System revenues recognized without a written acceptance from the customer were approximately 16.6%, 14.1% and 17.1% of total revenues for the three months ended March 31, 2008, December 31, 2007 and March 31, 2007, respectively, and 14.8% and 13.2% for the nine months ended March 31, 2008 and March 31, 2007, respectively. The increase in revenue recognized without a written acceptance is primarily driven by increased shipments of tools that have previously met the required acceptance criteria at those customer fabs, and an increase in sales of systems with perfunctory installation. Shipping charges billed to customers are included in system revenues, and the related shipping costs are included in costs of revenues.

With the exception of the below paragraph that discusses the impact of Financial Accounting Standards Board ( FASB ) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109* ( FIN 48 ) on our critical accounting policy and estimates for accounting for income taxes, during the nine months ended March 31, 2008 there were no significant changes in our critical accounting policies and estimates. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our fiscal year ended June 30, 2007 for a more complete discussion of our critical accounting policies and estimates.

**Income Taxes.** We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that a portion of the deferred tax asset will not be realized. We have determined that our future taxable income will be sufficient to recover all of our deferred tax assets. However, should there be a change in our ability to recover our deferred tax assets, we could be required to record a valuation allowance against our deferred tax assets. This would result in an increase to our tax provision in the period in which we determined that the recovery was not probable.

On a quarterly basis, we provide for income taxes based upon an estimated annual effective income tax rate. The effective tax rate is highly dependent upon the geographic composition of worldwide earnings, tax regulations governing each region, availability of tax credits and the effectiveness of our tax planning strategies. We carefully monitor the changes in many factors and adjust our effective income tax rate on a timely basis. If actual results differ from these estimates, this could have a material effect on our financial condition and results of operations.

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. As a result of the implementation of FIN 48, we recognize liabilities for uncertain tax positions based on the two-step process prescribed within the interpretation. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement.

We adopted FIN 48 on July 1, 2007. See Note 11, *Income Taxes* to the Condensed Consolidated Financial Statements for a detailed description.

**Effects of Recent Accounting Pronouncements.** In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities - an amendment of SFAS No. 133*. This statement changes the disclosure requirements for derivative instruments and hedging activities. SFAS No. 161 requires the Company to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. SFAS No. 161 is effective for the Company's interim period beginning January 1, 2009. The Company is currently evaluating the impact of the implementation of SFAS No. 161 on its consolidated financial position, results of operations and cash flows.

In February 2008, the FASB adopted FASB Staff Position SFAS No. 157-2 *Effective Date of FASB Statement No. 157* delaying the effective date of SFAS No. 157 for one year for all non financial assets and non financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The Company is currently evaluating the impact of the implementation of SFAS No. 157 on its consolidated financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations*. SFAS No. 141(R) retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. SFAS No. 141(R) defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest at their fair values as of the acquisition date. In addition, SFAS No. 141(R) requires expensing of acquisition-related and restructure-related costs, remeasurement of earn-out provisions at fair value,

measurement of equity securities issued for purchase at the date of close of the transaction and non-expensing of in-process research and development related intangibles. SFAS No. 141(R) is effective for our business combinations for which the acquisition date is on or after July 1, 2009. We are currently evaluating the impact of the implementation of SFAS No. 141(R) on our consolidated financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements - an amendment of ARB No. 51*. This Statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. This Statement establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation. SFAS No. 160 is effective for our fiscal year beginning July 1, 2009. We are currently evaluating the impact of the implementation of SFAS No. 160 on its consolidated financial position, results of operations and cash flows.

In June 2007, the FASB ratified EITF Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities*. This issue provides that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. EITF Issue No. 07-3 is effective for the Company's fiscal year beginning July 1, 2008. The adoption of EITF Issue No. 07-3 is not expected to have a material impact on our consolidated financial position, results of operations and cash flows.

## EXECUTIVE SUMMARY

KLA-Tencor Corporation is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. Within our primary area of focus, our comprehensive portfolio of products, services, software and expertise helps integrated circuit manufacturers manage yield throughout the entire wafer fabrication process - from research and development to final volume production.

Our products and services are used by virtually every major wafer, IC and photomask manufacturer in the world. Our revenues are driven largely by capital spending by our customers who operate in one or more of several key markets, including the memory, foundry and logic markets. Over the past few years, customers in the memory market have made significant increases in capital spending and, as a consequence, constitute an increased share of our revenues. Our customers purchase our products to either ramp up production in response to the need to drive advances in process technologies or to satisfy demand from industries such as communication, data processing, consumer electronics, automotive, and aerospace. Our customers today are investing in advanced technologies and new materials to enable smaller design rules and higher density applications, as well as reduced cost, which in turn are driving increased adoption of process control to reduce defectivity. While demand from various industries continues to steadily rise, the demand for our products is affected by profitability of our customers which is driven by capacity and market supply for their products. Industry analysts expect demand for capital equipment to decline in calendar year 2008 compared to calendar year 2007.

As a supplier to the global semiconductor and semiconductor-related industries, we are subject to business cycles, the timing, length and volatility of which can be difficult to predict. The industries we serve have historically been cyclical due to sudden changes in demand and manufacturing capacity. We expect our customers' capital spending on process control to increase over the long term. We believe that this increase in process control spending will be driven by the demand for more precise diagnostics capabilities to address multiple new defects as a result of further shrinking of device feature sizes, the transition to new materials, new devices and circuit architecture, new lithography challenges and fab process innovation. We anticipate that these factors will drive increased demand for our products and services over the coming years. The key drivers in the semiconductor equipment industry today are the ramping up at the 65nm design nodes and increasing adoption of 45nm technology. These drivers are fueled by competitive pressures for our customers to improve yields, lower their costs and get products to market more quickly in order to benefit from the increased demand for products from the consumer electronics, computing and communication industries.

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

(In thousands, except net income per share - diluted)	Fiscal year 2008 (to date)				Fiscal year 2007		
	Three months ended				Three months ended		
	March 31, 2008	December 31, 2007	September 30, 2007	June 30, 2007	March 31, 2007	December 31, 2006	September 30, 2006
Revenues	\$ 602,219	\$ 635,783	\$ 693,020	\$ 736,388	\$ 716,208	\$ 649,270	\$ 629,363

Edgar Filing: KLA TENCOR CORP - Form 10-Q

Income from operations	125,200	93,487	177,278	174,864	182,655	78,359	153,990
Net income	110,980	83,935	88,158	147,342	154,785	90,049	135,922
Cash flow from operations	148,212	126,427	205,162	155,470	198,608	149,640	106,968
Net income per share - diluted	0.61	0.45	0.46	0.75	0.76	0.44	0.67

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

(Dollar amounts in thousands)	Three months ended			Q3 FY08 vs. Q2 FY08	Q3 FY08 vs. Q3 FY07		
	March 31, 2008	December 31, 2007	March 31, 2007				
<b>Revenues:</b>							
Product	\$ 476,274	\$ 513,449	\$ 607,390	\$ (37,175)	-7%	\$ (131,116)	-22%
Service	125,945	122,334	108,818	3,611	3%	17,127	16%
Total revenues	\$ 602,219	\$ 635,783	\$ 716,208	\$ (33,564)		\$ (113,989)	
Costs of revenues	\$ 285,650	\$ 285,005	\$ 306,751	\$ 645	0%	\$ (21,101)	-7%
Gross margin percentage	53%	55%	57%	-2%			-4%
Stock-based compensation expense included in costs of revenues	\$ 5,670	\$ 4,700	\$ 6,629	\$ 970		\$ (959)	

(Dollar amounts in thousands)	Nine months ended		Q3 FY08 YTD vs. Q3 FY07 YTD	
	March 31, 2008	March 31, 2007		
<b>Revenues:</b>				
Product	\$ 1,568,155	\$ 1,682,619	\$ (114,464)	-7%
Service	362,867	312,222	50,645	16%
Total revenues	\$ 1,931,022	\$ 1,994,841	\$ (63,819)	
Costs of revenues	\$ 876,548	\$ 874,642	\$ 1,906	0%
Gross margin percentage	55%	56%	-1%	
Stock-based compensation expense included in costs of revenues	\$ 16,623	\$ 23,218	\$ (6,595)	

**Product revenues**

Product revenues decreased during the three months ended March 31, 2008 from the three months ended December 31, 2007 and March 31, 2007 as a result of lower backlog of shipped tools awaiting customer acceptance at the beginning of the third quarter of fiscal year 2008 and lower backlog of consignment tools awaiting buyout from customers.

Product revenues decreased during the nine months ended March 31, 2008 compared to the nine months ended March 31, 2007, primarily as a result of a lower level of backlog of shipped tools awaiting customer acceptance at the beginning of the first, second and third quarter of fiscal year 2008 and lower backlog of consignment tools awaiting buyout from customers.

In each of the three and nine months ended March 31, 2008 and March 31, 2007, no customer accounted for greater than 10% of revenue. As of March 31, 2008, one customer accounted for more than 10% of net accounts receivable. As of June 30, 2007, no customer accounted for greater than 10% of net accounts receivable.

**Service revenues**

Service revenues are generated from maintenance service contracts, as well as time and material billable service calls made to our customers after the expiration of the warranty period. Service revenues continued to increase through the periods disclosed in the table above as our installed product base of equipment at our customers' sites continued to grow. The amount of service revenues generated is primarily a function of the number of post-warranty systems installed at our customers' sites and the utilization levels for those systems.

**Revenues by region**

Revenues by region for the periods indicated were as follows:

(In thousands)	March 31, 2008		Three months ended December 31, 2007		March 31, 2007	
United States	\$ 108,725	18%	\$ 90,635	14%	\$ 198,479	28%
Taiwan	105,770	18%	168,586	27%	143,949	20%
Japan	141,591	23%	173,203	27%	173,362	24%
Europe & Israel	80,000	13%	93,135	15%	82,341	12%
Korea	100,106	17%	51,473	8%	51,976	7%
Asia Pacific	66,027	11%	58,751	9%	66,101	9%
<b>Total</b>	<b>\$ 602,219</b>	<b>100%</b>	<b>\$ 635,783</b>	<b>100%</b>	<b>\$ 716,208</b>	<b>100%</b>

(In thousands)	March 31, 2008		Nine months ended March 31, 2007	
United States	\$ 346,313	18%	\$ 494,497	25%
Taiwan	\$ 471,370	24%	407,559	20%
Japan	\$ 497,004	26%	415,826	21%
Europe & Israel	\$ 242,913	12%	204,310	10%
Korea	\$ 185,638	10%	213,232	11%
Asia Pacific	\$ 187,784	10%	259,417	13%
<b>Total</b>	<b>\$ 1,931,022</b>	<b>100%</b>	<b>\$ 1,994,841</b>	<b>100%</b>

A significant portion of our revenues continues to be generated outside of the United States because a substantial portion of the world's semiconductor manufacturing capacity is located, and the majority of new fabs are being built, in regions other than the United States, and we expect that will continue to be the case.

**Gross margin**

Our gross margin fluctuates with revenue levels and product mix, and is affected by variations in costs related to manufacturing and servicing our products. Our gross margin percentage was lower during the three months ended March 31, 2008 compared to the three months ended December 31, 2007 primarily due to \$18.3 million of service inventory disposed of during the three months ended March 31, 2008 which was partially offset by lower costs of revenues. Improvements in customer service efficiencies arising from improvements in tool reliability have reduced the future needs of service parts near customer locations, and as a result they were disposed of during the three months ended March 31, 2008. The decrease in gross margin percentage was partially offset by one-time expenses that were charged in the three months ended December 31, 2007 that did not recur during the three months ended March 31, 2008.

The following are expenses that were recorded in the three months ended December 31, 2007 compared to the three months ended March 31, 2008:

\$3.1 million write down of inventory related to discontinued products compared to no such changes during the three months ended March 31, 2008,

\$6.2 million impairment of certain intangibles related to the discontinued products compared to no such changes during the three months ended March 31, 2008, and

\$4.7 million for stock-based compensation expense, compared to \$5.7 million during the three months ended March 31, 2008.

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

Our gross margin percentage was lower during the three months ended March 31, 2008 compared to the three months ended March 31, 2007 primarily because approximately \$18.3 million of service inventory was disposed of in the three months ended March 31, 2008. Also, the following other charges were recorded in the three months ended March 31, 2007 compared to the three months ended March 31, 2008:

\$10.5 million for amortization and impairment of intangibles and fair value adjustment for inventory related to acquisitions, compared to \$6.3 million in the three months ended March 31, 2008,

\$1.7 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits resulting from the temporary suspension of our ESPP during fiscal year 2007, compared to no charges for such reimbursements and payments during the three months ended March 31, 2008,

\$6.6 million for stock-based compensation expense, compared to \$5.7 million during the three months ended March 31, 2008, and

No charges were recorded for severance and benefits related to employee workforce reductions in the three months ended March 31, 2007, compared to \$1.4 million recorded during the three months ended March 31, 2008.



Our gross margin percentage during the nine months ended March 31, 2008 decreased compared to the gross margin percentage for the nine months ended March 31, 2007. The following charges were recorded in the nine months ended March 31, 2007 compared to the nine months ended March 31, 2008:

\$20.7 million for amortization and impairment of intangibles and fair value adjustment for inventory related to acquisitions, compared to \$28.5 million in the nine months ended March 31, 2008,

\$2.8 million for severance and benefits related to employee workforce reduction, compared to \$3.3 million in the nine months ended March 31, 2008,

\$4.6 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits resulting from a temporary suspension of our ESPP during fiscal year 2007, compared to no charges for such reimbursements and payments during the nine months ended March 31, 2008,

No charges recorded for inventory write downs related to discontinued products and disposal of service inventory in the nine months ended March 31, 2007, compared to \$21.3 million in charges recorded in the nine months ended March 31, 2008, and

\$23.2 million for stock-based compensation expense, compared to \$16.6 million during the nine months ended March 31, 2008.

#### Backlog

Our backlog for system shipments and associated warranty totaled \$795 million and \$1,061 million as of March 31, 2008 and June 30, 2007, respectively, and includes orders where written customer requests have been received and the delivery is anticipated within the next 12 months. We make backlog adjustments for backlog obtained from acquired companies, cancellations, customer delivery date changes and currency adjustments. Orders for service and unreleased products are excluded from backlog. All orders are subject to cancellation or delay by the customer, with limited or no penalties. Due to possible customer changes in delivery schedules or cancellation of orders and as some orders are received and shipped within the same quarter, our backlog at any particular date is not necessarily indicative of business volumes or actual sales for any succeeding period.

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

(Dollar amounts in thousands)	Three months ended			Q3 FY08 vs. Q2 FY08	Q3 FY08 vs. Q3 FY07
	March 31, 2008	December 31, 2007	March 31, 2007		
R&D expenses	\$ 96,646	\$ 97,513	\$ 106,265	\$ (867) -1%	\$ (9,619) -9%
R&D expenses as a percentage of total revenues	16%	15%	15%		
Stock-based compensation expense included in R&D expenses	\$ 8,052	\$ 7,109	\$ 11,036	\$ 943	\$ (2,984)

(Dollar amounts in thousands)	Nine months ended			Q3 FY08 YTD vs. Q3 FY07 YTD
	March 31, 2008	March 31, 2007		
R&D expenses	\$ 293,503	\$ 313,659		\$ (20,156) -6%
R&D expenses as a percentage of total revenues	15%	16%		
Stock-based compensation expense included in R&D expenses	\$ 23,753	\$ 33,984		\$ (10,231)

R&D expenses during the three months ended March 31, 2008 were flat compared to the three months ended December 31, 2007.

The decrease in R&D expenses during the three months ended March 31, 2008 compared to the three months ended March 31, 2007 was primarily due to lower stock-based compensation expense recorded in R&D expenses in the three months ended March 31, 2008 compared to the three months ended March 31, 2007 primarily due to the cash bonus accrued during the three months ended March 31, 2007 to pay to

employees in connection with the amendment of their stock options for purposes of

Section 409A, a portion of which bonus accrual was classified as stock-based compensation as the bonus was directly related to stock option amendments. In addition, there were one-time charges recorded during the three months ended March 31, 2007 related to cash payments to employees to compensate them for lost benefits resulting from the temporary suspension of our ESPP during fiscal year 2007. The following charges were recorded during the three months ended March 31, 2007 compared to the three months ended March 31, 2008:

\$11.0 million for stock-based compensation expense, compared to \$8.1 million in the three months ended March 31, 2008,

\$2.0 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits resulting from the temporary suspension of our ESPP during fiscal year 2007, compared to no charges for such reimbursements and payments during the three months ended March 31, 2008,

\$1.7 million for in-process research and development charges and amortization of intangibles associated with acquisitions, compared to \$0.7 million in the three months ended March 31, 2008, and

No charges recorded for severance and benefits related to employee workforce reductions, compared to \$0.7 million during the three months ended March 31, 2008.

The decrease in R&D expenses during the nine months ended March 31, 2008 compared to the nine months ended March 31, 2007 was primarily due to lower stock-based compensation expense recorded in R&D expenses in the nine months ended March 31, 2008 compared to the nine months ended March 31, 2007 primarily due to the cash bonus accrued during the three months ended March 31, 2007 to pay to employees in connection with the amendment of their stock options for purposes of Section 409A, a portion of which bonus accrual was classified as stock-based compensation as the bonus was directly related to stock option amendments. In addition, there were one-time charges recorded during the nine months ended March 31, 2007 related to employee severance payments as well as benefits and reimbursements related to IRC Section 409A and our ESPP. The following charges were recorded during the nine months ended March 31, 2007 compared to the nine months ended March 31, 2008:

\$34.0 million for stock-based compensation expense, compared to \$23.8 million during the nine months ended March 31, 2008,

\$2.1 million for severance and benefits related to an employee workforce reduction, compared to \$1.2 million during the nine months ended March 31, 2008, and

\$5.4 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits resulting from the temporary suspension of our ESPP during the nine months ended March 31, 2007, compared to no charges for such reimbursements and payments during the nine months ended March 31, 2008.

During the fiscal year ended June 30, 2007, we recorded \$16.6 million for in-process research and development ( IPR&D ) charges primarily related to the acquisition of a development stage company. During the nine months ended March 31, 2008, we recorded \$4.2 million for IPR&D charges also primarily related to the acquisition of development stage companies. The fair value of the purchased IPR&D was determined using the income approach, which discounts expected future cash flows from projects to their net present value. Future cash flows were estimated, taking into account the expected life cycles of the products and the underlying technology, relevant market sizes and industry trends. We determined a discount rate for each project based on the relative risks inherent in the project's development horizon, the estimated costs of development, and the level of technological change in the project and the industry, among other factors. IPR&D was expensed upon acquisition because technological feasibility had not been achieved and no future alternative uses existed. As of March 31, 2008, there have been no material changes from the underlying assumptions that were used in the original computation of the value of the acquired IPR&D.

R&D expenses include the benefit of \$5.0 million, \$4.0 million and \$4.4 million of external funding received during the three months ended March 31, 2008, December 31, 2007 and March 31, 2007, respectively, for certain strategic development programs from government grants. R&D expenses include the benefit of \$13.1 million and \$10.6 million of external funding received during the nine months ended March 31, 2008 and March 31, 2007, respectively.

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

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

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

(Dollar amounts in thousands)	Three months ended			Q3 FY08 vs. Q2 FY08	Q3 FY08 vs. Q3 FY07
	March 31, 2008	December 31, 2007	March 31, 2007		
SG&A expenses	\$ 94,723	\$ 159,778	\$ 120,537	\$ (65,055) -41%	\$ (25,814) -21%
SG&A expenses as a percentage of total revenues	16%	25%	17%		
Stock-based compensation expense included in SG&A expenses	\$ 12,133	\$ 11,443	\$ 11,604	\$ 690	\$ 529

(Dollar amounts in thousands)	Nine months ended			Q3 FY08 YTD vs. Q3 FY07 YTD
	March 31, 2008	March 31, 2007	March 31, 2007	
SG&A expenses	\$ 365,006	\$ 391,536	\$ 365,006	\$ (26,530) -7%
SG&A expenses as a percentage of total revenues	19%	20%	19%	
Stock-based compensation expense included in SG&A expenses	\$ 36,814	\$ 25,182	\$ 36,814	\$ 11,632

SG&A expenses decreased during the three months ended March 31, 2008 compared to the three months ended December 31, 2007 primarily as a result of a one-time charge of \$67.0 million during the three months ended December 31, 2007 to cover the pending class action litigation related to the Company's historical stock option practices, as described in Note 12, "Litigation and Other Legal Matters," in addition to savings realized from our cost reduction strategies. These reductions were slightly offset by a decrease in the amount of gain on the sale of real estate assets in the three months ended March 31, 2008. The following charges and benefits were recorded in the three months ended December 31, 2007 compared to the three months ended March 31, 2008:

\$67.0 million charge to cover the \$65.0 million settlement plus related litigation expenses for the pending shareholder class action litigation relating to the Company's historical stock option practices, as described in Note 12, "Litigation and Other Legal Matters," in the three months ended December 31, 2007, compared to \$5.2 million in the three months ended March 31, 2008, and

\$9.0 million in gains recorded on the sale of real estate assets in the three months ended December 31, 2007, compared to \$7.9 million in net gains recorded in the three months ended March 31, 2008.

SG&A expenses decreased during the three months ended March 31, 2008 compared to the three months ended March 31, 2007 primarily as a result of gains on the sale of real estate assets, a decrease in legal and other expenses related to the stock options investigation, shareholder litigation and related matters, and lower compensation costs attributable to cost saving strategies. The following charges were recorded in the three months ended March 31, 2007 compared to the three months ended March 31, 2008:

No gain recorded on the sale of certain real estate assets, compared to a \$7.9 million net gain in the three months ended March 31, 2008,

\$8.4 million for litigation expenses related to the Company's historical stock option practices, compared to \$5.2 million recorded in the three months ended March 31, 2008, as described in Note 12, "Litigation and Other Legal Matters,"

\$5.4 million for amortization of intangibles associated with acquisitions, compared to \$2.1 million recorded in the three months ended March 31, 2008, and

\$3.1 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits resulting from the temporary suspension of our ESPP during fiscal year 2007.

SG&A expenses decreased during the nine months ended March 31, 2008 compared to the nine months ended March 31, 2007 primarily as a result of lower one-time charges. The following charges were recorded in the nine months ended March 31, 2007 compared to the nine months ended March 31, 2008:

\$56.8 million for impairment charges related to the write down of buildings, compared to a gain on sale of certain real estate assets of \$16.9 million in the nine months ended March 31, 2008,

\$14.5 million for litigation expenses related to the Company's historical stock option practices, compared to \$74.3 million recorded in the nine months ended March 31, 2008 to cover the \$65.0 million settlement to resolve the pending shareholder class and derivative action litigation relating to historical stock option practices, as described in Note 12, "Litigation and Other Legal Matters," plus related litigation expenses,

\$20.3 million reversal of stock-based compensation expense related to our former Chief Executive Officer, compared to no such charge during the nine months ended March 31, 2008,

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

\$45.5 million for stock-based compensation expense, compared to \$36.8 million during the nine months ended March 31, 2008, excluding the \$20.3 million reversal related to our former Chief Executive Officer discussed below. The decrease is primarily due to the cash bonus accrued during the three months ended March 31, 2007 to pay to employees in connection with the amendment of their stock options for purposes of Section 409A, a portion of which bonus accrual was classified as stock-based compensation as the bonus was directly related to stock option amendments,

\$7.5 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits resulting from the temporary suspension of our ESPP during fiscal year 2007,

\$10.6 million for amortization of intangibles associated with acquisitions, compared to \$6.7 million recorded in the nine months ended March 31, 2008, and

\$5.5 million for severance and benefits related to an employee workforce reduction, compared to \$3.9 million recorded during the nine months ended March 31, 2008.

On October 16, 2006, we terminated all aspects of Mr. Schroeder's employment relationship and agreement with us. In connection with the cancellation of certain equity awards held by Mr. Schroeder at the time of termination, in the three months ended December 31, 2006 we reversed \$20.3 million of the non-cash, stock-based compensation charges that had been recorded in prior periods related to unvested option shares and restricted stock award shares. See Note 7, "Stock-Based Compensation" to the Condensed Consolidated Financial Statements for more information.

During the three months ended December 31, 2006, as part of our long-term business plan, we decided to sell certain real estate properties owned by us in San Jose, California and Livermore, California. Based on the valuation of these assets using relevant market indicators such as range of estimated selling prices, we recorded an asset impairment charge of approximately \$56.8 million, which was included in SG&A in the three months ended December 31, 2006. The real estate properties owned by us in Livermore were sold in the three months ended December 31, 2007, and a gain of \$9.0 million was recognized in SG&A expenses. The real estate properties owned by us in San Jose were sold and leased back during the three months ended March 31, 2008, which resulted in a total gain of \$13.2 million, of which \$8.5 million was immediately recognized in SG&A. The \$8.5 million represents the portion of the gain in excess of the present value of the minimum lease payments. The remaining gain of \$4.7 million has been deferred and will be amortized ratably in proportion to rent expense over the 39-month term of the lease.

### Interest Income and Other, Net

(Dollar amounts in thousands)	Three months ended		
	March 31, 2008	December 31, 2007	March 31, 2007
Interest income and other, net	\$ 36,009	\$ 13,269	\$ 20,817
Percentage of total revenues	6%	2%	3%

(Dollar amounts in thousands)	Nine months ended	
	March 31, 2008	March 31, 2007
Interest income and other, net	\$ 66,752	\$ 65,931
Percentage of total revenues	3%	3%

Interest income and other, net is comprised primarily of interest income earned on our investment and cash portfolio, realized gains or losses on sales of marketable securities, as well as gains or losses from our net foreign currency hedging activities. The increase in interest income and other, net in the three months ended March 31, 2008 was primarily due to realized gains of \$9.5 million on the sale of investments and unrealized gains of \$11.0 million on a forward exchange derivative option we purchased to hedge the exposure of the ICOS purchase. The change in interest income and other, net for the nine months ended March 31, 2008 was flat due to a decrease in interest income due to lower levels of cash as a result of share repurchases during the nine months ended March 31, 2008 of \$990 million, which was offset by the realized gains on the sale of investments and unrealized gains on a forward exchange derivative option noted above.

### Provision for Income Taxes

Our effective income tax rate was 31.1% and 23.8% for the three months ended March 31, 2008 and March 31, 2007, respectively, and 38.8% and 21.1% for the nine months ended March 31, 2008 and March 31, 2007, respectively.

The increase in the effective tax rate in the three months ended March 31, 2008 compared to the three months ended March 31, 2007 is primarily due to the reduction in the effective tax rate from a non-recurring item for which the tax effect was recognized in the three months ended March 31, 2007. The non-recurring item resulted from compensation expense related to reimbursing employees for tax liabilities related IRC Section 409A. In addition, there was an increase to the effective tax rate for the three months ended March 31, 2008 due to decreases in the tax benefits related to the decrease of tax exempt interest as a percentage of pre-tax income, and the expiration of the research and development credit and the extraterritorial income exclusion, partially offset by an increase in income earned outside the United States subject to lower tax rates than the statutory tax rate.

The increase in the effective tax rate for the nine months ended March 31, 2008 compared to the nine months ended March 31, 2007 is primarily due to the immediate impact of \$46.6 million of incremental U.S. tax expense associated with the implementation of our global manufacturing



Edgar Filing: KLA TENCOR CORP - Form 10-Q

strategy during the three months ended September 30, 2007. The incremental U.S. tax expense was a result of an inter-company licensing agreement related to the migration of a portion of the Company's

manufacturing to Singapore. In addition, there was an increase to the effective tax rate for the nine months ended March 31, 2008 compared to the nine months ended March 31, 2007 due to decreases in the tax benefits related to the decrease of tax exempt interest as a percentage of pre-tax income, and the expiration of the research and development credit and the extraterritorial income exclusion, partially offset by an increase in income earned outside the United States subject to lower tax rates than the statutory tax rate.

We expect the tax rate in future periods of the year ending June 30, 2008 to result in an annual rate of approximately 37%, which includes the effect of the higher tax expense associated with the implementation of our global manufacturing strategy offset by the tax benefit related to the expense to settle the shareholder class action lawsuit.

Our future effective income tax rate depends on various factors, such as tax legislation, the geographic composition of our pre-tax income, non tax-deductible expenses incurred in connection with acquisitions, amounts of tax-exempt interest income and research and development credits as a percentage of aggregate pre-tax income, and the effectiveness of our tax planning strategies.

### Equity Incentive Program

Our equity incentive program is a broad-based, long-term retention program that is intended to attract and retain key employees, and align stockholder and employee interests. The equity incentive program consists of two plans: one under which non-employee directors may be granted options to purchase shares of our stock, and another in which non-employee directors, officers, key employees, consultants and all other employees may be granted options to purchase shares of our stock, restricted stock units and other types of equity awards. For the past several years until June 30, 2006, stock options were generally granted at the market price of our common stock on the date of grant, 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 time-based or performance-based vesting. Substantially all of our employees that meet established performance goals and qualify as key employees participate in our main equity incentive plan. Since July 1, 2006, we have granted only restricted stock units under our equity incentive program, except for options granted to non-employee directors, which were part of their regular compensation package for service through the end of the first quarter of fiscal year 2008 but are no longer a component thereof.

(In thousands)	Three months ended		Nine months ended	
	March 31, 2008	March 31, 2007	March 31, 2008	March 31, 2007
Stock-based compensation expense:				
Costs of revenues	\$ 5,670	\$ 6,629	\$ 16,623	\$ 23,218
Engineering, research and development	8,052	11,036	23,753	33,984
Selling, general and administrative	12,133	11,604	36,814	25,182
<b>Total stock-based compensation</b>	<b>\$ 25,855</b>	<b>\$ 29,269</b>	<b>\$ 77,190</b>	<b>\$ 82,384</b>

Stock-based compensation expense decreased during the three months ended March 31, 2008 compared to three months ended March 31, 2007 primarily due to the cash bonus accrued during the three months ended March 31, 2007 to pay to employees in connection with the amendment of their stock options for purposes of Section 409A, a portion of which bonus accrual was classified as stock-based compensation as the bonus was directly related to stock option amendments.

### LIQUIDITY AND CAPITAL RESOURCES

(Dollar amounts in thousands)	March 31, 2008	June 30, 2007
Cash and cash equivalents	\$ 563,482	\$ 722,511
Marketable securities	131,195	988,118
<b>Total cash, cash equivalents and marketable securities</b>	<b>\$ 694,677</b>	<b>\$ 1,710,629</b>

Percentage of total assets

17% 37%

Nine months ended

Edgar Filing: KLA TENCOR CORP - Form 10-Q

<b>(In thousands)</b>	<b>March 31, 2008</b>	<b>March 31, 2007</b>
Cash provided by operating activities	\$ 479,801	\$ 455,216
Cash provided by (used in) investing activities	282,838	(277,960)
Cash used in financing activities	(933,254)	(708,984)
Effect of exchange rate changes on cash and cash equivalents	11,586	6,953
Net decrease in cash and cash equivalents	\$ (159,029)	\$ (524,775)

We have historically financed our operations through cash generated from operations. Cash provided by operating activities was \$479.8 million and \$455.2 million for the nine months ended March 31, 2008 and 2007, respectively. Cash provided by operating activities during the nine months ended March 31, 2008 consisted primarily of net income of \$283.1 million, increased by non-cash depreciation and amortization of \$79.9 million, stock-based compensation of \$77.2 million, a decrease in inventories of \$87.1 million due to lower build plan as a result of lower bookings, and a decrease in accounts receivable of \$56.2 million as collections exceeded shipments during the nine months ended March 31, 2008. These increases in operating cash flow were partially offset by changes in other assets and liabilities of \$75.4 million in the nine months ended March 31, 2008.

Cash provided by operating activities during the nine months ended March 31, 2007 consisted primarily of net income of \$380.8 million increased by non-cash depreciation and amortization of \$73.2 million, non-cash impairment charges of \$56.8 million, and stock-based compensation of \$73.2 million, offset by an increase in accounts receivable of \$39.7 million, increase in inventories of \$31.7 million, and changes in other assets and liabilities of \$55.6 million.

Investing activities typically consist of purchases and sales or maturities of marketable securities, purchases of capital assets to support long-term growth and acquisitions of technology or other companies to allow access to new markets or emerging technologies. Cash provided by investing activities was \$282.8 million during the nine months ended March 31, 2008 which includes proceeds from sale of real estate assets of \$63.3 million and net proceeds of \$854.3 million from sale and maturity of marketable securities, offset by increase in restricted cash of \$581.5 million (net of \$38.4 million of gain on exchange rate fluctuation) related to cash set aside in a restricted cash account as required by applicable Belgian regulations in connection with the Company's proposed acquisition of ICOS and capital expenditures of \$47.7 million. Cash used in investing activities was \$278.0 million during the nine months ended March 31, 2007.

Financing activities include dividend payments to our common stockholders and sales and repurchases of our common stock. Since the inception of the repurchase program in 1997 through March 31, 2008, the Board of Directors has authorized us to repurchase a total of 47.8 million shares. We spent \$989.7 million in the nine months ended March 31, 2008, and accrued an additional \$3.3 million at March 31, 2008, in connection with the repurchase of 18.6 million shares of our common stock. The decrease in cash, cash equivalents and marketable securities from the nine months ended March 31, 2007 to the nine months ended March 31, 2008 was primarily due to the repurchase of shares in the first nine months of fiscal year 2008.

During the third quarter of the fiscal year ended June 30, 2005, our Board of Directors approved the initiation of a quarterly cash dividend. During the three months ended March 31, 2008, our Board of Directors authorized a quarterly cash dividend of \$0.15 per share, which was paid on March 3, 2008 to stockholders of record at the close of business on February 25, 2008. During the three months ended March 31, 2007, we declared and paid a quarterly cash dividend of \$0.12 per share. The total amount of dividends paid during the three months ended March 31, 2008 and 2007 was \$26.7 million and \$23.9 million, respectively.

The following is a schedule summarizing our significant obligations to make future payments under contractual obligations as of March 31, 2008:

(in thousands)	Total	Fiscal year ending June 30,						Other <sup>(2)</sup>
		2008 <sup>(1)</sup>	2009	2010	2011	2012	Thereafter	
Purchase commitments	\$ 150,600	\$ 103,577	\$ 47,023	\$	\$	\$	\$	
Litigation settlement	65,000	65,000						
Operating leases	37,736	3,022	10,008	7,088	5,192	2,552	9,874	
Pension obligations	9,739	216	924	976	1,001	902	5,720	
Non-current income tax payable	58,921							58,921
Total contractual cash obligations	\$ 321,996	\$ 171,815	\$ 57,955	\$ 8,064	\$ 6,193	\$ 3,454	\$ 15,594	\$ 58,921

(1) Remaining 3 months

(2) Represents the non-current tax payable obligation under FIN 48. We are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

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



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

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs and related discounting fees paid for the three and nine months ended March 31, 2008 and 2007:

(In thousands)	Three months ended		Nine months ended	
	March 31, 2008	March 31, 2007	March 31, 2008	March 31, 2007
Receivables sold under factoring agreements	\$ 62,850	\$ 53,036	\$ 218,262	\$ 197,640
Proceeds from sales of LCs	\$ 20,596	\$ 4,302	\$ 38,125	\$ 43,014
Discounting fees paid on sales of LCs (1)	\$ 149	\$ 47	\$ 226	\$ 545

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

We maintain guarantee arrangements of \$28.7 million in various locations to fund customs guarantees for VAT and LC needs of our subsidiaries in Europe and Asia. Approximately \$22.6 million was outstanding under these arrangements as of March 31, 2008.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply chain for key components. Our liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. Our open inventory purchase commitments were approximately \$150.6 million as of March 31, 2008 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 change in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

In December 2007, we reached an agreement in principle for the settlement of a securities class action that named KLA-Tencor and certain of its current and former directors and officers as defendants relating to its historical stock option practices. Under the terms of a memorandum of understanding entered into in January 2008 confirming such agreement in principle, we will be required to make a payment of \$65.0 million to the settlement class. The settlement, which is subject to a final agreement and court approval, will provide a full release of KLA-Tencor and the other named defendants in connection with the allegation raised in the lawsuit. Accordingly, as the liability had been incurred at December 31, 2007 and it could be reasonably estimated, an amount of \$65.0 million was accrued by a charge to SG&A expenses during the three months ended December 31, 2007.

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

Working capital decreased to \$1,793 million as of March 31, 2008, compared to \$2,247 million as of June 30, 2007. This decrease is primarily due to cash payments for the repurchase of shares of \$993.0 million during the nine months ended March 31, 2008 offset by cash generated from operations during the nine months ended March 31, 2008. As of March 31, 2008, our principal sources of liquidity consisted of \$694.7 million of cash, cash equivalents, and marketable securities. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Our investment portfolio consists of both corporate and government securities that have a maximum effective maturity of 10 years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. We have the ability to realize the full value of all these investments upon maturity. Unrealized losses are due to changes in interest rates and bond yields. Although cash requirements will fluctuate based on the timing and extent of these factors, we believe that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for at least the next twelve months.

During the three months ended March 31, 2008 as required by applicable Belgian regulations, the Company established and funded a restricted cash account in connection with the Company's proposed acquisition of ICOS containing the aggregate cash consideration of 392.3 million that may be payable for all securities of ICOS upon successful completion of the offer. Concurrently, the Company entered into a foreign exchange contract to sell the same amount at a forward date of July 15, 2008. In addition, in order to hedge the economic risk of the acquisition, the Company entered into a foreign exchange Euro call option contract with a notional amount of 320.0 million and an expiry date of July 15, 2008. As of March 31, 2008, the fair value of restricted cash balance in that account was \$619.9 million, which includes \$38.4 million of gain resulting

from exchange rate fluctuation.

Our investment portfolio includes 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, and a pool of student loans or collateralized debt obligations whose interest rates are reset, typically 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 held by us are backed by student loans and are collateralized, insured and guaranteed by the United States Federal Department of Education. In addition, all auction rate securities held by us are rated by the major independent rating agencies as either AAA or Aaa. Beginning in February 2008, auctions failed for approximately \$48.2 million in par value of municipal auction rate securities we held because sell orders exceeded buy orders. These failures are not believed to be a credit issue, but rather caused by a lack of liquidity. The funds associated with these failed auctions may not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures. As a result, we have classified these securities with failed auctions as long-term assets in our consolidated balance sheet. Although we believe our securities continue to represent sound investments, we may be forced to sell some of our auction rate securities portfolio under illiquid market conditions, which could result in our recognizing a loss on such sales. During the three months ended March 31, 2008, the Company recorded a temporary impairment charge of \$0.9 million (net of tax of \$0.5 million), calculated using a discounted cash flow model, in accumulated other comprehensive income, a component of stockholders equity. The balance of the long-term marketable securities at March 31, 2008 was \$46.8 million. Based on our expected operating cash flows and our other sources of cash, we do not believe that any reduction in liquidity of our municipal auction rate securities will have a material impact on our overall ability to meet our liquidity needs.

### Off-Balance Sheet Arrangements

Under our foreign-currency risk management strategy, we utilize derivative instruments to protect our interests from unanticipated fluctuations in earnings and cash flows caused by volatility in currency exchange rates. This financial exposure is monitored and managed as an integral part of our overall risk management program which focuses on the unpredictability of financial markets and seeks to reduce the potentially adverse effects that the volatility of these markets may have on our operating results. The outstanding hedge contracts, with maximum maturity of 13 months, as of March 31, 2008 and June 30, 2007 were as follows:

(In thousands)	As of March 31, 2008	As of June 30, 2007
Cash flow hedge contracts		
Purchase	\$ 6,448	\$ 4,651
Sell	(196,253)	(242,942)
Other foreign currency hedge contracts		
Purchase	653,012	126,992
Sell	(847,681)	(265,378)
Net outstanding hedge contracts	\$ (384,474)	\$ (376,677)

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

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments, such as foreign currency hedges. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position as of March 31, 2008. Actual results may differ materially.

As of March 31, 2008, we had an investment portfolio of fixed income securities of approximately \$131.2 million, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of March 31, 2008, the fair value of the portfolio would have declined by \$0.2 million.

As of March 31, 2008, we had net forward and options contracts to sell \$384.5 million in foreign currency in order to hedge currency exposures (see Note 14, Derivative Instruments and Hedging Activities, to Condensed Consolidated Financial Statements (unaudited) for a detailed description). If we had entered into these contracts on March 31, 2008, the U.S. dollar equivalent would be \$450.0 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by \$57.5 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on net income or cash flows.



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

See Note 3 to the financial statements in Part I, Item 1; Management's Discussion and Analysis of Financial Condition and Results of Operations, *Liquidity and Capital Resources*, in Part I, Item 2; and Risk Factors in Part II, Item 1A of this Quarterly Report on Form 10-Q for a description of recent market events that may affect the liquidity of certain municipal auction rate securities that we held at March 31, 2008.

---

**ITEM 4. CONTROLS AND PROCEDURES**

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

*Evaluation of Disclosure Controls and Procedures*

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

Attached as exhibits to this Quarterly Report are certifications of the CEO and CFO, which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended (Exchange Act). This Controls and Procedures section includes the information concerning the controls evaluation referred to in the certifications, and it should be read in conjunction with the certifications for a more complete understanding of the topics presented.

*Definition of Disclosure Controls*

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

*Limitations on the Effectiveness of Controls*

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

There were no changes in the Company's internal control over financial reporting that occurred during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

---

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The information set forth above under Note 12 contained in the Condensed Consolidated Financial Statements in Item 1 of Part I is incorporated herein by reference.

### ITEM 1A. RISK FACTORS

The risk factors included herein include any material changes to and supersede the description of the risk factors as previously disclosed in Item 1A to Part I of our Annual Report on Form 10-K for the year ended June 30, 2007, filed with the Securities and Exchange Commission on August 20, 2007.

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

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

The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. This cyclical nature of the industry in which we operate affects our ability to accurately predict future revenue and, thus, future expense levels. In the current environment, our ability to accurately predict future revenue and expense levels is particularly low. When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During a down cycle, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles.

*Our business is ultimately driven by the global demand for electronic devices by consumers and businesses. A majority of our annual revenue is derived from outside the United States, and we expect that international revenue will continue to represent a substantial percentage of our revenue. A protracted global economic slowdown may adversely affect our business and results of operations.*

A majority of our annual revenue is derived from outside the United States, and we expect that international revenue will continue to represent a substantial percentage of our revenue. Our international revenue and operations are affected by economic conditions specific to each country and region. Because of our significant dependence on international revenue, a decline in the economies of any of the countries or regions in which we do business could negatively affect our operating results. Managing global operations and sites located throughout the world presents challenges associated with, among other things, cultural diversity and organizational alignment. Moreover, each region in the global semiconductor equipment market exhibits unique characteristics that can cause capital equipment investment patterns to vary significantly from period to period. Periodic local or international economic downturns, trade balance issues, political instability, legal or regulatory changes or terrorism in regions where we have operations along with fluctuations in interest and currency exchange rates could negatively affect our business and results of operations. Although we attempt to manage near-term currency risks through the use of hedging instruments, there can be no assurance that such efforts will be adequate.

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

Our industry includes large manufacturers with substantial resources to support customers worldwide. Some of our competitors are diversified companies with greater financial resources and more extensive research, engineering, manufacturing, marketing and customer service and support capabilities than we possess. We face competition from companies whose strategy is to provide a broad array of products and services, some of which compete with the products and services that we offer. These competitors may bundle their products in a manner that may discourage customers from purchasing our products, including pricing such competitive tools significantly below our product offerings. In addition, we face competition from smaller emerging semiconductor equipment companies whose strategy is to provide a portion of the products and services that we offer, using innovative technology to sell products into specialized markets. Loss of competitive position could negatively affect our prices, customer orders, revenue, gross margins, and market share, any of which would negatively affect our operating results and financial condition.

#### Risks Related to Our Business

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

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

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

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

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers to supply these materials. We generally do not have guaranteed supply arrangements with our suppliers. Because of the variability and uniqueness of customers' orders, we do not maintain an extensive inventory of materials for manufacturing. We seek to minimize the risk of production and service interruptions and/or shortages of key parts by selecting and qualifying alternative suppliers for key parts, monitoring the financial stability of key suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, key parts may be available only from a single supplier or a limited group of suppliers. Our operating results and business may be adversely impacted if we are unable to obtain parts to meet our production requirements, or if we are only able to do so on unfavorable terms.

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

Most of our manufacturing facilities are located in the United States, with additional operations located in Israel and Singapore. Operations at our manufacturing facilities and our assembly subcontractors are subject to disruption for a variety of reasons, including work stoppages, acts of war, terrorism, fire, earthquake, energy shortages, flooding or other natural disasters. Such disruption could cause delays in shipments of products to our customers. We cannot ensure that alternate production capacity would be available if a major disruption were to occur or that, if it were available, it could be obtained on favorable terms.

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

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

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

Our success is dependent in part on our technology and other proprietary rights. We own various United States and international patents and have additional pending patent applications relating to some of our products and technologies. The process of seeking patent protection is lengthy and expensive, and we cannot be certain that pending or future applications will actually result in issued patents or that issued patents will be of sufficient scope or strength to provide meaningful protection or commercial advantage to us. Other companies and individuals, including our larger competitors, may develop technologies and obtain patents relating to our business that are similar or superior to our

technology or may design around the patents we own, adversely affecting our business.

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

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

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

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

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

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

***There are significant risks associated with our proposed acquisition of ICOS Vision Systems Corporation NV.***

We recently announced that we have entered into an agreement to launch a friendly voluntary takeover bid for all of the outstanding capital stock of ICOS at \$36.50 per share. Upon successful completion of the offer, the Company will pay cash consideration of up to \$392.3 million for all securities of ICOS.

The transaction is currently expected to close during the quarter ending June 30, 2008. However, completion of our proposed acquisition of ICOS is subject to a number of conditions, including our holding (directly or indirectly) at least 85% of ICOS's outstanding shares as of the completion of the bid, the receipt of applicable regulatory approvals and the absence of any material adverse change with respect to ICOS. There is no assurance that these conditions (including without limitation receipt of the necessary regulatory approvals) will be satisfied within the anticipated timeframe, or that they will ever be satisfied. Failure to complete the proposed acquisition (or significant delays in such completion) would prevent us from realizing the anticipated benefits of the acquisition. In addition, even if the proposed transaction is not completed, we would nevertheless remain liable for significant transaction costs, including legal, accounting and other fees.

Furthermore, the transaction, if successful, will involve the combination of the businesses of two companies with substantial business operations. The difficulties of combining the companies' businesses include:

the necessity of coordinating geographically separated organizations, systems and facilities;

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

the need to harmonize our current business practices with the legal, regulatory and cultural practices of several different countries, including Belgium, which is where ICOS' s headquarters are located and is a country in which we do not currently have operations;

the challenge of entering into new market segments for which we have not previously manufactured and sold products;



identifying and realizing opportunities for the two companies, which currently serve different market segments, to mutually benefit from exchanges of technology, business and market expertise, and personnel; and

integrating personnel with diverse business backgrounds.

There is no assurance that the benefits that we anticipate realizing from the combination of the two companies will ever be realized. In addition, the process of combining the businesses of KLA-Tencor and ICOS could cause an interruption of, or loss of momentum in, the activities of either or both companies and the loss of key personnel. The diversion of our management's attention and any delays or difficulties encountered in connection with the acquisition and the combination of the two companies' businesses could result in the disruption of our ongoing business. For example, if we complete the acquisition but fail to acquire at least 95% of ICOS's outstanding shares through the bid or otherwise, we may be required to maintain ICOS as a publicly traded company for some period following the completion, which would require compliance with applicable legal, regulatory and listing requirements and thus could divert management's attention from our ongoing business. In addition, ICOS's customers, suppliers, employees and others with whom it has business dealings may have a potentially adverse reaction to the acquisition, which could in turn harm our operating results.

***Acquisitions are an important element of our strategy but, because of the uncertainties involved, we may not find suitable acquisition candidates and we may not be able to successfully integrate and manage acquired businesses.***

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

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

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

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

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

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

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

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

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

The threat of terrorism targeted at the regions of the world in which we do business increases the uncertainty in our markets. Any act of terrorism which affects the economy or the semiconductor industry could adversely affect our business. Increased international political

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

instability, disruption in air transportation and further enhanced security measures as a result of terrorist attacks, and the continuing instability in the Middle East, may hinder our ability to do business and may increase our costs of operations. Such continuing instability could cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. This same instability could have the same effects on our suppliers and their ability to timely deliver their products. If this international political instability continues or increases, our business and results of operations could be harmed. We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war.

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

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

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

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

For example, the adoption of Statement of Financial Accounting Standards No. 123(R), *Share-Based Payment* which required us to measure all employee stock-based compensation awards using a fair value method beginning in fiscal year 2006 and record such expense in our consolidated financial statements, has had a material impact on our consolidated financial statements, as reported under accounting principles generally accepted in the United States of America.

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

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

***We are exposed to various risks related to the regulatory environments where we perform our operations and conduct our business.***

We are subject to various risks related to new, different, inconsistent or even conflicting laws, rules and regulations that may be enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply, including environmental and safety regulations. Changes to existing laws, rules or regulations, including changes that result in inconsistent or conflicting laws, rules or regulations, in the countries in which we operate may adversely affect our reported financial results or the way we conduct our business.

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

We have some exposure to fluctuations in foreign currency exchange rates, primarily the Japanese Yen. We have international subsidiaries that operate and sell our products globally. We routinely hedge these exposures in an effort to minimize the impact of currency rate fluctuations, but these hedges may be inadequate to protect us from currency rate fluctuations. To the extent that these hedges are inadequate, our reported financial results or the way we conduct our business could be adversely affected.

***We are exposed to fluctuations in the market values of our portfolio investments and in interest rates; impairment of our investments could harm our earnings.***

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

Auction rate securities backed by student loans which are collateralized, insured and guaranteed by the United States Federal Department of Education are also included in our investment portfolio. Due to the current illiquidity in the auction rate security market, the funds associated

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

with these failed auctions may not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures. Although we believe our auction rate securities continue to represent sound investments due to the AAA/Aaa credit ratings of the underlying investments, we may be forced to sell some of our auction rate securities portfolio under illiquid market conditions, which could result in our recognizing a loss on such sales.

---

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

Our global operations are linked by information systems, including telecommunications, the internet, our corporate intranet, network communications, email and various computer hardware and software applications. Despite our implementation of network security measures, our tools and servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems and tools located at customer sites. Any such event could have an adverse effect on our business, operating results and financial condition.

***We may experience difficulties with our new customer relationship management ( CRM ) system or existing enterprise resource planning ( ERP ) system and other IT systems. System failure or malfunctioning may result in a disruption of operations or the inability to process transactions, and this could adversely affect our financial results.***

We may experience difficulties with our new CRM system implemented in fiscal year 2008 that could disrupt our ability to timely and accurately process and report key components of the results of our consolidated operations, our financial position and cash flows. System failure or malfunctioning could disrupt our ability to timely and accurately process and report key components of our results of operations, financial position and cash flows. Any disruptions or difficulties that may occur in connection with our ERP system or other systems could also adversely affect our ability to complete important business processes such as the evaluation of our internal controls and attestation activities pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. If we encounter unforeseen problems with regard to our ERP system or other systems, our business could be adversely affected.

#### **Risks Related to the Restatement of Our Prior Financial Results**

***Our efforts to correct past material weaknesses in our internal controls may not have been sufficient, and we may discover additional material weaknesses in our internal controls.***

As previously disclosed, the Company has undergone an investigation of the Company's historical stock option practices by the Special Committee of the Company's Board of Directors (for more information regarding the Special Committee investigation and its findings, please refer to Item 3, Legal Proceedings in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007, which was filed with the SEC on August 20, 2007). As a result of that Special Committee investigation and our management's internal review of our historical stock option practices and related matters, we identified past material weaknesses in our internal controls and procedures (see Item 9A, Controls and Procedures in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007, which was filed with the SEC on August 20, 2007). A material weakness is a control deficiency, or combination of them, that results in more than a remote likelihood that a material misstatement in our financial statements will not be prevented or detected. We believe that we have remedied the past material weaknesses in our internal controls and procedures, but there can be no assurance that our corrections were sufficient or fully effective, or that we will not discover additional material weaknesses in our internal controls and procedures in the future.

***The Special Committee investigation of our historical stock option practices and the resulting restatements have been time consuming and expensive, and have had a material adverse effect on us.***

The Special Committee investigation and the resulting restatement activities have required us to expend significant management time and incur significant accounting, legal and other expenses. In addition, we have established a Special Litigation Committee to oversee the litigation matters that have arisen out of the investigation and the restatements, and we cannot predict what additional actions may be required by these Committees. The period of time that will be necessary to resolve these matters is uncertain, and these matters could require significant additional attention and resources.

***The ongoing government inquiries relating to our historical stock option practices is time consuming and expensive and could result in injunctions, fines and penalties that may have a material adverse effect on our financial condition, results of operations and cash flow.***

On July 25, 2007, we announced that the Company had reached a settlement with the SEC by consenting to the entry of a permanent injunction against future violations of the reporting, books and records, and internal controls provisions of the federal securities laws. The settlement resolves completely the SEC investigation into the Company's historical stock option granting practices. KLA-Tencor was not charged by the SEC with fraud, nor was the Company required to pay any civil penalty, fine or money damages as part of the settlement. While the SEC has completed its investigation, the inquiry by the United States Attorney's Office for the Northern District of California ( USAO ) into our historical stock option practices is ongoing. We have fully cooperated with the USAO and intend to continue to do so. The period of time necessary to resolve this inquiry is uncertain, and we cannot predict the outcome of this inquiry or whether we will face additional government inquiries, investigations or other actions related to our historical stock option practices. The Company has also responded to inquiries from the U.S. Department of Labor, which is conducting an examination of the Company's 401(k) Savings Plan prompted by the Company's stock option



issues. The Company is cooperating fully with this examination and intends to continue to do so. Further, the Internal Revenue Service is conducting an audit covering calendar year 2006 related to the Company's historical stock option practices. These inquiries may require us to continue to expend significant management time and incur significant legal and other expenses, and could result in criminal actions seeking, among other things, injunctions against the Company and the payment of significant fines and penalties by the Company, which may have a material adverse effect on our financial condition, results of operations and cash flow.

***We have been named as a party to a number of shareholder derivative and class action lawsuits relating to our historical stock option practices, and we may be named in additional lawsuits in the future. This litigation could become time consuming and expensive and could result in the payment of significant judgments and settlements, which could have a material adverse effect on our financial condition and results of operations.***

In connection with our historical stock option practices and resulting restatements, a number of derivative actions were filed against certain of our current and former directors and officers purporting to assert claims on the Company's behalf. In addition, a number of securities class action complaints were filed against us and certain of our current and former directors and officers seeking damages related to our historical stock option practices and the resulting investigation, inquiries and restatements. There may be additional lawsuits of this nature filed in the future. We cannot predict the outcome of these lawsuits, other than the shareholder class action for which we have agreed in principle on a settlement (as described in Note 12, "Litigation and Other Legal Matters"), nor can we predict the amount of time and expense that will be required to resolve these lawsuits. If these lawsuits become time consuming and expensive, or if there are unfavorable outcomes in any of these cases, there could be a material adverse effect on our business, financial condition and results of operations.

Our insurance coverage will not cover our total liabilities and expenses in these lawsuits, in part because we have a significant deductible on certain aspects of the coverage. In addition, subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees in connection with the investigation of our historical stock option practices and the related litigation and ongoing government inquiry. We currently hold insurance policies for the benefit of our directors and officers, although our insurance coverage may not be sufficient in some or all of these matters. Furthermore, the insurers may seek to deny or limit coverage in some or all of these matters, in which case we may have to self-fund all or a substantial portion of our indemnification obligations.

***We are subject to the risks of additional government actions, shareholder lawsuits and other legal proceedings related to our historical stock option practices, the resulting restatements, and the remedial measures we have taken.***

It is possible that there may be additional governmental actions, shareholder lawsuits and other legal proceedings brought against us in connection with our historical stock option practices. In addition, we may be sued or taken to arbitration by former officers and employees in connection with their stock options, employment terminations and other matters. These proceedings may require us to expend significant management time and incur significant accounting, legal and other expenses, and may divert attention and resources from the operation of our business. These expenditures and diversions, as well as the adverse resolution of any specific lawsuit, could have a material adverse effect on our business, financial condition and results of operations.

***Failure to maintain effective internal controls may cause us to delay filing our periodic reports with the SEC, affect our Nasdaq listing, and adversely affect our stock price.***

The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on internal control over financial reporting in their annual reports on Form 10-K that contain an assessment by management of the effectiveness of the Company's internal control over financial reporting. In addition, our independent registered public accounting firm must attest to and report on the effectiveness of the internal control over financial reporting. The Company has in prior periods identified certain material weaknesses in its internal control over financial reporting. However, we believe the Company remediated those past material weaknesses, and we have not identified any material weaknesses in our internal control over financial reporting for the fiscal year ended June 30, 2007. Although we review our internal control over financial reporting in order to ensure compliance with the Section 404 requirements, if our independent registered public accounting firm is not satisfied with our internal control over financial reporting or the level at which these controls are documented, designed, operated or reviewed, or if our independent registered public accounting firm interprets the requirements, rules and/or regulations differently from our interpretation, then they may issue a report that is qualified. This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact our stock price.

***It may be difficult or costly to obtain director and officer insurance coverage as a result of the issues arising out of our historical stock option practices.***

We expect that the issues arising from our previous retroactive pricing of stock options will make it more difficult to obtain director and officer insurance coverage in the future. If we are able to obtain this coverage, it could be significantly more costly than in the past, which would have an adverse effect on our financial results and cash flow. Alternatively, if we are unable to obtain director and officer insurance coverage, or if we

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

are only able to obtain such policies subject to material restrictions or limitations, our directors and officers could face increased risks of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified directors and officers, which could adversely affect our business.



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

Following is a summary of stock repurchases for the three months ended March 31, 2008. <sup>(1)</sup>

Period	Total Number of Shares Purchased	Average Price Paid per Share	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs(3)
January 1, 2008 to January 31, 2008(2)	1,550,000	\$ 42.84	6,831,000
February 1, 2008 to February 29, 2008(2)	1,545,000	\$ 42.46	5,286,000
March 1, 2008 to March 31, 2008(2)	1,115,000	\$ 39.42	4,171,000
Total	4,210,000	\$ 41.79	

- (1) In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. Since the inception of the repurchase program in 1997 through March 31, 2008, the Board of Directors has authorized KLA-Tencor to repurchase a total of 47.8 million shares. The Company's systematic buyback program was suspended in May 2006, and resumed in February 2007.
- (2) All shares were purchased pursuant to the publicly announced repurchase programs described in footnote 1 above.
- (3) The stock repurchase programs have no expiration date. Future repurchases of the Company's common stock under the Company's repurchase programs may be effected through various different repurchase transaction structures, including isolated open market transactions or systematic repurchase plans.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

Exhibit Number	Exhibit Description	Incorporated by Reference			
		Form	File No.	Exhibit Number	Filing Date
2.1		8-K	000-09992	2.1	February 21,

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

Agreement Relating to a Friendly Take-Over Bid to be Brought for ICOS Vision Systems Corporation NV, entered into between KLA-Tencor Corporation and ICOS Vision Systems Corporation NV, dated February 20, 2008

2008

- 31.1 Certification of Chief Executive Officer under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934
- 31.2 Certification of Chief Financial Officer under Rule 13a-14(a) /15d-14(a) of the Securities Exchange Act of 1934
- 32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350

\* Denotes a management contract, plan or arrangement

**SIGNATURES**

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

**KLA-Tencor Corporation**  
(Registrant)

April 28, 2008  
(Date)

/s/ RICHARD P. WALLACE  
Richard P. Wallace  
Chief Executive Officer  
(Principal Executive Officer)

April 28, 2008  
(Date)

/s/ JOHN H. KISPERT  
John H. Kispert  
President, Chief Operating Officer and Chief Financial Officer  
(Principal Financial Officer)

April 28, 2008  
(Date)

/s/ VIRENDRA A. KIRLOSKAR  
Virendra A. Kirloskar  
Chief Accounting Officer  
(Principal Accounting Officer)

**KLA-TENCOR CORPORATION**

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Exhibit Description</b>	<b>Incorporated by Reference</b>		
		<b>Form</b>	<b>File No.</b>	<b>Exhibit Number</b> <b>Filing Date</b>
2.1	Agreement Relating to a Friendly Take-Over Bid to be Brought for ICOS Vision Systems Corporation NV, entered into between KLA-Tencor Corporation and ICOS Vision Systems Corporation NV, dated February 20, 2008	8-K	000-09992	2.1 February 21, 2008
31.1	Certification of Chief Executive Officer under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934			
31.2	Certification of Chief Financial Officer under Rule 13a-14(a) /15d-14(a) of the Securities Exchange Act of 1934			
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350			

\* Denotes a management contract, plan or arrangement