KLA TENCOR CORP
Form 10-Q
October 24, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark one)
x QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2014
or
¨ TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 000-09992
KLA-Tencor Corporation
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	04-2564110 (I.R.S. Employer Identification No.)
One Technology Drive, Milpitas, California (Address of Principal Executive Offices)	95035 (Zip Code)

(408) 875-3000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes ¨ No x
As of October 10, 2014, there were 164,476,980 shares of the registrant's Common Stock, $0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

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

(In thousands)	September 30, 2014	June 30, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$669,683	$630,861
Marketable securities	2,272,809	2,521,776
Accounts receivable, net	444,048	492,863
Inventories	676,241	656,457
Deferred income taxes	232,706	215,676
Other current assets	73,050	69,197
Total current assets	4,368,537	4,586,830
Land, property and equipment, net	329,959	330,263
Goodwill	335,315	335,355
Purchased intangibles, net	23,624	27,697
Other non-current assets	244,137	258,519
Total assets	$5,301,572	$5,538,664
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$108,287	$103,422
Deferred system profit	88,801	147,923
Unearned revenue	54,034	59,176
Other current liabilities	553,715	585,090
Total current liabilities	804,837	895,611
Non-current liabilities:		
Long-term debt	748,054	747,919
Unearned revenue	56,003	57,500
Other non-current liabilities	162,958	168,288
Total liabilities	1,771,852	1,869,318
Commitments and contingencies (Note 12 and Note 13)		
Stockholders' equity:		
Common stock and capital in excess of par value	1,235,986	1,220,504
Retained earnings	2,329,936	2,479,113
Accumulated other comprehensive income (loss)	(36,202)	(30,271)
Total stockholders' equity	3,529,720	3,669,346
Total liabilities and stockholders' equity	$5,301,572	$5,538,664

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

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

	Three months ended September 30,	
(In thousands, except per share data)	2014	2013
Revenues:		
Product	$476,598	$501,740
Service	166,303	156,597
Total revenues	642,901	658,337
Costs and operating expenses:		
Costs of revenues	288,467	277,657
Engineering, research and development	143,637	132,273
Selling, general and administrative	101,644	98,496
Total costs and operating expenses	533,748	508,426
Income from operations	109,153	149,911
Interest income and other, net	3,375	3,615
Interest expense	13,521	13,662
Income before income taxes	99,007	139,864
Provision for income taxes	26,774	28,667
Net income	$72,233	$111,197
Net income per share:		
Basic	$0.44	$0.67
Diluted	$0.43	$0.66
Cash dividends declared per share	$0.50	$0.45
Weighted-average number of shares:		
Basic	164,845	165,886
Diluted	166,580	168,734

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

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KLA-TENCOR CORPORATION
Condensed Consolidated Statements of Comprehensive Income
(Unaudited)

	Three months ended September 30,	
(In thousands)	2014	2013
Net income	$72,233	$111,197
Other comprehensive income (loss):		
Currency translation adjustments:		
Change in currency translation adjustments	(7,736)	5,110
Change in income tax benefit or expense	2,872	(1,315)
Net change related to currency translation adjustments	(4,864)	3,795
Cash flow hedges:		
Change in net unrealized gains or losses	2,033	(291)
Reclassification adjustments for net gains or losses included in net income	(228)	(2,516)
Change in income tax benefit or expense	(650)	1,005
Net change related to cash flow hedges	1,155	(1,802)
Net change related to unrecognized losses and transition obligations in connection with defined benefit plans	733	199
Available-for-sale securities:		
Change in net unrealized gains or losses	(2,735)	4,139
Reclassification adjustments for gains or losses included in net income	(1,635)	(234)
Change in income tax benefit or expense	1,415	(1,342)
Net change related to available-for-sale securities	(2,955)	2,563
Other comprehensive income (loss)	(5,931)	4,755
Total comprehensive income	$66,302	$115,952

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

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

(In thousands)	Three months ended September 30, 2014	2013
Cash flows from operating activities:		
Net income	$72,233	$111,197
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	21,159	20,637
Non-cash stock-based compensation expense	15,483	19,219
Excess tax benefit from equity awards	(14,223)	(18,605)
Net gain on sale of marketable securities and other investments	(1,635)	(234)
Changes in assets and liabilities:		
Decrease in accounts receivable, net	39,261	85,771
Increase in inventories	(23,445)	(29,805)
Increase in other assets	(2,732)	(9,425)
Increase (decrease) in accounts payable	5,276	(1,058)
Increase (decrease) in deferred system profit	(59,122)	7,966
Decrease in other liabilities	(17,329)	(8,415)
Net cash provided by operating activities	34,926	177,248
Cash flows from investing activities:		
Capital expenditures, net	(13,445)	(21,751)
Purchase of available-for-sale securities	(624,860)	(348,031)
Proceeds from sale of available-for-sale securities	732,337	203,541
Proceeds from maturity of available-for-sale securities	135,097	32,058
Purchase of trading securities	(22,567)	(20,851)
Proceeds from sale of trading securities	18,986	18,366
Net cash provided by (used in) investing activities	225,548	(136,668)
Cash flows from financing activities:		
Issuance of common stock	4,677	41,047
Tax withholding payments related to vested and released restricted stock units	(27,168)	(48,264)
Common stock repurchases	(124,839)	(60,504)
Payment of dividends to stockholders	(82,413)	(74,617)
Excess tax benefit from equity awards	14,223	18,605
Net cash used in financing activities	(215,520)	(123,733)
Effect of exchange rate changes on cash and cash equivalents	(6,132)	2,712
Net increase (decrease) in cash and cash equivalents	38,822	(80,441)
Cash and cash equivalents at beginning of period	630,861	985,390
Cash and cash equivalents at end of period	$669,683	$904,949
Supplemental cash flow disclosures:		
Income taxes paid, net	$20,361	$19,052
Interest paid	$136	$217
Non-cash investing activities:		
Purchase of land, property and equipment	$3,571	$1,798

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

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KLA-TENCOR CORPORATION
Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1 – BASIS OF PRESENTATION

Basis of Presentation. The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation (“KLA-Tencor” or the “Company”) pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations, comprehensive income, 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, 2014, filed with the SEC on August 8, 2014.

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

The results of operations for the three months ended September 30, 2014 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, 2015.

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

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

Revenue Recognition. KLA-Tencor recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. The Company derives revenue from three sources—sales of systems, spare parts and services. In general, the Company recognizes revenue for systems when the system has been installed, is operating according to predetermined specifications and is accepted by the customer. When a customer delays installation for products for which the Company has demonstrated a history of successful installation and acceptance, the Company recognizes revenue upon delivery and customer acceptance. Under certain circumstances, however, the Company recognizes revenue prior to acceptance from the customer, as follows:

- When the customer fab has previously accepted the same tool, with the same specifications, and when the Company can objectively demonstrate that the tool meets all of the required acceptance criteria.
- When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% payment is due based upon shipment.
- When the installation of the system is deemed perfunctory.
- When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

In circumstances in which the Company recognizes revenue prior to installation, the portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation.

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In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. The Company also allows for multiple element revenue arrangements in cases where certain elements of a sales arrangement are not delivered and accepted in one reporting period. To determine the relative fair value of each element in a revenue arrangement, the Company allocates arrangement consideration based on the selling price hierarchy. For substantially all of the arrangements with multiple deliverables pertaining to products and services, the Company uses vendor-specific objective evidence (“VSOE”) or third-party evidence (“TPE”) to allocate the selling price to each deliverable. The Company determines TPE based on historical prices charged for products and services when sold on a stand-alone basis. When the Company is unable to establish relative selling price using VSOE or TPE, the Company uses estimated selling price (“ESP”) in its allocation of arrangement consideration. The objective of ESP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products. The Company regularly reviews relative selling prices and maintains internal controls over the establishment and updates of these estimates.

In a multiple element revenue arrangement, the Company defers revenue recognition associated with the relative fair value of each undelivered element until that element is delivered to the customer. To be considered a separate element, the product or service in question must represent a separate unit of accounting, which means that such product or service must fulfill the following criteria: (a) the delivered item(s) has value to the customer on a stand-alone basis; and (b) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the Company. If the arrangement does not meet all the above criteria, the entire amount of the sales contract is deferred until all elements are accepted by the customer.

Trade-in rights are occasionally granted to customers to trade in tools in connection with subsequent purchases. The Company estimates the value of the trade-in right and reduces the revenue recognized on the initial sale. This amount is recognized at the earlier of the exercise of the trade-in right or the expiration of the trade-in right.

Spare parts revenue is recognized when the product has been shipped, risk of loss has passed to the customer and collection of the resulting receivable is probable.

Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a maintenance contract, including consulting and training revenue, is recognized when the related services are performed and collectibility is reasonably assured.

The Company sells stand-alone software that is subject to the software revenue recognition guidance. The Company periodically reviews selling prices to determine whether VSOE exists, and in situations where the Company is unable to establish VSOE for undelivered elements such as post-contract service, revenue is recognized ratably over the term of the service contract.

The Company also defers the fair value of non-standard warranty bundled with equipment sales as unearned revenue. Non-standard warranty includes services incremental to the standard 40-hour per week coverage for 12 months. Non-standard warranty is recognized ratably as revenue when the applicable warranty term period commences.

The deferred system profit balance equals the amount of deferred system revenue that was invoiced and due on shipment, less applicable product and warranty costs. Deferred system revenue represents the value of products that have been shipped and billed to customers which have not met the Company’s revenue recognition criteria. Deferred system profit does not include the profit associated with product shipments to certain customers in Japan, to whom title does not transfer until customer acceptance. Shipments to such customers in Japan are classified as inventory at cost until the time of acceptance.

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Recent Accounting Pronouncements.

Recently Adopted

In July 2013, the Financial Accounting Standards Board ("FASB") issued an accounting standard update that provides explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. Under the new standard update, in most circumstances, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the Company's financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward. This accounting standard update became effective for the Company's interim period ended September 30, 2014, and the adoption did not have a material impact on the Company's condensed consolidated financial statements.

Updates Not Yet Effective

In May 2014, the FASB issued an accounting standard update regarding revenue from customer contracts to transfer goods and services or enter into contracts for the transfer of non-financial assets (unless covered by other standards for example insurance or lease contracts). Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration which the entity expects to be entitled in exchange for those goods or services. The updates are effective for the Company beginning the first quarter of the fiscal year ending June 30, 2018. Early adoption is not permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In June 2014, the FASB issued an accounting standard update regarding stock-based compensation that clarifies the accounting when terms of an award provide that a performance target could be achieved after the requisite service period. The amendments require that a performance target that affects vesting which could be achieved after the requisite service period be treated as a performance condition. The update is effective for the Company beginning in the first quarter of the Company's fiscal year ending June 30, 2017, with early adoption permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

NOTE 2 – FAIR VALUE MEASUREMENTS

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

Fair Value of Financial Instruments. KLA-Tencor has evaluated the estimated fair value of financial instruments using available market information and valuations as provided by third-party sources. The use of different market assumptions and/or estimation methodologies could have a significant effect on the estimated fair value amounts. The fair value of the Company's cash equivalents, accounts receivable, accounts payable and other current liabilities approximate their carrying amounts due to the relatively short maturity of these items.

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

Level 1	Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.
Level 2	Valuations based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities.

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

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

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The Company's financial instruments were classified within Level 1 or Level 2 of the fair value hierarchy as of September 30, 2014, because they were valued using quoted market prices, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency. As of September 30, 2014, the types of instruments valued based on quoted market prices in active markets included money market funds, U.S. Treasury securities and certain U.S. Government agency securities, U.S. Treasury securities and sovereign securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

As of September 30, 2014, the types of instruments valued based on other observable inputs included corporate debt securities, municipal securities and certain U.S. Government agency securities and sovereign securities. The market inputs used to value these instruments generally consist of market yields, reported trades and broker/dealer quotes. Such instruments are generally classified within Level 2 of the fair value hierarchy.

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

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

As of September 30, 2014 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
Corporate debt securities	$92,160	$—	$92,160
Money market and other	451,045	451,045	—
Marketable securities:			
U.S. Treasury securities	323,504	323,504	—
U.S. Government agency securities	851,272	833,272	18,000
Municipal securities	79,868	—	79,868
Corporate debt securities	962,462	—	962,462
Sovereign securities	49,009	9,124	39,885
Total cash equivalents and marketable securities[(1)]	2,809,320	1,616,945	1,192,375
Other current assets:			
Derivative assets	5,607	—	5,607
Other non-current assets:			
Executive Deferred Savings Plan	161,287	93,631	67,656
Total financial assets[(1)]	$2,976,214	$1,710,576	$1,265,638
Liabilities			
Other current liabilities:			
Derivative liabilities	$(1,350)	$—	$(1,350)
Total financial liabilities	$(1,350)	$—	$(1,350)

(1) Excludes cash of $105.3 million held in operating accounts and time deposits of $27.8 million as of September 30, 2014.

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

As of June 30, 2014 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
U.S. Government agency securities	$28,000	$8,000	$20,000
Municipal securities	2,891	—	2,891
Corporate debt securities	68,992	—	68,992
Money market and other	397,517	397,517	—
Marketable securities:			
U.S. Treasury securities	384,400	365,401	18,999
U.S. Government agency securities	839,843	811,841	28,002
Municipal securities	93,325	—	93,325
Corporate debt securities	1,155,176	—	1,155,176
Sovereign securities	42,264	9,253	33,011
Total cash equivalents and marketable securities(1)	3,012,408	1,592,012	1,420,396
Other current assets:			
Derivative assets	666	—	666
Other non-current assets:			
Executive Deferred Savings Plan	159,995	105,311	54,684
Total financial assets(1)	$3,173,069	$1,697,323	$1,475,746
Liabilities			
Other current liabilities:			
Derivative liabilities	$(898)	$—	$(898)
Total financial liabilities	$(898)	$—	$(898)

(1) Excludes cash of $106.7 million held in operating accounts and time deposits of $33.5 million as of June 30, 2014.
There were no transfers in and out of Level 1 and Level 2 fair value measurements during the three months ended September 30, 2014. The Company did not have significant assets or liabilities measured at fair value on a recurring basis within Level 3 fair value measurements as of September 30, 2014 or June 30, 2014.

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NOTE 3 – FINANCIAL STATEMENT COMPONENTS

Balance Sheet Components

(In thousands)	As of September 30, 2014	As of June 30, 2014
Accounts receivable, net:		
Accounts receivable, gross	$465,866	$514,690
Allowance for doubtful accounts	(21,818)	(21,827)
	$444,048	$492,863
Inventories:		
Customer service parts	$216,796	$203,194
Raw materials	218,959	221,612
Work-in-process	179,806	171,249
Finished goods	60,680	60,402
	$676,241	$656,457
Other current assets:		
Prepaid expenses	$37,877	$35,478
Income tax related receivables	24,848	27,452
Other current assets	10,325	6,267
	$73,050	$69,197
Land, property and equipment, net:		
Land	$41,840	$41,848
Buildings and leasehold improvements	310,854	302,537
Machinery and equipment	494,960	491,167
Office furniture and fixtures	21,136	20,945
Construction-in-process	3,308	8,945
	872,098	865,442
Less: accumulated depreciation and amortization	(542,139)	(535,179)
	$329,959	$330,263
Other non-current assets:		
Executive Deferred Savings Plan(1)	$161,287	$159,996
Deferred tax assets – long-term	66,663	75,138
Other non-current assets	16,187	23,385
	$244,137	$258,519
Other current liabilities:		
Warranty	$33,059	$37,746
Executive Deferred Savings Plan(1)	162,224	160,527
Compensation and benefits	163,808	203,990
Income taxes payable	15,593	15,283
Interest payable	21,706	8,769
Other accrued expenses	157,325	158,775
	$553,715	$585,090
Other non-current liabilities:		
Pension liabilities	$57,353	$59,908
Income taxes payable	61,721	59,575
Other non-current liabilities	43,884	48,805
	$162,958	$168,288

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(1) KLA-Tencor has a non-qualified deferred compensation plan whereby certain executives and non-employee directors may defer a portion of their compensation. Participants are credited with returns based on their allocation of their account balances among measurement funds. The Company controls the investment of these funds, and the participants remain general creditors of KLA-Tencor. Distributions from the plan commence following a participant's retirement or termination of employment or on a specified date allowed per the plan provisions, except in cases where such distributions are required to be delayed in order to avoid a prohibited distribution under Internal Revenue Code Section 409A. As of September 30, 2014, the Company had a deferred compensation plan related asset and liability included as a component of other non-current assets and other current liabilities on the Condensed Consolidated Balance Sheet. The plan assets are classified as trading securities.

Accumulated Other Comprehensive Income (Loss)

The components of accumulated other comprehensive income (loss) ("OCI") as of the dates indicated below were as follows:

(In thousands)	Currency Translation Adjustments	Unrealized Gains (Losses) on Available-for-Sale Securities	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total
Balance as of September 30, 2014	$(22,135)	$ (155)	$1,143	$(15,055)	$(36,202)
Balance as of June 30, 2014	$(17,271)	$ 2,800	$(12)	$(15,788)	$(30,271)

The effects on net income of amounts reclassified from accumulated OCI to the Condensed Consolidated Statement of Operations for the indicated period were as follows (in thousands):

Accumulated OCI Components	Location in the Condensed Consolidated Statements of Operations	Three months ended September 30, 2014	Three months ended September 30, 2013
Unrealized gains (losses) on cash flow hedges from foreign exchange contracts	Revenues	$269	$2,450
	Costs of revenues	(41)	66
	Net gains reclassified from accumulated OCI	$228	$2,516
Unrealized gains on available-for-sale securities	Interest income and other, net	$1,635	$234

The amounts reclassified out of accumulated OCI related to the Company's defined pension plans which were recognized as a component of net periodic cost for the three months ended September 30, 2014 and 2013 were $0.8 million and $0.3 million, respectively. For additional details, refer to Note 11, "Employee Benefit Plans" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2014.

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NOTE 4 – MARKETABLE SECURITIES

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

As of September 30, 2014 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses		Fair Value
U.S. Treasury securities	$323,560	$84	$(140	)	$323,504
U.S. Government agency securities	851,734	246	(708	)	851,272
Municipal securities	79,880	54	(66	)	79,868
Corporate debt securities	1,054,280	1,185	(843	)	1,054,622
Money market and other	451,045	—	—		451,045
Sovereign securities	48,993	35	(19	)	49,009
Subtotal	2,809,492	1,604	(1,776	)	2,809,320
Add: Time deposits(1)	27,830	—	—		27,830
Less: Cash equivalents	564,344	—	(3	)	564,341
Marketable securities	$2,272,978	$1,604	$(1,773	)	$2,272,809

As of June 30, 2014 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses		Fair Value
U.S. Treasury securities	$384,165	$287	$(52	)	$384,400
U.S. Government agency securities	867,309	651	(117	)	867,843
Municipal securities	96,198	93	(75	)	96,216
Corporate debt securities	1,220,794	3,526	(152	)	1,224,168
Money market and other	397,517	—	—		397,517
Sovereign securities	42,227	46	(9	)	42,264
Subtotal	3,008,210	4,603	(405	)	3,012,408
Add: Time deposits(1)	33,509	—	—		33,509
Less: Cash equivalents	524,149	—	(8	)	524,141
Marketable securities	$2,517,570	$4,603	$(397	)	$2,521,776

(1) Time deposits excluded from fair value measurements.

KLA-Tencor's investment portfolio consists of both corporate and government securities that have a maximum maturity of three years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. All unrealized losses are due to changes in market interest rates, bond yields and/or credit ratings. The Company has the ability to realize the full value of all of these investments upon maturity. The following table summarizes the fair value and gross unrealized losses of the Company's investments that were in an unrealized loss position as of the date indicated below:

As of September 30, 2014 (In thousands)	Fair Value	Gross Unrealized Losses(1)	
U.S. Treasury securities	$169,353	$(140	)
U.S. Government agency securities	449,673	(708	)
Municipal securities	32,441	(66	)
Corporate debt securities	400,740	(840	)
Sovereign securities	28,416	(19	)
Total	$1,080,623	$(1,773	)

(1)

Of the total gross unrealized losses, the amount of total gross unrealized losses related to investments that had been in a continuous loss position for 12 months or more was immaterial.

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

As of September 30, 2014 (In thousands)	Amortized Cost	Fair Value
Due within one year	$778,612	$779,234
Due after one year through three years	1,494,366	1,493,575
	$2,272,978	$2,272,809

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Realized gains on available-for-sale securities for the three months ended September 30, 2014 and September 30, 2013 were $1.7 million and $0.3 million, respectively. Realized losses on available-for-sale securities for the three months ended September 30, 2014 and September 30, 2013 were immaterial.

NOTE 5 – BUSINESS COMBINATION

On March 28, 2014, the Company acquired certain assets and liabilities of a privately-held company that developed and sold software to mask manufacturers, semiconductor fabs and mask inspection and review equipment manufacturers, for a total purchase consideration of $18 million in cash.

The following table represents the preliminary purchase price allocation and summarizes the aggregate estimated fair values of the net assets acquired on the closing date of the acquisition:

(In thousands)	Preliminary Purchase Price Allocation
Intangibles	$9,400
Goodwill	8,730
Liabilities assumed	(130)
Cash consideration paid	$18,000

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired. The $8.7 million of goodwill was assigned to the Defect Inspection reporting unit.

NOTE 6 – GOODWILL AND PURCHASED INTANGIBLE ASSETS

Goodwill

The following table presents goodwill balances and the movements during the three months ended September 30, 2014:

(In thousands)	
As of June 30, 2014	$335,355
Adjustments	(40)
As of September 30, 2014	$335,315

The changes in the gross goodwill balance since June 30, 2014 resulted from the foreign currency translation adjustments.

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination.

The Company has four reporting units: Defect Inspection, Metrology, Service and Other. As of September 30, 2014, substantially all of the goodwill balance resided in the Defect Inspection reporting unit.

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The Company performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2013 during the three months ended December 31, 2013 and concluded that it was more likely than not that the fair value of each of the reporting units exceeded its carrying amount. In assessing the qualitative factors, the Company considered the impact of key factors including change in industry and competitive environment, market capitalization, stock price, earnings multiples, budgeted-to-actual revenue performance from prior year, gross margin and cash flow from operating activities. As such, it was not necessary to perform the two-step quantitative goodwill impairment test at that time. In addition, there have been no significant events or circumstances affecting the valuation of goodwill subsequent to the qualitative assessment performed in the second quarter of the fiscal year ended June 30, 2014. The next annual assessment of the goodwill by reporting unit will be performed in the second quarter of the fiscal year ending June 30, 2015.

Purchased Intangible Assets

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

(In thousands)		As of September 30, 2014			As of June 30, 2014		
Category	Range of Useful Lives	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount
Existing technology	4-7 years	$141,659	$ 128,618	$13,041	$141,659	$ 126,567	$15,092
Patents	6-13 years	57,648	55,048	2,600	57,648	54,398	3,250
Trade name/Trademark	4-10 years	19,893	17,802	2,091	19,893	17,427	2,466
Customer relationships	6-7 years	54,680	49,636	5,044	54,680	48,915	5,765
Other	0-1 year	17,599	16,751	848	17,599	16,475	1,124
Total		$291,479	$ 267,855	$23,624	$291,479	$ 263,782	$27,697

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.

For the three months ended September 30, 2014 and 2013, amortization expense for intangible assets was $4.1 million and $4.5 million, respectively. Based on the intangible assets recorded as of September 30, 2014, 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)
2015 (remaining 9 months)	$11,729
2016	7,564
2017	2,806
2018	1,525
Total	$23,624

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NOTE 7 – LONG-TERM DEBT

In April 2008, the Company issued $750 million aggregate principal amount of 6.90% senior, unsecured long-term debt due in 2018 with an effective interest rate of 7.00%. The discount on the debt amounted to $5.4 million and is being amortized over the life of the debt using the straight-line method as opposed to the interest method due to immateriality. Interest is payable semi-annually on November 1 and May 1. The debt indenture includes covenants that limit the Company's ability to grant liens on its facilities and to enter into sale and leaseback transactions, subject to significant allowances under which certain sale and leaseback transactions are not restricted. The Company was in compliance with all of its covenants as of September 30, 2014.

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

Based on the trading prices of the debt on the applicable dates, the fair value of the debt as of September 30, 2014 and June 30, 2014 was $884.8 million and $893.7 million, respectively. While the debt is recorded at cost, the fair value of the long-term debt was determined based on quoted prices in markets that are not active; accordingly, the long-term debt is categorized as Level 2 for purposes of the fair value measurement hierarchy.

As described in detail under Note 17, "Subsequent Events," to the condensed consolidated financial statements, on October 23, 2014, the Company announced that its Board of Directors has authorized the financing of a leveraged recapitalization pursuant to which the Company intends to add up to $2.5 billion of incremental debt, consisting of a combination of investment grade senior notes and a pre-payable term loan facility, subject to market conditions. In addition, the Company also expects to enter into a revolving credit facility, subject to market conditions.

NOTE 8 – EQUITY AND LONG-TERM INCENTIVE COMPENSATION PLANS

Equity Incentive Program

As of September 30, 2014, the Company had two plans under which the Company was able to issue equity incentive awards, such as restricted stock units and stock options, to its employees, consultants and members of its Board of Directors: the 2004 Equity Incentive Plan (the "2004 Plan") and the 1998 Director Plan (the "Outside Director Plan").

2004 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 the Company's employees, consultants and members of its Board of Directors. As of September 30, 2014, 6.0 million shares were available for issuance under the 2004 Plan.

Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date are counted against the total number of shares issuable under the 2004 Plan as follows, based on the grant date of the applicable award: (a) for any such awards granted before November 6, 2013, the awards counted against the 2004 Plan share reserve as 1.8 shares for every one share subject thereto; and (b) for any such awards granted on or after November 6, 2013, the awards count against the 2004 Plan share reserve as 2.0 shares for every one share subject thereto.

In addition, in November 2013, the Company's stockholders also approved amendments to the 2004 Plan that included, among other things, giving the plan administrator the ability to grant "dividend equivalent" rights in connection with awards of restricted stock units, performance shares, performance units and deferred stock units before they are fully vested. It allows the plan administrator, at its discretion, to grant a right to receive dividends on the aforementioned awards which may be settled in cash or Company stock at the discretion of the plan administrator subject to meeting the vesting requirement of the underlying awards.

Outside Director Plan

The Outside Director Plan only permits the issuance of stock options to the non-employee members of the Board of Directors. As of September 30, 2014, 1.7 million shares were available for grant under the Outside Director Plan.

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Equity Incentive Plans - General Information

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

(In thousands)	Available For Grant
Balances as of June 30, 2014	8,804
Restricted stock units granted[(1)(3)]	(1,133)
Restricted stock units canceled[(1)]	38
Options canceled/expired/forfeited	10
Plan shares expired[(2)]	(10)
Balances as of September 30, 2014	7,709

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(1) The number of restricted stock units provided in this row reflects the application of the award multiplier as described above (1.8x or 2.0x depending on the grant date of the applicable award).

(2) Represents the portion of shares listed as "Options canceled/expired/forfeited" above, that were issued under the Company's equity incentive plans other than the 2004 Plan and the Outside Director Plan. Because the Company is only currently authorized to issue equity awards under the 2004 Plan and the Outside Director Plan, any equity awards that are canceled, expired or are forfeited under any other Company equity incentive plans do not result in additional shares being available to the Company for future grant.

(3) Includes restricted stock units granted to senior management during the three months ended September 30, 2014 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of September 30, 2014, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units granted during the three months ended September 30, 2014, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum levels and all applicable service-based criteria are fully satisfied (i.e., 0.6 million shares for the three months ended September 30, 2014 after the application of 2.0x multiplier described above).

The Company has granted only restricted stock units under its equity incentive program since October 2007. For the preceding several years until October 31, 2007, stock options were granted at the market price of the Company's common stock on the date of grant generally with vesting period term ranging from one to five years. Restricted stock units may be granted with varying criteria such as service-based and/or performance-based vesting.

The fair value of stock-based awards is measured at the grant date and is recognized as an expense over the employee's requisite service period. The fair value for purchase rights under the Company's Employee Stock Purchase Plan is determined using a Black-Scholes valuation model and for restricted stock units granted without "dividend equivalent" rights using the closing price of the Company's common stock on the grant date, adjusted to exclude the present value of dividends which are not accrued on those restricted stock units. In November 2013, the Company's stockholders approved amendments to the 2004 Plan that included, among other things, giving the plan administrator the ability to grant "dividend equivalent" rights in connection with awards of restricted stock units, performance shares, performance units and deferred stock units before they are fully vested as discussed above. The fair value for restricted stock units granted with "dividend equivalent" rights is determined using the closing price of the Company's common stock on the grant date. As of September 30, 2014, the Company accrued $0.2 million of dividends payable in connection with the restricted stock units with dividend equivalent rights granted during the three months ended September 30, 2014, which entitle the holders of such equity awards to the same dividend value per share as holders of common stock subject to meeting the vesting requirements of the underlying equity awards.

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

(In thousands)	Three months ended September 30, 2014	2013
Stock-based compensation expense by:		
Costs of revenues	$2,237	$3,177
Engineering, research and development	3,740	5,408
Selling, general and administrative	9,506	10,634
Total stock-based compensation expense	$15,483	$19,219

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

(In thousands)	As of September 30, 2014	As of June 30, 2014
Inventory	$5,148	$8,278

Stock Options

The following table summarizes the activity and weighted-average exercise price for stock options under all plans during the three months ended September 30, 2014:

Stock Options	Shares (In thousands)	Weighted-Average Exercise Price
Outstanding stock options as of June 30, 2014	141	$ 40.70
Granted	—	$ —
Exercised	(101)	$ 40.45
Canceled/expired/forfeited	(10)	$ 39.80
Outstanding stock options as of September 30, 2014 (all outstanding and all vested and exercisable)	30	$ 41.81

The Company has not issued any stock options since October 2007. As of September 30, 2014, the Company had no unrecognized stock-based compensation balance related to outstanding stock options. The weighted-average remaining contractual term for total options outstanding under all plans all of which were vested and exercisable as of September 30, 2014 was 0.5 years. The aggregate intrinsic value for total options outstanding under all plans (all of which were vested and exercisable as of September 30, 2014) was $1.1 million.

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

(In thousands)	Three months ended September 30, 2014	2013
Total intrinsic value of options exercised	$3,478	$7,883
Total cash received from employees and non-employee Board members as a result of stock option exercises	$4,677	$41,047
Tax benefits realized by the Company in connection with these exercises	$1,617	$2,617

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

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Restricted Stock Units

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value for restricted stock units granted, vested and released, withheld for taxes, and forfeited during the three months ended September 30, 2014 and restricted stock units outstanding as of September 30, 2014 and June 30, 2014:

Restricted Stock Units	Shares (In thousands) [1]	Weighted-Average Grant Date Fair Value
Outstanding restricted stock units as of June 30, 2014	3,356	$ 38.95
Granted[2]	567	$ 74.26
Vested and released	(666)	$ 31.41
Withheld for taxes	(358)	$ 31.41
Forfeited	(21)	$ 32.65
Outstanding restricted stock units as of September 30, 2014	2,878	$ 48.63

(1) Share numbers reflect actual shares subject to awarded restricted stock units. As described above, under the terms of the 2004 Plan, the number of shares subject to each award reflected in this number is multiplied by either 1.8 or 2.0 (depending on the grant date of the award) to calculate the impact of the award on the share reserve under the 2004 Plan.

(2) Includes restricted stock units granted to senior management during the three months ended September 30, 2014 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of September 30, 2014, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum and all applicable service-based criteria are fully satisfied (i.e., 0.3 million shares during the three months ended September 30, 2014).

The restricted stock units granted by the Company since the beginning of the fiscal year ended June 30, 2013 generally vest (a) with respect to awards with only service-based vesting criteria, in four equal installments on the first, second, third and fourth anniversaries of the grant date and (b) with respect to awards with both performance-based and service-based vesting criteria, in two equal installments on the third and fourth anniversaries of the grant date, in each case subject to the recipient remaining employed by the Company as of the applicable vesting date. The restricted stock units granted by the Company from the beginning of the fiscal year ended June 30, 2007 through the fiscal year ended June 30, 2012 generally vest in two equal installments on the second and fourth anniversaries of the grant date, subject to the recipient remaining employed by the Company as of the applicable vesting date.

The following table shows the weighted-average grant date fair value per unit for the restricted stock units granted and tax benefits realized by the Company in connection with vested and released restricted stock units for the indicated periods:

	Three months ended September 30,	
(In thousands, except for weighted-average grant date fair value)	2014	2013
Weighted-average grant date fair value per unit	$74.26	$53.02
Tax benefits realized by the Company in connection with vested and released restricted stock units	$23,301	$40,606

As of September 30, 2014, the unrecognized stock-based compensation expense balance related to restricted stock units was $104.2 million, excluding the impact of estimated forfeitures, and will be recognized over a weighted-average remaining contractual term and an estimated weighted-average amortization period of 1.6 years. The intrinsic value of outstanding restricted stock units as of September 30, 2014 was $226.7 million.

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Cash-Based Long-Term Incentive Compensation

Starting in the fiscal year ended June 30, 2013, the Company adopted a cash-based long-term incentive (“Cash LTI”) program for many of its employees as part of the Company’s employee compensation program. During the three months ended September 30, 2014, the Company approved Cash LTI awards of $1.6 million under the Company’s Cash Long-Term Incentive Plan (“Cash LTI Plan”). Cash LTI awards issued to employees under the Cash LTI Plan will vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date. Executives and non-employee Board members are not participating in this program. During the three months ended September 30, 2014 and 2013, the Company recognized $7.8 million and $4.1 million, respectively, in compensation expense under the Cash LTI Plan. As of September 30, 2014, the unrecognized compensation balance (excluding the impact of estimated forfeitures) related to the Cash LTI Plan was $77.7 million.

Employee Stock Purchase Plan

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

The offering period (or length of the look-back period) under the ESPP has a duration of six months, and the purchase price with respect to each offering period beginning on or after such date is, until otherwise amended, equal to 85% of the lesser of (i) the fair market value of the Company’s common stock at the commencement of the applicable six-month offering period or (ii) the fair market value of the Company’s common stock on the purchase date. The Company estimates the fair value of purchase rights under the ESPP using a Black-Scholes valuation model.

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

	Three months ended September 30,	
	2014	2013
Stock purchase plan:		
Expected stock price volatility	23.5 %	29.1 %
Risk-free interest rate	0.1 %	0.1 %
Dividend yield	2.7 %	2.9 %
Expected life (in years)	0.5	0.5

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

(In thousands, except for weighted-average fair value per share)	Three months ended September 30,	
	2014	2013
Tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP	$1,083	$786
Weighted-average fair value per share based on Black-Scholes model	$14.66	$11.80

The ESPP shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. In August 2014, the Company added 2.0 million additional shares to the ESPP pursuant to the plan’s share replenishment provision with respect to the fiscal year ending June 30, 2015. As of September 30, 2014, a total of 2.9 million shares were reserved and available for issuance under the ESPP.

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Cash Dividends on Shares of Common Stock

The total amount of dividends paid by the Company during the three months ended September 30, 2014 and 2013 was $82.4 million and $74.6 million, respectively. On July 8, 2014, the Company announced that its Board of Directors had authorized a further increase in the level of the Company's quarterly dividend from $0.45 to $0.50 per share. On August 7, 2014, the Company declared a quarterly cash dividend of $0.50 per share on the outstanding shares of the Company's common stock, paid on September 2, 2014 to the stockholders of record as of the close of business on August 18, 2014. On October 23, 2014, the Company announced that its Board of Directors has authorized the financing of a leveraged recapitalization, which would feature a special cash dividend of $16.50 per share, the declaration and payment of which shall be subject to the Company's ability to obtain requisite debt financing on satisfactory terms and conditions. Refer to Note 17, "Subsequent Events" for additional details.

NOTE 9 – STOCK REPURCHASE PROGRAM

The Company's Board of Directors has authorized a program for the Company to repurchase shares of the Company's common stock. The intent of this program is to offset the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, as well as to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases will be made from time to time in the open market in compliance with applicable securities laws, including the Securities Exchange Act of 1934 and the rules promulgated thereunder, such as Rule 10b-18. On July 8, 2014, the Company's Board of Directors authorized KLA-Tencor to repurchase up to 13 million additional shares of the Company's common stock. As of September 30, 2014, 13.3 million shares were available for repurchase under the Company's repurchase program.

Share repurchases for the indicated periods (based on the trade date of the applicable repurchase) were as follows:

	Three months ended September 30,	
(In thousands)	2014	2013
Number of shares of common stock repurchased	1,742	1,038
Total cost of repurchases	$130,683	$60,504

As of September 30, 2014, the Company repurchased 73,400 shares for $5.8 million, which repurchases did not settle prior to September 30, 2014 and were recorded as a component of other current liabilities. On October 23, 2014, the Company announced that its Board of Directors has authorized the financing of a leveraged recapitalization, which would feature a special cash dividend. In addition, the Board of Directors authorized an increase to the existing stock repurchase program. Refer to Note 17, "Subsequent Events" for additional details.

NOTE 10 – NET INCOME PER SHARE

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

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The following table sets forth the computation of basic and diluted net income per share:

(In thousands, except per share amounts)	Three months ended September 30, 2014	2013
Numerator:		
Net income	$72,233	$111,197
Denominator:		
Weighted-average shares-basic, excluding unvested restricted stock units	164,845	165,886
Effect of dilutive options and restricted stock units	1,735	2,848
Weighted-average shares-diluted	166,580	168,734
Basic net income per share	$0.44	$0.67
Diluted net income per share	$0.43	$0.66
Anti-dilutive securities excluded from the computation of diluted net income per share	73	30

NOTE 11 – INCOME TAXES

The following table provides details of income taxes:

(Dollar amounts in thousands)	Three months ended September 30, 2014	2013
Income before income taxes	$99,007	$139,864
Provision for income taxes	$26,774	$28,667
Effective tax rate	27.0 %	20.5 %

The Company’s estimated annual effective tax rate for the fiscal year ending June 30, 2015 is approximately 23.8%. The difference between the actual effective tax rate of 27.0% during the three months ended September 30, 2014 and the estimated annual effective tax rate of 23.8% is primarily due to a forecasted decrease in the Company’s unrecognized tax benefits from the expiration of the statute of limitations in future periods of the fiscal year ending June 30, 2015.

Tax expense was higher as a percentage of income before taxes during the three months ended September 30, 2014 compared to the three months ended September 30, 2013 primarily due to the impact of the following items:

- Tax expense was decreased by $4.6 million during the three months ended September 30, 2013 related to the U.S. federal research credit. The research credit was not available during the three months ended September 30, 2014 because the credit expired on December 31, 2013; and
- Tax expense was decreased by $2.7 million during the three months ended September 30, 2013 related to a non-taxable increase in the value of the assets held within the Company’s Executive Deferred Savings Plan compared to an increase to tax expense of $0.8 million during the three months ended September 30, 2014 related to a non-deductible decrease in the value of the assets held within the Company’s Executive Deferred Savings Plan.

In the normal course of business, the Company is subject to examination by tax authorities throughout the world. The Company is subject to U.S. federal income tax examination for all years beginning from the fiscal year ended June 30, 2011. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2010. The Company is also subject to examinations in other major foreign jurisdictions, including Singapore, for all years beginning from the fiscal year ended June 30, 2010. It is possible that certain examinations may be concluded in the next twelve months. The Company believes it is possible that it may recognize up to $11.6 million of its existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of examinations with various tax authorities.

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NOTE 12 – LITIGATION AND OTHER LEGAL MATTERS

The Company is named from time to time as a party to lawsuits and other types of legal proceedings and claims in the normal course of its business. Actions filed against the Company include commercial, intellectual property, customer, and labor and employment related claims, including complaints of alleged wrongful termination and potential class action lawsuits regarding alleged violations of federal and state wage and hour and other laws. In general, legal proceedings and claims, regardless of their merit, and associated internal investigations (especially those relating to intellectual property or confidential information disputes) are often expensive to prosecute, defend or conduct and may divert management’s attention and other company resources. Moreover, the results of legal proceedings are difficult to predict, and the costs incurred in litigation can be substantial, regardless of outcome. The Company believes the amounts provided in its condensed consolidated financial statements are adequate in light of the probable and estimated liabilities. However, because such matters are subject to many uncertainties, the ultimate outcomes are not predictable, and there can be no assurances that the actual amounts required to satisfy alleged liabilities from the matters described above will not exceed the amounts reflected in the Company’s condensed consolidated financial statements or will not have a material adverse effect on its results of operations, financial condition or cash flows.

NOTE 13 – COMMITMENTS AND CONTINGENCIES

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

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

	Three months ended September 30,	
(In thousands)	2014	2013
Receivables sold under factoring agreements	$25,620	$45,882
Proceeds from sales of LCs	$6,920	$—

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

Facilities. KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was $2.3 million and $2.1 million for the three months ended September 30, 2014 and 2013, respectively.

The following is a schedule of expected operating lease payments:

Fiscal year ending June 30,	Amount (In thousands)
2015 (remaining 9 months)	$6,404
2016	7,178
2017	5,241
2018	3,689
2019	1,814
2020 and thereafter	1,841
Total minimum lease payments	$26,167

Purchase Commitments. KLA-Tencor maintains commitments to purchase inventory from its suppliers as well as goods and services in the ordinary course of business. The Company’s liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company’s estimate of its significant purchase commitments is approximately $291.9 million as of September 30, 2014 which are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

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Cash Long-Term Incentive Plan. As of September 30, 2014, the Company had committed $106.9 million for future payment obligations under its Cash LTI Plan. The calculation of compensation expense related to the Cash LTI Plan includes estimated forfeiture rate assumptions. Cash LTI awards issued to employees under the Cash LTI Plan vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date.

Warranties, Guarantees and Contingencies. KLA-Tencor provides standard warranty coverage on its systems for 40 hours per week for 12 months, providing labor and parts necessary to repair the systems during the warranty period. The Company accounts for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. Utilizing actual service records, the Company calculates the average service hours and parts expense per system and applies the actual labor and overhead rates to determine the estimated warranty charge. The Company updates these estimated charges on a quarterly basis. The actual product performance and/or field expense profiles may differ, and in those cases the Company adjusts its warranty accruals accordingly.

The following table provides the changes in the product warranty accrual for the indicated periods:

	Three months ended September 30,	
(In thousands)	2014	2013
Beginning balance	$37,746	$42,603
Accruals for warranties issued during the period	6,979	9,308
Changes in liability related to pre-existing warranties	(1,470)	(3,384)
Settlements made during the period	(10,196)	(11,213)
Ending balance	$33,059	$37,314

The Company maintains guarantee arrangements available through various financial institutions for up to $27.0 million, of which $24.5 million had been issued as of September 30, 2014, primarily to fund guarantees to customs authorities for value-added tax (“VAT”) and other operating requirements of the Company’s subsidiaries in Europe and Asia.

KLA-Tencor is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in connection with contracts and license agreements or the sale of assets, under which the Company customarily agrees to hold the other party harmless against losses arising from, or provides customers with other remedies to protect against, bodily injury or damage to personal property caused by the Company’s products, non-compliance with the Company’s product performance specifications, infringement by the Company’s products of third-party intellectual property rights and a breach of warranties, representations and covenants related to matters such as title to assets sold, validity of certain intellectual property rights, non-infringement of third-party rights, and certain income tax-related matters. In each of these circumstances, payment by the Company is typically subject to the other party making a claim to and cooperating with the Company pursuant to the procedures specified in the particular contract.

This usually allows the Company to challenge the other party’s claims or, in case of breach of intellectual property representations or covenants, to control the defense or settlement of any third-party claims brought against the other party. Further, the Company’s obligations under these agreements may be limited in terms of amounts, activity (typically at the Company’s option to replace or correct the products or terminate the agreement with a refund to the other party), and duration. In some instances, the Company may have recourse against third parties and/or insurance covering certain payments made by the Company.

Subject to certain limitations, the Company is obligated to indemnify its current and former directors, officers and employees with respect to certain litigation matters and investigations that arise in connection with their service to the Company. These obligations arise under the terms of 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.

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In addition, the Company may in limited circumstances enter into agreements that contain customer-specific pricing, discount, rebate or credit commitments. Furthermore, the Company may give these customers limited audit or inspection rights to enable them to confirm that the Company is complying with these commitments. If a customer elects to exercise its audit or inspection rights, the Company may be required to expend significant resources to support the audit or inspection, as well as to defend or settle any dispute with a customer that could potentially arise out of such audit or inspection. To date, the Company has made no significant accruals in its condensed consolidated financial statements for this contingency. While the Company has not in the past incurred significant expenses for resolving disputes regarding these types of commitments, the Company cannot make any assurance that it will not incur any such liabilities in the future.

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.

Leveraged Recapitalization

On October 23, 2014, the Company announced that its Board of Directors has authorized the financing of a leveraged recapitalization, which would feature a special cash dividend. In addition, the Board of Directors has authorized an increase to the existing stock repurchase program. Refer to Note 17, “Subsequent Events” for additional details.

NOTE 14 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

KLA-Tencor’s foreign subsidiaries operate and sell KLA-Tencor’s products in various global markets. As a result, KLA-Tencor is exposed to risks relating to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts and option contracts to hedge against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions, such as the Japanese yen, the euro, the New Taiwan dollar and the Israeli new shekel. The Company routinely hedges its exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. These currency forward exchange contracts and options, designated as cash flow hedges, generally have maturities of less than 18 months. Cash flow hedges are evaluated for effectiveness monthly, based on changes in total fair value of the derivatives. If a financial counterparty to any of the Company’s hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, the Company may experience material losses.

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

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

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Derivatives in Cash Flow Hedging Relationships: Foreign Exchange Contracts

The locations and amounts of designated and non-designated derivative instruments' gains and losses reported in the condensed consolidated financial statements for the indicated periods were as follows:

(In thousands)	Location in Financial Statements	Three months ended September 30, 2014	2013
Derivatives Designated as Hedging Instruments			
Gains (losses) in accumulated OCI on derivatives (effective portion)	Accumulated OCI	$2,033	$(291)
Gains reclassified from accumulated OCI into income (effective portion):	Revenues	$269	$2,450
	Costs of revenues	(41)	66
	Net gains reclassified from accumulated OCI into income (effective portion)	$228	$2,516
Gains (losses) recognized in income on derivatives (ineffective portion and amount excluded from effectiveness testing)	Interest income and other, net	$43	$(18)
Derivatives Not Designated as Hedging Instruments			
Gains recognized in income	Interest income and other, net	$3,925	$2,626

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

(In thousands)	As of September 30, 2014	As of June 30, 2014
Cash flow hedge contracts		
Purchase	$11,966	$6,066
Sell	$37,801	$33,999
Other foreign currency hedge contracts		
Purchase	$74,988	$108,901
Sell	$105,141	$106,322

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

	Asset Derivatives			Liability Derivatives		
	Balance Sheet Location	As of September 30, 2014	As of June 30, 2014	Balance Sheet Location	As of September 30, 2014	As of June 30, 2014
(In thousands)		Fair Value			Fair Value	
Derivatives designated as hedging instruments						
Foreign exchange contracts	Other current assets	$2,439	$120	Other current liabilities	$628	$100
Total derivatives designated as hedging instruments		$2,439	$120		$628	$100
Derivatives not designated as hedging instruments						
Foreign exchange contracts	Other current assets	$3,168	$546	Other current liabilities	$722	$798
		$3,168	$546		$722	$798

Total derivatives not designated as hedging instruments				
Total derivatives	$5,607	$666	$1,350	$898

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The following table provides the balances and changes in accumulated OCI, before taxes, related to derivative instruments for the indicated periods:

(In thousands)	Three months ended September 30, 2014	2013
Beginning balance	$(20)	$2,484
Amount reclassified to income	(228)	(2,516)
Net change	2,033	(291)
Ending balance	$1,785	$(323)

Offsetting of Derivative Assets and Liabilities

KLA-Tencor presents derivatives at gross fair values in the Condensed Consolidated Balance Sheets. The Company has entered into arrangements with each of its counterparties, which reduce credit risk by permitting net settlement of transactions with the same counterparty under certain conditions. As of September 30, 2014 and June 30, 2014, information related to the offsetting arrangements was as follows (in thousands):

As of September 30, 2014				Gross Amounts of Derivatives Not Offset in the Condensed Consolidated Balance Sheets		
Description	Gross Amounts of Derivatives	Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets	Net Amount of Derivatives Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	Net Amount
Derivatives - Assets	$5,607	$—	$5,607	$(1,350)	$—	$4,257
Derivatives - Liabilities	$(1,350)	$—	$(1,350)	$1,350	$—	$—

As of June 30, 2014				Gross Amounts of Derivatives Not Offset in the Condensed Consolidated Balance Sheets		
Description	Gross Amounts of Derivatives	Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets	Net Amount of Derivatives Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	Net Amount
Derivatives - Assets	$666	$—	$666	$(423)	$—	$243
Derivatives - Liabilities	$(898)	$—	$(898)	$423	$—	$(475)

Subsequent to September 30, 2014, the Company entered into certain forward contracts in relation to the leveraged recapitalization plan. Refer to “Note 17, “Subsequent Events” to the condensed consolidated financial statements for additional details.

NOTE 15 – RELATED PARTY TRANSACTIONS

During the three months ended September 30, 2014 and 2013, the Company purchased from, or sold to, several entities, where one or more executive officers of the Company or members of the Company’s Board of Directors, or their immediate family members, also serves as an executive officer or a board member, including Cisco Systems, Inc., Avago Technologies Ltd., NetApp, Inc. and Citrix Systems, Inc. The following table provides the transactions with these parties for the indicated periods (for the portion of such period that they were considered related):

	Three months ended September 30,	
(In thousands)	2014	2013
Total revenues	$482	$385
Total purchases	$278	$456

The receivable balance from these parties as of September 30, 2014 was immaterial and $0.7 million as of June 30, 2014. Management believes that such transactions are at arm’s length and on similar terms as would have been obtained from unaffiliated third parties.

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NOTE 16 – SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

KLA-Tencor reports one reportable segment in accordance with the provisions of the authoritative guidance for segment reporting. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. KLA-Tencor's chief operating decision maker is the Chief Executive Officer.

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

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

The following is a summary of revenues by geographic region, based on ship-to location, for the indicated periods (as a percentage of total revenues):

	Three months ended September 30,				
(Dollar amounts in thousands)	2014		2013		
Revenues:					
North America	$195,370	30 %	$179,395	28 %	
Taiwan	126,577	20 %	117,291	18 %	
Japan	112,224	17 %	81,412	12 %	
Europe & Israel	55,176	9 %	121,487	18 %	
Korea	69,287	11 %	77,278	12 %	
Rest of Asia	84,267	13 %	81,474	12 %	
Total	$642,901	100 %	$658,337	100 %	

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

	Three months ended September 30,			
(Dollar amounts in thousands)	2014		2013	
Revenues:				
Defect inspection	$372,987	58 %	$343,163	52 %
Metrology	94,873	15 %	132,982	20 %
Service	166,303	26 %	156,597	24 %
Other	8,738	1 %	25,595	4 %
Total	$642,901	100 %	$658,337	100 %

In the three months ended September 30, 2014, three customers accounted for approximately 13%, 13% and 12% of total revenues. In the three months ended September 30, 2013, two customers accounted for approximately 25%, and 10% of total revenue. One and four customers each accounted for greater than 10% of net accounts receivables as of September 30, 2014 and September 30, 2013, respectively.

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

(In thousands)	As of September 30, 2014	As of June 30, 2014
Long-lived assets:		
United States	$218,874	$219,280
Europe	19,178	19,527
Singapore	49,557	48,938
Israel	33,731	33,388
Rest of Asia	8,619	9,130
Total	$329,959	$330,263

NOTE 17 – SUBSEQUENT EVENTS

On October 23, 2014, the Company announced that the Company's Board of Directors has authorized the financing of a leveraged recapitalization, which would feature a special cash dividend (the "Special Cash Dividend") of $16.50 per share, and an increase to the Company's existing stock repurchase program for up to 3.6 million additional shares of the Company's common stock. This increase is in addition to the prior repurchase authorizations under which approximately 13.3 million shares remained available for repurchase as of September 30, 2014.

The intended Special Cash Dividend of $16.50 per share, which is estimated to be approximately $2.75 billion in the aggregate after including the portion of the special cash dividend that could be payable to holders of outstanding equity awards under the 2004 Plan, will be funded in part with a portion of the cash on the Company's balance sheet, and in part with incremental debt. To fund the debt financed portion of the Special Cash Dividend, the Company intends to add up to $2.5 billion of incremental debt, consisting of a combination of investment grade senior notes and a pre-payable term loan facility, subject to market conditions. The Company also expects to enter into a revolving credit facility, subject to market conditions.

The declaration and payment of the Special Cash Dividend are conditioned on the Company's ability to obtain requisite debt financing on satisfactory terms and conditions. Subject to the close of necessary financing, the Board of Directors currently expects to declare and pay the Special Cash Dividend before the end of the second quarter of the fiscal year ending June 30, 2015. The Special Cash Dividend is intended to be in addition to the Company's regular $0.50 per share quarterly cash dividend.

In anticipation of obtaining the intended debt financing, the Company has entered into certain forward contracts ("Rate Lock Agreements") to lock the 10-year treasury rate ("benchmark rate") on a portion of the intended debt. The objective of the Rate Lock Agreements is to hedge the risk associated with the variability in interest rates due to the changes in the benchmark rate leading up to the closing of the intended financing, on the notional amount being hedged. The Rate Lock Agreements have a notional amount of $1 billion in aggregate with contract termination dates in the second quarter of the fiscal year ending June 30, 2015. Each forward contract will be closed out when the pricing of the portion of intended debt being hedged is completed or the expiration date, whichever happens earlier. The Company designated each of the Rate Lock Agreements as a qualifying hedging instrument to be accounted for as a cash flow hedge. The effective portion of the gain or loss on the close out of the Rate Lock Agreements will be initially recognized in accumulated other comprehensive income (loss) as a component of total stockholders' equity which will be amortized into earnings as a component of interest expense over the term of the underlying debt. The ineffective portion, if any, shall be recognized into earnings immediately.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in Part II, Item 1A, "Risk Factors" in this report as well as in Item 1, "Business" and Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended June 30, 2014, filed with the Securities and Exchange Commission on August 8, 2014. You should carefully review these risks and also review the risks described in other documents we file from time to time with the Securities and Exchange Commission. You are cautioned not to place undue reliance on these forward-looking statements, and we expressly assume no obligation and do not intend to update the forward-looking statements in this report after the date hereof.

EXECUTIVE SUMMARY

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

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

As we are a supplier to the global semiconductor and semiconductor-related industries, our customer base continues to become more highly concentrated over time, thereby increasing the potential impact of a sudden change in capital spending by a major customer on our revenues and profitability. As our customer base becomes increasingly more concentrated, large orders from a relatively limited number of customers account for a substantial portion of our sales, which potentially exposes us to more volatility for revenues and earnings. In addition, we are subject to the cyclical capital spending that has historically characterized the semiconductor and semiconductor-related industries. The timing, length, intensity and volatility of the capacity-oriented capital spending cycles of our customers are unpredictable.

However, in addition to these trends of consolidation and cyclicality, the semiconductor industry has also been significantly impacted by constant technological innovation. The growing use of increasingly sophisticated semiconductor devices has caused many of our customers to invest in additional semiconductor manufacturing capabilities and capacity. These investments have included process control and yield management equipment and services and have had a significant favorable impact on our revenues over the long term.

During the three months ended September 30, 2014, new orders for our equipment declined from prior quarter levels and were below our expectations, as a result of a lower level of new orders from one of our foundry market customers. Our semiconductor industry customer base is concentrated and large orders from a relatively limited number of customers account for a substantial portion of our sales, which potentially exposes us to new order volatility. We believe that the low level of new orders for process control and yield management equipment in the September quarter will have an adverse impact on revenues in the next quarter, unless market conditions improve and demand for our products recovers as our leading edge foundry customers make new investments in equipment to meet the next-generation production ramp schedules in 2015.

The demand for our products and our revenue levels are driven by our customers’ needs to solve the process challenges that they face as they adopt new technologies required to fabricate advanced ICs that are increasingly incorporated into sophisticated mobile devices. Our earnings will depend not only on our revenue levels, but also on the amount of research and development spending required to meet our customers’ technology roadmaps. We have continued to scale our production volumes and capacity to meet anticipated customer requirements and remain at risk of incurring significant inventory-related and other restructuring charges if business conditions deteriorate. We believe that, over the long term, our customers will continue to invest in advanced technologies and new materials to enable smaller design rules and higher density applications, as well as to reduce cost. We expect, particularly among our foundry and logic customers, that this in turn will drive high levels of long-term adoption of process control equipment and services that reduce semiconductor defectivity and improve manufacturing yields, reinforcing the longer-term growth drivers in our industry.

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The following table sets forth some of our key quarterly unaudited financial information for each of our last five quarters:

	Three months ended				
(In thousands, except net income per share)	September 30, 2014	June 30, 2014	March 31, 2014	December 31, 2013	September 30, 2013
Total revenues	$642,901	$734,343	$831,599	$705,129	$658,337
Total costs and operating expenses	$533,748	$561,329	$570,436	$517,147	$508,426
Gross margin	$354,434	$407,678	$488,773	$419,315	$380,680
Income from operations	$109,153	$173,014	$261,163	$187,982	$149,911
Net income	$72,233	$128,731	$203,581	$139,246	$111,197
Net income per share:					
Basic (1)	$0.44	$0.78	$1.22	$0.84	$0.67
Diluted (1)	$0.43	$0.77	$1.21	$0.83	$0.66

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

CRITICAL ACCOUNTING ESTIMATES AND POLICIES

The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions in applying our accounting policies that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2014 describes the significant accounting policies and methods used in preparation of the Condensed Consolidated Financial Statements. We base these estimates and assumptions on historical experience, and evaluate them on an on-going basis to ensure that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed our related disclosure in this Quarterly Report on Form 10-Q. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

- Revenue Recognition
- Inventories
- Warranty
- Allowance for Doubtful Accounts
- Equity and Cash-Based Long-Term Incentive Compensation Plans
- Contingencies and Litigation
- Goodwill and Intangible Assets
- Income Taxes
- Valuation of Marketable Securities

There were no significant changes in our critical accounting estimates and policies during the three months ended September 30, 2014. 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, 2014 for a more complete discussion of our critical accounting policies and estimates.

Valuation of Goodwill and Intangible Assets

We have four reporting units: Defect Inspection, Metrology, Service and Other. As of September 30, 2014, substantially all of the goodwill balance resided in the Defect Inspection reporting unit. We performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2013 during the three months ended December 31, 2013 and concluded that there was no impairment. We assess goodwill for impairment annually as well as whenever events or changes in circumstances indicate that the carrying amount of goodwill in any reporting unit may not be recoverable. Long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that the assets' carrying amount may not be recoverable.

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Our next annual assessment of the goodwill by reporting unit will be performed during the three months ending December 31, 2014. If we were to encounter challenging economic conditions, such as a decline in our operating results, an unfavorable industry or macroeconomic environment, a substantial decline in our stock price, or any other adverse change in market conditions, we may be required to perform the two-step quantitative goodwill impairment analysis. In addition, if such conditions have the effect of changing one of the critical assumptions or estimates we use to calculate the value of our goodwill or intangible assets, we may be required to record goodwill and/or intangible asset impairment charges in future periods, whether in connection with our next annual impairment assessment in the second quarter of fiscal year 2015 or prior to that, if any triggering event occurs outside of the quarter during which the annual goodwill impairment assessment is performed. It is not possible at this time to determine if any such future impairment charge would result or, if it does, whether such charge would be material to our results of operations.

Revenue Recognition

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. We derive revenue from three sources—sales of systems, spare parts and services. In general, we recognize revenue for systems when the system has been installed, is operating according to predetermined specifications and is accepted by the customer. When a customer delays installation for products for which we have demonstrated a history of successful installation and acceptance, we recognize revenue upon delivery and customer acceptance.

Under certain circumstances, however, we recognize revenue prior to acceptance from the customer, as follows:

- When the customer fab has previously accepted the same tool, with the same specifications, and when we can objectively demonstrate that the tool meets all of the required acceptance criteria.
- When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% payment is due based upon shipment.
- When the installation of the system is deemed perfunctory.
- When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

In circumstances in which we recognize revenue prior to installation, the portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation.

In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. We also allow for multiple element revenue arrangements in cases where certain elements of a sales arrangement are not delivered and accepted in one reporting period. To determine the relative fair value of each element in a revenue arrangement, we allocate arrangement consideration based on the selling price hierarchy. For substantially all of the arrangements with multiple deliverables pertaining to products and services, we use vendor-specific objective evidence ("VSOE") or third-party evidence ("TPE") to allocate the selling price to each deliverable. We determine TPE based on historical prices charged for products and services when sold on a stand-alone basis. When we are unable to establish relative selling price using VSOE or TPE, we use estimated selling price ("ESP") in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products. We regularly review relative selling prices and maintain internal controls over the establishment and updates of these estimates. In a multiple element revenue arrangement, we defer revenue recognition associated with the relative fair value of each undelivered element until that element is delivered to the customer. To be considered a separate element, the product or service in question must represent a separate unit of accounting, which means that such product or service must fulfill the following criteria: (a) the delivered item(s) has value to the customer on a stand-alone basis; and (b) if the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in our control. If the arrangement does not meet all the above criteria, the entire amount of the sales contract is deferred until all elements are accepted by the customer.

Trade-in rights are occasionally granted to customers to trade in tools in connection with subsequent purchases. We estimate the value of the trade-in right and reduce the revenue recognized on the initial sale. This amount is

recognized at the earlier of the exercise of the trade-in right or the expiration of the trade-in right.
Spare parts revenue is recognized when the product has been shipped, risk of loss has passed to the customer and collection of the resulting receivable is probable.
Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a maintenance contract, including consulting and training revenue, is recognized when the related services are performed and collectibility is reasonably assured.

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We sell stand-alone software that is subject to the software revenue recognition guidance. We periodically review selling prices to determine whether VSOE exists, and in situations where we are unable to establish VSOE for undelivered elements such as post-contract service, revenue is recognized ratably over the term of the service contract.
We also defer the fair value of non-standard warranty bundled with equipment sales as unearned revenue. Non-standard warranty includes services incremental to the standard 40-hour per week coverage for 12 months. Non-standard warranty is recognized ratably as revenue when the applicable warranty term period commences.
The deferred system profit balance equals the amount of deferred system revenue that was invoiced and due on shipment, less applicable product and warranty costs. Deferred system revenue represents the value of products that have been shipped and billed to customers which have not met our revenue recognition criteria. Deferred system profit does not include the profit associated with product shipments to certain customers in Japan, to whom title does not transfer until customer acceptance. Shipments to such customers in Japan are classified as inventory at cost until the time of acceptance.
We enter into sales arrangements that may consist of multiple deliverables of our products and services where certain elements of the sales arrangement are not delivered and accepted in one reporting period. Judgment is required to properly identify the accounting units of the multiple deliverable transactions and to determine the manner in which revenue should be allocated among the accounting units. Additionally, judgment is required to interpret various commercial terms and determine when all criteria of revenue recognition have been met in order for revenue recognition to occur in the appropriate accounting period. While changes in the allocation of the estimated selling price between the accounting units will not affect the amount of total revenue recognized for a particular arrangement, any material changes in these allocations could impact the timing of revenue recognition, which could have a material effect on our financial position and results of operations.

Recent Accounting Pronouncements

Recently Adopted

In July 2013, the FASB issued an accounting standard update that provides explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. Under the new standard update, in most circumstances, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the Company’s financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit carryforward. This accounting standard update became effective for our interim period ended September 30, 2014, and its adoption did not have a material impact on our condensed consolidated financial statements.

Updates Not Yet Effective

In May 2014, the FASB issued an accounting standard update regarding revenue from customer contracts to transfer goods and services or non-financial assets, unless the contracts are covered by other standards (for example, insurance or lease contracts). Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The updates are effective for us beginning the first quarter of our fiscal year ending June 30, 2018. Early adoption is not permitted. We are currently evaluating the impact of this accounting standard update on our condensed consolidated financial statements.
In June 2014, the FASB issued an accounting standard update regarding stock-based compensation that clarifies the accounting when terms of an award provide that a performance target could be achieved after the requisite service period. The amendments require that a performance target that affects vesting which could be achieved after the requisite service period be treated as a performance condition. The update is effective for us beginning the first quarter of our fiscal year ending June 30, 2017, with early adoption permitted. We are currently evaluating the impact of this accounting standard update on our condensed consolidated financial statements.

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RESULTS OF OPERATIONS

Revenues and Gross Margin

(Dollar amounts in thousands)	Three months ended September 30, 2014	June 30, 2014	September 30, 2013	Q1 FY15 vs. Q4 FY14		Q1 FY15 vs. Q1 FY14	
Revenues:							
Product	$476,598	$570,431	$ 501,740	$(93,833)	(16)%	$(25,142)	(5)%
Service	166,303	163,912	156,597	2,391	1 %	9,706	6 %
Total revenues	$642,901	$734,343	$ 658,337	$(91,442)	(12)%	$(15,436)	(2)%
Costs of revenues	$288,467	$326,665	$ 277,657	$(38,198)	(12)%	$10,810	4 %
Gross margin percentage	55 %	56 %	58 %				

Product revenues

Our business is affected by the increasingly concentrated nature of our semiconductor manufacturer customer base and the cyclicality of the capital equipment procurement practices of those manufacturers, with revenues directly impacted by their investment patterns. Our product revenues in any particular quarter are significantly impacted by the amount of new orders that we receive during that quarter and, due to the duration of manufacturing and installation cycles, in the preceding quarters.

Product revenues decreased during the three months ended September 30, 2014 compared to the three months ended June 30, 2014 and September 30, 2013, respectively, primarily as a result of the delay in shipments of our products to our customers due to shifts in the timing of new technology ramps and capacity-related expansion plans.

Service revenues

Service revenues are generated from maintenance contracts, as well as billable time and material service calls made to our customers after the expiration of the warranty period. The amount of our service revenues is typically a function of the number of post-warranty systems installed at our customers' sites and the utilization of those systems, but it is also impacted by other factors, such as our rate of service contract renewals, the types of systems being serviced and fluctuations in foreign exchange rates. Service revenues during the three months ended September 30, 2014 increased compared to the three months ended June 30, 2014 and September 30, 2013, respectively, primarily due to an increase over time in the number of post-warranty systems installed at our customers' sites.

Revenues by region

The following is a summary of revenues by geographic region, based on ship-to location, for the indicated periods (as a percentage of total revenues):

(Dollar amounts in thousands)	Three months ended September 30, 2014		June 30, 2014		September 30, 2013	
North America	$195,370	30 %	$200,971	28 %	$179,395	28 %
Taiwan	126,577	20 %	232,723	32 %	117,291	18 %
Japan	112,224	17 %	89,131	12 %	81,412	12 %
Europe & Israel	55,176	9 %	69,275	9 %	121,487	18 %
Korea	69,287	11 %	60,658	8 %	77,278	12 %
Rest of Asia	84,267	13 %	81,585	11 %	81,474	12 %
Total	$642,901	100 %	$734,343	100 %	$658,337	100 %

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

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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, including our ability to scale our operations efficiently and effectively in response to prevailing business conditions.

The following tables summarize the major factors that contributed to the changes in gross margin percentage:

	Gross Margin Percentage Three months ended			Gross Margin Percentage Three months ended	
June 30, 2014	55.5	%	September 30, 2013	57.8	%
Revenue volume of products and service	(2.2	)%	Revenue volume of products and service	(0.8	)%
Mix of products and services sold	2.0	%	Mix of products and services sold	(1.6	)%
Manufacturing labor, overhead and efficiencies	(1.3	)%	Manufacturing labor, overhead and efficiencies	(1.0	)%
Other service and manufacturing costs	1.1	%	Other service and manufacturing costs	0.7	%
September 30, 2014	55.1	%	September 30, 2014	55.1	%

Changes in gross margin percentage driven by revenue volume of products and services reflect our ability to leverage existing infrastructure to generate higher revenues. It also includes the effect of fluctuations in foreign exchange rates, average customer pricing and customer revenue deferrals associated with volume purchase agreements. Changes in gross margin percentage from mix of products and services sold reflect the impact of changes in the composition within product and service offerings. Changes in gross margin percentage from manufacturing labor, overhead and efficiencies reflect our ability to manage costs and drive productivity as we scale our manufacturing activity to respond to customer requirements; this includes the impact of capacity utilization, use of overtime and variability of cost structure. Changes in gross margin percentage from other service and manufacturing costs include the impact of customer support costs, including the efficiencies with which we deliver services to our customers, and the effectiveness with which we manage our production plans and inventory risk.

Our gross margin during the three months ended September 30, 2014 and during the three months ended June 30, 2014 remained substantially flat, primarily due to favorable mix of products and services and due to lower charges for inventory obsolescence as well as lower warranty costs. This was offset by less favorable volume of products and service as well as the impact of lower manufacturing volumes.

Our gross margin decreased to 55.1% during the three months ended September 30, 2014 from 57.8% during the three months ended September 30, 2013, primarily due to less favorable mix and volume of products and service as well as the impact of lower manufacturing volumes, partially offset by lower charges for inventory obsolescence.

Engineering, Research and Development (“R&D”)

(Dollar amounts in thousands)	Three months ended September 30, 2014		June 30, 2014		September 30, 2013		Q1 FY15 vs. Q4 FY14			Q1 FY15 vs. Q1 FY14		
R&D expenses	$143,637		$138,448		$ 132,273		$5,189	4	%	$11,364	9	%
R&D expenses as a percentage of total revenues	22	%	19	%	20	%						

Our R&D expenses have generally increased over time, primarily due to higher costs associated with advanced product and technology development projects. We incur significant costs associated with these projects, including compensation for engineering talent, engineering material costs, and other expenses, as technological innovation is essential to our success. During certain periods, R&D expenses may fluctuate relative to product development phases and project timing.

R&D expenses during the three months ended September 30, 2014 increased compared to the three months ended June 30, 2014, primarily due to an increase in employee-related expenses of $8.2 million as a result of higher employee benefit expenses, increase in severance expenses and higher compensation costs on account of additional engineering headcount, partially offset by a decrease in consulting, traveling and depreciation expenses of $2.9 million.

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R&D expenses during the three months ended September 30, 2014 increased compared to the three months ended September 30, 2013, primarily due to the stage and timing of our development projects. R&D expenses during the three months ended September 30, 2014 were impacted by an increase in employee-related expenses of $10.8 million as a result of annual compensation adjustments and additional engineering headcount and a lower benefit from external funding of $3.2 million, partially offset by a $2.6 million decrease in engineering materials and consulting costs.

R&D expenses include the benefit of $0.4 million, $0.2 million and $3.6 million of external funding received from government grants during the three months ended September 30, 2014, June 30, 2014 and September 30, 2013, respectively, for certain strategic development programs.

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 September 30, 2014	June 30, 2014	September 30, 2013	Q1 FY15 vs. Q4 FY14		Q1 FY15 vs. Q1 FY14	
SG&A expenses	$101,644	$96,216	$ 98,496	$5,428	6 %	$3,148	3 %
SG&A expenses as a percentage of total revenues	16 %	13 %	15 %				

SG&A expenses during the three months ended September 30, 2014 increased compared to the three months ended June 30, 2014, primarily due to an increase in employee-related expenses of $5.5 million as a result of higher benefit expenses and increase variable compensation and an increase in cost of support for sales evaluations of $1.9 million. This was partially offset by a decrease in travel expenses of $1.6 million.

SG&A expenses during the three months ended September 30, 2014 increased compared to the three months ended September 30, 2013, primarily due to an increase in cost of support for sales evaluations and consulting costs of $3.4 million.

Interest Income and Other, Net and Interest Expense

(Dollar amounts in thousands)	Three months ended September 30, 2014	June 30, 2014	September 30, 2013