KLA TENCOR CORP
Form 10-Q
October 31, 2007
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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, 2007

or

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the transition period from_____ to_____

Commission File Number 0-09992

KLA-Tencor Corporation

(Exact name of registrant as specified in its charter)

Delaware	**04-2564110**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

One Technology Drive

Milpitas, California

95035

(Address of principal executive offices)

(Zip Code)

(408) 875-3000

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

As of October 2, 2007 there were 182,147,118 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, 2007	June 30, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 514,051	$ 722,511
Marketable securities	768,882	988,118
Accounts receivable, net	618,959	581,500
Inventories	500,286	535,370
Deferred income taxes	345,108	339,133
Other current assets	70,320	86,139
Total current assets	2,817,606	3,252,771
Land, property and equipment, net	379,189	382,240
Goodwill	311,330	311,856
Purchased intangibles, net	167,626	175,432
Other assets	516,349	500,950
Total assets	$ 4,192,100	$ 4,623,249
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 119,050	$ 92,165
Deferred system profit	208,046	201,747
Unearned revenue	54,188	52,304
Other current liabilities	578,540	659,346
Total current liabilities	959,824	1,005,562
Non-current liabilities:		
Income Tax Payable	87,444	
Unearned revenue	51,665	46,950
Other non-current liabilities	35,659	20,695
Total liabilities	1,134,592	1,073,207
Commitments and contingencies (Note 9 and Note 10)		
Stockholders equity:		
Common stock and capital in excess of par value	651,720	967,886
Retained earnings	2,385,949	2,570,751
Accumulated other comprehensive income	19,839	11,405
Total stockholders equity	3,057,508	3,550,042
Total liabilities and stockholders equity	$ 4,192,100	$ 4,623,249

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)	**2007**	**2006**
Revenues:		
Product	$ 578,432	$ 530,927
Service	114,588	98,436
Total revenues	693,020	629,363
Costs and operating expenses:		
Costs of revenues*	305,893	270,119
Engineering, research and development*	99,344	99,293
Selling, general and administrative*	110,505	105,961
Total costs and operating expenses	515,742	475,373
Income from operations	177,278	153,990
Interest income and other, net	17,474	22,457
Income before income taxes and minority interest	194,752	176,447
Provision for income taxes	106,594	41,368
Income before minority interest	88,158	135,079
Minority interest		843
Net income	$ 88,158	$ 135,922
Net income per share:		
Basic	$ 0.47	$ 0.68
Diluted	$ 0.46	$ 0.67
Weighted average number of shares:		
Basic	187,789	199,416
Diluted	193,043	203,323
* includes the following amounts related to equity awards		
Costs of revenues	$ 6,253	$ 8,587
Engineering, research and development	$ 8,592	$ 11,705
Selling, general and administrative	$ 13,238	$ 16,755

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

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Cash Flows

(Unaudited)

	Three months ended September 30,	
(In thousands)	**2007**	**2006**
Cash flows from operating activities:		
Net income	$ 88,158	$ 135,922
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	24,952	14,798
Non-cash, stock-based compensation	28,083	37,047
Tax benefit from employee stock options	6,516	465
Excess tax benefit from stock-based compensation	(2,840)	(1,045)
Minority interest		(843)
Net (gain) loss on sale of marketable securities and other investments	(62)	2,199
Changes in assets and liabilities:		
Accounts receivable, net	(18,755)	20,626
Inventories	39,697	(43,104)
Other assets	15,155	991
Accounts payable	26,320	12,209
Deferred system profit	6,299	(7,553)
Other liabilities	(8,361)	(64,744)
Net cash provided by operating activities	205,162	106,968
Cash flows from investing activities:		
Capital expenditures, net	(14,883)	(12,313)
Purchase of available-for-sale securities	(336,373)	(1,156,837)
Proceeds from sale of available-for-sale securities	552,383	1,001,712
Proceeds from maturity of available-for-sale securities	3,300	133,271
Net cash provided by (used in) investing activities	204,427	(34,167)
Cash flows from financing activities:		
Issuance of common stock	96,655	18,600
Common stock repurchases	(683,534)	
Payment of dividends to stockholders	(28,459)	(24,160)
Excess tax benefit from stock-based compensation	2,840	1,045
Net cash used in financing activities	(612,498)	(4,515)
Effect of exchange rate changes on cash and cash equivalents	(5,551)	2,492
Net increase (decrease) in cash and cash equivalents	(208,460)	70,778
Cash and cash equivalents at beginning of period	722,511	1,129,191
Cash and cash equivalents at end of period	$ 514,051	$ 1,199,969
Supplemental cash flow disclosures:		

Income taxes paid, net	$ 31,858	$ 83,868
Interest paid	$ 395	$ 737

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 Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, Financial Statements and Supplementary Data included in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2007, filed with the Securities and Exchange Commission on August 20, 2007.

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

The results of operations for the three month period ended September 30, 2007 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2008.

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

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

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

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NOTE 2 BALANCE SHEET COMPONENTS

(In thousands)	September 30, 2007	June 30, 2007
Cash equivalents and marketable securities:		
U.S. Government agency securities	$ 3,043	$ 3,043
Municipal bonds	770,328	997,877
Corporate debt securities		3,500
Corporate equity securities		283
Money market bank deposits and other	255,060	538,275
	1,028,431	1,542,978
Less: Cash equivalents	(259,549)	(554,860)
Short-term marketable securities	$ 768,882	$ 988,118
Accounts receivable, net		
Accounts receivable, gross	$ 630,668	$ 593,229
Allowance for doubtful accounts	(11,709)	(11,729)
	$ 618,959	$ 581,500
Inventories		
Customer service parts	$ 183,217	$ 175,763
Raw materials	140,206	155,846
Work-in-process	94,170	105,254
Finished goods and demonstration equipment	82,693	98,507
	$ 500,286	$ 535,370
Land, property and equipment, net		
Land	$ 84,509	$ 84,456
Buildings and improvements	153,397	151,466
Machinery and equipment	425,929	419,840
Office furniture and fixtures	38,711	37,919
Leasehold improvements	142,595	141,236
Construction in process	19,887	17,191
	865,028	852,108
Less: accumulated depreciation and amortization	(485,839)	(469,868)
	$ 379,189	$ 382,240
Other assets		
Long-term investments	$ 183,974	$ 179,725
Deferred tax assets long-term	321,496	309,487
Other	10,879	11,738
	$ 516,349	$ 500,950
Other current liabilities		
Warranty and retrofit	$ 64,297	$ 66,669
Compensation and benefits	287,779	314,046

Income taxes payable	73,081	85,993
Other accrued expenses	153,383	192,638
	$ 578,540	$ 659,346

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NOTE 3 GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

The following table presents goodwill balances and the movements during the three months ended September 30, 2007:

(In thousands)	Amount
As of June 30, 2007	$ 311,856
Adjustments	(526)
As of September 30, 2007	$ 311,330

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. The carrying value of goodwill was allocated to KLA-Tencor s reporting units pursuant to Statement of Financial Accounting Standards (SFAS)No. 142. In accordance with SFAS No. 142, KLA-Tencor completed its annual evaluation of the goodwill by reporting unit during the quarter ended December 31, 2006 and concluded that there was no impairment. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to the impairment test performed in the quarter ended December 31, 2006. Adjustments to goodwill during the three months ended September 30, 2007 resulted primarily from the fair value adjustments reflecting purchase price allocation adjustments related to entities that were acquired in the fiscal year ended June 30, 2007. For a detailed description of acquisitions completed in the fiscal year ended June 30, 2007, refer to Note 5, Business Combinations to the Consolidated Financial Statements included in Item 8 of the Company s Annual Report on Form 10-K for the year ended June 30, 2007.

Purchased Intangible Assets

The components of purchased intangible assets as of September 30, 2007 and June 30, 2007 were as follows:

(in thousands)		As of September 30, 2007			As of June 30, 2007		
Category	Range of Useful Lives	Gross Carrying Amount	Accumulated Amortization	Net Amount	Gross Carrying Amount	Accumulated Amortization	Net Amount
Existing technology	4-7 years	$ 97,233	$ 18,464	$ 78,769	$ 96,534	$ 14,152	$ 82,382
Patents	6-13 years	38,997	9,530	29,467	38,997	8,114	30,883
Trade name / Trademark	4-10 years	20,835	2,683	18,152	20,835	2,086	18,749
Customer relationships	6-7 years	44,870	5,270	39,600	44,870	3,591	41,279
Other	0-1 year	10,688	9,050	1,638	10,695	8,556	2,139
Total		$ 212,623	$ 44,997	$ 167,626	$ 211,931	$ 36,499	$ 175,432

For the three months ended September 30, 2007 and 2006, amortization expense for purchased intangible assets was $8.5 million and $0.8 million, respectively. Based on the intangible assets recorded as of September 30, 2007, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated amortization expense is expected to be as follows:

Fiscal year ending June 30:	Amortization (In thousands)
2008 (remaining 9 months)	$ 25,219
2009	32,142
2010	32,041
2011	31,035
2012	27,947

Thereafter	19,242
Total	$ 167,626

NOTE 4 STOCK-BASED COMPENSATION

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

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The following table shows pre-tax stock-based compensation expense by type of award for the three months ended September 30, 2007 and 2006:

(In thousands)	Three months ended September 30, 2007	2006
Stock-based compensation expense by type of award:		
Employee stock options	$ 17,012	$ 30,118
Employee stock purchase plan	4,051	4,455
Restricted stock units	7,020	2,474
Total stock-based compensation	$ 28,083	$ 37,047

As of September 30, 2007, the unrecognized stock-based compensation balance was $160.7 million.

Stock Options

The following table shows the number of options granted, grant-date fair value, and stock-based compensation expense related to stock options for the three months ended September 30, 2007 and 2006:

(In thousands)	Three months ended September 30, 2007	2006
Number of options granted	12	190
Grant-date fair value after estimated forfeitures	$ 219	$ 1,947
Stock-based compensation expense	$ 17,012	$ 30,118

As of September 30, 2007, the unrecognized stock-based compensation balance related to stock options was $88.6 million and will be recognized over an estimated weighted average amortization period of 2.4 years.

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

(In thousands)	September 30, 2007	June 30, 2007
Inventory	$ 6,622	$ 6,229
Deferred system profit	$ 1,031	$ 1,386

Valuation Assumptions

The Company estimates the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS No. 123(R), SEC Staff Accounting Bulletin (SAB) No. 107. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach with the following weighted-average assumptions:

	Three months ended September 30, 2007	2006
Stock option plan:		
Expected stock price volatility	32%	35%
Risk free interest rate	4.8%	5.0%

Dividend yield	0.9%	1.2%
Expected life of options (in years)	4.7	4.4
Stock purchase plan:		
Expected stock price volatility	32%	35%
Risk free interest rate	4.9%	5.1%
Dividend yield	0.9%	1.2%
Expected life of options (in years)	1.3	1.3

SFAS No. 123(R) requires the use of option-pricing models that were not developed for use in valuing employee stock options. The Black-Scholes option-pricing model was developed for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option s expected life and the expected price volatility of the underlying stock. The expected stock price volatility assumption was determined using the implied volatility of the Company s common

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stock. The Company s computation of expected volatility is based on market-based implied volatility from traded options on the Company s stock. The Company determined that implied volatility is more reflective of market conditions and a better indicator of expected volatility than a blended volatility.

Equity Incentive Program

The Company s equity incentive program is a broad-based, long-term retention program that is intended to attract and retain key employees, and align stockholder and employee interests. The equity incentive program consists of two plans: one under which non-employee directors may be granted options to purchase shares of the Company s stock, and another in which non-employee directors, officers, key employees, consultants and all other employees may be granted options to purchase shares of the Company s stock, restricted stock units and other types of equity awards. For the past several years until June 30, 2006, stock options (except for the retroactively priced options which were granted primarily from July 1, 1997 to June 30, 2002) were generally granted at the market price of the Company s common stock on the date of grant, with a vesting period of five years and an exercise period not to exceed seven years (ten years for options granted prior to July 1, 2005) from the date of issuance. Restricted stock units may be granted with varying criteria such as time-based or performance-based vesting. Substantially all of the Company s employees that meet established performance goals and qualify as key employees participate in its main equity incentive plan. Since July 1, 2006, the Company has granted only restricted stock units under its equity incentive program, except for options granted to non-employee directors as part of their regular compensation package for service through September 30, 2007.

On October 18, 2004, the Company s stockholders approved the 2004 Equity Incentive Plan (the 2004 Plan) which 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 our Board of Directors. Since the adoption of the 2004 Plan, no further grants are permitted under the 1982 Stock Option Plan or 2000 Nonstatutory Stock Option Plan. The 2004 Plan permits the issuance of up to 12.5 million shares of common stock, of which 1.6 million shares were available for grant as of September 30, 2007. The Company s Board of Directors has approved an increase of 8.5 million shares of common stock to the number of shares reserved for issuance under the 2004 Plan, subject to stockholder approval of such increase at the Company s Annual Meeting of Stockholders to be held on November 15, 2007. Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date shall be counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto. Total options outstanding under all plans as of September 30, 2007 ware 16.9 million. As of September 30, 2007 and 2006, restricted stock units outstanding that had been granted to senior management with performance-based vesting were approximately 0.2 million and 0.4 million, respectively.

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

(In thousands except for Weighted-Average Exercise Price)	Available For Grant	Options Outstanding	Weighted-Average Exercise Price
Balances at June 30, 2007	3,317	19,585	$ 42.28
Plan shares expired	(141)		
Options granted	(12)	12	$ 56.79
Restricted stock units granted(1)	(425)		
Restricted stock units canceled(1)	164		
Options canceled/expired/forfeited	242	(242)	$ 45.43
Options exercised		(2,466)	$ 39.20
Balances at September 30, 2007	3,145	16,889	$ 42.70

(1) Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date shall be counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto.

The weighted-average grant date fair value of options, as determined under SFAS No. 123(R), granted during the three months ended September 30, 2007 and 2006 was $18.25 and $13.51 per share, respectively. As of September 30, 2007, 11.5 million options were exercisable with a weighted-average exercise price of $41.77 per share and weighted-average remaining contractual term of 5 years. The aggregate intrinsic

value for the options exercisable as of September 30, 2007 was $161.0 million.

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The total intrinsic value of options exercised during the three months ended September 30, 2007 and 2006 was $50.5 million and $10.0 million, respectively. The total cash received from employees as a result of employee stock option exercises during the three months ended September 30, 2007 and 2006 was approximately $96.7 million and $18.6 million, respectively. In connection with these exercises, the tax benefits realized by the Company for the three months ended September 30, 2007 and 2006 was $17.5 million and $3.6 million, respectively.

The Company currently settles employee stock option exercises with newly issued common shares.

Restricted Stock Units

The following table shows the number of restricted stock units granted, grant-date fair value, and stock-based compensation expense for the three months ended September 30, 2007 and 2006:

	Three months ended September 30,	
(In thousands)	**2007**	**2006**
Number of shares granted	236	2,536
Grant-date fair value	$ 8,306	$ 81,306
Stock-based compensation expense	$ 7,020	$ 2,474

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

As of September 30, 2007, the unrecognized stock-based compensation balance related to restricted stock units was $72.1 million and will be recognized over an estimated weighted-average amortization period of 3.3 years. Additionally, the number of restricted stock units outstanding as of September 30, 2007 was 4.2 million.

Employee Stock Purchase Plan

KLA-Tencor s Amended and Restated 1997 Employee Stock Purchase Plan (ESPP) provides that eligible employees may contribute up to 10% of their eligible earnings toward the semi-annual purchase of KLA-Tencor s common stock. The ESPP is qualified under Section 423 of the Internal Revenue Code. The employee s purchase price is derived from a formula based on the fair market value of the common stock at the time of enrollment into the offering period versus the fair market value on the date of purchase. Offering periods are generally two years in length. On September 28, 2006, the ESPP was suspended due to the ongoing stock option investigation, and accordingly there were no shares purchased under the ESPP during the six months ended December 31, 2006. After the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2006 and its Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 were filed on January 29, 2007, approximately 0.3 million shares were purchased under the ESPP on February 1, 2007.

The compensation expense in connection with the ESPP in the three months ended September 30, 2007 and 2006 was $4.1 million and $4.5 million, respectively, calculated in accordance with SFAS No. 123(R). There were no shares purchased under the ESPP during the three months ended September 30, 2007 and September 30, 2006. In connection with the disqualifying dispositions of shares purchased under the ESPP, the Company realized tax benefits of $0.6 million for the three months ended September 30, 2007.

The number of shares available for issuance under the ESPP is replenished annually, typically on the first day of each fiscal year, by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. As of September 30, 2007, a total of 1.1 million shares were reserved and available for issuance under the ESPP; however, that number does not include any shares expected to be added to the ESPP with respect to fiscal year 2008.

NOTE 5 STOCK REPURCHASE PROGRAM

In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. This program was put into place to reduce the dilution from KLA-Tencor s issuance of shares pursuant to

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its employee benefit and incentive plans such as the stock option and employee stock purchase plans, and to return excess cash to the Company s shareholders. Since the inception of the repurchase program in 1997 through September 30, 2007 the Board of Directors had authorized KLA-Tencor to repurchase a total of 47.8 million shares, including 10.0 million shares authorized in August 2007. The Company s systematic buyback program was suspended in May 2006, and resumed in February 2007. The Company accounts for repurchased common stock under the cost method and includes such treasury stock as a component of its stockholders equity. During the three months ended September 30, 2007, the common stock repurchases of $683.5 million reduced capital in excess of par and retained earnings.

Share repurchases for the three months ended September 30, 2007 and 2006 were as follows:

	Three months ended September 30,	
(In thousands)	**2007**	**2006**
Number of shares of common stock repurchased	11,656	
Total cost of repurchase	$ 683,534	$

NOTE 6 EARNINGS PER SHARE

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding during the period. Diluted earnings per share is calculated by using the weighted-average number of common shares outstanding during the period increased to include the number of additional shares of common stock that would have been outstanding if the dilutive potential shares of common stock had been issued. The dilutive effect of outstanding options and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method, which includes consideration of stock-based compensation required by SFAS No. 123(R), *Share-Based Payment* and SFAS No. 128, *Earnings Per Share*. The following table sets forth the computation of basic and diluted earnings per share:

	Three months ended September 30,	
(In thousands, except per share amounts)	**2007**	**2006**
Numerator:		
Net income	$ 88,158	$ 135,922
Denominator:		
Weighted average shares outstanding, excluding unvested restricted stock units	187,789	199,416
Effect of dilutive options and restricted stock units	5,254	3,907
Denominator for diluted earnings per share	193,043	203,323
Basic earnings per share	$ 0.47	$ 0.68
Diluted earnings per share	$ 0.46	$ 0.67
Potentially dilutive securities (1)	1,803	20,179

(1) These securities are excluded from the computation of diluted earnings per share for the above periods because their effect would have been anti-dilutive.

During the three months ended September 30, 2007, the Company s Board of Directors authorized a quarterly cash dividend of $0.15 per share, which was paid on September 1, 2007 to stockholders of record on August 20, 2007. During the same period in fiscal year 2007, the Company declared and paid a quarterly cash dividend of $0.12 per share. The total amount of dividends paid during the three months ended September 30, 2007 and 2006 was $28.5 million and $24.2 million, respectively.

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NOTE 7 COMPREHENSIVE INCOME

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

(In thousands)	Three months ended September 30, 2007	2006
Net income	$ 88,158	$ 135,922
Other comprehensive income (loss):		
Currency translation adjustments	14,987	(1,107)
Gain (loss) on cash flow hedging instruments, net	(9,219)	5,094
Change in unrecognized losses and transition obligation reated to pension and post retirement plans	14	
Unrealized gains on investments (1)	2,652	6,290
Other comprehensive income	$ 8,434	$ 10,277
Total comprehensive income	$ 96,592	$ 146,199
(1) Taxes included in unrealized gains on investments	$ 1,605	$ 3,742

NOTE 8 INCOME TAXES

The Company recorded a provision of $106.6 million for the three months ended September 30, 2007, which is an effective tax rate of 54.6%. The increase in the effective tax rate over prior periods is primarily due to the immediate impact of $46.6 million of incremental U.S. tax expense associated with the implementation of the Company s global manufacturing strategy during the three months ended September 30, 2007. In addition, there was an increase to the effective tax rate for the three months ended September 30, 2007 compared to the year ended June 30, 2007, due to decreases in the tax benefits related to tax exempt interest, research and development credit and extraterritorial income exclusion. We expect the tax rate in future periods of the year ending June 30, 2008 to result in an annual rate of approximately 37% which includes the effect of the higher tax expense associated with the implementation of our global manufacturing strategy.

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

As a result of the adoption of FIN 48, the Company increased the liability for net unrecognized tax benefits by $8.4 million, and accounted for the increase as a cumulative effect of change in accounting principle that resulted in a reduction of retained earnings of $8.4 million at July 1, 2007. The Company has historically classified accruals for tax uncertainties in current taxes payable. Upon adoption of FIN 48, the Company has reclassified taxes payable of $62.1 million from current to non-current liability. In addition, as a result of the adoption of FIN 48, at September 30, 2007, long-term liabilities increased by $24.4 million; non-current deferred tax assets increased by $17.3 million; and goodwill related to acquisitions decreased by $1.3 million.

As of the adoption date of FIN 48, the Company had gross tax affected unrecognized tax benefits of approximately $77.7 million of which $73.0 million, if recognized, would affect the effective tax rate, while the remaining $4.7 million would reduce acquisition related goodwill. The increase in the uncertain tax benefits for the quarter ended September 30, 2007 was approximately $11.3 million related to various tax positions. The Company anticipates an increase of approximately $8.0 million to the unrecognized tax benefits during the remainder of the year ending June 30, 2008, related to various tax positions. The Company has included the effects of these items in current estimates of the forecasted tax provision for the year ending June 30, 2008. The Company will reexamine the tax provision and the effect of estimated unrecognized tax benefits on the financial position at each reporting period.

The Company s policy is to include interest and penalties related to unrecognized tax benefits within interest income and other, net. As of the adoption date of FIN 48, the Company had accrued interest and penalties related to unrecognized tax benefits of approximately $12.9 million. The accrued interest and penalties on unrecognized tax benefits increased by approximately $1.0 million for the three months ended September 30, 2007 to $13.9 million as of September 30, 2007.

The Company conducts business globally and, as a result, the Company and one or more of its subsidiaries file income tax returns in various jurisdictions throughout the world including with the United States federal government, various U.S. state and foreign jurisdictions. In the normal course of business the Company is subject to examination by taxing authorities

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throughout the world. The Company is not under federal examination at this time, but remains subject to federal examination for all years from the year ended June 30, 2004. The Company has concluded federal examinations up through the year ended June 30, 2004. The Company is subject to state examinations for all years from the year ended June 30, 2002. The Company is currently under a tax examination in California for the years ended June 30, 2004 and 2005 and various other state examinations. The Company is also subject to examinations in major foreign jurisdictions, including Israel and Singapore, for all years from the year ended June 30, 2002 and is currently under tax examinations in various foreign tax jurisdictions.

NOTE 9 LITIGATION AND OTHER LEGAL MATTERS

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

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

The Company has also responded to inquiries from the U.S. Department of Labor, which is conducting an examination of our 401(k) Savings Plan prompted by the Company s stock option issues. The Company is cooperating fully with this examination and intend to continue to do so.

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

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

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

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The derivative actions are at an early stage. The defendants are not yet required to respond to the complaints in the actions pending in California, and the defendants have moved to dismiss or stay the action pending in Delaware. The Company s Board of Directors has appointed a Special Litigation Committee (SLC) composed solely of independent directors to conduct an independent investigation of the claims asserted in the derivative actions and to determine the Company s position with respect to those claims. The SLC s investigation is in progress. The Company cannot predict whether these actions are likely to result in any material recovery by or expense to KLA-Tencor.

Shareholder Class Action Litigation Relating to Historical Stock Option Practices. KLA-Tencor and various of its current and former directors and officers were named as defendants in a putative securities class action filed on June 29, 2006 in the U.S. District Court for the Northern District of California. Two similar actions were filed later in the same court, and all three cases have been consolidated into one action. The consolidated complaint alleges claims under Section 10(b) and Rule 10b-5 thereunder, Section 14(a), Section 20(a), and Section 20A of the Securities Exchange Act of 1934 as a result of the Company s past stock option grants and related accounting and reporting, and seek unspecified monetary damages and other relief. The plaintiffs seek to represent a class consisting of purchasers of KLA-Tencor stock between June 30, 2001 and May 22, 2006 who allegedly suffered losses as a result of material misrepresentations in KLA-Tencor s SEC filings and public statements during that period. The lead plaintiffs, who seek to represent the class, are the Police and Fire Retirement System of the City of Detroit, the Louisiana Municipal Police Employees Retirement System, and the City of Philadelphia Board of Pensions and Retirement. The defendants are KLA-Tencor, Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Gary E. Dickerson, Richard J. Elkus, Jr., Jeffrey L. Hall, Stephen P. Kaufman, John H. Kispert, Kenneth Levy, Michael E. Marks, Stuart J. Nichols, Kenneth L. Schroeder, Jon D. Tompkins, Lida Urbanek and Richard P. Wallace.

This litigation is at an early stage. Discovery has not commenced, and the court has not yet determined whether the plaintiffs may sue on behalf of any class of purchasers. The Company and all other defendants filed motions to dismiss these cases in June 2007, which are now pending before the Court. The Company intends to vigorously defend this litigation.

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

Another plaintiff, Chris Crimi, filed a putative class action complaint in the Superior Court of the State of California for the County of Santa Clara on September 4, 2007 against the Company and certain of its current and former directors and officers. The plaintiff seeks to represent a class consisting of persons who held KLA-Tencor common stock between September 20, 2002 and September 27, 2006, alleges causes of action for breach of fiduciary duty and rescission based on alleged misstatements and omissions in the Company s SEC filings concerning the Company s past stock option grants, and seeks unspecified damages based upon purported dilution of the Company s stock, injunctive relief, and rescission. The named defendants, in addition to the Company, are Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Richard J. Elkus, Jr., Stephen P. Kaufman, Kenneth Levy, Michael E. Marks, Dean O. Morton, Kenneth L. Schroeder, Jon D. Tompkins, and Richard P. Wallace. This litigation is at an early stage, and the defendants have not yet been required to respond to the complaint. The Company intends to vigorously defend this litigation.

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

Indemnification Obligations. Subject to certain limitations, the Company is obligated to indemnify its current and former directors, officers and employees in connection with the investigation of the Company s historical stock option practices and the related litigation and ongoing government inquiry. These obligations arise under the terms of the Company s certificate of incorporation, its bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify generally means that the Company is required to pay or reimburse the individuals reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. The Company is currently paying or reimbursing legal expenses being incurred in connection with these matters by a number of its current and former directors, officers and employees. Although the maximum potential amount of future payments KLA-Tencor could be required to make under these agreements is theoretically unlimited, the Company believes the fair value of this liability, to the extent estimable, is appropriately considered within the reserve it has established for currently pending legal proceedings.

Other Legal Matters. The Company is named from time to time as a party to lawsuits in the normal course of its business. Litigation, in general, and intellectual property and securities litigation in particular, can be expensive and

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disruptive to normal business operations. Moreover, the results of legal proceedings are difficult to predict, and the costs incurred in litigation can be substantial, regardless of outcome.

NOTE 10 COMMITMENTS AND CONTINGENCIES

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

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs and related discounting fees paid for the three months ended September 30, 2007 and 2006:

	Three months ended September 30,	
(In thousands)	**2007**	**September 30, 2006**
Receivables sold under factoring agreements	$ 70,534	$ 79,828
Proceeds from sales of LCs	$ 6,818	$ 30,189
Discounting fees paid on sales of LCs (1)	$ 21	$ 365

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

Facilities. KLA-Tencor leases certain of its facilities under operating leases, which qualify for operating lease accounting treatment under SFAS No. 13, *Accounting for Leases* and, as such, these facilities are not included on its Condensed Consolidated Balance Sheet. Rent expense was approximately $3.0 million and $2.0 million for the three months ended September 30, 2007 and 2006, respectively.

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

Fiscal year ended June 30,	**Amount**
2008 (remaining 9 months)	$ 7,705
2009	8,160
2010	5,545
2011	3,868
2012	2,371
2013 and thereafter	8,388
Total minimum lease payments	$ 36,037

Purchase Commitments. KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. KLA-Tencor s liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. The Company s open inventory purchase commitments were approximately $159.3 million as of September 30, 2007 and are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may change in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

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

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The following table provides the changes in the product warranty accrual for the three months ended September 30, 2007 and 2006:

	Three months ended September 30,	
(In thousands)	**2007**	**2006**
Beginning balance	$ 52,838	$ 45,642
Accruals for warranties issued during the period	14,845	14,254
Changes in liability related to pre-existing warranties	(496)	(2,470)
Settlements made during the period	(15,909)	(10,443)
Ending balance	$ 51,278	$ 46,983

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

KLA-Tencor is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in connection with contracts and license agreements or the sale of assets, under which the Company customarily agrees to hold the other party harmless against losses arising from a breach of warranties, representations and covenants related to such matters as title to assets sold, validity of certain intellectual property rights, non-infringement of third-party rights, and certain income tax-related matters. In each of these circumstances, payment by the Company is typically subject to the other party making a claim to and cooperating with the Company pursuant to the procedures specified in the particular contract. This usually allows the Company to challenge the other party s claims or, in case of breach of intellectual property representations or covenants, to control the defense or settlement of any third-party claims brought against the other party. Further, the Company s obligations under these agreements may be limited in terms of amounts, activity (typically at the Company s option to replace or correct the products or terminate the agreement with a refund to the other party), and duration. In some instances, the Company may have recourse against third parties and/or insurance covering certain payments made by the Company.

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

The Company maintains guarantee arrangements of $29.8 million in various locations to fund customs guarantees for VAT and letter of credit needs of its subsidiaries in Europe and Asia. Approximately $19.9 million was outstanding under these arrangements as of September 30, 2007.

NOTE 11 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

The outstanding hedge contracts, with maximum maturity of 13 months, were as follows:

(In thousands)	**As of September 30, 2007**	**As of June 30, 2007**
Cash flow hedge contracts		
Purchase	$ 11,660	$ 4,651
Sell	(246,316)	(242,942)
Other foreign currency hedge contracts		

Purchase		134,774		126,992
Sell		(301,056)		(265,378)
Net	$	(400,938)	$	(376,677)

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NOTE 12 RELATED PARTY TRANSACTIONS

During the three months ended September 30, 2007 and 2006, the Company purchased from, or sold to, JDS Uniphase Corporation, Freescale Semiconductor, Inc., National Semiconductor Corp., STMicroelectronics, NV and Oracle Corporation, where one or more members of the Company s Board of Directors also serves as an executive officer or board member. For the three months ended September 30, 2007 and 2006, the Company s total revenues from transactions with these parties from the period that they were considered related were approximately $12 million and $2 million, respectively. In addition, for the three months ended September 30, 2007 and 2006 the Company s total purchases from transactions with these parties were approximately $2 million and $0.5 million. The Company had a receivable balance from these parties of approximately $8 million and $7 million at September 30, 2007 and June 30, 2007, respectively. Management believes that such transactions are at arms length and on similar terms as would have been obtained from unaffiliated third parties.

NOTE 13 SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

KLA-Tencor reports one reportable segment in accordance with the provisions of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. KLA-Tencor s chief operating decision makers are the Chief Executive Officer and the Chief Operating Officer.

KLA-Tencor is engaged primarily in designing, manufacturing, and marketing process control and yield management solutions for the semiconductor and related microelectronics industries. All operating units have been aggregated due to their inter-dependencies, commonality of long-term economic characteristics, products and services, the production processes, class of customer and distribution processes. The Company s service products are an extension of the system product portfolio and provide customers with spare parts and fab management services (including system preventive maintenance and optimization services) to improve yield, increase production uptime and throughput, and lower the cost of ownership. Since KLA-Tencor operates in one segment, all financial segment information required by SFAS No. 131 can be found in the condensed consolidated financial statements.

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

The following is a summary of revenues by geographic region for the three months ended September 30, 2007 and 2006:

	Three months ended September 30,	
(In thousands)	**2007**	**2006**
Revenue:		
United States	$ 146,953	$ 130,257
Taiwan	197,014	137,297
Japan	182,210	107,266
Europe & Israel	69,778	70,319
Korea	34,059	87,315
Asia Pacific	63,006	96,909
Total	$ 693,020	$ 629,363

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

(In thousands)	**September 30, 2007**	**June 30, 2007**
Long-lived assets:		
United States	$ 313,395	$ 321,146

Taiwan	1,615	1,720
Japan	6,002	6,821
Europe & Israel	11,726	11,466
Korea	6,134	6,524
Asia Pacific	51,196	46,301
Total	$ 390,068	$ 393,978

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The following is a summary of revenues by major products for the three months ended September 30, 2007 and 2006 (as a percentage of total revenue):

	Three months ended September 30,	
	2007	2006
Revenue:		
Defect inspection	59%	64%
Metrology	22%	15%
Service	16%	15%
Other	3%	6%
Total	100%	100%

For the three months ended September 30, 2007 and September 30, 2006, no customer accounted for greater than 10% of revenue. As of June 30, 2007, no customer accounted for greater than 10% of net accounts receivable. As of September 30, 2007, one customer accounted for approximately 10% of net accounts receivable.

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

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward-looking statements. You can identify these and other forward-looking statements by the use of words such as may, will, could, would, should, expects, plans, anticipates, relies, believes, estimates, predicts, intends, potential, continue, or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Such forward-looking statements include, among others, forecasts of the future results of our operations; the percentage of spending that our customers allocate to process control; orders for our products and capital equipment generally; sales of semiconductors; the allocation of capital spending by our customers; growth of revenue in the semiconductor industry, the semiconductor capital equipment industry and our business; technological trends in the semiconductor industry; the future impact of the restatement of our historical financial statements, shareholder litigation and related matters arising from the discovery that we had retroactively priced stock options (primarily from July 1, 1997 to June 30, 2002) and had not accounted for them correctly; our future product offerings and product features; the success and market acceptance of new products; timing of shipment of backlog; the future of our product shipments and our product and service revenues; our future gross margins; our future selling, general and administrative expenses; international sales and operations; maintenance of our competitive advantage; success of our product offerings; creation and funding of programs for research and development; attraction and retention of employees; results of our investment in leading edge technologies; the effects of hedging transactions; the effect of the sale of trade receivables and promissory notes from customers; our future income tax rate; dividends; the completion of any acquisitions of third parties, or the technology or assets thereof; benefits received from any acquisitions and development of acquired technologies; sufficiency of our existing cash balance, investments and cash generated from operations to meet our operating and working capital requirements; and the adoption of new accounting pronouncements.

Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in Item 1A, Risk Factors as well as in Item 1, Business and Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended June 30, 2007, filed with the Securities and Exchange Commission on August 20, 2007. You should carefully review these risks and also review the risks described in this document and the other documents we file from time to time with the Securities and Exchange Commission, including the Quarterly Reports on Form 10-Q that we will file during the remainder of the fiscal year ending June 30, 2008. You are cautioned not to place undue reliance on these forward-looking statements, and we expressly assume no obligation to update the forward-looking statements in this report after the date hereof.

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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. We based these estimates and assumptions on historical experience, and evaluate them on an on-going basis to ensure that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed the Company s related disclosure in this Quarterly Report on Form 10-Q. The items in our financial statements requiring significant estimates and judgments are as follows:

Revenue Recognition. We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the seller s price is fixed or determinable, and collectibility is reasonably assured. We derive revenue from three sources system sales, spare part sales and service contracts. We typically recognize revenue for system sales upon acceptance by the customer that the system has been installed and is operating according to predetermined specifications. We also recognize revenue prior to written acceptance from the customer, as follows:

When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% payment is due upon shipment, revenue is recognized upon shipment;

When the installation of the system is deemed perfunctory, revenue is recognized upon shipment. The portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation;

When the customer fab has previously accepted the same tool, with the same specifications, and it can be objectively demonstrated that the tool meets all of the required acceptance criteria upon shipment, revenue is recognized upon shipment. The portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation;

When the customer withholds signature on our acceptance document due to issues unrelated to product performance, revenue is recognized when the system is performing as intended and meets all published and contractually agreed specifications; and

When the system is damaged during transit, revenue is recognized upon receipt of cash payment from the customer.

Total revenue recognized without a written acceptance from the customer was approximately 13.9% and 6.4% of total revenues for the three months ended September 30, 2007 and September 30, 2006, respectively. The increase in revenue recognized without a written acceptance is primarily driven by increased shipments of tools that have previously met the required acceptance criteria at those customer fabs, and an increase in sales of systems with perfunctory installation. Shipping charges billed to customers are included in system revenue, and the related shipping costs are included in costs of revenues.

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 of 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 revenue is recognized ratably over the term of the maintenance contract. Consulting and training revenue is recognized when the related services are performed.

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.

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 twelve months. Non-standard warranty is recognized ratably as revenue when the applicable warranty term period commences.

Software is incidental to our products as determined in accordance with AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* and Emerging Issues Task Force (EITF) Issue No. 03-05, *Applicability of SOP 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*. We periodically review the software element of our systems in accordance with SOP No. 97-2 and EITF Issue No. 03-05.

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Inventories. Inventories are stated at the lower of cost (on a first-in, first-out basis) or market. Demonstration units are stated at their manufacturing cost, and reserves are recorded to state the demonstration units at their net realizable value. We review the adequacy of our inventory reserves on a quarterly basis.

We review and set standard costs semi-annually at current manufacturing costs in order to approximate actual costs. Our manufacturing overhead standards for product costs are calculated assuming full absorption of forecasted spending over projected volumes, adjusted for excess capacity. Abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are recognized as current period charges.

We write down inventory based on forecasted demand and technological obsolescence. These factors are impacted by market and economic conditions, technology changes, new product introductions and changes in strategic direction and require estimates that may include uncertain elements. Actual demand may differ from forecasted demand, and such differences may have a material effect on recorded inventory values.

Warranty. We provide standard warranty coverage on our systems for 40 hours per week for twelve months, providing labor and parts necessary to repair the systems during the warranty period. We account for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. Utilizing actual service records, we calculate the average service hours and parts expense per system and apply the labor and overhead rates to determine the estimated warranty charge. We update these estimated charges on a quarterly basis. The actual product performance and/or field expense profiles may differ, and in those cases we adjust our warranty reserves accordingly. The difference between the estimated and actual warranty costs tends to be larger for new product introductions as there is limited or no historical product performance to estimate warranty expense; more mature products with longer product performance histories tend to be more stable in our warranty charge estimates. Non-standard warranty generally includes services incremental to the standard 40-hour per week coverage for twelve months. Non-standard warranty is deferred as unearned revenue and is recognized ratably as revenue when the applicable warranty term period commences. See Note 10, Commitments and Contingencies to the Condensed Consolidated Financial Statements for a detailed description.

Allowance for Doubtful Accounts. A majority of our trade receivables are derived from sales to large multinational semiconductor manufacturers throughout the world. In order to monitor potential credit losses, we perform ongoing credit evaluations of our customers financial condition. An allowance for doubtful accounts is maintained for probable credit losses based upon our assessment of the expected collectibility of all accounts receivable. The allowance for doubtful accounts is reviewed on a quarterly basis to assess the adequacy of the allowance. We take into consideration (1) any circumstances of which we are aware of a customer s inability to meet its financial obligations; and (2) our judgments as to prevailing economic conditions in the industry and their impact on our customers. If circumstances change, and the financial condition of any of our customers is adversely affected and they are unable to meet their financial obligations to us, we may need to take additional allowances, which would result in a reduction of our net income.

Stock-Based Compensation. Beginning July 1, 2005, we have accounted for stock-based compensation using the fair value of stock options based on a Black-Scholes option-pricing model, consistent with the provisions of SFAS No. 123(R), as clarified by SEC SAB No. 107. We elected to adopt the modified prospective application method as provided by SFAS No. 123(R). Accordingly, during the fiscal years ended June 30, 2006 and 2007, we recorded stock-based compensation expense totaling the amount that would have been recognized had the fair value method been applied under SFAS No. 123 since the effective date of SFAS No. 123 for the grants made prior to the fiscal year ended June 30, 2006, and under SFAS No. 123(R) for the grants made during the fiscal years ended June 30, 2006 and 2007.

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

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Award*s (FSP 123R-3). We have elected not to adopt the alternative transition method provided in FSP 123R-3 for calculating the tax effects of stock-based compensation pursuant to SFAS No. 123(R). We followed paragraph 81 of SFAS No. 123(R) to calculate the initial pool of excess tax benefits and to determine the subsequent impact on the Additional Paid-in-Capital (APIC) pool and

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Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that were outstanding upon adoption of SFAS No. 123(R). We have elected to ignore the indirect tax effects of stock-based compensation deductions when calculating the windfall benefits and are recognizing the full effect of these deductions in the income statement in the period in which the taxable event occurs. See Note 4, Stock-Based Compensation to the Condensed Consolidated Financial Statements for a detailed description.

Contingencies and Litigation. We are subject to the possibility of losses from various contingencies. Considerable judgment is necessary to estimate the probability and amount of any loss from such contingencies. An accrual is made when it is probable that a liability has been incurred or an asset has been impaired and the amount of loss can be reasonably estimated. We accrue a liability and charge operations for the estimated costs expected to be incurred over the next twelve months of adjudication or settlement of asserted and unasserted claims existing as of the balance sheet date. See Note 9, Litigation and Other Legal Matters and Note 10, Commitments and Contingencies to the Condensed Consolidated Financial Statements for a detailed description.

Goodwill and Intangible Assets. As required by SFAS No. 142, *Goodwill and Other Intangible Assets,* goodwill is not amortized but is subject to impairment tests annually, or earlier if indicators of potential impairment exist, using a fair-value-based approach. Purchased technology, patents, trademarks and other intangible assets are presented at cost, net of accumulated amortization. Intangible assets are amortized on a straight line basis which approximates their estimated useful lives and assessed for impairment under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. 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. We completed the annual evaluation of the goodwill by reporting unit during the quarter ended December 31, 2006 and concluded that there was no impairment. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to the impairment test performed in the quarter ended December 31, 2006.

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

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

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

We adopted FASB Interpretation No. 48 (FIN 48), *Accounting for uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, on July 1, 2007. See Note 8, Income Taxes to the Condensed Consolidated Financial Statements for a detailed description.

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

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EXECUTIVE SUMMARY

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

Revenues, income from operations, net income, cash flow from operations, and diluted earnings per share are some of the key indicators we use to monitor our financial condition and operating performance. The following table sets forth some of the key quarterly unaudited financial information which we use to manage our business.

	Fiscal year 2008	Fiscal year 2007			
(In thousands)	First Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues	$ 693,020	$ 629,363	$ 649,270	$ 716,208	$ 736,388
Income from operations	$ 177,278	$ 153,990	$ 78,359	$ 182,655	$ 174,864
Net income	$ 88,158	$ 135,922	$ 90,049	$ 154,785	$ 147,342
Cash flow from operations	$ 205,162	$ 106,968	$ 149,640	$ 198,608	$ 155,470
Net income per share-diluted	$ 0.46	$ 0.67	$ 0.44	$ 0.76	$ 0.75

Industry Trends

As a supplier to the global semiconductor and semiconductor-related industries, we are subject to business cycles, the timing, length and volatility of which can be difficult to predict. The industries we serve have historically been cyclical due to sudden changes in demand and manufacturing capacity. We expect our customers capital spending on process control to increase over the long term. We believe that this increase in process control spending will be driven by the demand for more precise diagnostics capabilities to address multiple new defects as a result of further shrinking of device feature sizes, the transition to new materials, new devices and circuit architecture, new lithography challenges and fab process innovation. We anticipate that these factors will drive increased demand for our products and services over the coming years. The key drivers in the semiconductor equipment industry in calendar year 2007 are the continued progression of transition to 300mm, ramping up at the 65nm design nodes and increasing adoption of 45nm technology. These drivers are fueled by competitive pressures for our customers to improve yields, lower their costs and get to market quicker in order to benefit from the increased demand for products from the consumer electronics, computing and communication industries.

RESULTS OF OPERATIONS

Revenues and Gross Margin

	Three months ended						
				Q1 FY08 vs.		Q1 FY08 vs.	
(In thousands)	September 30, 2007	June 30, 2007	September 30, 2006	Q4 FY07		Q1 FY07	
Revenues:							
Product	$ 578,432	$ 626,323	$ 530,927	$ (47,891)	-8%	$ 47,505	9%
Service	$ 114,588	$ 110,065	98,436	$ 4,523	4%	16,152	16%
Total revenues	$ 693,020	$ 736,388	$ 629,363	$ (43,368)		$ 63,657	
Cost of revenues	$ 305,893	$ 315,681	$ 270,119	$ (9,788)	-3%	$ 35,774	13%
Stock-based compensation expense included in costs of revenues	$ 6,253	$ 5,965	$ 8,587	$ 288		$ (2,334)	
Gross margin percentage	56%	57%	57%	-1%		-1%	

Stock-based compensation expense included in cost of revenues as a percentage of total revenues	1%	1%	1%	0%	0%

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Product revenues

Product revenues decreased during the first quarter of fiscal year 2008 from the fourth quarter of fiscal year 2007 as a result of lower backlog of shipped tools awaiting customer acceptance at the beginning of the first quarter of fiscal year 2008, lower revenue on shipment of tools that have previously met the required acceptance criteria and lower revenue from buyouts of tools on consignment by our customers. Product revenues increased during the first quarter of fiscal year 2008 from the corresponding period in fiscal year 2007, primarily as a result of a higher level of backlog of shipped tools awaiting customer acceptance at the beginning of the fourth quarter of fiscal year 2007 which reflected a higher level of customer spending. The higher level of customer spending was driven by our customers demand for more precise diagnostics capabilities to address multiple new defects as a result of further shrinking of device feature sizes, the transition to new materials, new devices and circuit architecture, new lithography challenges and fab process innovation.

For the three months ended September 30, 2007 and 2006, no customer accounted for greater than 10% of revenue. As of June 30, 2007, no customer accounted for greater than 10% of net accounts receivable. As of September 30, 2007, one customer accounted for approximately 10% of net accounts receivable.

Service revenues

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

Revenues by region

Revenues by region for the periods indicated were as follows:

	Three months ended					
	September 30,				September 30,	
(In thousands)	2007		June 30, 2007		2006	
United States	$ 146,953	21%	$ 153,317	21%	$ 130,257	21%
Taiwan	197,014	29%	151,393	21%	137,297	22%
Japan	182,210	26%	185,166	25%	107,266	17%
Europe & Israel	69,778	10%	67,504	9%	70,319	11%
Korea	34,059	5%	75,523	10%	87,315	14%
Asia Pacific	63,006	9%	103,485	14%	96,909	15%
Total	$ 693,020	100%	$ 736,388	100%	$ 629,363	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 will continue to be the case.

Gross margin

Our gross margin fluctuates with revenue levels and product mix, and is affected by variations in costs related to manufacturing and servicing our products. The decrease in gross margin during the first quarter of fiscal year 2008 compared to the corresponding period of the fiscal year 2007 is primarily due to costs of $10.0 million related to the amortization of intangibles and fair value adjustment for inventory of acquisitions completed as of June 30, 2007.

The slight decrease in gross margin during the first quarter of fiscal 2008 compared to the fourth quarter of fiscal year 2007 is due to lower levels of revenue.

Engineering, Research and Development (R&D)

	Three months ended						
(In thousands)	September 30, 2007	June 30, 2007	September 30, 2006	Q1 FY08 vs. Q4 FY07		Q1 FY08 vs. Q1 FY07	
R&D expenses	$ 99,344	$ 123,854	$ 99,293	$ (24,510)	-20%	$ 51	0%
Stock-based compensation expense included in R&D expenses	$ 8,592	$ 8,447	$ 11,705	$ 145	2%	$ (3,113)	-27%
R&D expenses as a percentage of total revenues	14%	17%	16%	-3%		-2%	

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	Three months ended				
(In thousands)	September 30, 2007	June 30, 2007	September 30, 2006	Q1 FY08 vs. Q4 FY07	Q1 FY08 vs. Q1 FY07
Stock-based compensation expense included in R&D expenses as a percentage of total revenues	1%	1%	2%	0%	-1%

R&D expenses during the first quarter of fiscal year 2008 were flat compared to the corresponding period in fiscal year 2007. The decrease in R&D expenses during the first quarter of fiscal year 2008 compared to the fourth quarter of fiscal year 2007 primarily reflects the following additional charges recorded during the fourth quarter of fiscal year 2007:

- $12.3 million for in-process research and development charges and amortization of intangibles associated with the acquisitions that we had completed as of June 30, 2007;
- $10.0 million for impairment of certain patents that we determined not to further develop and for which we did not have any alternative use;
- $2.2 million for severance and benefits related to an employee workforce reduction.

R&D expenses include the benefit of $4.1 million, $2.1 million and $3.0 million of external funding received during the three months ended September 30, 2007, June 30, 2007, and September 30, 2006, respectively, for certain strategic development programs from government grants.

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

Selling, General and Administrative (SG&A)

	Three months ended						
(In thousands)	September 30, 2007	June 30, 2007	September 30, 2006	Q1 FY08 vs. Q4 FY07		Q1 FY08 vs. Q1 FY07	
SG&A expenses	$ 110,505	$ 121,989	$ 105,961	$ (11,484)	-9%	$ 4,544	4%
Stock-based compensation expense included in SG&A expenses	$ 13,238	$ 11,982	$ 16,755	$ 1,256	10%	$ (3,517)	-21%
SG&A expenses as a percentage of total revenues	16%	17%	17%	-1%		-1%	
Stock-based compensation expense included in SG&A expenses as a percentage of total revenues	2%	2%	3%	0%		-1%	

SG&A expenses during the first quarter of fiscal year 2008 were slightly higher compared to the corresponding period in fiscal year 2007 primarily due to severance and benefits related to employee workforce reduction of $1.4 million recorded in the first quarter of fiscal year 2008. The decrease in SG&A expenses during the first quarter of fiscal year 2008 compared to the fourth quarter of fiscal year 2007 reflects a decrease in severance and benefits related to employee workforce reduction from $6.1 million in the fourth quarter of fiscal year 2007 to $1.4 million in the first quarter of fiscal year 2008. In addition, in the first quarter of fiscal 2008, we had lower employee compensation costs attributable to cost saving strategies.

Interest Income and Other, Net

	Three months ended		
(Dollar amounts in thousands)	**September 30, 2007**	**June 30, 2007**	**September 30, 2006**
Interest income and other, net	$ 17,474	$ 21,436	$ 22,457
Percentage of total revenues	3%	3%	4%

Interest income and other, net is comprised primarily of interest income earned on our investment and cash portfolio, realized gains or losses on sales of marketable securities, as well as gains or losses recorded upon settlement of certain foreign currency contracts. The decrease in interest income and other, net in the first quarter of fiscal year 2008 compared to the first and fourth quarters of fiscal year 2007 was primarily due to lower levels of cash as a result of share repurchases of

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$683.5 million in the first quarter of fiscal year 2008. Additionally, the decrease in interest income and other, net in the first quarter of fiscal year 2008 as compared to the fourth quarter of fiscal year 2007 was due to a gain of $3.9 million from the sale of equity interest in a development stage company recorded in the fourth quarter of fiscal year 2007.

Provision for Income Taxes

Our effective income tax rate was 54.6%, 24.9%, and 23.4% for the three months ended September 30, 2007, June 30, 2007 and September 30, 2006, respectively.

The increase in the effective tax rate from 24.9% and 23.4% for the three months ended June 30, 2007 and September 30, 2006, respectively, to 54.6% for the three months ended September 30, 2007, is primarily due to the immediate impact of $46.6 million of incremental U.S. tax expense associated with this quarter s implementation of our global manufacturing strategy. In addition, there was an increase to the effective tax rate for the three months ended September 30, 2007 compared to the three months ended June 30, 2007 and September 30, 2006 due to decreases in the tax benefits related to tax exempt interest, research and development credit and extraterritorial income exclusion. We expect the tax rate in future periods of the year ending June 30, 2008 to result in an annual rate of approximately 37% which includes the effect of the higher tax expense associated with the implementation of our global manufacturing strategy.

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

Equity Incentive Program

The Company s equity incentive program is a broad-based, long-term retention program that is intended to attract and retain key employees, and align stockholder and employee interests. The equity incentive program consists of two plans: one under which non-employee directors may be granted options to purchase shares of the Company s stock, and another in which non-employee directors, officers, key employees, consultants and all other employees may be granted options to purchase shares of the Company s stock, restricted stock units and other types of equity awards. For the past several years until June 30, 2006, stock options (except for the retroactively priced options which were granted primarily from July 1, 1997 to June 30, 2002) were generally granted at the market price of the Company s common stock on the date of grant, with a vesting period of five years and an exercise period not to exceed seven years (ten years for options granted prior to July 1, 2005) from the date of issuance. Restricted stock units may be granted with varying criteria such as time-based or performance-based vesting. Substantially all of the Company s employees that meet established performance goals and qualify as key employees participate in its main equity incentive plan. Since July 1, 2006, the Company has granted only restricted stock units under its equity incentive program, except for options granted to non-employee directors as part of their regular compensation package for service through September 30, 2007.

On October 18, 2004, our stockholders approved the 2004 Equity Incentive Plan (the 2004 Plan) which provides for the grant of options to purchase shares of our common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to our employees, consultants and members of our Board of Directors. Since the adoption of the 2004 Plan, no further grants are permitted under the 1982 Stock Option Plan or 2000 Nonstatutory Stock Option Plan. The 2004 Plan permits the issuance of up to 12.5 million shares of common stock, of which 1.6 million shares were available for grant as of September 30, 2007. Our Board of Directors has approved an increase of 8.5 million shares of common stock to the number of shares reserved for issuance under the 2004 Plan, subject to stockholder approval of such increase at our Annual Meeting of Stockholders to be held on November 15, 2007. Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date shall be counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto. Total options outstanding under all plans as of September 30, 2007 were 16.9 million. As of September 30, 2007 and 2006, restricted stock units outstanding that had been granted to senior management with performance-based vesting were approximately 0.2 million and 0.4 million, respectively.

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

(In thousands except for Weighted-Average Exercise Price)	Available For Grant	Options Outstanding	Weighted-Average Exercise Price
Balances at June 30, 2007	3,317	19,585	$ 42.28
Plan shares expired	(141)		
Options granted	(12)	12	$ 56.79
Restricted stock units granted(1)	(425)		
Restricted stock units canceled(1)	164		
Options canceled/expired/forfeited	242	(242)	$ 45.43
Options exercised		(2,466)	$ 39.20
Balances at September 30, 2007	3,145	16,889	$ 42.70

(1) Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date shall be counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto.

The weighted-average grant date fair value of options, as determined under SFAS No. 123(R), granted during the three months ended September 30, 2007 and 2006 was $18.25 and $13.51 per share, respectively. As of September 30, 2007, 11.5 million options were exercisable with a weighted-average exercise price of $41.77 per share and weighted-average remaining contractual term of 5 years. The aggregate intrinsic value for the options exercisable as of September 30, 2007 was $161.0 million.

The total intrinsic value of options exercised during the three months ended September 30, 2007 and 2006 was $50.5 million and $10.0 million, respectively. The total cash received from employees as a result of employee stock option exercises during the three months ended September 30, 2007 and 2006 was approximately $96.7 million and $18.6 million, respectively. In connection with these exercises, the tax benefits realized by the Company for the three months ended September 30, 2007 and 2006 was $17.5 million and $3.6 million, respectively.

The Company currently settles employee stock option exercises with newly issued common shares.

Restricted Stock Units

The following table shows the number of restricted stock units granted, grant-date fair value, and stock-based compensation expense for the three months ended September 30, 2007 and 2006:

(In thousands)	Three months ended September 30, 2007	2006
Number of shares granted	236	2,536
Grant-date fair value	$ 8,306	$ 81,306
Stock-based compensation expense	$ 7,020	$ 2,474

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

As of September 30, 2007, the unrecognized stock-based compensation balance related to restricted stock units was $72.1 million and will be recognized over an estimated weighted-average amortization period of 3.3 years. Additionally, the number of restricted stock units outstanding as of September 30, 2007 was 4.2 million.

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Employee Stock Purchase Plan

KLA-Tencor s Amended and Restated 1997 Employee Stock Purchase Plan (ESPP) provides that eligible employees may contribute up to 10% of their eligible earnings toward the semi-annual purchase of KLA-Tencor s common stock. The ESPP is qualified under Section 423 of the Internal Revenue Code. The employee s purchase price is derived from a formula based on the fair market value of the common stock at the time of enrollment into the offering period versus the fair market value on the date of purchase. Offering periods are generally two years in length. On September 28, 2006, the ESPP was suspended due to the ongoing stock option investigation, and accordingly there were no shares purchased under the ESPP during the six months ended December 31, 2006. After the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2006 and its Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 were filed on January 29, 2007, approximately 0.3 million shares were purchased under the ESPP on February 1, 2007.

The compensation expense in connection with the ESPP in the three months ended September 30, 2007 and 2006 was $4.1 million and $4.5 million, respectively, calculated in accordance with SFAS No. 123(R). There were no shares purchased under the ESPP during the three months ended September 30, 2007 and September 30, 2006. In connection with the disqualifying dispositions of shares purchased under the ESPP, the Company realized tax benefits of $0.6 million for the three months ended September 30, 2007.

The number of shares available for issuance under the ESPP is replenished annually, typically on the first day of each fiscal year, by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. As of September 30, 2007, a total of 1.1 million shares were reserved and available for issuance under the ESPP; however, that number does not include any shares expected to be added to the ESPP with respect to fiscal year 2008.

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LIQUIDITY AND CAPITAL RESOURCES

(Dollar amounts in thousands)	September 30, 2007	June 30, 2007
Cash and cash equivalents	$ 514,051	$ 722,511
Marketable securities	768,882	988,118
Total cash, cash equivalents and marketable securities	$ 1,282,933	$ 1,710,629
Percentage of total assets	31%	37%

	Three months ended	
(In thousands)	September 30, 2007	September 30, 2006
Cash provided by operating activities	$ 205,162	$ 106,968
Cash provided by (used in) investing activities	204,427	(34,167)
Cash used in financing activities	(612,498)	(4,515)
Effect of exchange rate changes on cash and cash equivalents	(5,551)	2,492
Net increase (decrease) in cash and cash equivalents	$ (208,460)	$ 70,778

We have historically financed our operations through cash generated from operations. Cash provided by operating activities was $205.2 million and $107.0 million for the three months ended September 30, 2007 and 2006, respectively. Cash provided by operating activities during the three months ended September 30, 2007 consisted primarily of net income of $88.2 million, increased by non-cash depreciation and amortization of $25.0 million, and stock-based compensation of $28.1 million, a decrease in inventories of $39.7 million, and an increase in accounts payable of $26.3 million, partially offset by an increase in accounts receivable of $18.8 million.

Cash provided by operating activities during the three months ended September 30, 2006 consisted primarily of net income of $135.9 million, increased by non-cash depreciation and amortization of $14.8 million and stock-based compensation of $37.0 million and a decrease in accounts receivable of $20.6 million due to improved collection efforts, partially offset by an increase in inventories of $43.1 million to meet the production demand triggered by new order increases from previous quarters as well as anticipated future demand, and a decrease in other current liabilities of $64.7 million due to tax payments made in the quarter ended September 30, 2006.

Investing activities typically consist of purchases and sales or maturities of marketable securities, purchases of capital assets to support long-term growth and acquisitions of technology or other companies to allow access to new markets or emerging technologies. Cash provided by investing activities was $204.4 million during the three months ended September 30, 2007, while cash used in investing activities was $34.2 million during the three months ended September 30, 2006.

Financing activities include dividend payments to our common stockholders and sales and repurchases of our common stock. Issuance of common stock provided $96.7 million and $18.6 million in the three months ended September 30, 2007 and 2006, respectively.

Since the inception of the repurchase program in 1997 through September 30, 2007, the Board of Directors has authorized the Company to repurchase a total of 47.8 million shares, including 10.0 million authorized in August 2007. We used $683.5 million in the three months ended September 30, 2007 to repurchase 11.7 million shares of our common stock. Because the stock repurchase program was suspended in May 2006 and resumed in February 2007, we did not repurchase stock in the three months ended September 30, 2006. The decrease in cash, cash equivalents and marketable securities from the three months ended September 30, 2006 to the three months ended September 30, 2007 was primarily due to the repurchase of shares in the first quarter of fiscal year 2008.

During the third quarter of the fiscal year ended June 30, 2005, our Board of Directors approved the initiation of a quarterly cash dividend. During the three months ended September 30, 2007, the Company declared a dividend of $0.15 per share of our outstanding common stock, which was paid on September 1, 2007 to our stockholders on record as of August 20, 2007. During the same period in fiscal year 2007, the Company declared and paid a quarterly cash dividend of $0.12 per share. The total amount of dividends paid during the three months ended September 30, 2007 and 2006 was $28.5 million and $24.2 million, respectively.

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The following is a schedule summarizing our significant obligations to make future payments under contractual obligations as of September 30, 2007:

(in thousands)	Total	2008 (1)	2009	2010	2011	2012	Thereafter
Purchase commitments	$ 159,334	$ 152,965	$ 6,369	$	$	$	$
Operating leases	36,037	7,705	8,160	5,545	3,868	2,371	8,388
Pension obligations	10,171	648	924	976	1,001	902	5,720
Other obligations	37,659	37,659					
Total contractual cash obligations	$ 243,201	$ 198,977	$ 15,453	$ 6,521	$ 4,869	$ 3,273	$ 14,108

(1) Remaining 9 months

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

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs and related discounting fees paid for the three months ended September 30, 2007 and 2006:

	Three months ended	
(In thousands)	September 30, 2007	September 30, 2006
Receivables sold under factoring agreements	$ 70,534	$ 79,828
Proceeds from sales of LCs	$ 6,818	$ 30,189
Discounting fees paid on sales of LCs (1)	$ 21	$ 365

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

We maintain guarantee arrangements of $29.8 million in various locations to fund customs guarantees for VAT and LC needs of our subsidiaries in Europe and Asia. Approximately $19.9 million was outstanding under these arrangements as of September 30, 2007.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply chain for key components. Our liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. Our open inventory purchase commitments were approximately $159.3 million as of September 30, 2007 and are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may change in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

As of September 30, 2007, the non-current tax payable under FIN 48 was $87.4 million. We are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes. This obligation is excluded from the schedule summarizing our significant obligations to make future payments under contractual obligations as of September 30, 2007 presented above.

We provide standard warranty coverage on our systems for 40 hours per week for twelve months, providing labor and parts necessary to repair the systems during the warranty period. We account for the estimated warranty cost as a charge to cost of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. The actual product performance and/or field expense profiles may differ, and in those cases we adjust our warranty accruals accordingly. The difference between the estimated and actual warranty costs tends to be larger for new product introductions as there is limited or no historical product performance to estimate warranty expense; more mature products with longer product performance histories tend to be more stable in our warranty charge estimates. Non-standard warranty coverage generally includes services incremental to the standard 40-hour per week coverage for twelve months. See Note 10 Commitments and Contingencies to the Condensed Consolidated Financial Statements for a detailed description.

Working capital decreased to $1,857.8 million as of September 30, 2007, compared to $2,247.2 million as of June 30, 2007. This decrease is primarily due to cash payments for the repurchase of shares of $683.5 million in the first quarter of fiscal year 2008 offset by cash generated from operations in the first quarter of fiscal year 2008. As of September 30, 2007, our principal sources of liquidity consisted of $1,282.9 million of cash, cash equivalents, and marketable securities. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, we believe that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for at least the next twelve months.

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Off-Balance Sheet Arrangements

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

(In thousands)	As of September 30, 2007	As of June 30, 2007
Cash flow hedge contracts		
Purchase	$ 11,660	$ 4,651
Sell	(246,316)	(242,942)
Other foreign currency hedge contracts		
Purchase	134,774	126,992
Sell	(301,056)	(265,378)
Net	$ (400,938)	$ (376,677)

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments, such as foreign currency hedges. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position as of September 30, 2007. Actual results may differ materially.

As of September 30, 2007, we had an investment portfolio of fixed income securities of approximately $768.9 million, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of September 30, 2007, the fair value of the portfolio would have declined by $3.9 million.

As of September 30, 2007, we had net forward contracts to sell $400.9 million in foreign currency in order to hedge currency exposures (see Note 11, Derivative Instruments and Hedging Activities, to Condensed Consolidated Financial Statements (unaudited) for a detailed description). If we had entered into these contracts on September 30, 2007, the U.S. dollar equivalent would be $402.1 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by $57.5 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on net income or cash flows.

ITEM 4. CONTROLS AND PROCEDURES

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

Evaluation of Disclosure Controls and Procedures

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

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

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Definition of Disclosure Controls

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

Limitations on the Effectiveness of Controls

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

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

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth above under Note 9 contained in the Condensed Consolidated Financial Statements in Item 1 of Part 1 is incorporated herein by reference.

ITEM 1A. RISK FACTORS

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

Risks Associated with Our Industry and Market Conditions

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

The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. This cyclical nature of the industry in which we operate affects our ability to accurately predict future revenue and, thus, future expense levels. When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During a down cycle, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. In addition, during periods of rapid

growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles.

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

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

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

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

Risks Related to Our Business

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

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

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

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

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers to supply these materials. We generally do not have guaranteed supply arrangements with our suppliers. Because of the

variability and uniqueness of customers orders, we do not maintain an extensive inventory of materials for manufacturing. We seek to minimize the risk of production and service interruptions

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and/or shortages of key parts by selecting and qualifying alternative suppliers for key parts, monitoring the financial stability of key suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, key parts may be available only from a single supplier or a limited group of suppliers. Our operating results and business may be adversely impacted if we are unable to obtain parts to meet our production requirements, or if we are only able to do so on unfavorable terms.

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

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

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

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

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

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

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

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

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

As is typical in the semiconductor equipment industry, from time to time we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which they believe cover certain of our products, processes, technologies or information. Litigation tends to be expensive and requires

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significant management time and attention and could have a negative effect on our results of operations or business if we lose or have to settle a case on significantly adverse terms. Our customary practice is to evaluate such infringement assertions and to consider whether to seek licenses where appropriate. However, we cannot ensure that licenses can be obtained or, if obtained, will be on acceptable terms or that costly litigation or other administrative proceedings will not occur. The inability to obtain necessary licenses or other rights on reasonable terms, or the instigation of litigation or other administrative proceedings, could seriously harm our operating results and financial condition.

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

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

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

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

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

- we may have to devote unanticipated financial and management resources to acquired businesses;
- we may not be able to realize expected operating efficiencies or product integration benefits from our acquisitions;
- we may have to write-off goodwill or other intangible assets; and
- we may incur unforeseen obligations or liabilities in connection with acquisitions.

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

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

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

The threat of terrorism targeted at the regions of the world in which we do business increases the uncertainty in our markets. Any act of terrorism which affects the economy or the semiconductor industry could adversely affect our business. Increased international political instability, disruption in air transportation and further enhanced security measures as a result of terrorist attacks, and the continuing instability in the Middle East, may hinder our ability to do business and may increase our costs of operations. Such continuing instability could cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. This same instability could have the same effects on our suppliers and their ability to timely deliver their products.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Risks Related to the Restatement of Our Prior Financial Results

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

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

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

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

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

On July 25, 2007, we announced that the Company had reached a settlement with the SEC by consenting to the entry of a permanent injunction against future violations of the reporting, books and records, and internal controls provisions of the federal securities laws. The settlement resolves completely the SEC investigation into the Company s historical stock option granting practices. KLA-Tencor was not charged by the SEC with fraud, nor was the Company required to pay any civil penalty, fine or money damages as part of the settlement. While the SEC has completed its investigation, the inquiry by the

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United States Attorney s Office for the Northern District of California (USAO) into our historical stock option practices is ongoing. We have fully cooperated with the USAO and intend to continue to do so. The period of time necessary to resolve this inquiry is uncertain, and we cannot predict the outcome of this inquiry or whether we will face additional government inquiries, investigations or other actions related to our historical stock option practices. This inquiry may require us to continue to expend significant management time and incur significant legal and other expenses, and could result in criminal actions seeking, among other things, injunctions against the Company and the payment of significant fines and penalties by the Company, which may have a material adverse effect on our financial condition, results of operations and cash flow.

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

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

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

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

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

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

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

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

We expect that the issues arising from our previous retroactive pricing of stock options will make it more difficult to obtain director and officer insurance coverage in the future. If we are able to obtain this coverage, it could be significantly more costly than in the past, which would have an adverse effect on our financial results and cash flow. As a result of this and related factors, our directors and officers could face increased risks of personal liability in connection with the performance of their duties. As a result, we may have difficulty attracting and retaining qualified directors and officers, which could adversely affect our business.

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

Following is a summary of stock repurchases for the quarter ended September 30, 2007. (1)

Period	Total Number of Shares Purchased	Average Price Paid per Share	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs(3)
July 1, 2007 to July 31, 2007(2)	25,000	$ 57.50	**12,711,500**
August 1, 2007 to August 31, 2007(2)	10,110,500	$ 58.92	**12,601,000(4)**
September 1, 2007 to September 30, 2007(2)	1,520,000	$ 56.83	**11,081,000**
Total	11,655,500	$ 58.64	

(1) In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. This program was put into place to reduce the dilution from KLA-Tencor s issuance of shares pursuant to its employee benefit and incentive plans such as the stock option and employee stock purchase plans and to return excess cash to the Company s stockholders. Since the inception of the repurchase program in 1997 through September 30, 2007, the Board of Directors has authorized KLA-Tencor to repurchase a total of 47.8 million shares, including 10.0 million authorized in August 2007. The Company s systematic buyback program was suspended in May 2006, and resumed in February 2007.

(2) All shares were purchased pursuant to the publicly announced repurchase programs described in footnote 1 above.

(3) The stock repurchase programs have no expiration date. Future repurchases of the Company s common stock under the Company s repurchase programs may be effected through various different repurchase transaction structures, including isolated open market transactions or systematic repurchase plans.

(4) Reflects the authorization by the Company s Board of Directors in August 2007 for KLA-Tencor to repurchase up to an additional 10.0 million shares of its common stock under the repurchase program.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. SUBMISSION OF MATTERS TO VOTE OF SECURITY HOLDERS

None.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

10.38	Fiscal Year 2008 Performance Bonus Plan * +
10.39	Executive Severance Plan (as amended on September 20, 2007) *
31.1	Certification of Chief Executive Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C Section 1350.

* Denotes a management contract, plan or arrangement

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

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SIGNATURES

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

KLA-Tencor Corporation
(Registrant)

October 31, 2007
(Date)

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

October 31, 2007
(Date)

/s/ JEFFREY L. HALL
Jeffrey L. Hall
Senior Vice President and Chief Financial Officer
(Principal Financial Officer and Principal Accounting Officer)

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KLA-TENCOR CORPORATION

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference			
		Form	File No.	Exhibit Number	Filing Date
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