

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

---

**FORM 10-Q**

---

(Mark one)

**QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2014

or

**TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 000-09992

---

**KLA-Tencor Corporation**

(Exact name of registrant as specified in its charter)

---

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

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

**One Technology Drive, Milpitas, California**  
(Address of Principal Executive Offices)

**95035**  
(Zip Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

As of October 10, 2014, there were 164,476,980 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

---

INDEX

	<u>Page Number</u>
<b><u>PART I</u></b>	<b><u>FINANCIAL INFORMATION</u></b>
Item 1	<u>Financial Statements (Unaudited)</u>
	<u>Condensed Consolidated Balance Sheets as of September 30, 2014 and June 30, 2014</u>
	<u>3</u>
	<u>Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2014 and 2013</u>
	<u>4</u>
	<u>Condensed Consolidated Statements of Comprehensive Income for the Three Months Ended September 30, 2014 and 2013</u>
	<u>5</u>
	<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended September 30, 2014 and 2013</u>
	<u>6</u>
	<u>Notes to Condensed Consolidated Financial Statements</u>
	<u>7</u>
Item 2	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>
	<u>31</u>
Item 3	<u>Quantitative and Qualitative Disclosures About Market Risk</u>
	<u>45</u>
Item 4	<u>Controls and Procedures</u>
	<u>46</u>
<b><u>PART II</u></b>	<b><u>OTHER INFORMATION</u></b>
Item 1	<u>Legal Proceedings</u>
	<u>47</u>
Item 1A	<u>Risk Factors</u>
	<u>47</u>
Item 2	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
	<u>62</u>
Item 3	<u>Defaults Upon Senior Securities</u>
	<u>62</u>
Item 4	<u>Mine Safety Disclosures</u>
	<u>62</u>
Item 5	<u>Other Information</u>
	<u>62</u>
Item 6	<u>Exhibits</u>
	<u>63</u>
<b><u>SIGNATURES</u></b>	<b><u>64</u></b>
<b><u>EXHIBIT INDEX</u></b>	<b><u>65</u></b>

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

**KLA-TENCOR CORPORATION**  
**Condensed Consolidated Balance Sheets**  
(Unaudited)

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

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

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

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

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

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

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

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

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

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

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

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

**NOTE 1 – BASIS OF PRESENTATION**

**Basis of Presentation.** The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation (“KLA-Tencor” or the “Company”) pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations, comprehensive income, and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, “Financial Statements and Supplementary Data” included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2014, filed with the SEC on August 8, 2014.

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

The results of operations for the three months ended September 30, 2014 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2015.

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

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

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

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

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

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

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

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

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

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

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

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

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



**Recent Accounting Pronouncements.**

*Recently Adopted*

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

*Updates Not Yet Effective*

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

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

**NOTE 2 – FAIR VALUE MEASUREMENTS**

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

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

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

- |         |  |
|---------|--|
| Level 1 | Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.   |
| Level 2 | Valuations based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable data for substantially the full term of the assets or liabilities. |
| Level 3 | Valuations based on inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.   |

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

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

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

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

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

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

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

[Table of Contents](#)

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

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

(1) Excludes cash of \$106.7 million held in operating accounts and time deposits of \$33.5 million as of June 30, 2014.

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the three months ended September 30, 2014. The Company did not have significant assets or liabilities measured at fair value on a recurring basis within Level 3 fair value measurements as of September 30, 2014 or June 30, 2014.

**NOTE 3 – FINANCIAL STATEMENT COMPONENTS**
**Balance Sheet Components**

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

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

**Accumulated Other Comprehensive Income (Loss)**

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

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

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

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

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

**NOTE 4 – MARKETABLE SECURITIES**

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

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

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

(1) Time deposits excluded from fair value measurements.

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

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

(1) Of the total gross unrealized losses, the amount of total gross unrealized losses related to investments that had been in a continuous loss position for 2 months or more was immaterial.

[Table of Contents](#)

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

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

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

#### NOTE 5 – BUSINESS COMBINATION

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

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

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

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

#### NOTE 6 – GOODWILL AND PURCHASED INTANGIBLE ASSETS

##### Goodwill

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

<u>(In thousands)</u>	
As of June 30, 2014	\$ 335,355
Adjustments	(40)
As of September 30, 2014	<u>\$ 335,315</u>

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

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

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

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

**Purchased Intangible Assets**

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

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

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable.

For the three months ended September 30, 2014 and 2013, amortization expense for intangible assets was \$4.1 million and \$4.5 million, respectively. Based on the intangible assets recorded as of September 30, 2014, and assuming no subsequent additions to, or impairment of, the underlying assets, the remaining estimated amortization expense is expected to be as follows:

<b>Fiscal year ending June 30:</b>	<b>Amortization (In thousands)</b>
2015 (remaining 9 months)	\$ 11,729
2016	7,564
2017	2,806
2018	1,525
Total	\$ 23,624



## **NOTE 7 – LONG-TERM DEBT**

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

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

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

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

## **NOTE 8 – EQUITY AND LONG-TERM INCENTIVE COMPENSATION PLANS**

### **Equity Incentive Program**

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

#### 2004 Plan:

The 2004 Plan provides for the grant of options to purchase shares of the Company's common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to the Company's employees, consultants and members of its Board of Directors. As of September 30, 2014, 6.0 million shares were available for issuance under the 2004 Plan.

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

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

#### Outside Director Plan

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

**Equity Incentive Plans - General Information**

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

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

- (1) The number of restricted stock units provided in this row reflects the application of the award multiplier as described above (1.8x or 2.0x depending on the grant date of the applicable award).
- (2) Represents the portion of shares listed as "Options canceled/expired/forfeited" above, that were issued under the Company's equity incentive plans other than the 2004 Plan and the Outside Director Plan. Because the Company is only currently authorized to issue equity awards under the 2004 Plan and the Outside Director Plan, any equity awards that are canceled, expired or are forfeited under any other Company equity incentive plans do not result in additional shares being available to the Company for future grant.
- (3) Includes restricted stock units granted to senior management during the three months ended September 30, 2014 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of September 30, 2014, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units granted during the three months ended September 30, 2014, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum levels and all applicable service-based criteria are fully satisfied (i.e., 0.6 million shares for the three months ended September 30, 2014 after the application of 2.0x multiplier described above).

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

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

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

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

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

<u>(In thousands)</u>	As of September 30, 2014	As of June 30, 2014
Inventory	\$ 5,148	\$ 8,278

**Stock Options**

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

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

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

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

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

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

**Restricted Stock Units**

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

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

- (1) Share numbers reflect actual shares subject to awarded restricted stock units. As described above, under the terms of the 2004 Plan, the number of shares subject to each award reflected in this number is multiplied by either 1.8 or 2.0 (depending on the grant date of the award) to calculate the impact of the award on the share reserve under the 2004 Plan.
- (2) Includes restricted stock units granted to senior management during the three months ended September 30, 2014 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of September 30, 2014, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum and all applicable service-based criteria are fully satisfied (i.e., 0.3 million shares during the three months ended September 30, 2014).

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

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

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

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

**Cash-Based Long-Term Incentive Compensation**

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

**Employee Stock Purchase Plan**

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

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

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

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

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

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

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

### Cash Dividends on Shares of Common Stock

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

### NOTE 9 – STOCK REPURCHASE PROGRAM

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

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

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

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

### NOTE 10 – NET INCOME PER SHARE

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

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

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

**NOTE 11 – INCOME TAXES**

The following table provides details of income taxes:

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

The Company's estimated annual effective tax rate for the fiscal year ending June 30, 2015 is approximately 23.8%.

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

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

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

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

**NOTE 12 – LITIGATION AND OTHER LEGAL MATTERS**

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

**NOTE 13 – COMMITMENTS AND CONTINGENCIES**

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

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

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

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

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

The following is a schedule of expected operating lease payments:

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

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



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

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

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

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

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

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

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

Subject to certain limitations, the Company is obligated to indemnify its current and former directors, officers and employees with respect to certain litigation matters and investigations that arise in connection with their service to the Company. These obligations arise under the terms of the Company's certificate of incorporation, its bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify generally means that the Company is required to pay or reimburse the individuals' reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters.

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

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

#### **Leveraged Recapitalization**

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

#### **NOTE 14 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

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

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

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

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

**Derivatives in Cash Flow Hedging Relationships: Foreign Exchange Contracts**

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

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

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

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

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

<u>(In thousands)</u>	<u>Asset Derivatives</u>			<u>Liability Derivatives</u>		
	<u>Balance Sheet Location</u>	<u>As of September 30, 2014</u>	<u>As of June 30, 2014</u>	<u>Balance Sheet Location</u>	<u>As of September 30, 2014</u>	<u>As of June 30, 2014</u>
		<u>Fair Value</u>			<u>Fair Value</u>	
<b>Derivatives designated as hedging instruments</b>						
Foreign exchange contracts	Other current assets	\$ 2,439	\$ 120	Other current liabilities	\$ 628	\$ 100
<b>Total derivatives designated as hedging instruments</b>		<b>\$ 2,439</b>	<b>\$ 120</b>		<b>\$ 628</b>	<b>\$ 100</b>
<b>Derivatives not designated as hedging instruments</b>						
Foreign exchange contracts	Other current assets	\$ 3,168	\$ 546	Other current liabilities	\$ 722	\$ 798
<b>Total derivatives not designated as hedging instruments</b>		<b>\$ 3,168</b>	<b>\$ 546</b>		<b>\$ 722</b>	<b>\$ 798</b>
<b>Total derivatives</b>		<b>\$ 5,607</b>	<b>\$ 666</b>		<b>\$ 1,350</b>	<b>\$ 898</b>

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

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

**Offsetting of Derivative Assets and Liabilities**

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

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

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

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

**NOTE 15 – RELATED PARTY TRANSACTIONS**

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

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

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

**NOTE 16 – SEGMENT REPORTING AND GEOGRAPHIC INFORMATION**

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

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

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

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

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

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

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

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

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

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

#### NOTE 17 – SUBSEQUENT EVENTS

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

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

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

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

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

### SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

### EXECUTIVE SUMMARY

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

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

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

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

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

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



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

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

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

### CRITICAL ACCOUNTING ESTIMATES AND POLICIES

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

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

There were no significant changes in our critical accounting estimates and policies during the three months ended September 30, 2014. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our fiscal year ended June 30, 2014 for a more complete discussion of our critical accounting policies and estimates.

### Valuation of Goodwill and Intangible Assets

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

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

## Revenue Recognition

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

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

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

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

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

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

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

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

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

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

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

We enter into sales arrangements that may consist of multiple deliverables of our products and services where certain elements of the sales arrangement are not delivered and accepted in one reporting period. Judgment is required to properly identify the accounting units of the multiple deliverable transactions and to determine the manner in which revenue should be allocated among the accounting units. Additionally, judgment is required to interpret various commercial terms and determine when all criteria of revenue recognition have been met in order for revenue recognition to occur in the appropriate accounting period. While changes in the allocation of the estimated selling price between the accounting units will not affect the amount of total revenue recognized for a particular arrangement, any material changes in these allocations could impact the timing of revenue recognition, which could have a material effect on our financial position and results of operations.

## **Recent Accounting Pronouncements**

### *Recently Adopted*

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

### *Updates Not Yet Effective*

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

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

**RESULTS OF OPERATIONS**

**Revenues and Gross Margin**

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

**Product revenues**

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

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

**Service revenues**

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

**Revenues by region**

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

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

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

**Gross margin**

Our gross margin fluctuates with revenue levels and product mix and is affected by variations in costs related to manufacturing and servicing our products, including our ability to scale our operations efficiently and effectively in response to prevailing business conditions.

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

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

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

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

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

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

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

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

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

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

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

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

#### Selling, General and Administrative (“SG&A”)

<b>(Dollar amounts in thousands)</b>	<b>Three months ended</b>			<b>Q1 FY15 vs. Q4 FY14</b>	<b>Q1 FY15 vs. Q1 FY14</b>
	<b>September 30, 2014</b>	<b>June 30, 2014</b>	<b>September 30, 2013</b>		
SG&A expenses	\$ 101,644	\$ 96,216	\$ 98,496	\$ 5,428	6%
SG&A expenses as a percentage of total revenues	16%	13%	15%		3%

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

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

#### Interest Income and Other, Net and Interest Expense

<b>(Dollar amounts in thousands)</b>	<b>Three months ended</b>		
	<b>September 30, 2014</b>	<b>June 30, 2014</b>	<b>September 30, 2013</b>
Interest income and other, net	\$ 3,375	\$ 7,035	\$ 3,615
Interest expense	\$ 13,521	\$ 13,443	\$ 13,662
Interest income and other, net as a percentage of total revenues	1 %	1 %	1 %
Interest expense as a percentage of total revenues	2 %	2 %	2 %

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, gains or losses from revaluations of certain foreign currency denominated assets and liabilities as well as foreign currency contracts, impairments associated with equity investments in privately-held companies, and interest-related accruals (such as interest and penalty accruals related to our tax obligations).

Interest income and other, net during the three months ended September 30, 2014 decreased compared to the three months ended June 30, 2014, primarily due to the impact of \$3.7 million in proceeds from the sale of an equity investment in a privately-held company during the three months ended June 30, 2014.

Interest income and other, net during the three months ended September 30, 2014 compared to the three months ended September 30, 2013 remained relatively unchanged.

Interest expense for all the periods presented is primarily attributable to the \$750 million aggregate principal amount of senior fixed rate notes that we issued in the fourth quarter of the fiscal year ended June 30, 2008.

**Provision for Income Taxes**

The following table provides details of income taxes:

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

Our estimated annual effective tax rate for the fiscal year ending June 30, 2015 is approximately 23.8%.

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

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

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

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

**LIQUIDITY AND CAPITAL RESOURCES**

<b>(Dollar amounts in thousands)</b>	<b>As of September 30, 2014</b>	<b>As of June 30, 2014</b>
Cash and cash equivalents	\$ 669,683	\$ 630,861
Marketable securities	2,272,809	2,521,776
Total cash, cash equivalents and marketable securities	\$ 2,942,492	\$ 3,152,637
Percentage of total assets	56%	57%

As of September 30, 2014, our cash, cash equivalents and marketable securities totaled \$2.9 billion, which is a decrease of \$210 million from June 30, 2014. As of September 30, 2014, \$1.3 billion of our \$2.9 billion of cash, cash equivalents and marketable securities were held by our foreign subsidiaries and branch offices. We currently intend to permanently reinvest \$1.1 billion of the cash held by our foreign subsidiaries and branch offices. If, however, a portion of these funds were to be needed for our operations in the United States, we would be required to accrue and pay U.S. and foreign taxes of approximately 30%-50% of the funds repatriated. The amount of taxes due will depend on the amount and manner of the repatriation, as well as the location from where the funds are repatriated. We have accrued (but have not paid) U.S. taxes on the remaining cash of \$133 million of the \$1.3 billion held by our foreign subsidiaries and branch offices. As such, these funds can be returned to the U.S. without accruing any additional U.S. tax expense.

During three months ended September 30, 2014, our Board of Directors declared a dividend of \$0.50 per share of our outstanding common stock, which was paid on September 2, 2014 to our stockholders of record as of the close of business on August 18, 2014. During the same period in fiscal year 2014, our Board of Directors declared and paid a quarterly cash dividend of \$0.45 per share. The total amount of dividends paid during the three months ended September 30, 2014 and 2013 was \$82.4 million and \$74.6 million, respectively. The increase in the amount of dividends paid during the three months ended September 30, 2014 reflected the increase in the level of our quarterly dividend from \$0.45 to \$0.50 per share that was instituted during the three months ended September 30, 2014. On October 23, 2014, we announced that our Board of Directors has authorized a plan to finance a leveraged recapitalization, which would feature a special cash dividend. Refer to Note 17, "Subsequent Events" for additional details.

The shares repurchased under our stock repurchase program have decreased our basic and diluted weighted-average shares outstanding for the three months ended September 30, 2014 compared to the three months ended September 30, 2013. The stock repurchase program decrease is intended to offset shares issued in connection with the exercise of employee stock options, purchases under our ESPP program and the vesting of employee restricted stock units.

We have historically financed our liquidity requirements through cash generated from operations. Net cash provided by operating activities during the three months ended September 30, 2014 decreased by \$142 million compared to the three months ended September 30, 2013 primarily as a result of the following factors:

- A decrease in collections of approximately \$145 million due to lower shipments during the three months ended September 30, 2014 compared to the three months ended September 30, 2013,
- An increase in payroll payments of approximately \$12 million during the three months ended September 30, 2014 compared to the three months ended September 30, 2013; partially offset by
- A decrease in accounts payable payments of approximately \$11 million during the three months ended September 30, 2014 compared to the three months ended September 30, 2013, and
- A decrease in tax benefit from equity awards of approximately \$4 million during the three months ended September 30, 2014 compared to the three months ended September 30, 2013.

Net cash provided by investing activities during the three months ended September 30, 2014 increased compared to the net cash used in investing activities during the three months ended September 30, 2013, as a result of \$354 million net proceeds from available-for-sale and trading securities which includes \$170 million associated with liquidation of investment portfolio in the three months ended September 30, 2014.

Net cash used in financing activities during the three months ended September 30, 2014 increased by \$92 million compared to the three months ended September 30, 2013. Net cash used in financing activities was impacted by:

- An increase in common stock repurchases of \$64 million during the three months ended September 30, 2014 compared to the three months ended September 30, 2013,
- A decrease of \$36 million in proceeds from issuance of common stock during the three months ended September 30, 2014 compared to the three months ended September 30, 2013,
- An increase in dividend payments of \$8 million during the three months ended September 30, 2014 compared to the three months ended September 30, 2013, reflecting an increase in our quarterly dividend from \$0.45 to \$0.50 per share that was instituted during the three months ended September 30, 2014,
- A decrease of \$4 million in excess tax benefits realized upon exercise and vesting of equity awards during the three months ended September 30, 2014 compared to the three months ended September 30, 2013, partially offset by
- A decrease of \$21 million in payroll tax withholding payments related to the net share settlement of vested and released restricted stock units during the three months ended September 30, 2014 compared to the three months ended September 30, 2013.

Our liquidity position may be significantly impacted in the second quarter of our fiscal year ending June 30, 2015 considering our leveraged recapitalization, which would feature a special cash dividend as discussed below and in Note 17, "Subsequent Events" to the condensed consolidated financial statements in Part I, Item 1.

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



The intended Special Cash Dividend of \$16.50 per share, which is estimated to be approximately \$2.75 billion in the aggregate after including the portion of the special cash dividend that could be payable to holders of outstanding equity awards under the 2004 Equity Incentive Plan, is intended to be funded in part with a portion of cash on the our balance sheet, and in part with incremental debt. To fund the debt financed portion of the Special Cash Dividend, we intend to add up to \$2.5 billion of incremental debt, consisting of a combination of investment grade senior notes and a pre-payable term loan facility, subject to market conditions. We also expect to enter into a revolving credit facility, subject to market conditions. The declaration and payment of the Special Cash Dividend are conditioned on our ability to obtain requisite debt financing on satisfactory terms and conditions. Subject to the close of necessary financing, our Board of Directors currently expects to declare and pay the Special Cash Dividend before the end of the second quarter of the fiscal year ending June 30, 2015. The Special Cash Dividend is intended to be in addition to our regular \$0.50 per share quarterly cash dividend. Our regular \$0.50 per share quarterly cash dividend is expected to be declared and paid following our regularly scheduled Board of Directors meeting in November 2014.

In connection with our leveraged recapitalization plan, we may pre-pay our existing \$750 million unsecured long-term debt due in 2018 with additional indebtedness, consisting of a combination of investment grade senior notes and a pre-payable term loan facility, subject to market conditions, such that our overall indebtedness does not exceed approximately \$3.25 billion. Our existing \$750 million unsecured long-term debt due in 2018 provides for redemption at the option of the Company at a redemption price which shall be the greater of (1) 100% of the principal amount of the notes to be redeemed or (2) the sum of the present values of the remaining scheduled payments discounted at a rate equal to the sum of the treasury rate plus 50 basis points, plus, in each case, accrued and unpaid interest to, but not including, the redemption date. If we choose to pre-pay our existing debt, the amount of loss we could incur will vary depending upon the prevailing market rate and the market conditions on the date of extinguishment. Considering the comparable treasury rates as of September 30, 2014, we believe the range of loss on extinguishment of our existing debt will be \$125 - \$150 million. Comparable treasury rate means the rate applicable on treasury securities with similar time to maturity as our existing debt.

The following is a schedule summarizing our significant obligations to make future payments under contractual obligations as of September 30, 2014:

(In thousands)	Fiscal year ending June 30,							
	Total	2015 <sup>(2)</sup>	2016	2017	2018	2019	2020 and thereafter	Other
Long-term debt obligations <sup>(1)</sup>	\$ 750,000	\$ —	\$ —	\$ —	\$ 750,000	\$ —	\$ —	\$ —
Interest payment associated with long-term debt obligations	185,438	38,813	51,750	51,750	43,125	—	—	—
Purchase commitments <sup>(3)</sup>	291,864	286,601	4,550	713	—	—	—	—
Non-current income taxes payable <sup>(4)</sup>	68,876	—	—	—	—	—	—	68,876
Operating leases	26,167	6,404	7,178	5,241	3,689	1,814	1,841	—
Cash long-term incentive program <sup>(5)</sup>	106,866	29,555	30,328	30,328	16,269	386	—	—
Pension obligations	24,509	1,275	1,635	1,532	1,969	1,853	16,245	—
Other <sup>(6)</sup>	158	18	18	61	61	—	—	—
<b>Total contractual cash obligations</b>	<b>\$ 1,453,878</b>	<b>\$ 362,666</b>	<b>\$ 95,459</b>	<b>\$ 89,625</b>	<b>\$ 815,113</b>	<b>\$ 4,053</b>	<b>\$ 18,086</b>	<b>\$ 68,876</b>

(1) In April 2008, we issued \$750 million aggregate principal amount of senior notes due in 2018.

(2) For remaining nine months of fiscal year 2015.

(3) Represents an estimate of significant commitments to purchase inventory from our suppliers as well as an estimate of significant purchase commitments associated with other goods and services in the ordinary course of business. Our liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

[Table of Contents](#)

- (4) Represents the non-current income tax payable obligation and related accrued interest. 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.
- (5) Represents the amount committed under our cash long-term incentive program. The expected payment after estimated forfeitures is approximately \$88.1 million.
- (6) Represents the amount committed for accrued dividend payable for certain equity awards with dividend equivalent rights. For additional details, refer to Note 8, "Equity and Long-term Incentive Compensation Plans".

Starting in fiscal year ended June 30, 2013, we adopted a cash-based long-term incentive ("Cash LTI") program for many of our employees as part of our employee compensation program. Cash LTI awards issued to employees under the Cash Long-Term Incentive Plan ("Cash LTI Plan") generally vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under the Cash LTI Plan, participants must remain employed by us as of the applicable award vesting date.

We have agreements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, we periodically sell certain letters of credit ("LCs"), without recourse, received from customers in payment for goods.

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

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

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

We maintain guarantee arrangements available through various financial institutions for up to \$27.0 million, of which \$24.5 million had been issued as of September 30, 2014, primarily to fund guarantees to customs authorities for value-added tax ("VAT") and other operating requirements of our subsidiaries in Europe and Asia.

We provide standard warranty coverage on our systems for 40 hours per week for 12 months, providing labor and parts necessary to repair the systems during the warranty period. We account for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. The actual product performance and/or field expense profiles may differ, and in those cases we adjust our warranty accruals accordingly. The difference between the estimated and actual warranty costs tends to be larger for new product introductions as there is limited historical product performance to estimate warranty expense; our warranty charge estimates for more mature products with longer product performance histories tend to be more stable. Non-standard warranty coverage generally includes services incremental to the standard 40 hours per week coverage for 12 months. See Note 13, "Commitments and Contingencies," to the condensed consolidated financial statements for a detailed description.

Working capital was \$3.6 billion as of September 30, 2014, which was a decrease of \$127.5 million compared to our working capital as of June 30, 2014. As of September 30, 2014, our principal source of liquidity consisted of \$2.9 billion 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 and regional 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 and cash equivalents balances, will be sufficient to satisfy our liquidity requirements for at least the next 12 months. Our working capital is expected to be impacted in the second quarter of the fiscal year ending June 30, 2015 considering our leveraged recapitalization plan, which would feature a special cash dividend and an increase to our stock repurchase program as discussed above.

Our credit ratings and outlooks as of September 30, 2014 are summarized below:

<u>Rating Agency</u>	<u>Rating</u>	<u>Outlook</u>
Fitch	BBB	Stable
Moody's	Baa1	Stable
Standard & Poor's	BBB+	Stable

Factors that can affect our credit ratings include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, and changes in our business strategy.

#### 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 (see Note 14, "Derivative Instruments and Hedging Activities," to the condensed consolidated financial statements for a detailed description). Our outstanding hedge contracts, with maximum maturity of 18 months, were as follows:

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

Subsequent to September 30, 2014, in anticipation of obtaining the intended debt financing in connection with the leveraged recapitalization as discussed above, we entered into certain forward contracts ("Rate Lock Agreements") to lock the 10-year treasury rate ("benchmark rate") on a portion of the intended debt. The objective of the Rate Lock Agreements is to hedge the risk associated with the variability in interest rates due to the changes in the benchmark rate leading up to the closing of the intended financing, on the notional amount being hedged. The Rate Lock Agreements have a notional amount of \$1 billion in aggregate with contract termination dates in our second quarter of the fiscal year ending June 30, 2015. Each forward contract will be closed out when the pricing of the portion of intended debt being hedged is completed or the expiration date, whichever happens earlier. We designated each of the Rate Lock Agreements as a qualifying hedging instrument to be accounted for as a cash flow hedge. The effective portion of gain or loss on the close out of the Rate Lock Agreements will be initially recognized in accumulated other comprehensive income (loss) as a component of total stockholders' equity which will be amortized into earnings as a component of interest expense over the term of the underlying debt. The ineffective portion, if any, shall be recognized into earnings immediately. If the benchmark rate was to decrease uniformly by 10% in comparison to the rate locked under the Rate Lock Agreements, it would decrease the fair value of such agreements by approximately \$20 million, and increase our loss on the forward contracts.

**Indemnification Obligations and Certain Contractual Commitments.** Subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees with respect to certain litigation matters and investigations that arise in connection with their service to us. These obligations arise under the terms of our certificate of incorporation, our bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify generally means that we are required to pay or reimburse the individuals' reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. For example, we have paid or reimbursed legal expenses incurred in connection with the investigation of our historical stock option practices and the related litigation and government inquiries by a number of our current and former directors, officers and employees. Although the maximum potential amount of future payments we could be required to make under the indemnification obligations generally described in this paragraph is theoretically unlimited, we believe the fair value of this liability, to the extent estimable, is appropriately considered within the reserve we have established for currently pending legal proceedings.

We are a party to a variety of agreements pursuant to which we 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 we customarily agree to hold the other party harmless against losses arising from, or provide customers with other remedies to protect against, bodily injury or damage to personal property caused by our products, non-compliance with our product performance specifications, infringement of third-party intellectual property rights used in our products and a breach of warranties, representations and covenants related to matters such as title to assets sold, validity of certain intellectual property rights, non-infringement of third-party rights, and certain income tax-related matters. In each of these circumstances, payment by us is typically subject to the other party making a claim to and cooperating with us pursuant to the procedures specified in the particular contract. This usually allows us 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, our obligations under these agreements may be limited in terms of amounts, activity (typically at our option to replace or correct the products or terminate the agreement with a refund to the other party), and duration. In some instances, we may have recourse against third parties and/or insurance covering certain payments made by us.

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

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

**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. All of the potential changes noted below are based on sensitivity analyses performed on our financial position as of September 30, 2014. Actual results may differ materially.

As of September 30, 2014, we had an investment portfolio of fixed income securities of \$2.5 billion. 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, 2014, the fair value of the portfolio would have declined by \$1.3 million.

In April 2008, we issued \$750 million aggregate principal amount of 6.90% senior, unsecured long-term debt due in 2018. The fair market value of long-term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall and decrease as interest rates rise. As of September 30, 2014, the book value and the fair value of our fixed rate debt were \$748.1 million and \$884.8 million, respectively.

As described in detail under Note 17, "Subsequent Events," to the condensed consolidated financial statements in Part I, Item 1 and Management's Discussion and Analysis of Financial Condition and Results of Operations, "*Liquidity and Capital Resources*," in Part I, Item 2, on October 23, 2014, we announced that our Board of Directors has authorized the financing of a leveraged recapitalization pursuant to which we intend to add up to \$2.5 billion of incremental debt, consisting of a combination of investment grade senior notes and a pre-payable term loan facility, subject to market conditions. In addition, we also expect to enter into a revolving credit facility, subject to market conditions.

See Note 4, "Marketable Securities," to the condensed consolidated financial statements in Part I, Item 1; Management's Discussion and Analysis of Financial Condition and Results of Operations, "*Liquidity and Capital Resources*," in Part I, Item 2; and Risk Factors in Part II, Item 1A of this Quarterly Report on Form 10-Q for a description of recent market events that may affect the value of the investments in our portfolio that we held as of September 30, 2014.

As of September 30, 2014, we had net forward and option contracts to sell \$56.0 million in foreign currency in order to hedge certain currency exposures (see Note 14, "Derivative Instruments and Hedging Activities," to the condensed consolidated financial statements for a detailed description). If we had entered into these contracts on September 30, 2014, the U.S. dollar equivalent would have been \$51.7 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by \$16.2 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, as a result of the hedging of certain of our foreign currency exposure, changes in most relevant foreign currency exchange rates should have no material impact on our income or cash flows.

Subsequent to September 30, 2014, in anticipation of obtaining the intended debt financing in connection with the leveraged recapitalization, we entered into certain forward contracts ("Rate Lock Agreements") to lock the 10-year treasury rate ("benchmark rate") on a portion of the intended debt. The objective of the Rate Lock Agreements is to hedge the risk associated with the variability in interest rates due to the changes in the benchmark rate leading up to the closing of the intended financing, on the notional amount being hedged. The Rate Lock Agreements have a notional amount of \$1 billion in aggregate with contract termination dates in our second quarter of the fiscal year ending June 30, 2015. Each forward contract will be closed out when the pricing of the portion of intended debt being hedged is completed or the expiration date, whichever happens earlier. We designated each of the Rate Lock Agreements as a qualifying hedging instrument to be accounted for as a cash flow hedge. The effective portion of gain or loss on the close out of the Rate Lock Agreements will be initially recognized in accumulated other comprehensive income (loss) as a component of total stockholders' equity which will be amortized into earnings as a component of interest expense over the term of the underlying debt. The ineffective portion, if any, shall be recognized into earnings immediately. If the benchmark rate was to decrease uniformly by 10% in comparison to the rate locked under the Rate Lock Agreements, it would decrease the fair value of such agreements by approximately \$20 million, and increase our loss on the forward contracts.

**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 Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) (“Disclosure Controls”) as of the end of the period covered by this Quarterly Report on Form 10-Q (this “Report”) required by Exchange Act Rules 13a-15(b) or 15d-15(b). The controls evaluation was conducted under the supervision and with the participation of the Company’s management, including the Company’s Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”). Based on this evaluation, the CEO and CFO have concluded that as of the end of the period covered by this Report the Company’s Disclosure Controls were effective at a reasonable assurance level.

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

*Definition of Disclosure Controls*

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

*Limitations on the Effectiveness of Controls*

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

*Changes in Internal Control over Financial Reporting*

There were no changes in the Company’s internal control over financial reporting during the three months ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

The information set forth above under Note 12, "Litigation and Other Legal Matters," to the condensed consolidated financial statements in Item 1 of Part 1 is incorporated herein by reference.

### ITEM 1A. RISK FACTORS

A description of factors that could materially affect our business, financial condition or operating results is provided below.

#### Risks Associated with Our Industry

*Ongoing changes in the technology industry, as well as the semiconductor industry in particular, could expose our business to significant risks.*

The semiconductor equipment industry and other industries that we serve are constantly developing and changing over time. Many of the risks associated with operating in these industries are comparable to the risks faced by all technology companies, such as the uncertainty of future growth rates in the industries that we serve, pricing trends in the end-markets for consumer electronics and other products (which place a growing emphasis on our customers' cost of ownership), changes in our customers' capital spending patterns and, in general, an environment of constant change and development, including decreasing product and component dimensions; use of new materials; and increasingly complex device structures, applications and process steps. If we fail to appropriately adjust our cost structure and operations to adapt to any of these trends, or, with respect to technological advances, if we do not timely develop new technologies and products that successfully anticipate and address these changes, we could experience a material adverse effect on our business, financial condition and operating results.

In addition, we face a number of risks specific to ongoing changes in the semiconductor industry, as the significant majority of our sales are made to semiconductor manufacturers. Some of the trends that our management monitors in operating our business include the following:

- the increasing cost of building and operating fabrication facilities and the impact of such increases on our customers' investment decisions;
- differing market growth rates and capital requirements for different applications, such as memory, logic and foundry;
- the emergence of disruptive technologies that change the prevailing semiconductor manufacturing processes (or the economics associated with semiconductor manufacturing) and, as a result, also impact the inspection and metrology requirements associated with such processes;
- the possible introduction of integrated products by our larger competitors that offer inspection and metrology functionality in addition to managing other semiconductor manufacturing processes;
- changes in semiconductor manufacturing processes that are extremely costly for our customers to implement and, accordingly, impact the amount of their budgets that are available for process control equipment;
- the possibility that next-generation technological advances within the semiconductor manufacturing industry could actually reverse the historical trend of declining cost per transistor, and the impact that such reversal would have upon our industry and business;
- the bifurcation of the semiconductor manufacturing industry into (a) leading edge manufacturers driving continued research and development into next-generation products and technologies and (b) other manufacturers that are content with existing (including previous generation) products and technologies;
- the ever escalating cost of next-generation product development, which may result in joint development programs between us and our customers or government entities to help fund such programs that could restrict our control of, ownership of and profitability from the products and technologies developed through those programs;
- the potential industry transition from 300mm to 450mm wafers;
- and
- the entry by some semiconductor manufacturers into collaboration or sharing arrangements for capacity, cost or risk with other manufacturers, as well as increased outsourcing of their manufacturing activities, and greater focus only on specific markets or applications, whether in response to adverse market conditions or other market pressures.

Any of the changes described above may negatively affect our customers' rate of investment in the capital equipment that we produce, which could result in downward pressure on our prices, customer orders, revenues and gross margins. If we do not successfully manage the risks resulting from any of these or other potential changes in our industries, our business, financial condition and operating results could be adversely impacted.

***We are exposed to risks associated with a highly concentrated customer base.***

Our customer base, particularly in the semiconductor industry, historically has been, and is becoming increasingly, highly concentrated. In this environment, orders from a relatively limited number of manufacturers have accounted for, and are expected to continue to account for, a substantial portion of our sales. This increasing concentration exposes our business, financial condition and operating results to a number of risks, including the following:

- The mix and type of customers, and sales to any single customer, may vary significantly from quarter to quarter and from year to year, which exposes our business and operating results to increased volatility tied to individual customers.
- New orders from our foundry customers in the past several years have constituted a significant portion of our total orders. This concentration increases the impact that future business or technology changes within the foundry industry may have on our business, financial condition and operating results.
- In a highly concentrated business environment, if a particular customer does not place an order, or if they delay or cancel orders, we may not be able to replace the business. Furthermore, because our products are configured to customer specifications, any changes, delays or cancellations of orders may result in significant, non-recoverable costs.
- In recent years, our customer base has become increasingly concentrated due to corporate consolidation, acquisitions and business closures. As a result of this consolidation, the customers that survive the consolidation represent a greater portion of our sales. Those surviving customers may have more aggressive policies regarding engaging alternative, second-source suppliers for the products we offer and, in addition, may seek, and on occasion receive, pricing, payment, intellectual property-related, or other commercial terms that are less favorable to us. Any of these changes could negatively impact our prices, customer orders, revenues and gross margins.
- Certain customers have undergone significant ownership changes, created alliances with other companies, experienced management changes or have outsourced manufacturing activities, any of which may result in additional complexities in managing customer relationships and transactions.
- The highly concentrated business environment also increases our exposure to risks related to the financial condition of each of our customers. For example, as a result of the challenging economic environment during fiscal year 2009, we were (and in some cases continue to be) exposed to additional risks related to the continued financial viability of certain of our customers. To the extent our customers experience liquidity issues in the future, we may be required to incur additional bad debt expense with respect to receivables owed to us by those customers. In addition, customers with liquidity issues may be forced to discontinue operations or may be acquired by one of our customers, and in either case such event would have the effect of further consolidating our customer base.
- Semiconductor manufacturers generally must commit significant resources to qualify, install and integrate process control and yield management equipment into a semiconductor production line. We believe that once a semiconductor manufacturer selects a particular supplier's process control and yield management equipment, the manufacturer generally relies upon that equipment for that specific production line application for an extended period of time. Accordingly, we expect it to be more difficult to sell our products to a given customer for that specific production line application and other similar production line applications if that customer initially selects a competitor's equipment. Similarly, we expect it to be challenging for a competitor to sell its products to a given customer for a specific production line application if that customer initially selects our equipment.

Any of these factors could have a material adverse effect on our business, financial condition and operating results.

***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. The cyclical nature of the primary industry in which we operate is largely a function of our customers' capital spending patterns and need for expanded manufacturing capacity, which in turn are affected by factors such as capacity utilization, consumer demand for products, inventory levels and our customers' access to capital. This cyclicity affects our ability to accurately predict future revenue and, in some cases, future expense levels. During down cycles in our industry, the financial results of our customers may be negatively impacted, which could result not only in a decrease in, or cancellation or delay of, orders (which are generally subject to cancellation or delay by the customer with limited or no penalty) but also a weakening of their financial condition that could impair their ability to pay for our products or our ability to recognize revenue from certain customers. Our ability to recognize revenue from a particular customer may also be negatively impacted by the customer's funding status, which could be weakened not only by adverse business conditions or inaccessibility to capital markets for any number of macroeconomic or company-specific reasons, but also by funding limitations imposed by the customer's unique corporate structure. Any of these factors could negatively impact our business, operating results and financial condition.



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 periods of declining revenues, as was experienced during fiscal year 2009, 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. If we fail to respond, or if our attempts to respond fail to accomplish our intended results, then our business could be seriously harmed. Furthermore, any workforce reductions and cost reduction actions that we adopt in response to down cycles may result in additional restructuring charges, disruptions in our operations and loss of key personnel. 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. Each of these factors could adversely impact our operating results and financial condition.

In addition, our management typically provides quarterly forecasts for certain financial metrics, which, when made, are based on business and operational forecasts that are believed to be reasonable at the time. However, largely due to the cyclical nature of our business and the industries in which we operate, and the fact that business conditions in our industries can change very rapidly as part of these cycles, our actual results may vary (and have varied in the past) from forecasted results. These variations can occur for any number of reasons, including, but not limited to, unexpected changes in the volume or timing of customer orders, product shipments or product acceptances; an inability to adjust our operations rapidly enough to adapt to changing business conditions; or a different than anticipated effective tax rate. The impact on our business of delays or cancellations of customer orders may be exacerbated by the short lead times that our customers expect between order placement and product shipment. This is because order delays and cancellations may lead not only to lower revenues, but also, due to the advance work we must do in anticipation of receiving a product order in order to meet the expected lead times, to significant inventory write-offs and manufacturing inefficiencies that decrease our gross margin. Any of these factors could materially and adversely affect our financial results for a particular quarter and could cause those results to differ materially from financial forecasts we have previously provided. We provide these forecasts with the intent of giving investors and analysts a better understanding of management's expectations for the future, but parties reviewing such forecasts must recognize that such forecasts are comprised of, and are themselves, forward-looking statements subject to the risks and uncertainties described in this Item 1A and elsewhere in this report and in our other public filings and public statements. If our operating or financial results for a particular period differ from our forecasts or the expectations of investment analysts, or if we revise our forecasts, the market price of our common stock could decline.

#### **Risks Related to Our Business Model and Capital Structure**

***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 diagnostic products such as ours, we cannot be sure that these trends 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, features and functionality of our products, to keep pace with competitive products and to satisfy customer demands. 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 revenues 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.

In addition, the complexity of our products exposes us to other risks. We regularly recognize revenue from a sale upon shipment of the applicable product to the customer (even before receiving the customer's formal acceptance of that product) in certain situations, including sales of products for which installation is considered perfunctory, transactions in which the product is sold to an independent distributor and we have no installation obligations, and sales of products where we have previously delivered the same product to the same customer location and that prior delivery has been accepted. However, our products are very technologically complex and rely on the interconnection of numerous subcomponents (all of which must perform to their respective specifications), so it is conceivable that a product for which we recognize revenue upon shipment may ultimately fail to meet the overall product's required specifications. In such a situation, the customer may be entitled to certain remedies, which could materially and adversely affect our operating results for various periods and, as a result, our stock price.

We derive a substantial percentage of our revenues from sales of defect inspection products. As a result, any delay or reduction of sales of these products could have a material adverse effect on our business, financial condition and operating results. The continued customer demand for these products and the development, introduction and market acceptance of new products and technologies are critical to our future success.

***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.***

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. In addition, we at times engage in collaborative technology development efforts with our customers and suppliers, and these collaborations may constitute a key component of certain of our ongoing technology and product research and development projects. The termination of any such collaboration, or delays caused by disputes or other unanticipated challenges that may arise in connection with any such collaboration, could significantly impair our research and development efforts, which could have a material adverse impact on our business and operations.

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.

***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. The strength of our competitive positions in many of our existing markets is largely due to our leading technology, which is the result of continuing significant investments in product research and development. However, we may enter new markets, whether through acquisitions or new internal product development, in which competition is based primarily on product pricing, not technological superiority. Further, some new growth markets that emerge may not require leading technologies. Loss of competitive position in any of the markets we serve, or an inability to sell our products on favorable commercial terms in new markets we may enter, could negatively affect our prices, customer orders, revenues, gross margins and market share, any of which would negatively affect our operating results and financial condition.

***Our business would be harmed if we do not receive parts sufficient in number and performance to meet our production requirements and product specifications 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. Through our business interruption planning, we seek to minimize the risk of production and service interruptions and/or shortages of key parts by, among other things, monitoring the financial stability of key suppliers, identifying (but not necessarily qualifying) possible alternative 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. Also, key parts we obtain from some of our suppliers incorporate the suppliers' proprietary intellectual property; in those cases we are increasingly reliant on third parties for high-performance, high-technology components, which reduces the amount of control we have over the availability and protection of the technology and intellectual property that is used in our products. In addition, if certain of our key suppliers experience liquidity issues and are forced to discontinue operations, which is a heightened risk during economic downturns, that would affect their ability to deliver parts and could result in delays for our products. Similarly, especially with respect to suppliers of high-technology components, our suppliers themselves have increasingly complex supply chains, and delays or disruptions at any stage of their supply chains may prevent us from obtaining parts in a timely manner and result in delays for our products. Our operating results and business may be adversely impacted if we are unable to obtain parts to meet our production requirements and product specifications, or if we are only able to do so on unfavorable terms. Furthermore, a supplier may discontinue production of a particular part for any number of reasons, including the supplier's financial condition or business operational decisions, which would require us to purchase, in a single transaction, a large number of such discontinued parts in order to ensure that a continuous supply of such parts remains available to our customers. Such "end-of-life" parts purchases could result in significant expenditures by us in a particular period, and ultimately any unused parts may result in a significant inventory write-off in a future period, either of which could have a material and adverse impact on our financial condition and results of operations for the applicable periods.

***If we fail to operate our business in accordance with our business plan, our operating results, business and stock price may be significantly and adversely impacted.***

We attempt to operate our business in accordance with a business plan that is established annually, revised frequently (generally quarterly), and reviewed by management even more frequently (at least monthly). Our business plan is developed based on a number of factors, many of which require estimates and assumptions, such as our expectations of the economic environment, future business levels, our customers' willingness and ability to place orders, lead-times, and future revenue and cash flow. Our budgeted operating expenses, for example, are based in part on our future revenue expectations. However, our ability to achieve our anticipated revenue levels is a function of numerous factors, including the volatile and cyclical nature of our primary industry, customer order cancellations, macroeconomic changes, operational matters regarding particular agreements, our ability to manage customer deliveries and resources for the installation and acceptance of our products (for products where customer acceptance is required before we can recognize revenue from such sales), our ability to manage delays or accelerations by customers in taking deliveries and the acceptance of our products (for products where customer acceptance is required before we can recognize revenue from such sales), our ability to operate our business and sales processes effectively, and a number of the other risk factors set forth in this Item 1A.

Because our expenses are in most cases relatively fixed in the short term, any revenue shortfall below expectations could have an immediate and significant adverse effect on our operating results. Similarly, if we fail to manage our expenses effectively or otherwise fail to maintain rigorous cost controls, we could experience greater than anticipated expenses during an operating period, which would also negatively affect our results of operations. If we fail to operate our business consistent with our business plan, our operating results in any period may be significantly and adversely impacted. Such an outcome could cause customers, suppliers or investors to view us as less stable, or could cause us to fail to meet financial analysts' revenue or earnings estimates, any of which could have a material adverse impact on our business, financial condition or stock price.

In addition, our management is constantly striving to balance the requirements and demands of our customers with the availability of resources, the need to manage our operating model and other factors. In furtherance of those efforts, we often must exercise discretion and judgment as to the timing and prioritization of manufacturing, deliveries, installations and payment scheduling. Any such decisions may impact our ability to recognize revenue, including the fiscal period during which such revenue may be recognized, with respect to such products, which could have a material adverse effect on our business, financial condition or stock price.

***There can be no assurance that we will continue to declare cash dividends at all or in any particular amounts.***

Our Board of Directors first instituted a quarterly dividend during the fiscal year ended June 30, 2005. Since that time, we have announced a number of increases in the amount of our quarterly dividend level. We intend to continue to pay quarterly dividends subject to capital availability and periodic determinations by our Board of Directors that cash dividends are in the best interest of our stockholders and are in compliance with all laws and agreements applicable to the declaration and payment of cash dividends by us. Future dividends may be affected by, among other factors: our views on potential future capital requirements for investments in acquisitions and the funding of our research and development; legal risks; stock repurchase programs; changes in federal and state income tax laws or corporate laws; and changes to our business model. Our dividend payments may change from time to time, and we cannot provide assurance that we will continue to declare dividends at all or in any particular amounts. A reduction in our dividend payments could have a negative effect on our stock price.

***There are risks associated with our outstanding indebtedness.***

As of September 30, 2014, we had \$750 million aggregate principal amount of outstanding indebtedness represented by our senior notes that will mature in 2018, and we may incur additional indebtedness in the future, including in connection with the financing of a leveraged recapitalization. Our ability to pay interest and repay the principal for our current indebtedness is dependent upon our ability to manage our business operations and the other risk factors discussed in this section. There can be no assurance that we will be able to manage any of these risks successfully.

In addition, changes by any rating agency to our outlook or credit rating could negatively affect the value and liquidity of both our debt and equity securities. Factors that can affect our credit rating include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, including the incurrence of additional indebtedness, and our business strategy.

In certain circumstances involving a change of control followed by a downgrade of the rating of our senior notes, we will be required to make an offer to repurchase the senior notes at a purchase price equal to 101% of the aggregate principal amount of the notes repurchased, plus accrued and unpaid interest. We cannot make any assurance that we will have sufficient financial resources at such time or will be able to arrange financing to pay the repurchase price of the senior notes. Our ability to repurchase the senior notes in such event may be limited by law, by the indenture associated with the senior notes, or by the terms of other agreements to which we may be party at such time. If we fail to repurchase the senior notes as required by the indenture, it would constitute an event of default under the indenture governing the senior notes which, in turn, may also constitute an event of default under other of our obligations.

***Our leveraged recapitalization plan may adversely affect our financial condition, results of operations and earnings per share***

Our Board of Directors has authorized the financing of a leveraged recapitalization, which would feature a Special Cash Dividend. The declaration and payment of the Special Cash Dividend are conditioned on the Company's ability to obtain requisite debt financing on satisfactory terms and conditions. Subject to the close of necessary financing, our Board of Directors currently expects to declare and pay the Special Cash Dividend before the end of our second quarter of our fiscal year ending June 30, 2015. Our Special Cash Dividend will be funded in part by a portion of the cash on our balance sheet, and in part with incremental debt. To fund our debt financed portion of the Special Cash Dividend, we intend to add up to \$2.5 billion of incremental debt, consisting of a combination of investment grade senior notes and a pre-payable term loan facility, subject to market conditions. We also expect to enter into a revolving credit facility, subject to market conditions. In connection with our leveraged recapitalization plan, we may pre-pay our existing \$750 million unsecured long-term debt due in 2018 with an additional indebtedness, consisting of a combination of investment grade senior notes and a pre-payable term loan facility, subject to market conditions, such that our overall indebtedness does not exceed approximately \$3.25 billion. Our intended issuance and maintenance of higher levels of indebtedness could have adverse consequences including, but not limited to:

- impacting our ability to satisfy our future obligations;
- increasing the portion of our cash flows that may have to be dedicated to interest and principal payments that may not be available for operations, working capital, capital expenditures, acquisitions, general corporate or other purposes;
- impairing our ability to obtain additional financing in the future; and
- requiring us to comply with restrictive and financial covenants.

Our ability to meet our future expenses and intended new debt obligations will depend on our future performance, which will be affected by financial, business, economic, regulatory and other factors. Furthermore, our future operations may not generate sufficient cash flows to enable us to meet our future expenses and service our intended new debt obligations, which may impact our ability to manage our capital structure to preserve and maintain our investment grade rating. If our future operations do not generate sufficient cash flows, we may need to enter into new financing arrangements to obtain necessary funds. If we determine it is necessary to seek additional funding for any reason, we may not be able to obtain such funding or, if funding is available, we may not be able to obtain it on acceptable terms. If we fail to make a payment associated with our intended new debt obligations, we could be in default on such debt, and such a default could cause us to be in default on our other outstanding indebtedness.

***We are exposed to risks related to our commercial terms and conditions, including our indemnification of third parties, as well as the performance of our products.***

Although our standard commercial documentation sets forth the terms and conditions that we intend to apply to commercial transactions with our business partners, counterparties to such transactions may not explicitly agree to our terms and conditions. In situations where we engage in business with a third party without an explicit master agreement regarding the applicable terms and conditions, or where the commercial documentation applicable to the transaction is subject to varying interpretations, we may have disputes with those third parties regarding the applicable terms and conditions of our business relationship with them. Such disputes could lead to a deterioration of our commercial relationship with those parties, costly and time-consuming litigation, or additional concessions or obligations being offered by us to resolve such disputes, or could impact our revenue or cost recognition. Any of these outcomes could materially and adversely affect our business, financial condition and results of operations.

In addition, in our commercial agreements, from time to time in the normal course of business we indemnify third parties with whom we enter into contractual relationships, including customers and lessors, with respect to certain matters. We have agreed, under certain conditions, to hold these third parties harmless against specified losses, such as those arising from a breach of representations or covenants, other third party claims that our products when used for their intended purposes infringe the intellectual property rights of such other third parties, or other claims made against certain parties. We may be compelled to enter into or accrue for probable settlements of alleged indemnification obligations, or we may be subject to potential liability arising from our customers' involvements in legal disputes. In addition, notwithstanding the provisions related to limitations on our liability that we seek to include in our business agreements, the counterparties to such agreements may dispute our interpretation or application of such provisions, and a court of law may not interpret or apply such provisions in our favor, any of which could result in an obligation for us to pay material damages to third parties and engage in costly legal proceedings. It is difficult to determine the maximum potential amount of liability under any indemnification obligations, whether or not asserted, due to our limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in any particular claim. Our business, financial condition and results of operations in a reported fiscal period could be materially and adversely affected if we expend significant amounts in defending or settling any purported claims, regardless of their merit or outcomes.

We are also exposed to potential costs associated with unexpected product performance issues. Our products and production processes are extremely complex and thus could contain unexpected product defects, especially when products are first introduced. Unexpected product performance issues could result in significant costs being incurred by us, including increased service or warranty costs, providing product replacements for (or modifications to) defective products, litigation related to defective products, reimbursement for damages caused by our products, product recalls, or product write-offs or disposal costs. These costs could be substantial and could have an adverse impact upon our business, financial condition and operating results. In addition, our reputation with our customers could be damaged as a result of such product defects, which could reduce demand for our products and negatively impact our business.

Furthermore, we occasionally enter into volume purchase agreements with our larger customers, and these agreements may provide for certain volume purchase incentives, such as credits toward future purchases. We believe that these arrangements are beneficial to our long-term business, as they are designed to encourage our customers to purchase higher volumes of our products. However, these arrangements could require us to recognize a reduced level of revenue for the products that are initially purchased, to account for the potential future credits or other volume purchase incentives. As a result, these volume purchase arrangements, while expected to be beneficial to our business over time, could materially and adversely affect our results of operations in near-term periods, including the revenue we can recognize on product sales and therefore our gross margins.

In addition, we may in limited circumstances enter into agreements that contain other types of customer-specific pricing, discount, rebate or credit commitments offered by us, which may adversely impact our revenues, margins or financial results. Furthermore, we may give these customers limited audit or inspection rights to enable them to confirm that we are complying with these commitments. If a customer elects to exercise its audit or inspection rights, we may be required to expend significant resources to support the audit or inspection, as well as to defend or settle any dispute with a customer that could potentially arise out of such audit or inspection. To date, we have made no significant accruals in our condensed consolidated financial statements for this contingency. While we have not in the past incurred significant expenses for resolving disputes regarding these types of commitments, we cannot make any assurance that we will not incur any such liabilities in the future. Our business, financial condition and results of operations in a reported fiscal period could be materially and adversely affected if we expend significant amounts in supporting an audit or inspection, or defending or settling any purported claims, regardless of their merit or outcomes.

***There are risks associated with our receipt of government funding for research and development.***

We are exposed to additional risks related to our receipt of external funding for certain strategic development programs from various governments and government agencies, both domestically and internationally. Governments and government agencies typically have the right to terminate funding programs at any time in their sole discretion, or a project may be terminated by mutual agreement if the parties determine that the project's goals or milestones are not being achieved, so there is no assurance that these sources of external funding will continue to be available to us in the future. In addition, under the terms of these government grants, the applicable granting agency typically has the right to audit the costs that we incur, directly and indirectly, in connection with such programs. Any such audit could result in modifications to, or even termination of, the applicable government funding program. For example, if an audit were to identify any costs as being improperly allocated to the applicable program, those costs would not be reimbursed, and any such costs that had already been reimbursed would have to be refunded. We do not know the outcome of any future audits. Any adverse finding resulting from any such audit could lead to penalties (financial or otherwise), termination of funding programs, suspension of payments, fines and suspension or prohibition from receiving future government funding from the applicable government or government agency, any of which could adversely impact our operating results, financial condition and ability to operate our business.

***We have recorded significant restructuring, inventory write-off and asset impairment charges in the past and may do so again in the future, which could have a material negative impact on our business.***

During the fiscal year ended June 30, 2009, we recorded material restructuring charges of \$38.7 million related to our global workforce reduction, large excess inventory write-offs of \$85.6 million, and material impairment charges of \$446.7 million related to our goodwill and purchased intangible assets. If we again encounter challenging economic conditions, we may implement additional cost reduction actions, discontinue certain business operations or make other organizational changes, which would require us to take additional, potentially material, restructuring charges related to, among other things, employee terminations or exit costs. We may also be required to write-off additional inventory if our product build plans or usage of service inventory decline. Also, as our lead times from suppliers increase (due to the increasing complexity of the parts and components they provide) and the lead times demanded by our customers decrease (due to the time pressures they face when introducing new products or technology or bringing new facilities into production), we may be compelled to increase our commitments, and therefore our risk exposure, to inventory purchases to meet our customers' demands in a timely manner, and that inventory may need to be written-off if demand for the underlying product declines for any reason. Such additional write-offs could constitute material charges.

As noted above, we recorded a material charge during the fiscal year ended June 30, 2009 related to the impairment of our goodwill and purchased intangible assets. Goodwill represents the excess of costs over the net fair value of net assets acquired in a business combination. Goodwill is not amortized, but is instead tested for impairment at least annually in accordance with authoritative guidance for goodwill. Purchased intangible assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment in accordance with authoritative guidance for long-lived assets. The valuation of goodwill and intangible assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. A substantial decline in our stock price, or any other adverse change in market conditions, particularly if such change has the effect of changing one of the critical assumptions or estimates we previously used to calculate the value of our goodwill or intangible assets (and, as applicable, the amount of any previous impairment charge), could result in a change to the estimation of fair value that could result in an additional impairment charge.

Any such additional material charges, whether related to restructuring or goodwill or purchased intangible asset impairment, may have a material negative impact on our operating results and related financial statements.

***We are exposed to risks related to our financial arrangements with respect to receivables factoring and banking arrangements.***

We enter into factoring arrangements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, we maintain bank accounts with several domestic and foreign financial institutions, any of which may prove not to be financially viable. If we were to stop entering into these factoring arrangements, our operating results, financial condition and cash flows could be adversely impacted by delays or failures in collecting trade receivables. However, by entering into these arrangements, and by engaging these financial institutions for banking services, we are exposed to additional risks. If any of these financial institutions experiences financial difficulties or is otherwise unable to honor the terms of our factoring or deposit arrangements, we may experience material financial losses due to the failure of such arrangements or a lack of access to our funds, any of which could have an adverse impact upon our operating results, financial condition and cash flows.

***We are subject to the risks of additional government actions in the event we were to breach the terms of any settlement arrangement into which we have entered.***

In connection with the settlement of certain government actions and other legal proceedings related to our historical stock option practices, we have explicitly agreed as a condition to such settlements that we will comply with certain laws, such as the books and records provisions of the federal securities laws. If we were to violate any such law, we might not only be subject to the significant penalties applicable to such violation, but our past settlements may also be impacted by such violation, which could give rise to additional government actions or other legal proceedings. Any such additional actions or 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 an adverse resolution of any such action or proceeding, could have a material adverse effect on our business, financial condition and results of operations.



## General Commercial, Operational, Financial and Regulatory Risks

*We are exposed to risks associated with a weakening in the condition of the financial markets and the global economy.*

The severe tightening of the credit markets, turmoil in the financial markets and weakening of the global economy that were experienced during the fiscal year ended June 30, 2009 contributed to slowdowns in the industries in which we operate, which slowdowns could recur or worsen if economic conditions were to deteriorate again.

The markets for semiconductors, and therefore our business, are ultimately driven by the global demand for electronic devices by consumers and businesses. Economic uncertainty frequently leads to reduced consumer and business spending, which caused our customers to decrease, cancel or delay their equipment and service orders from us in the economic slowdown during fiscal year 2009. In addition, the tightening of credit markets and concerns regarding the availability of credit that accompanied that slowdown made it more difficult for our customers to raise capital, whether debt or equity, to finance their purchases of capital equipment, including the products we sell. Reduced demand, combined with delays in our customers' ability to obtain financing (or the unavailability of such financing), has at times in the past adversely affected our product and service sales and revenues and therefore has harmed our business and operating results, and our operating results and financial condition may again be adversely impacted if economic conditions decline from their current levels.

In addition, a decline in the condition of the global financial markets could adversely impact the market values or liquidity of our investments. Our investment portfolio includes corporate and government securities, money market funds and other types of debt and equity investments. Although we believe our portfolio continues to be comprised of sound investments due to the quality and (where applicable) credit ratings and government guarantees of the underlying investments, a decline in the capital and financial markets would adversely impact the market value of our investments and their liquidity. If the market value of such investments were to decline, or if we were to have to sell some of our investments under illiquid market conditions, we may be required to recognize an impairment charge on such investments or a loss on such sales, either of which could have an adverse effect on our financial condition and operating results.

If we are unable to timely and appropriately adapt to changes resulting from difficult macroeconomic conditions, our business, financial condition or results of operations may be materially and adversely affected.

*A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We are exposed to numerous risks as a result of the international nature of our business and operations.*

A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We expect that these conditions will continue in the foreseeable future. Managing global operations and sites located throughout the world presents a number of challenges, including but not limited to:

- managing cultural diversity and organizational alignment;
- exposure to the unique characteristics of each region in the global semiconductor market, which can cause capital equipment investment patterns to vary significantly from period to period;
- periodic local or international economic downturns;
- potential adverse tax consequences, including withholding tax rules that may limit the repatriation of our earnings, and higher effective income tax rates in foreign countries where we do business;
- government controls, either by the United States or other countries, that restrict our business overseas or the import or export of semiconductor products or increase the cost of our operations;
- compliance with customs regulations in the countries in which we do business;
- tariffs or other trade barriers (including those applied to our products or to parts and supplies that we purchase);
- political instability, natural disasters, legal or regulatory changes, acts of war or terrorism in regions where we have operations or where we do business;
- fluctuations in interest and currency exchange rates. Fluctuations in currency exchange rates may adversely impact our ability to compete on price with local providers or the value of revenues we generate from our international business. 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;
- longer payment cycles and difficulties in collecting accounts receivable outside of the United States;
- difficulties in managing foreign distributors (including monitoring and ensuring our distributors' compliance with all applicable United States and local laws); and
- inadequate protection or enforcement of our intellectual property and other legal rights in foreign jurisdictions.

Any of the factors above could have a significant negative impact on our business and results of operations.



***We might be involved in claims or disputes related to intellectual property or other confidential information 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. In addition, we occasionally receive notification from customers who believe that we owe them indemnification or other obligations related to intellectual property claims made against such customers by third parties. With respect to intellectual property infringement disputes, 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 could seriously harm our results of operations and financial condition. Furthermore, we may potentially be subject to claims by customers, suppliers or other business partners, or by governmental law enforcement agencies, related to our receipt, distribution and/or use of third-party intellectual property or confidential information. Legal proceedings and claims, regardless of their merit, and associated internal investigations with respect to intellectual property or confidential information disputes are often expensive to prosecute, defend or conduct; may divert management's attention and other company resources; and/or may result in restrictions on our ability to sell our products, settlements on significantly adverse terms or adverse judgments for damages, injunctive relief, penalties and fines, any of which could have a significant negative effect on our business, results of operations and financial condition. There can be no assurance regarding the outcome of future legal proceedings, claims or investigations. The instigation of legal proceedings or claims, our inability to favorably resolve or settle such proceedings or claims, or the determination of any adverse findings against us or any of our employees in connection with such proceedings or claims could materially and adversely affect our business, financial condition and results of operations, as well as our business reputation.

***We are exposed to various risks related to the legal (including environmental), regulatory and tax environments in which we perform our operations and conduct our business.***

We are subject to various risks related to compliance with new, existing, different, inconsistent or even conflicting laws, rules and regulations enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply, including environmental, safety, antitrust, anti-corruption/anti-bribery, unclaimed property and export control regulations. Our failure or inability to comply with existing or future laws, rules or regulations, or 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 could result in violations of contractual or regulatory obligations that may adversely affect our operating results, financial condition and ability to conduct our business. From time to time, we may receive inquiries or audit notices from governmental or regulatory bodies, or we may participate in voluntary disclosure programs, related to legal, regulatory or tax compliance matters, and these inquiries, notices or programs may result in significant financial cost (including investigation expenses, defense costs, assessments and penalties), reputational harm and other consequences that could materially and adversely affect our operating results and financial condition.

Our properties and many aspects of our business operations are subject to various domestic and international environmental laws and regulations, including those that control and restrict the use, transportation, emission, discharge, storage and disposal of certain chemicals, gases and other substances. Any failure to comply with applicable environmental laws, regulations or requirements may subject us to a range of consequences, including fines, suspension of certain of our business activities, limitations on our ability to sell our products, obligations to remediate environmental contamination, and criminal and civil liabilities or other sanctions. In addition, changes in environmental regulations (including regulations relating to climate change and greenhouse gas emissions) could require us to invest in potentially costly pollution control equipment, alter our manufacturing processes or use substitute (potentially more expensive and/or rarer) materials. Further, we use hazardous and other regulated materials that subject us to risks of strict liability for damages caused by any release, regardless of fault. We also face increasing complexity in our manufacturing, product design and procurement operations as we adjust to new and prospective requirements relating to the materials composition of our products, including restrictions on lead and other substances and requirements to track the sources of certain metals and other materials. The cost of complying, or of failing to comply, with these and other regulatory restrictions or contractual obligations could adversely affect our operating results, financial condition and ability to conduct our business.

In addition, we may from time to time be involved in legal proceedings or claims regarding employment, contracts, product performance, product liability, antitrust, environmental regulations, securities, unfair competition and other matters (in addition to proceedings and claims related to intellectual property matters, which are separately discussed elsewhere in this Item 1A). These legal proceedings and claims, regardless of their merit, may be time-consuming and expensive to prosecute or defend, divert management's attention and resources, and/or inhibit our ability to sell our products. There can be no assurance regarding the outcome of current or future legal proceedings or claims, which could adversely affect our operating results, financial condition and ability to operate our business.

***Recent regulations related to "conflict minerals" may force us to incur additional expenses, may result in damage to our business reputation and may adversely impact our ability to conduct our business.***

In August 2012, under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC adopted new requirements for companies that use certain minerals and derivative metals (referred to as "conflict minerals," regardless of their actual country of origin) in their products. Some of these metals are commonly used in electronic equipment and devices, including our products. These new requirements require companies to annually investigate, disclose and report whether or not such metals originated from the Democratic Republic of Congo or adjoining countries. Our first report was filed on June 2, 2014 for the 2013 calendar year. We have an extremely complex supply chain, with numerous suppliers (many of whom are not obligated by the new law to investigate their own supply chains) for the components and parts used in each of our products. As a result, we may incur significant costs to comply with the diligence and disclosure requirements, including costs related to determining the source of any of the relevant metals used in our products. In addition, because our supply chain is so complex, we may not be able to sufficiently verify the origin of all the relevant metals used in our products through the due diligence procedures that we implement, which may harm our business reputation. Though we do not anticipate that our customers will need to know our conflict mineral status to satisfy their own SEC reporting obligations (if any), we may also face difficulties in satisfying customers if they nonetheless require that we prove or certify that our products are "conflict free." Key components and parts that can be shown to be "conflict free" may not be available to us in sufficient quantity, or at all, or may only be available at significantly higher cost to us. If we are not able to meet customer requirements, customers may choose to disqualify us as a supplier. Any of these outcomes could adversely impact our business, financial condition or operating results.

***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 and retain additional highly qualified employees to meet our needs in the future, our business and operations could be harmed.

***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 and certain accounting functions, 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, on our ability to quickly respond to changing market conditions, or on our ability to ensure compliance with all applicable domestic and foreign laws and regulations. In addition, many of these outsourced service providers, including certain hosted software applications that we use for confidential data storage, employ "cloud computing" technology for such storage (which refers to an information technology hosting and delivery system in which data is not stored within the user's physical infrastructure but instead is delivered to and consumed by the user as an Internet-based service). These providers' cloud computing systems may be susceptible to "cyber incidents," such as intentional cyber attacks aimed at theft of sensitive data or inadvertent cyber-security compromises, that are outside of our control. If we do not effectively develop and manage our outsourcing strategies, if required export and other governmental approvals are not timely obtained, if our third-party service providers do not perform as anticipated, or do not adequately protect our data from cyber-related security breaches, or if there are delays or difficulties in enhancing business processes, we may experience operational difficulties (such as limitations on our ability to ship products), increased costs, manufacturing or service interruptions or delays, loss of intellectual property rights or other sensitive data, quality and compliance issues, and challenges in managing our product inventory or recording and reporting financial and management information, any of which could materially and adversely affect our business, financial condition and results of operations.

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

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, or could be subject to system failures or malfunctions for other reasons. System failures or malfunctioning, such as difficulties with our customer relationship management (“CRM”) system, could disrupt our operations and our ability to timely and accurately process and report key components of our financial results. Our enterprise resource planning (“ERP”) system is integral to our ability to accurately and efficiently maintain our books and records, record transactions, provide critical information to our management, and prepare our financial statements. Any disruptions or difficulties that may occur in connection with our ERP system or other systems (whether in connection with the regular operation, periodic enhancements, modifications or upgrades of such systems or the integration of our acquired businesses into such systems) could adversely affect our ability to complete important business processes, such as the evaluation of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. Any such event could have an adverse effect on our business, operating results and financial condition.

***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. We are also exposed to risks in connection with strategic alliances into which we may enter.***

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 stockholders.

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 anticipated. 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;
- the combination of businesses may cause the loss of key personnel or an interruption of, or loss of momentum in, the activities of our company and/or the acquired business;
- we may not be able to realize expected operating efficiencies or product integration benefits from our acquisitions;
- we may experience challenges in entering into new market segments for which we have not previously manufactured and sold products;
- we may face difficulties in coordinating geographically separated organizations, systems and facilities;
- the customers, distributors, suppliers, employees and others with whom the companies we acquire have business dealings may have a potentially adverse reaction to the acquisition;
- we may have to write-off goodwill or other intangible assets; and
- we may incur unforeseen obligations or liabilities in connection with acquisitions.

At times, we may also enter into strategic alliances with customers, suppliers or other business partners with respect to development of technology and intellectual property. These alliances typically require significant investments of capital and exchange of proprietary, highly sensitive information. The success of these alliances depends on various factors over which we may have limited or no control and requires ongoing and effective cooperation with our strategic partners. Mergers and acquisitions and strategic alliances are inherently subject to significant risks, and the inability to effectively manage these risks could materially and adversely affect our business, financial condition and operating results.

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

We have significant manufacturing operations in the United States, Singapore, Israel, Germany and China. In addition, our business is international in nature, with our sales, service and administrative personnel and our customers located in numerous countries throughout the world. Operations at our manufacturing facilities and our assembly subcontractors, as well as our other operations and those of our customers, are subject to disruption for a variety of reasons, including work stoppages, acts of war, terrorism, health epidemics, fire, earthquake, volcanic eruptions, energy shortages, flooding or other natural disasters. Such disruption could cause delays in, among other things, shipments of products to our customers, our ability to perform services requested by our customers, or the installation and acceptance of our products at customer sites. We cannot ensure that alternate means of conducting our operations (whether through alternate production capacity or service providers or otherwise) would be available if a major disruption were to occur or that, if such alternate means were available, they could be obtained on favorable terms.

In addition, as part of our cost-cutting actions, we have consolidated several operating facilities. Our California operations are now primarily centralized in our Milpitas facility. The consolidation of our California operations into a single campus could further concentrate the risks related to any of the disruptive events described above, such as acts of war or terrorism, earthquakes, fires or other natural disasters, if any such event were to impact our Milpitas facility.

***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 operations could be harmed.***

The threat of terrorism targeted at, or acts of war in, the regions of the world in which we do business increases the uncertainty in our markets. Any act of terrorism or war that affects the economy or the semiconductor industry could adversely affect our business. Increased international political instability in various parts of the world, disruption in air transportation and further enhanced security measures as a result of terrorist attacks may hinder our ability to do business and may increase our costs of operations. We maintain significant manufacturing and research and development operations in Israel, an area that has historically experienced a high degree of political instability, and we are therefore exposed to risks associated with future instability in that region. Such instability could directly impact our ability to operate our business (or our customers' ability to operate their businesses) in the affected region, cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. Such instability could also have the same effects on our suppliers and their ability to timely deliver their products. If international political instability continues or increases in any region in which we do business, 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 risks are uninsurable, are insurable only at significant cost or cannot be mitigated with insurance. Accordingly, we may experience a loss that is not covered by insurance, either because we do not carry applicable insurance or because the loss exceeds the applicable policy amount or is less than the deductible amount of the applicable policy. For example, we do not currently hold earthquake insurance. An earthquake could significantly disrupt our manufacturing operations, a significant portion of which are conducted in California, an area highly susceptible to earthquakes. It could also significantly delay our research and engineering efforts on new products, much 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.

***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 Euro and the Japanese Yen. We have international subsidiaries that operate and sell our products globally. In addition, an increasing proportion of our manufacturing activities are conducted outside of the United States, and many of the costs associated with such activities are denominated in foreign currencies. We routinely hedge our exposures to certain foreign currencies with certain financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations, but these hedges may be inadequate to protect us from currency exchange rate fluctuations. To the extent that these hedges are inadequate, or if there are significant currency exchange rate fluctuations in currencies for which we do not have hedges in place, our reported financial results or the way we conduct our business could be adversely affected. Furthermore, if a financial counterparty to our hedges experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, we may experience material financial losses.

***We are exposed to fluctuations in interest rates and the market values of our portfolio investments; impairment of our investments could harm our earnings. In addition, we and our stockholders are exposed to risks related to the volatility of the market for our common stock.***

Our investment portfolio primarily consists of both corporate and government debt securities that have a maximum effective maturity of three years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As market interest rates and bond 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. However, an impairment of the fair market value of our investments, even if unrealized, must be reflected in our financial statements for the applicable period and may therefore have a material adverse effect on our results of operations for that period.

In addition, the market price for our common stock is volatile and has fluctuated significantly during recent years. The trading price of our common stock could continue to be highly volatile and fluctuate widely in response to various factors, including without limitation conditions in the semiconductor industry and other industries in which we operate, fluctuations in the global economy or capital markets, our operating results or other performance metrics, or adverse consequences experienced by us as a result of any of the risks described elsewhere in this Item 1A. Volatility in the market price of our common stock could cause an investor in our common stock to experience a loss on the value of their investment in us and could also adversely impact our ability to raise capital through the sale of our common stock or to use our common stock as consideration to acquire other companies.

***We are exposed to risks in connection with tax and regulatory compliance audits in various jurisdictions.***

We are subject to tax and regulatory compliance audits (such as related to customs or product safety requirements) in various jurisdictions, and such jurisdictions may assess additional income or other taxes, penalties, fines or other prohibitions against us. Although we believe our tax estimates are reasonable and that our products and practices comply with applicable regulations, the final determination of any such audit and any related litigation could be materially different from our historical income tax provisions and accruals related to income taxes and other contingencies. The results of an audit or litigation could have a material adverse effect on our operating results or cash flows in the period or periods for which that determination is made.

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

We earn profits in, and are therefore potentially subject to taxes in, the U.S. and numerous foreign jurisdictions, including Singapore, Israel and the Cayman Islands, the countries in which we earn the majority of our non-U.S. profits. Due to economic, political or other conditions, tax rates in those jurisdictions may be subject to significant change. A number of factors may adversely impact our future effective tax rates, such as the jurisdictions in which our profits are determined to be earned and taxed; changes in the tax rates imposed by those jurisdictions; 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 stock-based compensation expense; changes in tax laws or the interpretation of such tax laws (for example, proposals for fundamental United States international tax reform); changes in generally accepted accounting principles; and the repatriation of earnings from outside the United States for which we have not previously provided for United States taxes. A change in our effective tax rate can materially and adversely impact our results from operations.

*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 in the future are expected to 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.

*A change in accounting standards or practices or a change in existing taxation rules or practices (or changes in interpretations of such standards, practices or rules) 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 will continue to occur in the future. Changes to (or revised interpretations or applications of) existing tax or accounting rules or the questioning of current or past practices may adversely affect our reported financial results or the way we conduct our business.

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

**Equity Repurchase Plans**

The following is a summary of stock repurchases for the three months ended September 30, 2014 <sup>(1)</sup>:

<u>Period</u>	<u>Total Number of Shares Purchased <sup>(2)</sup></u>	<u>Average Price Paid per Share</u>	<u>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs <sup>(3)</sup></u>
July 1, 2014 to July 31, 2014	559,186	\$ 72.62	14,457,136
August 1, 2014 to August 31, 2014	633,000	\$ 73.69	13,824,136
September 1, 2014 to September 30, 2014	550,200	\$ 78.93	13,273,936
Total	1,742,386	\$ 75.00	

(1) Our Board of Directors has authorized a program for us to repurchase shares of our common stock. The total number and dollar amount of shares repurchased for the three months ended September 30, 2014 and fiscal years ended June 30, 2014, 2013 and 2012 were 1.7 million shares (\$130.7 million), 3.8 million shares (\$240.8 million), 5.4 million shares (\$273.3 million) and 5.8 million shares (\$263.9 million), respectively. On July 8, 2014, we announced that our Board of Directors had authorized us to repurchase up to 13 million additional shares under this program. On October 23, 2014, we announced that our Board of Directors had authorized us to repurchase up to 3.6 million additional shares under this program.

(2) All shares were purchased pursuant to the publicly announced repurchase program described in footnote 1 above. Shares are reported based on the settlement date of the applicable repurchase.

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

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not applicable.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

Exhibit Number	Exhibit Description	Form	Incorporated by Reference		Filing Date
			File Number	Exhibit Number	
10.53	Fiscal Year 2015 Equity Incentive Plan*+				
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				
101.INS	XBRL Instance Document				
101.SCH	XBRL Taxonomy Extension Schema Document				
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document				
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document				
101.LAB	XBRL Taxonomy Extension Label Linkbase Document				
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document				

\* Denotes a management contract, plan or arrangement.

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

**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 23, 2014

\_\_\_\_\_  
(Date)

/s/ RICHARD P. WALLACE

\_\_\_\_\_  
Richard P. Wallace  
President and Chief Executive Officer  
(Principal Executive Officer)

October 23, 2014

\_\_\_\_\_  
(Date)

/s/ BREN D. HIGGINS

\_\_\_\_\_  
Bren D. Higgins  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)

October 23, 2014

\_\_\_\_\_  
(Date)

/s/ VIRENDRA A. KIRLOSKAR

\_\_\_\_\_  
Virendra A. Kirloskar  
Senior Vice President and Chief Accounting Officer  
(Principal Accounting Officer)



**KLA-TENCOR CORPORATION**  
**EXHIBIT INDEX**

Exhibit Number	Exhibit Description	Form	Incorporated by Reference		Filing Date
			File Number	Exhibit Number	
10.53	Fiscal Year 2015 Executive Incentive Plan*+				
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				
101.INS	XBRL Instance Document				
101.SCH	XBRL Taxonomy Extension Schema Document				
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document				
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document				
101.LAB	XBRL Taxonomy Extension Label Linkbase Document				
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document				

\* Denotes a management contract, plan or arrangement.

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

**NOTE: Portions of this Exhibit are the subject of a Confidential Treatment Request by KLA-Tencor Corporation to the Securities and Exchange Commission (the "SEC"). Such portions have been redacted and are marked with a "\*" in place of the redacted language. The redacted information has been filed separately with the SEC.**



## **FY15 EXECUTIVE INCENTIVE PLAN**

(Annual Executive Bonus)

### **Plan Summary**

This KLA-Tencor Executive Incentive Plan (this "Plan") is intended to motivate senior executives to achieve short-term and long-term corporate objectives by providing a competitive bonus for target performance and potential upside for outstanding performance.

### **Plan Period**

This Plan is effective for the fiscal year period from July 1, 2014 through June 30, 2015 (the "Plan Period"). Newly eligible employees (e.g., employees promoted to an incentive-eligible position for the first time or a new hire) must be in an eligible position on or before April 1, 2015 and recorded in the HR system in order to qualify for participation in this fiscal year.

### **Eligible Positions**

The Company's Chief Executive Officer ("CEO") and employees holding a position at the X02 level and above (collectively, with the CEO, "Executives") are eligible to participate in the Plan.

### **Program Payments**

Bonus payments, based on performance during the Plan Period, will be paid within 90 days following June 30, 2015. Bonus calculations are based on paid base salary for the applicable Plan Period. Paid base salary includes base salary and seasonal bonuses paid in some countries if the seasonal bonus is considered a component of the employee's annual salary. Paid base salary does not include relocation allowances and reimbursements, tuition reimbursements, car/transportation allowances, expatriate allowances, commissions, long-term disability payments, or bonuses paid during the fiscal year. A participant must be a regular, active employee of the Company on the date of the payout in order to receive payment. Employees who are promoted or hired into an eligible position during the year (on or before April 1) will have their payouts calculated on paid salary from the effective date of the promotion or hire. If an employee's target bonus changes during the year, the payout will be prorated.

### **Target Bonus**

A target bonus is established as a percent of base salary for each Plan participant.

### Funding Threshold

Total available funding for the Plan will be determined by performance against a threshold level as measured by Balanced Scorecard and Operating Margin percentage (“OM”)\* performance for the fiscal year. The Plan will be fully funded (equivalent to the sum, for all Plan participants in the aggregate, of 3.00 times the product of each Plan participant’s target bonus percentage and base salary during the Plan Period) upon achievement of Operating Margin Performance of \*\*\*%. This performance threshold constitutes the performance threshold for purposes of Section 162(m) of the Internal Revenue Code (“Section 162(m)”). This fully funded amount represents the maximum bonus opportunity for all Plan participants in the aggregate and the maximum total cost of the Plan.

### Performance Matrix and Determination of Funding Available for Bonus Payments

The level of funding available for payment to participating Executives will be based on performance as measured against the Corporate Balanced Scorecard and OM performance, as provided in the table (“Final FY15 Executive Bonus Payout Table”) below. Amounts in the table represent the multiple of each participating Executive’s target bonus available for allocation of bonus payments, subject to any positive or negative adjustment based on such Executive’s IPM (as defined below).

Balanced Scorecard Performance		Operating Margin Performance								
		<***%	**%	**%	**%	**%	**%	**%	**%	**%
Exceptional	5	0%	43%	107%	129%	150%	225%	300%		
	4+	0%	37%	93%	111%	130%	195%	260%	390%	
	4	0%	31%	79%	94%	110%	165%	220%	330%	
Primarily Meets Expectations	3+	0%	29%	71%	86%	100%	150%	200%	300%	
	3	0%	26%	64%	77%	90%	135%	180%	270%	360%
	2+	0%	22%	55%	66%	78%	116%	155%	233%	310%
Opportunity for Improvement	2	0%	19%	46%	56%	65%	98%	130%	195%	260%
	1+	0%	15%	38%	45%	53%	79%	105%	158%	210%
	1	0%	11%	29%	34%	40%	60%	80%	120%	160%
		% of Plan	**%	**%	**%	**%	**%	**%	**%	**%

FY15 Target BSc and Non-GAAP Operating Margin Performance

Multiple cannot exceed 300% regardless of performance

### Individual Performance and Determination of Executive Bonus Payments

The actual bonus payment amount for each individual Executive (other than the CEO) will be based on the CEO’s assessment of the Executive’s performance for the year and determination of an Individual Performance Multiplier (“IPM”) ranging from 80-120%. The IPM is multiplied by the Executive’s target bonus and the multiple achieved from the Performance Matrix above to determine the actual bonus payment amount (see bonus calculation below). Each Executive’s performance will be evaluated based on how effectively they led their organization as demonstrated against the key Balanced Scorecard measures and objectives for the Executive’s respective organization. The IPM and final bonus payments for each Plan participant who is an executive officer of the Company for purposes of Section 16 of the Securities Exchange Act of 1934, as amended, with the exception of the CEO, will be recommended by the CEO and reviewed and approved by the Compensation Committee. The IPM and final bonus payment for the CEO will be determined and approved by the Company’s Board of Directors.

**Bonus Calculation**

The formula for a participant's bonus calculation is:

Participant's paid base salary for the Plan Period  
x Participant's target bonus percentage  
x Payout multiple from the Executive Bonus Payout Table  
x Participant's Individual Performance Multiplier (IPM)

In no event can an individual bonus payment to a participant exceed 3.00 times such participant's target bonus (i.e., 3.00 times the product of (a) the participant's paid base salary for the Plan Period times (b) the Participant's target bonus percentage).

**General Provisions**

The Compensation Committee (or the independent members of the Company's Board of Directors, within the meaning set forth in Section 162(m) (the "Independent Directors")) shall be the Plan Administrator. The Compensation Committee (or the Independent Directors) shall make such rules, regulations, interpretations and computations and shall take such other action to administer the Plan as it may deem appropriate. The establishment of the Plan shall not confer any legal rights upon any employee or other person for a continuation of employment, nor shall it interfere with the rights of the Company to discharge any employee and to treat him or her without regard to the effect which that treatment might have upon him or her as a participant in the Plan.

This Plan shall be construed, administered and enforced by the Compensation Committee (or the Independent Directors), in its sole discretion. The laws of the State of California will govern any legal dispute involving the Plan. The Compensation Committee (or the Independent Directors) may at any time alter, amend or terminate the Plan, subject to the requirements of Section 162(m).

This Plan is adopted pursuant to the KLA-Tencor Performance Bonus Plan and sets forth the terms and conditions for the fiscal year 2015 annual incentive program.

\* References in this Plan to Operating Margin refer to the Company's calculation of non-GAAP Operating Margin

**Certification of Chief Executive Officer**  
**Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) As Adopted**  
**Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Richard P. Wallace, certify that:

- 1 I have reviewed this Quarterly Report on Form 10-Q of KLA-Tencor Corporation;
- 2 Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3 Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4 The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5 The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

October 23, 2014

(Date)

/s/ RICHARD P. WALLACE

Richard P. Wallace

President and Chief Executive Officer  
(Principal Executive Officer)

**Certification of Chief Financial Officer**  
**Pursuant to Exchange Act Rule 13a-14(a)/15d-14(a) As Adopted**  
**Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Bren D. Higgins, certify that:

- 1 I have reviewed this Quarterly Report on Form 10-Q of KLA-Tencor Corporation;
- 2 Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
- 3 Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
- 4 The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
- 5 The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

October 23, 2014  
(Date)

/s/ BREN D. HIGGINS  
\_\_\_\_\_  
Bren D. Higgins  
Executive Vice President and Chief Financial Officer  
(Principal Financial Officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Richard P. Wallace, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended September 30, 2014 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

October 23, 2014

(Date)

By: /s/ RICHARD P. WALLACE

Name: Richard P. Wallace

Title: President and Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Bren D. Higgins, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended September 30, 2014 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

October 23, 2014

(Date)

By: /s/ BREN D. HIGGINS

Name: Bren D. Higgins

Title: Executive Vice President and Chief Financial Officer