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, 2005

or

☐ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from____________ to____________

Commission File Number 0-9992

KLA-Tencor Corporation
(Exact name of registrant as specified in its charter)

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

160 Rio Robles
San Jose, California
95134
(Address of principal executive offices)
(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities 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 checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes ☒ No ☐

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ☐ No ☒

As of November 3, 2005 there were 197,411,505 shares of the Registrant's Common Stock, $0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (Unaudited)

KLA-TENCOR CORPORATION
Condensed Consolidated Balance Sheets
(Unaudited)

(in thousands)	September 30, 2005	June 30, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 863,782	$ 874,509
Marketable securities	1,318,964	1,320,677
Accounts receivable, net	307,194	333,218
Inventories	396,006	358,339
Deferred income taxes	280,253	265,467
Other current assets	56,032	50,435
Total current assets	3,222,231	3,202,645
Land, property and equipment, net	382,713	385,222
Other assets	425,654	398,505
Total assets	$ 4,030,598	$ 3,986,372
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 58,001	$ 67,717
Deferred system profit	180,347	209,899
Unearned revenue	75,003	80,122
Other current liabilities	543,039	574,124
Total current liabilities	856,390	931,862
Commitments and contingencies (Note 10)		
Minority interest in subsidiary	$ 10,086	$ 9,253
Stockholders' equity:		
Common stock and capital in excess of par value	1,030,415	957,737
Deferred stock based compensation	(14,755)	(14,415)
Retained earnings	2,136,607	2,083,638
Accumulated other comprehensive income	11,855	18,297
Total stockholders' equity	3,164,122	3,045,257
Total liabilities, minority interest and stockholders' equity	$ 4,030,598	$ 3,986,372

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

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

(in thousands except per share data)	Three months ended September 30, 2005	2004
Revenues:		
Product	$ 399,950	$ 442,296
Service	83,910	76,477
Total revenues	483,860	518,773
Costs and operating expenses:		
Costs of revenues*	214,220	215,469
Engineering, research and development*	96,751	77,147
Selling, general and administrative*	92,051	69,190
Total costs and operating expenses	403,022	361,806
Income from operations	80,838	156,967
Interest income and other, net	14,776	6,985
Income before income taxes and minority interest	95,614	163,952
Provision for income taxes*	19,681	47,547
Income before minority interest	75,933	116,405
Minority interest	745	—
Net income	$ 76,678	$ 116,405
Net income per share:		
Basic	$ 0.39	$ 0.59
Diluted	$ 0.38	$ 0.58
Weighted average number of shares:		
Basic	197,408	196,110
Diluted	202,715	199,969

*includes the following amounts related to equity awards		
Costs of revenues	$ 6,811	$ —
Engineering, research and development	11,010	—
Selling, general and administrative	17,007	—
Provision for income taxes	(10,656)	—
Total	$ 24,172	$ —

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

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

(in thousands)	Three months ended September 30, 2005	2004
Cash flows from operating activities:		
Net income	$ 76,678	$ 116,405
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	17,114	18,590
Non-cash stock-based compensation	34,828	—
Tax benefit from equity awards	14,145	—
Gross tax windfall from stock-based compensation	(5,018)	—
Minority interest	(745)	—
Net (gain) loss on sale of marketable securities and other investments	(441)	536
Changes in assets and liabilities, net of effect of acquisitions of businesses:		
Accounts receivable, net	21,141	4,012
Inventories	(36,310)	(35,455)
Other assets	(15,085)	(7,599)
Accounts payable	(9,288)	(10,775)
Deferred system profit	(29,552)	(3,358)
Other current liabilities	(55,505)	8,433
Net cash provided by operating activities	11,962	90,789
Cash flows from investing activities:		
Acquisitions of businesses, net of cash received	—	(4,050)
Capital expenditures, net	(18,049)	(17,796)
Purchase of available-for-sale securities	(950,852)	(651,690)
Proceeds from sale of available-for-sale securities	884,090	534,640
Proceeds from maturity of available-for-sale securities	58,336	115,572
Net cash used in investing activities	(26,475)	(23,324)
Cash flows from financing activities:		
Issuance of common stock	56,142	11,973
Stock repurchases	(35,488)	(74,212)
Payment of dividends to stockholders	(23,709)	—
Proceeds from sale of minority interest in subsidiary	1,579	—
Gross tax windfall from stock-based compensation	5,018	—
Net cash provided by (used in) in financing activities	3,542	(62,239)
Effect of exchange rate changes on cash and cash equivalents	244	2,043
Net increase (decrease) in cash and cash equivalents	(10,727)	7,269
Cash and cash equivalents at beginning of period	874,509	598,698
Cash and cash equivalents at end of period	$ 863,782	$ 605,967
Supplemental cash flow disclosures:		
Income taxes paid, net	$ 8,660	$ 36,009
Interest paid	$ 297	$ 269

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

NOTE 1 – BASIS OF PRESENTATION

Basis of presentation The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation ("KLA-Tencor" or the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, "Financial Statements and Supplementary Data" included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2005, filed with the SEC on September 2, 2005.

The condensed consolidated financial statements include the accounts of KLA-Tencor and its majority-owned subsidiaries, and the ownership interests of minority investors are recorded as minority interests. All significant intercompany balances and transactions have been eliminated. The Company has included the results of operations of acquired companies from the date of acquisition. See Note 4 – "Business Combinations."

The results of operations for the three month periods ended September 30, 2005 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, 2006.

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

Reclassifications Certain prior period balances have been reclassified to conform to the current financial statement presentation. These reclassifications had no impact on previously reported results of operations or stockholders' equity.

Recent Accounting Pronouncements In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment." SFAS No. 123(R) which requires the Company to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107, which provides the Staff's views regarding interactions between SFAS No. 123(R) and certain SEC rules and regulations and provides interpretations of the valuation of share-based payments for public companies. The adoption of SFAS No. 123(R) requires additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. The adoption of SFAS No. 123(R) in the fiscal quarter ended September 30, 2005, had a material impact on the Company's consolidated results of operations, financial position and statement of cash flows. For more information on stock-based compensation costs during the three months ended September 30, 2005, refer to Note 6 – "Stock-Based Compensation."

In June 2005, the FASB issued SFAS No. 154, “Accounting Changes and Error Corrections”, a replacement of APB Opinion No. 20, “Accounting Changes”, and SFAS No. 3, “Reporting Accounting Changes in Interim Financial Statements”. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles were required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods’ financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS No. 154 is not expected to have a material effect on the Company’s consolidated financial position, results of operations or cash flows.

In March 2005, the FASB published FASB Interpretation No. 47, “Accounting for Conditional Asset Retirement Obligations,” which clarifies that the term, conditional asset retirement obligation, as used in SFAS No. 143, “Accounting for Asset Retirement Obligations,” refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. The interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The adoption of this Interpretation during the first quarter of fiscal year 2006 did not have a material effect on the Company’s consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 is effective for the Company for nonmonetary asset exchanges beginning in the first quarter of fiscal 2006. The adoption of SFAS No. 153 did not have a material effect on the Company’s consolidated financial position, results of operations or cash flows.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs, an amendment of ARB No. 43, Chapter 4”. SFAS No. 151 clarifies that abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are required to be recognized as current period charges. The provisions of SFAS No.151 are effective for the fiscal year beginning July 1, 2005. The adoption of SFAS No. 151 did not have a material impact on the Company’s consolidated financial position, results of operations and cash flows.

NOTE 2 – BALANCE SHEET COMPONENTS

(in thousands)	September 30, 2005	June 30, 2005
Cash equivalents and marketable securities		
U.S. Treasuries	$ 304,852	$ 42,582
Mortgage-backed securities	23,642	34,798
Municipal bonds	1,241,923	1,455,848
Corporate equity securities	8,634	11,887
Money market bank deposits and other	438,517	520,124
	$ 2,017,568	$ 2,065,239
Less: Cash equivalents	698,604	744,562
Short-term marketable securities	$ 1,318,964	$ 1,320,677

Prior to the third fiscal quarter of 2005, the Company classified auction rate securities with reset dates of 90 days or less, as cash equivalents on the Consolidated Balance Sheets. In the third fiscal quarter of 2005, the Company classified all auction rate securities as short-term investments. There was no impact on the Consolidated Statements of Operations as a result of the reclassification for the three months ended September 30, 2004. The impact on the Consolidated Statement of Cash Flows was a decrease of $138.8 million in cash used in investing activities for the three months ended September 30, 2004.

(in thousands)	September 30, 2005	June 30, 2005
Accounts receivable, net		
Accounts receivable, gross	$ 319,300	$ 345,443
Allowance for doubtful accounts	(12,106)	(12,225)
	$ 307,194	$ 333,218
Inventories, net		
Customer service parts	$ 137,817	$ 124,631
Raw materials	79,142	87,298
Work-in-process	78,634	64,388
Finished goods and demonstration equipment	100,413	82,022
	$ 396,006	$ 358,339
Property and equipment		
Land	$ 84,548	$ 84,548
Buildings and improvements	154,405	154,405
Machinery and equipment	354,749	348,145
Office furniture and fixtures	41,468	41,480
Leasehold improvements	138,793	138,787
Construction in process	10,030	6,276
	783,993	773,641
Less: accumulated depreciation	(401,280)	(388,419)
	$ 382,713	$ 385,222
Other assets		
Goodwill & other intangibles, net	$ 70,855	$ 58,670
Long-term investments	152,790	137,143
Deferred tax assets – long-term	192,521	192,613
Other	9,488	10,079
	$ 425,654	$ 398,505
Other current liabilities		
Warranty and retrofit	$ 51,374	$ 52,845
Compensation and benefits	242,201	251,060
Income taxes payable	145,537	142,855
Restructuring accrual	131	189
Other accrued expenses	103,796	127,175
	$ 543,039	$ 574,124

NOTE 3 – GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

The carrying value of goodwill was $47.4 million as of September 30, 2005 and June 30, 2005, respectively, and was allocated to KLA-Tencor's reporting units pursuant to SFAS No. 142. In accordance with SFAS No. 142, KLA-Tencor completed its annual evaluation of the goodwill by reporting unit during the quarter ended December 31, 2004, and concluded that there was no impairment. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to our impairment test performed in the second quarter of fiscal year 2005.

Other Intangible Assets

The components of other intangible assets as of September 30, 2005 (in thousands) were as follows:

	Gross Carrying Amount	Accumulated Amortization	Net Amount
Existing technology	$ 12,537	$ 3,374	$ 9,163
Patents	18,161	4,490	13,671
Trademark	1,225	649	576
Other	200	200	—
Total	$ 32,123	$ 8,713	$ 23,410

The components of other intangible assets as of June 30, 2005 (in thousands) were as follows:

	Gross Carrying Amount	Accumulated Amortization	Net Amount
Existing technology	$ 12,537	$ 2,807	$ 9,730
Patents	4,761	3,889	872
Trademark	1,225	602	623
Other	200	200	—
Total	$ 18,723	$ 7,498	$ 11,225

During the three months ended September 30, 2005, the Company entered into an agreement to license certain patents for approximately $14 million which will be amortized over a period of 10 years. For the three month periods ended September 30, 2005 and 2004, amortization expense for other intangible assets was $1.2 million and $0.4 million, respectively. Based on the intangible assets recorded at September 30, 2005, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated amortization expense is expected to be as follows (in thousands):

Fiscal year ending June 30:	Amount
2006 (remaining 9 months)	$ 2,911
2007	3,293
2008	2,922
2009	2,798
2010	2,798
Thereafter	8,688
Total	$ 23,410

NOTE 4 – BUSINESS COMBINATIONS

There were no business combinations completed during the three months ended September 30, 2005. The business combinations completed during fiscal year 2005 are disclosed in Note 5 of Notes to Consolidated Financial Statements included in Item 8 of the Company's Annual Report on Form 10-K for the year ended June 30, 2005.

In connection with the acquisitions completed during fiscal year 2005, KLA-Tencor is subject to a $9.1 million contingent cash payment based on the continued employment of certain employees over two years. The contingency is accounted for as compensation expense over the contingent employment period. None of this amount was paid at September 30, 2005.

The deferred stock-based compensation recognized in connection with these business combinations at September 30, 2005 is $245,000 and is being amortized over the period earned. Amortization of deferred stock-based compensation was $36,000 during the three months ended September 30, 2005.

NOTE 5 – EARNINGS PER SHARE

Basic earnings per share ("EPS") is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated by using the weighted average number of common shares outstanding during the period increased to include the number of additional shares of common stock that would have been outstanding if the dilutive potential shares of common stock had been issued. The dilutive effect of outstanding options and restricted stock is reflected in diluted earnings per share by application of the treasury stock method, which includes consideration of stock-based compensation required by SFAS No. 123(R).

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share amounts):

	Three months ended September 30,	
	2005	**2004**
Numerator:		
Net Income[1]	$ 76,678	$ 116,405
Denominator:		
Weighted average shares outstanding, excluding unvested restricted stock	197,408	196,110
Effect of dilutive options and restricted stock	5,307	3,859
Denominator for diluted earnings per share	$ 202,715	$ 199,969
Basic earnings per share[1]	$ 0.39	$ 0.59
Diluted earnings per share[1]	$ 0.38	$ 0.58

[1] Net income for the three months ended September 30, 2005 includes $24.2 million of stock-based compensation expense, net of tax. The effect of recording stock-based compensation expense on basic and diluted earnings per share was $0.12 per share.

Potentially dilutive securities that were excluded from the computation of diluted earnings per share for the above periods because their effect would have been anti-dilutive were as follows (in thousands):

	Three months ended September 30,	
	2005	2004
Number of shares	15,293	10,636

During the third fiscal quarter of 2005, the Company's Board of Directors authorized a quarterly cash dividend of $0.12 per share. The total amount of dividend paid during the three months ended September 30, 2005 was $23.7 million.

NOTE 6 – STOCK-BASED COMPENSATION

Effective July 1, 2005, KLA-Tencor adopted the provisions of SFAS No. 123(R), "Share-Based Payment". SFAS No. 123(R) establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee requisite service period. The Company previously applied Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations and provided the required pro forma disclosures of SFAS No. 123, "Accounting for Stock-Based Compensation".

Prior to the adoption of SFAS No. 123(R)

Prior to the adoption of SFAS No. 123(R), the Company provided the disclosures required under SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosures." No employee stock-based compensation was reflected in net income for the period ended September 30, 2004, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant.

The pro-forma information for the three months ended September 30, 2004 was as follows:

		Three months ended September 30, 2004
Net income – as reported	$	116,405
Deduct:		
Total stock-based compensation expense determined under fair value based method for all awards, net of tax		(20,453)
Net income – pro forma	$	95,952
Earnings per share:		
As reported		
Basic	$	0.59
Diluted	$	0.58
Pro forma		
Basic	$	0.49
Diluted	$	0.48

Impact of the adoption of SFAS No. 123(R)

The Company elected to adopt the modified prospective application method as provided by SFAS No. 123(R). Accordingly, during the three months ended September 30, 2005, the Company recorded stock-based compensation cost totaling the amount that would have been recognized had the fair value method been applied since the effective date of SFAS No. 123. Previously reported amounts have not been restated. The effect of recording stock-based compensation for the three month period ended September 30, 2005 was as follows:

		Three months ended September 30, 2005
Stock-based compensation expense by type of award:	$	
Employee stock options		30,024
Employee stock purchase plan		6,344
Restricted stock units[1]		1,094
Amounts capitalized as inventory and deferred system profit		(2,634)
Total stock-based compensation		34,828
Tax effect on stock-based compensation		(10,656)
Net effect on net income		24,172
Tax effect on:		
Cash flows from operations		(5,018)
Cash flows from financing activities		5,018
Effect on earnings per share:		
Basic	$	0.12
Diluted	$	0.12

[1] Stock-based compensation expense of $1.1 million related to restricted stock units would have been recorded under the provisions of APB No. 25.

As of July 1, 2005, the Company had an unrecorded deferred stock-based compensation balance related to stock options of $344.9 million before estimated forfeitures. In the Company's pro forma disclosures prior to the adoption of SFAS No. 123(R), the Company accounted for forfeitures upon occurrence. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised if necessary in subsequent periods if actual forfeitures differ from those estimates. Accordingly, as of July 1, 2005, the Company estimated that the stock-based compensation for the awards not expected to vest was $56.8 million, and therefore, the unrecorded deferred stock-based compensation balance related to stock options was adjusted to $288.1 million after estimated forfeitures.

During the three months ended September 30, 2005, the Company granted approximately 4.0 million stock options with an estimated total grant-date fair value of $58.7 million. Of this amount, the Company estimated that the stock-based compensation for the awards not expected to vest was $12.6 million. During the three months ended September 30, 2005, the Company recorded stock-based compensation related to stock options of $30.0 million.

As of September 30, 2005, the unrecorded deferred stock-based compensation balance related to stock options was $304.2 million and will be recognized over an estimated weighted average amortization period of 3.0 years.

Approximately $1.3 million and $1.3 million of stock-based compensation was capitalized as inventory and deferred system profit, respectively, at September 30, 2005. The Company elected not to capitalize any stock-based compensation to inventory or deferred system profit at July 1, 2005 when the provisions of SFAS No. 123(R) were initially adopted.

Valuation Assumptions

In connection with the adoption of SFAS No. 123(R), the Company reassessed its valuation technique and related assumptions. The Company estimates the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS No. 123(R), SEC SAB No. 107 and the Company's prior period pro forma disclosures of net earnings, including stock-based compensation (determined under a fair value method as prescribed by SFAS No. 123). The fair value of each option grant is estimated on the date of grant using the Black-Scholes option valuation model and the straight-line attribution approach with the following weighted-average assumptions:

	Three months ended September 30,	
	2005	2004
Stock option plan:		
Expected stock price volatility	29%	58%
Risk free interest rate	4.0%	3.6%
Dividend yield	1.0%	—
Expected life of options (in years)	4.9	5.5
Stock purchase plan:		
Expected stock price volatility	36%	42%
Risk free interest rate	3.5%	2.2%
Dividend yield	1.1%	—
Expected life of options (in years)	1.3	1.3

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

Equity Incentive Program

The Company's equity incentive program is a broad-based, long-term retention program that is intended to attract and retain qualified management and technical employees ("Knowledge Employees"), and align stockholder and employee interests. The equity incentive program consists of two plans: one under which non-employee directors may be granted options to purchase shares of our stock, and another in which non-employee directors, officers, key employees, consultants and all other employees may be granted options to purchase shares of our stock, restricted stock units and other types of equity awards. Under our equity incentive program, stock options generally have a vesting period of five years, are exercisable for a period not to exceed ten years from the date of issuance and are generally granted at prices not less than the fair market value of our common stock at the grant date. Restricted stock units may be granted with varying criteria such as time based or performance based vesting. Substantially all of our employees that meet established performance goals and that qualify as Knowledge Employees participate in our main equity incentive plan.

The following table summarizes our equity compensation plans as of September 30, 2005:

	Number of securities to be issued upon exercise of outstanding options, warrants and rights(1)	Weighted-average exercise price of outstanding options, warrants and rights.	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column 1)(2)
Equity compensation plans approved by stockholders	27,884,546	$ 38.75	10,764,885
Equity compensation plans not approved by stockholders	7,068,404	$ 38.50	—
Total	34,952,950	$ 38.70	10,764,885

(1) Amounts shown are for options granted only. There were 437,360 shares of restricted stock units issued under the 2004 Equity Incentive Plan as of September 30, 2005.

(2) Any 2004 Equity Incentive Plan awards of restricted stock, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date shall be counted against the total number of shares issuable under the plan as 1.8 shares for every one share subject thereto. Including the restricted stock units issued, and applying the 1.8 ratio as required by the 2004 Equity Incentive Plan, and including the 2,804,736 shares reserved for issuance under the employee stock purchase plan, the number of shares remaining available for future issuance under our equity compensation plans was 10,764,885 shares as of September 30, 2005.

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

	Available For Grant	Awards Outstanding	Weighted-Average Exercise Price
Balances at June 30, 2003	16,919,718	29,733,958	$ 29.94
Additional shares reserved	5,751,033	—	—
Options granted	(6,298,343)	6,298,343	52.09
Options canceled/expired/forfeited	978,478	(978,478)	38.66
Options exercised	—	(5,357,878)	25.74
Balances at June 30, 2004	17,350,886	29,695,945	$ 35.11
Additional shares reserved	18,369,456	—	—
Plan shares expired	(15,814,111)	—	—
Options granted [(1)]	(9,625,481)	9,625,481	40.31
Restricted stock units granted[(2)]	(732,528)	—	—
Options canceled/expired/forfeited	2,267,362	(2,267,362)	41.84
Options exercised	—	(3,675,077)	26.56
Balances at June 30, 2005	11,815,584	33,378,987	$ 37.08
Additional shares reserved	34,147	—	—
Plan shares expired	(329,683)	—	—
Options granted	(3,980,954)	3,980,954	$ 48.07
Restricted stock units granted[(2)]	(54,720)	—	—
Options canceled/expired/forfeited	475,775	(475,775)	$ 42.55
Options exercised	—	(1,931,216)	$ 29.14
Balances at September 30, 2005	7,960,149	34,952,950	$ 38.70

(1) Employees received stock options totaling 2,007,283 shares of common stock as an advance on their fiscal year 2006 stock option grants in the first fiscal quarter of 2005. The grant was equivalent to 50% of the employee’s fiscal year 2005 stock option grant. These advanced grant options vest on a six year schedule with 20% vesting after year two and the remaining option shares vesting 1/48th per month for the remainder of the vesting term.

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

The options outstanding and exercisable at September 30, 2005 were in the following exercise price ranges:

	Options Outstanding				Options Exercisable			
Range of Exercise Prices	Number of Shares Outstanding	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Number Vested and Exercisable	Weighted Average Remaining Contractual Term (in years)	Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
$5.95-$9.53	126,423	1.3	$ 9.00	$ 5,026	126,423	1.3	$ 9.00	$ 5,026
$9.53-$19.88	2,366,608	2.8	$ 11.87	$ 87,300	2,366,608	2.8	$ 11.87	$ 87,300
$19.88-$29.96	5,372,321	5.8	$ 28.64	$ 108,100	3,873,233	5.7	$ 28.39	$ 78,894
$29.96-$39.35	11,977,644	7.5	$ 36.94	$ 141,592	5,139,736	6.0	$ 35.10	$ 70,229
$39.35-$49.92	10,514,603	7.2	$ 45.53	$ 33,962	3,720,208	5.9	$ 44.96	$ 14,126
$49.92-$59.44	4,578,546	7.8	$ 54.04	—	2,100,563	7.6	$ 54.15	—
$59.44-$68.00	16,805	4.4	$ 68.00	—	16,805	4.4	$ 68.00	—
$5.95-$68.00	34,952,950	6.8	$ 38.70	$ 375,980	17,343,576	5.7	$ 34.70	$ 255,575

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company’s closing stock price of $48.76 as of September 30, 2005, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of September 30, 2005 was 15.0 million.

The weighted average grant date fair value of options, as determined under SFAS No. 123(R), granted during the three months ended September 30, 2005 was $14.28 per share. The total fair value of shares vested during the three months ended September 30, 2005 was $30.4 million. The total intrinsic value of options exercised during the three month period ended September 30, 2005 was $40.3 million. The total cash received from employees as a result of employee stock option exercises during the three months ended September 30, 2005 was approximately $56.1 million. In connection with these exercises, the tax benefits realized by the Company for the three months ended September 30, 2005 was $14.1 million.

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

A summary of the status of the Company’s nonvested shares as of September 30, 2005 and changes during the three months ended September 30, 2005, is presented below:

	Stock Options		Restricted Stock Units	
	Number of shares	Weighted-average grant-date fair value	Number of shares	Weighted-average grant-date fair value
Nonvested at June 30, 2005	16,047,453	$ 21.24	406,960	$ 40.36
Awards granted	3,980,954	$ 14.28	30,400	$ 48.35
Awards vested	(1,943,258)	$ 15.63	—	—
Awards canceled/expired/forfeited	(475,775)	$ 17.49	—	—
Nonvested at September 30, 2005	17,609,374	$ 20.39	437,360	$ 40.91

Restricted Stock

During the three months ended September 30, 2005, the Company's Board of Directors approved the grant of 30,400 shares of restricted stock units to selected members of the Company's senior management. These restricted stock units generally vest in two equal installments on the fourth and fifth anniversaries of the date of grant. The Company recorded the $1.5 million value of these restricted stock units as a component of stockholders' equity and will amortize that amount over the service period. The value of the restricted stock units was based on the closing market price of the Company's common stock on the date of award. Amortization cost for all restricted stock awards for the three months ended September 30, 2005 was $1.1 million.

As of September 30, 2005, there was $14.5 million of total deferred stock-based compensation related to nonvested restricted stock units granted under the Equity Incentive Program. That cost is recorded as a component of stockholders' equity and is expected to be recognized over an estimated weighted average amortization period of 3.4 years.

Employee Stock Purchase Plan

KLA-Tencor's employee stock purchase plan 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 employee's purchase price is derived from a formula based on the fair market value of the common stock at the time of enrollment into the offering period versus the fair market value on the date of purchase. Offering periods are generally two years in length. The compensation cost in connection with the plan for the three months ended September 30, 2005 was $6.3 million. There were no shares purchased under the employee stock purchase plan during the three months ended September 30, 2005.

The plan 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 2,000,000 shares or the number of shares which the KLA-Tencor estimates will be required to issue under the plan during the forthcoming fiscal year. At September 30, 2005, a total of 2,804,736 shares were reserved and available for issuance under this plan.

NOTE 7 – STOCK REPURCHASE PROGRAM

In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. This plan was entered into to reduce the dilution from KLA-Tencor's employee benefit and incentive plans such as the stock option and employee stock purchase plans, and to return excess cash to the Company's shareholders. Since the inception of the repurchase program in 1997 through September 30, 2005 the Board of Directors had authorized KLA-Tencor to repurchase a total of 27.8 million shares, including 10 million shares authorized in February 2005.

Share repurchases for the three months ended September 30, 2005 and 2004 were as follows (in thousands):

	Three months ended September 30,	
	2005	**2004**
Number of shares of common stock repurchased	739	2,038
Total cost of repurchase	$ 35,488	$ 74,212

As of September 30, 2005 and 2004, the amount related to unsettled share repurchases was $2.9 million, and $4.2 million respectively.

NOTE 8 – COMPREHENSIVE INCOME

The components of comprehensive income, net of tax, are as follows (in thousands):

	Three months ended September 30,	
	2005	2004
Net Income [1]	$ 76,678	$ 116,405
Other comprehensive income (loss):		
Currency translation adjustments	(4,116)	(668)
Gain (loss) on cash flow hedging instruments, net	2,023	4,200
Unrealized gains (losses) on investments, net of taxes (benefits) of $(1,642) and $86 for the three months ended September 30, 2005 and 2004, respectively	(4,349)	3,864
Other comprehensive income(loss)	(6,442)	7,396
Total comprehensive income	$ 70,236	$ 123,801

(1) Net income for the three months ended September 30, 2005 includes $24.2 million of stock-based compensation expense, net of tax.

NOTE 9 – EMPLOYEE BENEFIT PLANS

KLA-Tencor sponsors various retirement and pension plans, including defined contribution and defined benefit plans which cover most employees worldwide. Several of KLA-Tencor's foreign subsidiaries have retirement plans for full time employees, some of which are defined benefit plans. KLA-Tencor does not sponsor defined benefit plans in the United States.

Net periodic pension cost, determined in accordance with SFAS No. 87, for KLA-Tencor's defined benefit retirement plans for the three months ended September 30, 2005 and 2004 include the following components (in thousands):

	Three months ended September 30,	
	2005	2004
Service Cost	$ 534	$ 577
Interest Cost	127	93
Expected Return on Assets	(43)	(35)
Amortization of Net Transitional Obligation	40	62
Amortization of Net Gain	47	17
Net periodic pension cost	$ 705	$ 714

KLA-Tencor contributed $211,000 and $148,000 to its foreign subsidiary defined benefit pension plans for the three months ended September 30, 2005 and 2004, respectively, and expects to contribute $681,000 during the remainder of fiscal year 2006.

NOTE 10 – COMMITMENTS AND CONTINGENCIES

Factoring KLA-Tencor has agreements with financial institutions to sell certain of its trade receivables and promissory notes from customers without recourse. During the three months ended September 30, 2005 and 2004, approximately $54.5 million and $66.3 million of receivables were sold under these arrangements, respectively. KLA-Tencor does not believe it is at risk for any material losses as a result of these agreements.

In addition, from time to time KLA-Tencor will discount without recourse Letters of Credit ("LCs") received from customers in payment of goods. During the three months ended September 30, 2005 and 2004 several LCs were sold with proceeds totaling $17.7 million and $10.0 million, respectively. Discounting fees of $145,000 and $44,000 for the three months ended September 30, 2005 and 2004 were equivalent to interest expense and were recorded in interest and other income net.

Facilities KLA-Tencor leases certain of its facilities under operating leases, which qualify for operating lease accounting treatment under SFAS No. 13, "Accounting for Leases," and, as such, these facilities are not included on its Condensed Consolidated Balance Sheet.

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

Fiscal year ended June 30,	Amount
2006 (remaining 9 months)	$ 6,032
2007	6,233
2008	4,035
2009	2,872
2010	1,733
2011	1,087
Thereafter	1,931
Total minimum lease payments	$ 23,923

Purchase Commitments KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply chain for key components. KLA-Tencor's liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. The Company's open inventory purchase commitments were approximately $149.4 million as of September 30, 2005. 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 cancelled. Certain agreements provide for potential cancellation penalties.

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

The following table provides the changes in the product warranty accrual for the three months ended September 30, 2005 and 2004 (in thousands):

	Three months ended September 30,	
	2005	2004
Beginning balance	$ 46,647	$ 38,865
Accruals for warranties issued during the period	9,969	13,169
Changes in liability related to pre-existing warranties	(972)	1,053
Settlements made during the period	(10,798)	(5,266)
Ending balance	$ 44,846	$ 47,821

Subject to certain limitations, KLA-Tencor indemnifies its current and former officers and directors for certain events or occurrences. Although the maximum potential amount of future payments KLA-Tencor could be required to make under these agreements is theoretically unlimited, based on prior experience, we believe the fair value of this liability is de minimus and no liability has been recorded.

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

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

Legal Matters KLA-Tencor is named from time to time as a party to lawsuits in the normal course of its business. Litigation, in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict.

NOTE 11 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts to hedge against certain future movements in foreign exchange rates that affect certain foreign currency denominated sales and purchase transactions. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes. At September 30, 2005, KLA-Tencor had foreign exchange forward contracts maturing throughout fiscal 2006 to sell $456.5 million and purchase $105.3 million, in foreign currency, primarily Japanese Yen. At June 30, 2005, KLA-Tencor had foreign exchange forward contracts maturing throughout fiscal year 2006 to sell $365.2 million and purchase $76.4 million, in foreign currency, primarily Japanese yen.

NOTE 12 – SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

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

KLA-Tencor is engaged primarily in designing, manufacturing, and marketing yield management and process monitoring systems for the semiconductor industry. All operating units have been aggregated due to their inter-dependencies, commonality of long-term economic characteristics, products and services, the production processes, class of customer and distribution processes. Since KLA-Tencor operates in one segment, all financial segment information required by SFAS No. 131 can be found in the condensed consolidated financial statements.

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

The following is a summary of revenues by geographic region for three months ended September 30, 2005 and 2004 (in thousands).

	Three months ended September 30,	
	2005	**2004**
Revenue:		
United States	$ 98,449	$ 127,884
Europe & Israel	71,301	58,210
Japan	111,627	76,600
Taiwan	81,151	119,474
Korea	84,675	25,907
Asia Pacific	36,657	110,698
Total	$ 483,860	$ 518,773

Long-lived assets by geographic region as of September 30, 2005 and June 30, 2005 were as follows (in thousands):

	September 30, 2005	June 30, 2005
Long-lived assets:		
United States	$ 367,039	$ 372,425
Europe & Israel	9,808	9,074
Japan	4,096	4,350
Taiwan	2,171	2,356
Korea	5,080	4,849
Asia Pacific	4,007	2,247
Total	$ 392,201	$ 395,301

The following is a summary of revenues by major products for three months ended September 30, 2005 and 2004 (as a percentage of total revenue).

	Three months ended September 30,	
	2005	2004
Revenue:		
Defect inspection	62%	65%
Metrology	17%	17%
Service	16%	14%
Other	5%	4%
Total	100%	100%

For the three months ended September 30, 2005, two customers accounted for 16% and 11% of revenue, respectively. For the three months ended September 30, 2004, one customer accounted for 11% of revenue. As of September 30, 2005, three customers accounted for 17%, 13% and 11% of net accounts receivable, respectively. As of June 30, 2005 one customer accounted for 12% of net accounts receivable.

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

FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward looking statements. You can identify these and other forward-looking statements by the use of words such as "may," "will," "could," "would," "should," "expects," "plans," "anticipates," "relies," "believes," "estimates," "predicts," "intends," "potential," "continue," or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Such forward-looking statements include, among others, those statements regarding forecasts of the future results of our operations; our expectations regarding our customers' spending in process control products and our expected revenue from these sales; increased customer demand for our products and services and capital equipment generally; sales of semiconductors; the allocation of capital spending by our customers; growth of revenue in the semiconductor industry, the semiconductor capital equipment industry and business; technological trends in the semiconductor industry; our future product offerings and product features, as well as the success and market acceptance of new products; timing of shipment of backlog; the future of our product shipments and our product and service revenues; our future gross margins; the future of our engineering, research and development, and selling, general and administrative expenses; international sales and operations and our expectation that such sales will continue to represent a substantial portion of our revenue; maintenance of our competitive advantage; success of our product offerings; creation and funding of programs for research and development; attraction and retention of employees; results of our investment in leading edge technologies; the effects of hedging transactions; the effect of the sale of trade receivables and promissory notes from customers; our future income tax rate; dividends; future repurchases of our common stock; the completion of any acquisitions of third parties, or the technology or assets thereof; benefits received from any acquisitions and development of acquired technologies; sufficiency of our existing cash balance, investments and cash generated from operations to meet our operating and working capital requirements; and the adoption of new accounting pronouncements.

Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in this section and those set forth in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in this quarterly report on Form 10-Q. You should carefully review these risks and also review the risks described in other documents we file from time to time with the SEC. You are cautioned not to place undue reliance on these forward-looking statements. We expressly disclaim any obligation to update or alter our forward-looking statements, whether, as a result of new information, future events or otherwise.

EXECUTIVE SUMMARY

KLA-Tencor Corporation is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. Our portfolio of products, software, analysis, services and expertise is designed to help integrated circuit manufacturers manage yield throughout the entire wafer fabrication process – from research and development to final mass production yield analysis.

Effective July 1, 2005, we adopted the provisions of SFAS No. 123(R), "Share-Based Payment", which requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements. Prior to July 1, 2005, we had accounted for stock based compensation awards in accordance with Accounting Principles Board (APB) opinion No. 25. We have chosen to implement SFAS No 123(R) using the modified prospective method. Under this method, periods prior to July 1, 2005 are not restated to reflect stock based compensation using a fair value method.

We have not included stock based compensation in our management reporting systems. We use certain non-GAAP measures, including certain measures of our results of operations excluding stock based compensation expenses and net orders to assess business trends and performance, to forecast and plan future operations, and to enhance the evaluation of our results when compared to prior periods. These measures should be considered in addition to results prepared in accordance with GAAP but should not be considered a substitute for GAAP results. We have included certain non-GAAP measures, with a reconciliation to the GAAP results, in order to enhance the reader's understanding, as the prior comparative periods did not include stock-based compensation charges related to employee stock options and the employee stock purchase plan shares.

The following table sets forth the key quarterly financial information which we use to manage our business and evaluate our performance (in millions).

	Fiscal Year 2006	Fiscal Year 2005			
	First Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Revenues	$ 484	$ 519	$ 533	$ 541	$ 492
Income from operations (1)	$ 81	$ 157	$ 156	$ 155	$ 115
Net income (2)	$ 77	$ 117	$ 122	$ 123	$ 105
Net orders	$ 440	$ 529	$ 479	$ 422	$ 426

(1) includes stock based compensation of $35 million during the first fiscal quarter of fiscal year 2006, and $1 million during the second, third, and fourth fiscal quarters of fiscal year 2005, respectively.

(2) includes stock based compensation of $24 million during the first fiscal quarter of fiscal year 2006, and $1 million during the second, third, and fourth fiscal quarters of fiscal year 2005, respectively.

Outlook

The semiconductor industry grew almost 30% while the semiconductor equipment industry grew approximately 60% in calendar year 2004. Analysts are forecasting semiconductor revenue growth to slow to approximately 5% and semiconductor equipment revenues to decline by approximately 5% in calendar year 2005. Net orders, which consist of new system and service orders net of cancellations, increased sequentially by approximately $14 million or 3% in the quarter ended September 30, 2005, compared to the previous fiscal quarter. Net orders declined by approximately $89 million or 17% in the quarter ended September 30, 2005, compared to the same period in the previous fiscal year.

Over the longer term, we expect process control to continue to represent a higher percentage of our customers' capital spending. We believe this increase in process control spending will be driven by the demand for more precise diagnostics capabilities to address multiple new defects as a result of further shrinking of device feature sizes, the transition to new materials, and fab process innovation. We anticipate these factors will drive increased demand for our products and services.

Net orders by region were as follows (in millions):

	Fiscal Year 2006	Fiscal Year 2005			
	First Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
United States	$ 120	$ 107	$ 98	$ 96	$ 135
Europe & Israel	59	79	53	36	43
Japan	98	123	157	121	139
Taiwan	110	90	66	104	48
Korea	24	91	57	58	37
Asia Pacific	29	39	48	7	24
Total orders	$ 440	$ 529	$ 479	$ 422	$ 426

Orders received in a particular quarter affect revenue recognized in subsequent quarters. Net orders become revenue upon positive affirmation by the customer that the system has been installed and is operating according to predetermined specifications. Our backlog for unshipped system orders as of September 30, 2005 was approximately $677 million, a majority of which we expect to ship over the next six to nine months. In addition, as of September 30, 2005 there was $465 million that is related to products that have been delivered and invoiced but are awaiting written acceptance from the customer.

RESULTS OF OPERATIONS

Revenues and Gross Margin

(in millions)	Three months ended September 30, 2005	June 30, 2005	September 30, 2004
Revenues:			
Product	$ 400	$ 410	$ 442
Service	84	82	77
Total revenues	$ 484	$ 492	$ 519
Costs of revenues	$ 214	$ 207	$ 215
Stock-based compensation expense	7	—	—
Total costs of revenues excluding stock-based compensation expense	$ 207	$ 207	$ 215
Gross margin percentage	56%	58%	58%
Gross margin percentage excluding stock-based compensation expense	57%	58%	58%

Product revenues

Product revenues decreased $10 million or 2% to $400 million during the first quarter of fiscal year 2006 from $410 million during the fourth quarter of fiscal year 2005. Product revenues decreased $42 million or 10% to $400 million during the first quarter of fiscal year 2006 from $442 million during the same period in the previous fiscal year. Product revenue decreases were primarily the result of a lower level of orders received in prior quarters.

Total revenue recognized under conditions where we deviate from the need for a written acceptance by the customer were approximately 3.2%, 4.0% and 6.5% of total revenue for the three months ended September 30, 2005, June 30, 2005 and September 30, 2004, respectively.

For the three months ended September 30, 2005, two customers accounted for 16% and 11% of revenue, respectively. For the three months ended June 30, 2005, one customer accounted for 11% of revenue. For the three months ended September 30, 2004, one customer accounted for 11% of revenue.

Service revenues

Service revenue is generated from maintenance service contracts, as well as time and material billable service calls made to our customers after the expiration of the warranty period. Service revenues increased by $2 million or 2% to $84 million during the first quarter of fiscal year 2006 from $82 million during the fourth quarter of fiscal year 2005. Service revenues increased by $7 million or 10% to $84 million during the three months ended September 30, 2005 from $77 million during the three months ended September 30, 2004. The increase in service revenue is due to an increase in the number of post-warranty systems installed at our customers' sites and the degree of utilization of those systems.

Revenues by region

Revenues by region for the periods indicated were as follows (in millions):

	Three months ended								
	September 30, 2005			June 30, 2005			September 30, 2004		
United States	$	98	20%	$	98	20%	$	128	25%
Europe & Israel		71	15%		98	20%		58	11%
Japan		112	23%		119	24%		77	15%
Taiwan		81	17%		66	14%		119	23%
Korea		85	17%		51	10%		26	5%
Asia Pacific		37	8%		60	12%		111	21%
Total	$	484	100%	$	492	100%	$	519	100%

International revenues were 80% of revenue during the three months ended September 30, 2005 and June 30, 2005, and 75% of revenue during the three months ended September 30, 2004. A significant portion of our revenue continues to be generated in Asia where a significant portion of the world's semiconductor manufacturing capacity is located.

Gross margin

Gross margin percentage declined by 2 percentage points to 56% during the first quarter of fiscal year 2006 compared to 58% during the fourth quarter of fiscal year 2005 and the same period in the prior fiscal year. Of this decline, 1 percentage point is attributed to lower revenue levels and the increased costs of our installation, customer service and support programs; and 1 percentage point is attributed to stock-based compensation expense recorded during the first quarter of fiscal year 2006.

Stock-based compensation expense included in cost of revenues was $7 million or 1% of revenues during the first quarter of fiscal year 2006 compared to less than $100,000 during the fourth quarter of fiscal year 2005 and none during the same period in the previous fiscal year.

Engineering, Research and Development

(in millions)	Three months ended September 30, 2005	June 30, 2005	September 30, 2004
Net research and development ('R&D') expenses	$ 97	$ 87	$ 77
Stock-based compensation expense	11	—	—
Net R&D expenses excluding stock-based compensation expense	$ 86	$ 87	$ 77
Percentage of total revenues	20%	18%	15%
Percentage of total revenues excluding stock-based compensation expense	18%	18%	15%

Net R&D expenses excluding stock-based compensation expense decreased $1 million or 1% to $86 million during the first quarter of fiscal year 2006 from $87 million during the fourth quarter of fiscal year 2005. Net R&D expenses excluding stock-based compensation expense increased $9 million or 12% to $86 million during the first quarter of fiscal year 2006 from $77 million during the same period in the previous fiscal year. Stock-based compensation expense included in net R&D expenses was $11 million or 2% of total revenues during the first quarter of fiscal year 2006 compared to less than $100,000 during the fourth quarter of fiscal year 2005 and none during the same period in the previous fiscal year.

The gross dollars for R&D investment were partially offset by $3 million of external funding received during the three months ended September 30, 2005 for certain strategic development programs conducted with several of our customers and from government grants.

The businesses acquired during fiscal year 2005 contributed $4 million of the net R&D expenses during the three months ended September 30, 2005 and June 30, 2005 and none during the same period in the previous fiscal year. For more information on the business combinations completed during fiscal year 2005, see Note 4 "Business Combinations" of the Notes to our Consolidated Financial Statements at Item 1 "Financial Statements and Supplementary Data" of this quarterly report.

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 efforts. 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

(in millions)	Three months ended September 30, 2005	June 30, 2005	September 30, 2004
Selling, general and administrative (‘SG&A’) expenses	$ 92	$ 82	$ 69
Stock-based compensation expense	17	1	—
SG&A expenses excluding stock-based compensation expense	$ 75	$ 81	$ 69
Percentage of total revenues	19%	17%	13%
Percentage of total revenues excluding stock-based compensation expense	15%	16%	13%

SG&A expenses excluding stock-based compensation expense decreased $6 million or 7% to $75 million during the first quarter of fiscal year 2006 from $81 million during the fourth quarter of fiscal year 2005. SG&A expenses excluding stock-based compensation expense increased $6 million or 9% to $75 million during the first quarter of fiscal year 2006 from $69 million during the same period in the previous fiscal year.

The decrease in SG&A expenses excluding stock-based compensation expense compared to the previous fiscal quarter is primarily due to Company mandated time-off during the first fiscal quarter of 2006. The increase in SG&A expenses excluding stock-based compensation expense compared to the same period in the prior fiscal year is due to an increase in customer application support, increased staffing and consolidating the results of operations of the entities acquired during fiscal year 2005. The entities acquired during fiscal year 2005 contributed $3 million of the SG&A expenses for the three months ended September 30, 2005, $4 million of the SG&A expenses during the three months ended June 30, 2005 and none during the same period in the previous fiscal year. For more information on the business combinations completed during fiscal year 2005, see Note 4 “Business Combinations” of the Notes to our Consolidated Financial Statements at Item 1 “Financial Statements and Supplementary Data” of this quarterly report.

Stock-based compensation expense included in SG&A expenses was $17 million or 4% of total revenues during the first quarter of fiscal year 2006 compared to $1 million during the fourth quarter of fiscal year 2005 and none during the same period in the previous fiscal year.

Interest Income and Other, Net

(in millions)	Three months ended September 30, 2005	Three months ended June 30, 2005	Three months ended September 30, 2004
Interest income and other, net	$ 15	$ 16	$ 7
Percentage of total revenues	3%	3%	1%

Interest income and other, net is comprised primarily of interest income earned on the investment and cash portfolio, realized gains or losses on sales of marketable securities, as well as income recognized upon settlement of certain foreign currency contracts. The increase in interest income and other, net compared to the same period in the prior fiscal year is primarily due to the increase in short term interest rates.

Provision for Income Taxes

Our effective income tax rate was 20.6% and 29.0% for the three months ended September 30, 2005 and 2004, respectively. The current quarter decrease in the effective tax rate is primarily due to implementation of SFAS No. 123R, reinstatement of the federal research and development tax credit, successful conclusion of international tax audits and the expiration of applicable statutes of limitations. In general, the effective income tax rate differs from the statutory rate of 35% largely as a function of benefits realized from our Extraterritorial Income (“ETI”) exclusion, research and development tax credits and tax exempt interest.

On October 22, 2004 the American Jobs Creation Act (AJCA) was signed into law. The AJCA provides for a deduction of 85% of certain non-U.S. earnings that are repatriated to the U.S., as defined in the AJCA. The Company decided not to repatriate earnings from overseas under this provision after a careful review of the law, U.S. Treasury published guidance and the Company’s earnings by jurisdiction.

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

The Internal Revenue Service commenced an audit of the Company’s fiscal year 2003 and 2004 corporate tax returns. Liabilities for anticipated worldwide tax audit issues have been established based on our estimate of whether, and the extent to which, additional tax payments are probable. The Company believes that adequate reserves have been provided to cover any potential additional tax assessments.

Stock-based Compensation

Effective July 1, 2005, we adopted the provisions of SFAS No. 123(R), “Share-Based Payment”. SFAS No. 123(R) establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award which is computed using the Black-Scholes option valuation model, and is recognized as expense over the employee requisite service period. We previously applied Accounting Principles Board (APB) Opinion No. 25, “Accounting for Stock Issued to Employees,” and related Interpretations and provided the required pro forma disclosures of SFAS No. 123, “Accounting for Stock-Based Compensation”.

We elected to adopt the modified prospective application method as provided by SFAS No. 123(R). Accordingly, during the three months ended September 30, 2005, we recorded stock-based compensation cost totaling the amount that would have been recognized had the fair value method been applied since the effective date of SFAS No. 123. We did not restate previously reported amounts.

During the three months ended September 30, 2005, we recorded stock-based compensation related to stock options of $30.0 million. As of September 30, 2005, the unrecorded deferred stock-based compensation balance related to stock options was $304.2 million and will be recognized over an estimated weighted average amortization period of 3.0 years.

The compensation cost in connection with the employee stock purchase plan for the three months ended September 30, 2005 was $6.3 million. There were no shares purchased under the employee stock purchase plan during the three months ended September 30, 2005.

Amortization cost for all restricted stock units for the three months ended September 30, 2005 was $1.1 million. As of September 30, 2005, there was $14.5 million of total deferred stock-based compensation related to nonvested restricted stock units granted under the Equity Incentive Program. That cost is recorded as a component of stockholders' equity and is expected to be recognized over an estimated weighted average amortization period of 3.4 years.

Approximately $1.3 million and $1.3 million of stock-based compensation was capitalized as inventory and deferred system profit, respectively, at September 30, 2005. We elected not to capitalize any stock-based compensation to inventory or deferred system profit at July 1, 2005 when the provisions of SFAS No. 123(R) were initially adopted.

LIQUIDITY AND CAPITAL RESOURCES

(in millions)		September 30, 2005		June 30, 2005		Change
Cash and cash equivalents	$	864	$	875	$	(11)
Marketable securities		1,319		1,320		(1)
Total cash, cash equivalents and marketable securities	$	2,183	$	2,195	$	(12)
Percentage of total assets		54%		55%		

	Three months ended			
(in millions)		September 30, 2005		September 30, 2004
Cash provided by operating activities[1]	$	12	$	90
Cash used in investing activities		(26)		(23)
Cash provided by (used in) financing activities[1]		3		(62)
Effect of exchange rate changes on cash and cash equivalents		—		2
Net increase (decrease) in cash and cash equivalents	$	(11)	$	7

[1] Cash provided by financing activities during the three months ended September 30, 2005 includes $5.0 million of gross tax windfall from stock-based compensation which was previously recorded under cash provided by operating activities.

We have historically financed our operations through cash generated from operations. Cash provided by operating activities was $12 million and $90 million for the three months ended September 30, 2005 and 2004, respectively. Cash provided by operating activities during the three months ended September 30, 2005 consisted primarily of net income of $77 million increased by non-cash depreciation of $17 million and stock-based compensation of $35 million, and a decrease in accounts receivable of $21 million, offset by an increase in inventories of $36 million, an increase in other assets of $15 million, a decrease in deferred system profit of $30million, and a decrease in other liabilities of $56 million.

Cash provided by operating activities during the three months ended September 30, 2004 consisted primarily of net income of $116 million increased by non-cash depreciation of $19 million offset by an increase in inventories of $35 million and a decrease in accounts payable of $11 million.

Cash used in investing activities was $26 million and $23 million for the three months ended September 30, 2005 and 2004, respectively. Investing activities typically consist of purchases and sales or maturities of marketable securities, purchases of capital assets to support long-term growth and acquisitions of technology or other companies to allow access to new market segments or emerging technologies.

We generated $3 million of cash in financing activities during the three months ended September 30, 2005, compared with $62 million of cash used in financing activities during the three months ended September 30, 2004. Issuance of common stock provided $56 million and $12 million during the three months ended September 30, 2005 and 2004, respectively. We used $35 million and $74 million during the three months ended September 30, 2005 and 2004, respectively to repurchase shares of our common stock under the stock repurchase program initiated in 1997. During the third fiscal quarter of 2005, our Board of Directors also approved the initiation of a quarterly cash dividend and declared a dividend of 12 cents per share of our outstanding common stock. The total amount of dividend paid during the three months ended September 30, 2005 was $24 million. Further, the dividend for the first fiscal quarter of 2006 was declared on September 27, 2005 and is payable on December 1, 2005 to our stockholders of record on November 15 2005. The total amount of dividend payable during the second quarter of fiscal year 2006 is approximately $24 million.

At September 30, 2005, our principal sources of liquidity consisted of $2.2 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 economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, our management believes that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for at least the next twelve months.

The following is a schedule summarizing our significant operating lease commitments as of September 30, 2005 (in millions):

	Payments Due by Fiscal Year						
	Total	2006[(1)]	2007	2008	2009	2010	Thereafter
Operating leases	$ 23.9	$ 6.0	$ 6.2	$ 4.0	$ 2.9	$ 1.7	$ 3.1

(1) Remaining 9 months

We have agreements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. During the three months ended September 30, 2005 and 2004, approximately $55 million and $66 million of receivables were sold under these arrangements, respectively.

In addition, from time to time we will discount without recourse, Letters of Credit (“LCs”) received from customers in payment of goods. During the three months ended September 30, 2005 and 2004, several LCs were sold with proceeds totaling $18 million and $10 million, respectively. Discounting fees were $145,000 and $44,000 for the three months ended September 30, 2005 and 2004, respectively.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply chain for key components. Our liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. We estimate our open inventory purchase commitment as of September 30, 2005 to be approximately $149 million. 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 cancelled. Certain agreements provide for potential cancellation penalties.

Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries.

CRITICAL ACCOUNTING ESTIMATES

The preparation of our Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions in applying our accounting policies that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We based these estimates and assumptions on historical experience, and evaluate them on an on-going basis to ensure they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the audit committee of our board of directors on a quarterly basis, and the audit committee has reviewed the Company's related disclosure in this Quarterly Report on Form 10-Q. The items in our financial statements requiring significant estimates and judgments are as follows:

Revenue Recognition We recognize revenue when persuasive evidence of an arrangement exists, the sale price is fixed or determinable, delivery has occurred or services rendered, and collectibility is reasonably assured. System revenue includes hardware and software that is incidental to the product. We generally recognize system revenue upon positive affirmation by the customer that the system has been installed and is operating according to pre-determined specifications. This positive affirmation is generally evidenced by an acceptance document signed by the customer. In certain cases, we deviate from the need for written acceptance and recognize system revenue upon shipment. Total revenue recognized under conditions where we deviate from the need for a written acceptance by the customer were approximately 3.2%, 4.0% and 6.5% of total revenue for the three months ended September 30, 2005, June 30, 2005 and September 30, 2004, respectively. Shipping charges billed to customers are included in system revenue and the related shipping costs are included in cost of revenues.

Revenue from software license fees is typically recognized upon shipment if collection of the resulting receivable is probable, the fee is fixed or determinable, and vendor-specific objective evidence exists to allocate a portion of the total fee to any undelivered elements of the arrangement. Such undelivered elements in these arrangements typically consist of services and/or upgrades. If vendor-specific objective evidence does not exist for the undelivered elements of the arrangement, all revenue is deferred until such evidence does exist, or until all elements are delivered, whichever is earlier. In instances where an arrangement to deliver software requires significant modification or customization, license fees are recognized under the percentage of completion method of contract accounting. Allowances are established for potential product returns and credit losses.

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

Service and maintenance revenue is recognized ratably over the term of the maintenance contract. If maintenance is included in an arrangement, which includes a software license agreement, amounts related to maintenance are allocated based on vendor specific objective evidence. Consulting and training revenue is recognized when the related services are performed.

The deferred system profit balance equals the amount of deferred system revenue that was invoiced and due on shipment less applicable product and warranty costs.

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

Inventory Reserves We review the adequacy of our inventory reserves on a quarterly basis. For production inventory, our methodology involves matching our on-hand and on-order inventory with our build forecast over the next twelve months. We then evaluate the parts found to be in excess of the twelve-month demand and take appropriate reserves to reflect the risk of obsolescence. For spare parts inventory, we match our on-hand inventory against twenty-four months of usage. We then evaluate the parts in excess of the twenty-four month usage and take appropriate reserves to reflect risk of obsolescence. Both methodologies are significantly affected by the usage assumption. The longer the time period of estimated usage, the lower the reserves are required. Based on our past experience, we believe the twelve-month/twenty-four month time periods best reflect the reasonable and relative obsolescence risks. If actual demand or usage were to be substantially lower than estimated, additional inventory adjustments for excess or obsolete inventory may be required, which could have a material adverse effect on our business, financial condition and results of operations. Inventory reserves, once established, are not reversed until the related inventory has been sold or scrapped.

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

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

Stock-based Compensation We estimate the fair value of stock options using a Black-Scholes valuation model, consistent with the provisions of SFAS No. 123(R), SEC SAB No. 107 and our prior period pro forma disclosures of net earnings, including stock-based compensation (determined under a fair value method as prescribed by SFAS No.123). SFAS No. 123(R) requires the use of option pricing models that were not developed for use in valuing employee stock options. The Black-Scholes option-pricing model was developed for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock.

The expected stock price volatility assumption was determined using the implied volatility of the Company's common stock. Prior to the adoption of SFAS No. 123(R), we used a combination of historical and implied volatility in deriving its expected volatility assumption. We determined that implied volatility is more reflective of market conditions and a better indicator of expected volatility than a blended volatility.

Contingencies and Litigation We are named from time to time as a party to various legal proceedings. While we currently believe the ultimate outcome of these proceedings will not have a material adverse effect on our financial position, the results of complex legal proceedings are difficult to predict. We would accrue the cost of an adverse judgment if, in our estimation, the adverse settlement is probable and we can reasonably estimate the ultimate cost to us. We have made no such accruals as of September 30, 2005.

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

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

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. We recognize liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional tax payments are probable. If we ultimately determine that payment of these amounts is unnecessary, we reverse the liability and recognize a tax benefit during the period in which we determine that the liability is no longer necessary. We record an additional charge in our provision for taxes in the period in which we determine that the recorded tax liability is less than we expect the ultimate assessment to be.

FACTORS AFFECTING RESULTS, INCLUDING RISKS AND UNCERTAINTIES

Fluctuations in Operating Results and Stock Price

Our operating results and stock price have varied widely in the past, and our future operating results will continue to be subject to quarterly variations based upon numerous factors, including those listed in this section and throughout this Quarterly Report on Form 10-Q. Our stock price will continue to be subject to daily variations as well. In addition, our future operating results and stock price may not follow any past trends. We believe the factors that could make our results fluctuate and difficult to predict include:

- our ability to successfully implement new systems;
- the cyclical nature of the semiconductor industry;

- global economic uncertainty;
- changing international economic conditions;
- competitive pressure;
- our ability to develop and implement new technologies and introduce new products;
- our ability to comply with internal controls evaluations and attestation requirements;
- our customers' acceptance and adoption of our new products and technologies;
- our ability to maintain supply of key components;
- our ability to manage our manufacturing requirements;
- our reliance on services provided by third parties;
- our ability to protect our intellectual property;
- our ability to attract, retain, and replace key employees;
- our ability to manage risks associated with acquisitions;
- litigation;
- worldwide political instability;
- recently enacted and proposed changes in securities laws and regulations;
- earthquake and other uninsured risks;
- future changes in accounting and tax standards or practices;
- changing regulatory environment;
- our exposure to fluctuations in foreign currency exchange rates; and
- our ability to guard against computer viruses

Operating results also could be affected by sudden changes in customer requirements, currency exchange rate fluctuations and other economic conditions affecting customer demand and the cost of operations in one or more of the global markets in which we do business. As a result of these or other factors, we could fail to achieve our expectations as to future revenue, gross profit and income from operations. Our failure to meet the performance expectations set and published by external sources could result in a sudden and significant drop in the price of our stock, particularly on a short-term basis, and could negatively affect the value of any investment in our stock.

Implementation of New Systems

We may experience difficulties with our new enterprise resource planning ("ERP") system implemented as of February 7, 2005 that could disrupt our ability to timely and accurately process and report key components of the results of our consolidated operations, our financial position and cash flows. Any disruptions or difficulties that may occur in connection with this new ERP system or any future systems could also adversely affect our ability to complete the evaluation of our internal controls and attestation activities pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. System failure or malfunctioning may result in disruption of operations and the inability to process transactions and could adversely affect our financial results. If we encounter unforeseen problems with regard to system operations or the new ERP system, we could be adversely affected.

Semiconductor Equipment Industry Volatility

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

In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles. If we fail to respond to industry cycles, our business could be seriously harmed.

Global Economic Uncertainty

Our business is ultimately driven by the global demand for electronic devices by consumers and businesses. The picture of end-user demand has been mixed over the last few months and visibility has been reduced as a result of high oil prices, the continued threat of terrorist activities and political instability in certain regions of the world. A protracted global economic slowdown may adversely affect our business and results of operations.

International Trade, Operations and Economic Conditions

We serve an increasingly global market. A majority of our annual revenue is derived from outside the United States, and we expect that international revenue will continue to represent a substantial percentage of our revenue. Our international revenue and operations are affected by economic conditions specific to each country and region. Because of our significant dependence on international revenue, a decline in the economies of any of the countries or regions in which we do business could negatively affect our operating results.

Managing global operations and sites located throughout the world presents challenges associated with, among other things, cultural diversity and organizational alignment. Moreover, each region in the global semiconductor equipment market exhibits unique characteristics that can cause capital equipment investment patterns to vary significantly from period to period. Periodic local or international economic downturns, trade balance issues, political instability or terrorism in regions where we have operations along with fluctuations in interest and currency exchange rates could negatively affect our business and results of operations. Although we attempt to manage near-term currency risks through the use of hedging instruments, there can be no assurance that such efforts will be adequate.

Competition

Our industry includes large manufacturers with substantial resources to support customers worldwide. Our future performance depends, in part, upon our ability to continue to compete successfully 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 us. 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 service 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, similar to what we offer, using innovative technology to sell products into specialized markets. Loss of competitive position could negatively affect our prices, customer orders, revenue, gross margins, and market share, any of which would negatively affect our operating results and financial condition. Our failure to compete successfully with these other companies would seriously harm our business.

Technological Change and Customer Requirements

Success in the semiconductor equipment industry depends, in part, on continual improvement of existing technologies and rapid innovation of new solutions. For example, in the current semiconductor industry, the size of semiconductor devices continues to shrink, there is a transition to copper and other new materials, and a transition to new 300-millimeter fabs. While we expect these trends will increase our customers' reliance on our diagnostic products, we cannot ensure that they will directly improve our business. These and other evolving customer needs require us to respond with continued development programs and to cut back or discontinue older programs, which may no longer have industry-wide support. Technical innovations are inherently complex and require long development cycles and appropriate staffing of highly qualified employees. Our competitive advantage and future business success depend on our ability to accurately predict evolving industry standards, to develop and introduce new products which 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. 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.

In this environment, we must continue to make significant investments in research and development in order to enhance the performance and functionality of our products, to keep pace with competitive products and to satisfy customer demands for improved performance, features and functionality. There can be no assurance that revenue from future products or product enhancements will be sufficient to recover the development costs associated with such products or enhancements or that we will be able to secure the financial resources necessary to fund future development. Substantial research and development costs typically are incurred before we confirm the technical feasibility and commercial viability of a product, and not all development activities result in commercially viable products. In addition, we cannot ensure 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.

Key Suppliers

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

Manufacturing Disruption

Most of our manufacturing facilities are located in the United States, with a small operation located in Israel. Operations at our manufacturing facilities and our assembly subcontractors are subject to disruption for a variety of reasons, including work stoppages, acts of war, terrorism, fire, earthquake, energy shortages, flooding or other natural disasters. Such disruption could cause delays in shipments of products to our customers. We cannot ensure that alternate production capacity would be available if a major disruption were to occur or that, if it were available, it could be obtained on favorable terms. Such disruption could result in cancellation of orders or loss of customers and could seriously harm our business. We currently are in the initial stages of design and implementation of a new integrated financial and supply chain management system. Disruptions or delays in making changes to our integrated financial and supply chain management system could adversely impact our operations and our ability to forecast sales demand, ship products, manage our product inventory and record and report financial and management information on a timely and accurate basis.

Reliance on services provided by third parties

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

Intellectual Property Obsolescence and Infringement

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 technology that are similar or superior to our technology or may design around the patents we own, adversely affecting our business.

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

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

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. Our customary practice is to evaluate such assertions and to consider whether to seek licenses where appropriate. However, we cannot ensure that licenses can be obtained or, if obtained, will be on acceptable terms or that costly litigation or other administrative proceedings will not occur. The inability to obtain necessary licenses or other rights on reasonable terms, or instigation of litigation or other administrative proceedings could seriously harm our operating results and financial condition.

Key Employees

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

Acquisitions

In addition to our efforts to develop new technologies from internal sources, we also seek to 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. Acquisitions involve numerous risks, including management issues and costs in connection with the integration of the operations and personnel, technologies and products of the acquired companies, the possible write-downs of impaired assets, and the potential loss of key employees of the acquired companies. The inability to manage these risks effectively could seriously harm our business.

Litigation

From time to time we are involved in litigation of various types, including litigation alleging infringement of intellectual property rights and other claims. Litigation tends to be expensive and requires significant management time and attention and could have a negative effect on our results of operations or business if we lose or have to settle a case on significantly adverse terms.

Terrorism and Political Instability

The threat of terrorism targeted at the regions of the world in which we do business, including the United States, increases the uncertainty in our markets and may delay any recovery in the general economy. Any delay in the recovery of the economy and the semiconductor industry could adversely affect our business. Increased international political instability, as demonstrated by the September 2001 terrorist attacks, disruption in air transportation and further enhanced security measures as a result of the terrorist attacks, and the continuing instability in the Middle East, may hinder our ability to do business and may increase our costs of operations. Such continuing instability could cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. This same instability could have the same effects on our suppliers and their ability to timely deliver their products. If this international political instability continues or increases, our business and results of operations could be harmed. We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war.

Recently enacted and proposed changes in securities laws and regulations

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002, will increase our expenses as we evaluate the implications of new rules and devote resources to respond to the new requirements. Sarbanes- Oxley Act mandates, among other things, that companies adopt new corporate governance measures and imposes comprehensive reporting and disclosure requirements, sets stricter independence and financial expertise standards for audit committee members and imposes increased civil and criminal penalties for companies, their chief executive officers and chief financial officers and directors for securities law violations.

In particular, we expect to incur additional administrative expense as we implement Section 404 of the Sarbanes-Oxley Act, which requires management to report on, and our Independent Registered Public Accounting Firm to attest to, our internal control over financial reporting. In addition, The Nasdaq National Market, on which our common stock is listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased and will continue to increase the scope, complexity and cost of our corporate governance, reporting and disclosure practices, which could harm our results of operations and divert management's attention from business operations. We also expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance in the future, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, our board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficultly attracting and retaining qualified board members and executive officers, which would adversely affect our business.

Earthquake and Other Uninsured Risks

We purchase insurance to help mitigate the economic impact of certain insurable risks, however, certain other risks are uninsurable or are insurable only at significant costs and cannot be mitigated with insurance. An earthquake could significantly disrupt our manufacturing operations, most of which are conducted in California. It could also significantly delay our research and engineering effort on new products, most of which is also conducted in California. We take steps to minimize the damage that would be caused by an earthquake, but there is no certainty that our efforts will prove successful in the event of an earthquake. We self insure earthquake risks because we believe this is the 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.

Future Changes in Accounting and Taxation Standards or Practices

A change in accounting standards or practices or a change in existing taxation rules or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation practice have occurred and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business.

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

Exposure to various risks related to the regulatory environment.

We are subject to various risks related to new, different, inconsistent or even conflicting laws, rules and regulations that may be enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply.

Exposure to fluctuations in foreign currency exchange rates

We have some exposure to fluctuations in foreign currency exchange rates. We have international subsidiaries that operate and sell our products globally. We routinely hedge these exposures in an effort to minimize the impact of currency fluctuations. However, we may still be adversely affected by changes in foreign currency exchange rates or declining economic conditions in these countries.

Computer viruses may disrupt our operations

Despite our implementation of network security measures, our tools and servers are vulnerable to computer viruses, break-ins, and similar disruptions from unauthorized tampering with our computer systems and tools located at customer sites. Any such event could have an adverse effect on our business, operating results, and financial condition.

Effects of Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment." SFAS No. 123(R) which requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements. In March 2005, the SEC issued SAB 107, which provides the Staff's views regarding interactions between SFAS No. 123(R) and certain SEC rules and regulations and provides interpretations of the valuation of share-based payments for public companies. The adoption of SFAS No. 123(R) requires additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. The adoption of SFAS No. 123(R) during the first quarter of fiscal year 2006 had a material impact on our consolidated results of operations, financial position and statement of cash flows. For more information on stock-based compensation costs during the three months ended September 30, 2005, refer to Note 6 "Stock Based Compensation" of the Notes to the Condensed Consolidated Financial Statements included in Item 1 of this quarterly report.

In June 2005, the FASB issued SFAS No. 154, "Accounting Changes and Error Corrections", a replacement of APB Opinion No. 20, "Accounting Changes", and SFAS No. 3, "Reporting Accounting Changes in Interim Financial Statements". SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles were required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS No. 154 did not have a material effect on our consolidated financial position, results of operations or cash flows.

In March 2005, the FASB published FASB Interpretation No. 47, "Accounting for Conditional Asset Retirement Obligations," which clarifies that the term, conditional asset retirement obligation, as used in SFAS No. 143, "Accounting for Asset Retirement Obligations," refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. The interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The adoption of this Interpretation did not have a material effect on our consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 is effective for us for nonmonetary asset exchanges beginning in the first quarter of fiscal 2006. The adoption of SFAS No. 153 did not have a material effect on our consolidated financial position, results of operations or cash flows.

In November 2004, the FASB issued SFAS No. 151, “Inventory Costs, an amendment of ARB No. 43, Chapter 4”. SFAS No. 151 clarifies that abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are required to be recognized as current period charges. The provisions of SFAS No.151 are effective for the fiscal year beginning July 1, 2005. The adoption of SFAS No. 151 did not have a material impact on our consolidated financial position, results of operations and 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. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position at September 30, 2005. Actual results may differ materially.

As of September 30, 2005, we had an investment portfolio of fixed income securities of $1.3 billion, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of September 30, 2005, the fair value of the portfolio would have declined by $7 million.

As of September 30, 2005, we had net forward contracts to sell $351 million in foreign currency in order to hedge currency exposures (see Note 11 of the Notes to the Condensed Consolidated Financial Statements under “Derivative Instruments”). If we had entered into these contracts on September 30, 2005, the U.S. dollar equivalent would be $342 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by $47 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on net income or cash flows.

ITEM 4. CONTROLS AND PROCEDURES

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

We conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (Disclosure Controls) as of the end of the period covered by this Quarterly Report. The controls evaluation was conducted under the supervision and with the participation of management, including our Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on this evaluation, our CEO and our CFO have concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

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

Definition of Disclosure Controls

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

Limitations on the Effectiveness of Controls

The Company's management, including the CEO and CFO, does not expect that our Disclosure Controls or our 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 controls over financial reporting

There were no changes in our internal controls over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are named from time to time as a party to lawsuits in the normal course of our business. Litigation, in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict.

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

Following is a summary of stock repurchases for the quarter ended September 30, 2005:[1]

Period	Total Number of Shares (or Units) Purchased[2]	Average Price Paid per Share (or Unit)	Maximum Number of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs[3]
July 1, 2005 to July 31, 2005	284,500	$ 46.21	8,065,500
August 1, 2005 to August 31, 2005	216,000	$ 49.37	7,849,500
September 1, 2005 to September 30, 2005	238,000	$ 49.06	7,611,500
Total	738,500	$ 48.05	

(1) In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. This program was entered in order to reduce the dilution from KLA-Tencor's employee benefit and incentive plans such as the stock option and employee stock purchase plans. Since the inception of the repurchase program in 1997 through September 30, 2005 the Board of Directors had authorized KLA-Tencor to repurchase a total of 27.8 million shares. All such shares remain as treasury shares and are retired.

(2) All shares were purchased pursuant to the program publicly announced in July 1997 and as extended by the Board of Directors most recently in February 2005 by an additional 10.0 million shares.

(3) The stock repurchase program has no expiration date. We intend to continue making further purchases under the stock repurchase program.

ITEM 6. EXHIBITS

31.1 Certification of Chief Executive Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934.

31.2 Certification of Chief Financial Officer under Rule 13a-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.

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)
November 7, 2005 (Date)	/s/ KENNETH L. SCHROEDER
	Kenneth L. Schroeder Chief Executive Officer (Principal Executive Officer)
November 7, 2005 (Date)	/s/ JOHN H. KISPERT
	John H. Kispert Executive Vice President and Chief Financial Officer (Principal Accounting Officer)

KLA-TENCOR CORPORATION
EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference			
		Form	File No.	Exhibit Number	Filing Date
3.1	Amended and Restated Certificate of Incorporation	10-Q	No. 000-09992	3.1	May 14, 1997
3.2	Certificate of Amendment of Amendment and Restated Certificate of Incorporation	10-Q	No. 000-09992	3.1	February 14, 2001
3.3	Bylaws, as amended November 17, 1998	S-8	No. 333-68415	3.2	December 4, 1998
4.1	Amended and Restated Rights Agreement dated as of August 25, 1996 between the Company and First National Bank of Boston, as Rights Agent. The Agreement includes the Form of Right Certificate as Exhibit A and the Summary of Terms of Rights as Exhibit B	8-A/A, Amendment No. 2	No. 0-9992	1	September 24, 1996
10.1	1998 Outside Director Option Plan*	S-8	No. 333-68423	10.1	December 4, 1998
10.2	1997 Employee Stock Purchase Plan*	S-8	No. 333-45271	10.2	January 30, 1998
10.3	Tencor Instruments Amended and Restated 1993 Equity Incentive Plan	S-8	No. 333-22939	10.75	March 7, 1997
10.4	Restated 1982 Stock Option Plan, as amended November 18, 1996*	S-8	No. 333-22941	10.74	March 7, 1997
10.5	Excess Profit Stock Plan*	S-8	No. 333-60883	10.15	August 7, 1997
10.6	Form of KLA-Tencor Corporation Corporate Officers Retention Plan*	S-4	No. 333-23075	10.2	March 11, 1997
10.7	Form of Indemnification Agreement*	10-K	No. 000-09992	10.3	September 29, 1997
10.8	Livermore Land Purchase and Sale Agreement	10-K	No. 000-09992	10.16	September 28, 2000

10.9	Severance Agreement and General Release	10-K	No. 000-09992	10.9	August 30, 2004
10.10	2004 Equity Incentive Plan*	Proxy	No. 000-09992	Appendix A	September 9, 2004
10.11	Form of Option Agreement under 1998 Outside Director Option Plan*	8-K	No. 000-09992	10.1	October 18, 2004
10.12	Blue29 Corporation 2003 Stock Incentive Plan*	S-8	No. 333-120218	10.1	November 4, 2004
10.13	Agreement by and between KLA-Tencor Corporation and Kenneth L. Schroeder*	8-K	No. 000-09992	10.1	February 23, 2005
31.1	Certification of Chief Executive Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934				
31.2	Certification of Chief Financial Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934				
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350				

* Denotes a management contract, plan or arrangement

EXHIBIT 31.1

Certification of Chief Executive Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Kenneth L. Schroeder, 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.

November 7, 2005
(Date)

/s/ KENNETH L. SCHROEDER

Kenneth L. Schroeder
Chief Executive Officer
(Principal Executive Officer)

EXHIBIT 31.2

Certification of Chief Financial Officer
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, John H. Kispert, 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.

November 7, 2005
(Date)

/s/ JOHN H. KISPERT

John H. Kispert
Executive Vice President
and Chief Financial Officer
(Principal Accounting Officer)

Exhibit 32

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, Kenneth L. Schroeder, 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, 2005 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.

November 7, 2005 Dated	By:	/s/ Kenneth L. Schroeder
	Name:	Kenneth L. Schroeder
	Title:	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, John H. Kispert, 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, 2005 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.

November 7, 2005 Dated	By:	/s/ John H. Kispert
	Name:	John H. Kispert
	Title:	Executive Vice President and Chief Financial Officer