KLA TENCOR CORP
Form 10-Q
January 25, 2013

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

FORM 10-Q

(Mark one)

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

For the quarterly period ended December 31, 2012

or

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

For the transition period from to

Commission File Number 000-09992

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

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

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

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

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

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

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

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

As of January 10, 2013, there were 166,144,760 shares of the registrant's Common Stock, $0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

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

(In thousands)	December 31, 2012	June 30, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$767,313	$751,294
Marketable securities	1,810,940	1,783,150
Accounts receivable, net	606,115	701,280
Inventories	662,735	650,802
Deferred income taxes	168,369	184,670
Other current assets	120,828	92,847
Total current assets	4,136,300	4,164,043
Land, property and equipment, net	292,394	277,686
Goodwill	326,779	327,716
Purchased intangibles, net	43,514	55,636
Other non-current assets	269,776	275,227
Total assets	$5,068,763	$5,100,308
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$103,575	$139,183
Deferred system profit	156,775	147,218
Unearned revenue	53,257	63,095
Other current liabilities	468,130	513,411
Total current liabilities	781,737	862,907
Non-current liabilities:		
Long-term debt	747,104	746,833
Income tax payable	54,910	50,839
Unearned revenue	31,742	34,899
Other non-current liabilities	92,134	89,235
Total liabilities	1,707,627	1,784,713
Commitments and contingencies (Note 11 and Note 12)		
Stockholders' equity:		
Common stock and capital in excess of par value	1,123,422	1,089,480
Retained earnings	2,252,772	2,247,258
Accumulated other comprehensive income (loss)	(15,058)	(21,143)
Total stockholders' equity	3,361,136	3,315,595
Total liabilities and stockholders' equity	$5,068,763	$5,100,308

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

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

(In thousands, except per share data)	Three months ended December 31, 2012	2011	Six months ended December 31, 2012	2011
Revenues:				
Product	$523,023	$500,659	$1,097,101	$1,150,915
Service	149,988	141,823	296,619	288,043
Total revenues	673,011	642,482	1,393,720	1,438,958
Costs and operating expenses:				
Costs of revenues	303,915	272,855	621,140	613,204
Engineering, research and development	121,608	116,363	241,350	224,125
Selling, general and administrative	94,241	93,801	191,426	187,877
Total costs and operating expenses	519,764	483,019	1,053,916	1,025,206
Income from operations	153,247	159,463	339,804	413,752
Interest income and other, net	5,058	740	8,546	7,606
Interest expense	13,431	13,296	26,934	27,189
Income before income taxes	144,874	146,907	321,416	394,169
Provision for income taxes	38,244	36,110	79,419	91,377
Net income	$106,630	$110,797	$241,997	$302,792
Net income per share:				
Basic	$0.64	$0.67	$1.45	$1.82
Diluted	$0.63	$0.66	$1.43	$1.78
Cash dividends declared per share	$0.40	$0.35	$0.80	$0.70
Weighted average number of shares:				
Basic	166,268	166,343	166,632	166,513
Diluted	169,076	169,103	169,702	169,650

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

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

(In thousands)	Three months ended December 31, 2012	Three months ended December 31, 2011	Six months ended December 31, 2012	Six months ended December 31, 2011
Net income	$106,630	$110,797	$241,997	$302,792
Other comprehensive income (loss):				
Currency translation adjustments:				
Change in currency translation adjustments	(1,126)	(5,175)	5,496	(9,613)
Change in income tax benefit or expense	(1,035)	635	(2,712)	3,286
Net change related to currency translation adjustments	(2,161)	(4,540)	2,784	(6,327)
Cash flow hedges:				
Change in net unrealized gains or losses	2,242	(223)	2,001	(1,417)
Reclassification adjustments for gains or losses included in net income	(128)	702	964	925
Change in income tax benefit or expense	(753)	(170)	(1,056)	176
Net change related to cash flow hedges	1,361	309	1,909	(316)
Net change related to unrecognized losses and transition obligations in connection with defined benefit plans	160	139	317	241
Available-for-sale investments:				
Change in net unrealized gains or losses	(968)	(163)	2,949	(3,660)
Reclassification adjustments for gains or losses included in net income	(1,048)	662	(1,356)	556
Change in income tax benefit or expense	709	(154)	(518)	1,193
Net change related to available-for-sale securities	(1,307)	345	1,075	(1,911)
Other comprehensive income (loss)	(1,947)	(3,747)	6,085	(8,313)
Total comprehensive income	$104,683	$107,050	$248,082	$294,479

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

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

(In thousands)	Six months ended December 31, 2012	2011
Cash flows from operating activities:		
Net income	$241,997	$302,792
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	45,941	46,451
Asset impairment charges	1,327	1,378
Net gain on sale of assets	(1,160)	—
Non-cash stock-based compensation expense	33,942	40,142
Excess tax benefit from equity awards	(13,093)	—
Net gain on sale of marketable securities and other investments	(1,357)	(556)
Changes in assets and liabilities:		
Decrease in accounts receivable, net	89,583	45,408
Increase in inventories	(10,467)	(76,841)
Decrease in other assets	615	61,819
Decrease in accounts payable	(35,418)	(13,978)
Increase (decrease) in deferred system profit	9,557	(1,620)
Increase (decrease) in other liabilities	(38,631)	1,222
Net cash provided by operating activities	322,836	406,217
Cash flows from investing activities:		
Capital expenditures, net	(37,363)	(27,046)
Proceeds from sale of assets	1,838	2,228
Purchase of available-for-sale securities	(751,527)	(591,088)
Proceeds from sale and maturity of available-for-sale securities	718,124	556,167
Purchase of trading securities	(19,912)	(35,438)
Proceeds from sale of trading securities	19,438	34,529
Net cash used in investing activities	(69,402)	(60,648)
Cash flows from financing activities:		
Issuance of common stock	46,857	49,098
Tax withholding payments related to vested and released restricted stock units	(28,432)	(29,474)
Common stock repurchases	(136,600)	(129,972)
Payment of dividends to stockholders	(133,151)	(116,561)
Excess tax benefit from equity awards	13,093	—
Net cash used in financing activities	(238,233)	(226,909)
Effect of exchange rate changes on cash and cash equivalents	818	(5,003)
Net increase in cash and cash equivalents	16,019	113,657
Cash and cash equivalents at beginning of period	751,294	711,329
Cash and cash equivalents at end of period	$767,313	$824,986
Supplemental cash flow disclosures:		
Income taxes paid, net	$76,204	$7,645
Interest paid	$26,915	$27,515

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

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

NOTE 1 – BASIS OF PRESENTATION

Basis of Presentation. The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation ("KLA-Tencor" or the "Company") pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations 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, 2012, filed with the SEC on August 6, 2012.

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

The results of operations for the six months ended December 31, 2012 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, 2013.

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

Management Estimates. The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions 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.

Recent Accounting Pronouncements. In September 2011, the Financial Accounting Standards Board ("FASB") issued an accounting standard update intended to simplify testing goodwill for impairment. The amendments allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. An entity is no longer required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. The amendment, by its terms, became effective for annual and interim goodwill impairment tests performed for the Company's fiscal year ending June 30, 2013, and early adoption was permitted. The Company elected to early adopt this accounting guidance at the beginning of the three months ended December 31, 2011 (see Note 5, "Goodwill and Purchased Intangible Assets," for a detailed description).

In June 2011, the FASB issued an accounting standard update requiring an increase in the prominence of items reported in other comprehensive income. The amendment eliminated the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity and required that the total of comprehensive income, the components of net income, and the components of other comprehensive income be presented in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendment also required presentation of adjustments for items that are reclassified from other comprehensive income in the statement where the components of net income and the components of other comprehensive income are presented, but that requirement was indefinitely deferred by the FASB in December 2011. The amendment (other than the portion regarding the presentation of reclassification adjustments which, as noted above, has been deferred indefinitely) became effective for the Company's interim period ended September 30, 2012. The amendment did not have an impact on the Company's financial position, results of operations or cash flows as it is disclosure-only in nature.

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NOTE 2 – FAIR VALUE MEASUREMENTS

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

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

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

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

All of the Company's financial instruments were classified within Level 1 or Level 2 of the fair value hierarchy as of December 31, 2012, because they were valued using quoted market prices, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency. The types of instruments valued based on quoted market prices in active markets include money market funds, equity securities and certain U.S. Government agency securities, U.S. Treasury securities and sovereign securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

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

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

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

As of December 31, 2012 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
U.S. Government agency securities	$5,515	$5,515	$—
Money market and other	617,113	617,113	—
Marketable securities:			
U.S. Treasury securities	92,075	88,578	3,497
U.S. Government agency securities	574,781	571,783	2,998
Municipal securities	77,594	—	77,594
Corporate debt securities	1,008,378	—	1,008,378
Sovereign securities	17,245	9,552	7,693
Equity securities	357	357	—
Total cash equivalents and marketable securities[1]	2,393,058	1,292,898	1,100,160
Other current assets:			
Derivative assets	6,169	—	6,169
Other non-current assets:			
Executive Deferred Savings Plan:			
Money market and other	2,708	2,708	—
Mutual funds	129,336	97,065	32,271
Executive Deferred Savings Plan total	132,044	99,773	32,271
Total financial assets[1]	$2,531,271	$1,392,671	$1,138,600
Other current liabilities:			
Derivative liabilities	$(870)	$—	$(870)
Total financial liabilities	$(870)	$—	$(870)

(1) Excludes cash of $125.7 million held in operating accounts and time deposits of $59.5 million as of December 31, 2012.

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

As of June 30, 2012 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
Money market and other	$607,038	$607,038	$—
Marketable securities:			
U.S. Treasury securities	91,438	88,014	3,424
U.S. Government agency securities	634,492	634,492	—
Municipal securities	66,543	—	66,543
Corporate debt securities	917,392	—	917,392
Sovereign securities	29,145	10,129	19,016
Equity securities	10	10	—
Total cash equivalents and marketable securities[1]	2,346,058	1,339,683	1,006,375
Other current assets:			
Derivative assets	1,407	—	1,407
Other non-current assets:			
Executive Deferred Savings Plan:			
Money market and other	732	732	—
Mutual funds	124,622	94,572	30,050
Executive Deferred Savings Plan total	125,354	95,304	30,050
Total financial assets[1]	$2,472,819	$1,434,987	$1,037,832
Other current liabilities:			
Derivative liabilities	$(1,909)	$—	$(1,909)
Total financial liabilities	$(1,909)	$—	$(1,909)

(1) Excludes cash of $126.0 million held in operating accounts and time deposits of $62.4 million as of June 30, 2012.

There were no transfers in and out of Level 1 and Level 2 fair value measurements during the three and six months ended December 31, 2012 or June 30, 2012. The Company did not have any assets or liabilities measured at fair value on a recurring basis within Level 3 fair value measurements as of December 31, 2012 or June 30, 2012.

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NOTE 3 – BALANCE SHEET COMPONENTS

(In thousands)	As of December 31, 2012	As of June 30, 2012
Accounts receivable, net:		
Accounts receivable, gross	$628,448	$723,607
Allowance for doubtful accounts	(22,333)	(22,327)
	$606,115	$701,280
Inventories:		
Customer service parts	$211,889	$197,013
Raw materials	273,861	234,549
Work-in-process	129,301	170,254
Finished goods	47,684	48,986
	$662,735	$650,802
Other current assets:		
Prepaid expenses	$43,890	$53,472
Income tax related receivables	59,585	22,943
Other current assets	17,353	16,432
	$120,828	$92,847
Land, property and equipment, net:		
Land	$41,881	$41,397
Buildings and leasehold improvements	254,484	244,807
Machinery and equipment	461,654	443,668
Office furniture and fixtures	21,894	19,493
Construction in process	17,203	11,765
	797,116	761,130
Less: accumulated depreciation and amortization	(504,722)	(483,444)
	$292,394	$277,686
Other non-current assets:		
Executive Deferred Savings Plan(1)	$132,044	$125,354
Deferred tax assets – long-term	116,980	128,738
Other	20,752	21,135
	$269,776	$275,227
Other current liabilities:		
Warranty	$41,918	$46,496
Executive Deferred Savings Plan(1)	132,515	125,329
Compensation and benefits	138,143	175,007
Income taxes payable	11,533	11,251
Interest payable	8,769	8,769
Accrued litigation costs	1,954	1,080
Other accrued expenses	133,298	145,479
	$468,130	$513,411

(1) KLA-Tencor has a non-qualified deferred compensation plan whereby certain executives and non-employee directors may defer a portion of their compensation. Participants are credited with returns based on their allocation of their account balances among measurement funds. The Company controls the investment of these funds, and the participants remain general creditors of KLA-Tencor. Distributions from the plan commence the quarter following a participant's retirement or termination of employment, except in cases where such distributions are required to be delayed in order to avoid a prohibited distribution under Internal Revenue Code Section 409A. As of December 31, 2012, the Company had a deferred compensation plan related asset and liability included as a component of other non-current assets and other current liabilities on the Condensed Consolidated Balance Sheet.

NOTE 4 – MARKETABLE SECURITIES

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

As of December 31, 2012 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$91,927	$151	$(3)	$92,075
U.S. Government agency securities	579,062	1,240	(6)	580,296
Municipal securities	77,595	87	(88)	77,594
Corporate debt securities	1,003,918	4,796	(336)	1,008,378
Money market and other	617,113	—	—	617,113
Sovereign securities	17,191	57	(3)	17,245
Equity securities	350	7	—	357
Subtotal	2,387,156	6,338	(436)	2,393,058
Add: Time deposits[1]	59,467	—	—	59,467
Less: Cash equivalents	641,585	—	—	641,585
Marketable securities	$1,805,038	$6,338	$(436)	$1,810,940

As of June 30, 2012 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$91,387	$67	$(16)	$91,438
U.S. Government agency securities	633,587	981	(76)	634,492
Municipal securities	66,538	107	(102)	66,543
Corporate debt securities	914,134	3,826	(568)	917,392
Money market and other	607,038	—	—	607,038
Sovereign securities	29,056	89	—	29,145
Equity securities	10	—	—	10
Subtotal	2,341,750	5,070	(762)	2,346,058
Add: Time deposits[1]	62,431	—	—	62,431
Less: Cash equivalents	625,339	—	—	625,339
Marketable securities	$1,778,842	$5,070	$(762)	$1,783,150

(1) Time deposits excluded from fair value measurements.

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

As of December 31, 2012 (In thousands)	Fair Value	Gross Unrealized Losses[1]
U.S. Treasury securities	$4,999	$(3)
U.S. Government agency securities	37,083	(6)
Municipal securities	30,399	(88)
Corporate debt securities	200,660	(336)
Sovereign securities	966	(3)
Total	$274,107	$(436)

(1) Of the total gross unrealized losses, there were no amounts that, as of December 31, 2012, had been in a continuous loss position for 12 months or more.

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

As of December 31, 2012 (In thousands)	Amortized Cost	Fair Value
Due within one year	$355,965	$356,693
Due after one year through three years	1,449,073	1,454,247
	$1,805,038	$1,810,940

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Net realized gains on the Company's investments for the three months ended December 31, 2012 were $1.0 million. Net realized losses on the Company's investments for the three months ended December 31, 2011 were $0.1 million. Net realized gains for the six months ended December 31, 2012 and 2011 were $1.4 million and $0.6 million, respectively.

NOTE 5 – GOODWILL AND PURCHASED INTANGIBLE ASSETS

Goodwill

The following table presents goodwill balances as of the dates indicated below:

(In thousands)	As of December 31, 2012	As of June 30, 2012
Gross goodwill balance	$604,349	$604,302
Accumulated impairment losses	(277,570)	(276,586)
Net goodwill balance	$326,779	$327,716

The changes in the gross goodwill balance since June 30, 2012 resulted from foreign currency translation adjustments.

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Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. In September 2011, the FASB amended its guidance to simplify testing goodwill for impairment, allowing an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test.

The Company has four reporting units: Defect Inspection, Metrology, Service and Other. As of December 31, 2012, substantially all of the goodwill balance resided in the Defect Inspection reporting unit.

The fair value of each of the Company's reporting units was substantially in excess of its estimated carrying amount as of the most recent quantitative analysis of goodwill impairment performed in the three months ended December 31, 2010. There have been no triggering events or changes in circumstances since that quantitative analysis to indicate that the fair value of any of the Company's reporting units would be less than its carrying amount.

The Company performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2012 during the three months ended December 31, 2012 and concluded that it was more likely than not that the fair value of each of the reporting units exceeded its carrying amount. As a result of the Company's determination following its qualitative assessment, it was not necessary to perform the two-step goodwill impairment test at this time. In assessing the qualitative factors, the Company considered the impact of these key factors: change in industry and competitive environment, market capitalization, stock price, earnings multiples, budgeted-to-actual revenue performance from prior year, gross margin and cash flow from operating activities.

Based on the Company's assessment, goodwill in the reporting units was not impaired as of December 31, 2012 or 2011.

Purchased Intangible Assets

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

(In thousands)		As of December 31, 2012			As of June 30, 2012		
Category	Range of Useful Lives	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount
Existing technology	4-7 years	$133,659	$115,365	$18,294	$134,561	$110,370	$24,191
Patents	6-13 years	57,648	49,395	8,253	57,648	46,966	10,682
Trade name/Trademark	4-10 years	19,893	15,178	4,715	19,893	14,428	5,465
Customer relationships	6-7 years	54,680	42,428	12,252	54,823	39,525	15,298
Other	0-1 year	16,200	16,200	—	16,200	16,200	—
Total		$282,080	$238,566	$43,514	$283,125	$227,489	$55,636

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

For the three months ended December 31, 2012 and 2011, amortization expense for other intangible assets was $4.6 million and $7.7 million, respectively. For the six months ended December 31, 2012 and 2011, amortization expense for other intangible assets was $11.8 million and $15.7 million, respectively. Based on the intangible assets recorded as of December 31, 2012, and assuming no subsequent additions to, or impairment of, the underlying assets, the remaining estimated amortization expense is expected to be as follows:

Fiscal year ending June 30:	Amortization (In thousands)
2013 (remaining 6 months)	$8,999
2014	15,368
2015	12,752
2016	5,564
2017	806

2018 and thereafter	25
Total	$43,514

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NOTE 6 – LONG-TERM DEBT

In April 2008, the Company issued $750 million aggregate principal amount of 6.90% senior, unsecured long-term debt due in 2018 with an effective interest rate of 7.00%. The discount on the debt amounted to $5.4 million and is being amortized over the life of the debt using the straight-line method as opposed to the interest method due to immateriality. Interest is payable semi-annually on November 1 and May 1. The debt indenture includes covenants that limit the Company's ability to grant liens on its facilities and to enter into sale and leaseback transactions, subject to significant allowances under which certain sale and leaseback transactions are not restricted. The Company was in compliance with all of its covenants as of December 31, 2012.

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

Based on the trading prices of the debt on the applicable dates, the fair value of the debt as of December 31, 2012 and June 30, 2012 was $905.6 million and $902.2 million, respectively. While the debt is recorded at cost, the fair value of the long-term debt was determined based on quoted prices in markets that are not active; accordingly, the long-term debt is classified as Level 2 for purposes of the fair value measurement hierarchy.

NOTE 7 – EQUITY AND LONG-TERM INCENTIVE COMPENSATION PLANS

Equity Incentive Program

Under the Company's current equity incentive program, the Company issues equity awards from its 2004 Equity Incentive Plan (the "2004 Plan"), which provides for the grant of options to purchase shares of its common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to its employees, consultants and members of its Board of Directors. The 2004 Plan permits the issuance of up to 32.0 million shares of common stock. Any 2004 Plan awards of restricted stock units, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date are counted against the total number of shares issuable under the 2004 Plan as 1.8 shares for every one share subject thereto.

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

(In thousands)	Available For Grant
Balances as of June 30, 2012(1)	7,969
Restricted stock units granted(2)(3)	(1,454)
Restricted stock units canceled(2)	278
Options canceled/expired/forfeited	169
Plan shares expired(4)	(26)
Balances as of December 31, 2012(1)	6,936

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(1) Includes shares available for issuance under the 2004 Plan, as well as under the Company's 1998 Outside Director Option Plan (the "Outside Director Plan"), which only permits the issuance of stock options to the Company's non-employee members of the Board of Directors. As of December 31, 2012, 1.7 million shares were available for grant under the Outside Director Plan.

(2) The number of restricted stock units provided in this row reflects the application of the 1.8x multiple described above.

(3) Includes 0.3 million restricted stock units (reflected as 0.6 million shares in this table due to the application of the 1.8x multiple described above) granted to senior management during the six months ended December 31, 2012

with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2012, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares that may

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ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum and all applicable service-based criteria are fully satisfied.

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

Except for stock options granted to non-employee Board members as part of their regular compensation package for service through the end of the first quarter of fiscal year 2008, the Company has granted only restricted stock units under its equity incentive program since September 2006. For the preceding several years until September 30, 2006, stock options were granted at the market price of the Company's common stock on the date of grant (except for the previously disclosed retroactively priced options which were granted primarily prior to the fiscal year ended June 30, 2002), generally with a vesting period of five years and an exercise period not to exceed seven years (ten years for options granted prior to July 1, 2005) from the date of issuance. Restricted stock units may be granted with varying criteria such as service-based and/or performance-based vesting.

The fair value of stock-based awards is measured at the grant date and is recognized as an expense over the employee's requisite service period. The fair value is determined using a Black-Scholes valuation model for purchase rights under the Company's Employee Stock Purchase Plan and using the closing price of the Company's common stock on the grant date for restricted stock units, adjusted to exclude the present value of dividends which are not accrued on the restricted stock units.

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2012	2011	2012	2011
Stock-based compensation expense by:				
Costs of revenues	$2,624	$3,671	$5,899	$7,509
Engineering, research and development	4,270	5,756	9,733	11,577
Selling, general and administrative	8,064	10,219	18,310	21,056
Total stock-based compensation expense	$14,958	$19,646	$33,942	$40,142

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

(In thousands)	As of December 31, 2012	As of June 30, 2012
Inventory	$8,244	$7,692

Stock Options

The following table summarizes the activity and weighted-average exercise price for stock options under all plans during the six months ended December 31, 2012:

Stock Options	Shares (In thousands)	Weighted-Average Exercise Price
Outstanding stock options as of June 30, 2012	3,844	$ 47.36
Granted	—	$ —
Exercised	(613)	$ 43.57
Canceled/expired/forfeited	(169)	$ 48.46
Outstanding stock options as of December 31, 2012 (all outstanding and all vested and exercisable)	3,062	$ 48.07

The Company has not issued any stock options since November 1, 2007. The weighted-average remaining contractual terms for total options outstanding under all plans, and for total options vested and exercisable under all plans, as of December 31, 2012 were each 1.1 years. The aggregate intrinsic values for total options outstanding under all plans, and for total options vested and exercisable under all plans, as of December 31, 2012 were each $9.6 million.

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The authoritative guidance on stock-based compensation permits companies to select the option-pricing model used to estimate the fair value of their stock-based compensation awards. The Black-Scholes option-pricing model requires the input of assumptions, including the option's expected term and the expected price volatility of the underlying stock. For purposes of the fair value estimates presented in this report, the Company has based its expected stock price volatility assumption on the market-based implied volatility from traded options of the Company's common stock. As of December 31, 2012, the Company had no unrecognized stock-based compensation balance related to stock options.

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2012	2011	2012	2011
Total intrinsic value of options exercised	$847	$3,809	$4,774	$6,569
Total cash received from employees and non-employee Board members as a result of stock option exercises	$3,467	$20,201	$26,718	$29,903
Tax benefits realized by the Company in connection with these exercises	$285	$1,224	$1,579	$2,163

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

Restricted Stock Units

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value for restricted stock units granted, vested and released, withheld for taxes, and forfeited during the six months ended December 31, 2012 and restricted stock units outstanding as of December 31, 2012 and June 30, 2012:

Restricted Stock Units	Shares (In thousands) (1)	Weighted-Average Grant Date Fair Value
Outstanding restricted stock units as of June 30, 2012	6,418	$ 29.49
Granted(2)	808	$ 46.41
Vested and released	(1,205)	$ 24.76
Withheld for taxes	(567)	$ 24.76
Forfeited	(154)	$ 32.19
Outstanding restricted stock units as of December 31, 2012(2)	5,300	$ 33.57

(1) Share numbers reflect actual shares subject to awarded restricted stock units. Under the terms of the 2004 Plan, each of the share numbers presented in this column is multiplied by 1.8 to calculate the impact on the share reserve under the 2004 Plan.

(2) Includes 0.3 million restricted stock units granted to senior management during the six months ended December 31, 2012 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2012, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum and all applicable service-based criteria are fully satisfied.

The restricted stock units granted by the Company since the beginning of the fiscal year ending June 30, 2013 generally vest (a) with respect to awards with only service-based vesting criteria, in four equal installments on the first, second, third and fourth anniversaries of the grant date and (b) with respect to awards with both performance-based and service-based vesting criteria, in two equal installments on the third and fourth anniversaries of the grant date, in each case subject to the recipient remaining employed by the Company as of the applicable vesting date. The restricted stock units granted by the Company from the beginning of the fiscal year ended June 30, 2007 through June 30, 2012 generally vest in two equal installments on the second and fourth anniversaries of the grant date, subject to the recipient remaining employed by the Company as of the applicable vesting date. The fair value is determined using the closing price of the Company's common stock on the grant date for restricted stock units, adjusted to exclude the present value of dividends which are not accrued on the restricted stock units. The restricted stock units have been awarded under the 2004 Plan, and each unit will entitle the recipient to one share of

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common stock when the applicable vesting requirements for that unit are satisfied. However, for each share actually issued under the awarded restricted stock units, the share reserve under the 2004 Plan will be reduced by 1.8 shares, as provided under the terms of the 2004 Plan.

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

(In thousands, except for weighted-average grant date fair value)	Three months ended December 31,		Six months ended December 31,	
	2012	2011	2012	2011
Weighted-average grant date fair value per unit	$41.85	$36.87	$46.41	$25.67
Tax benefits realized by the Company in connection with vested and released restricted stock units	$10,153	$11,463	$28,024	$28,236

As of December 31, 2012, the unrecognized stock-based compensation expense balance related to restricted stock units was $119.8 million, excluding the impact of estimated forfeitures, and will be recognized over a weighted-average remaining contractual term and an estimated weighted-average amortization period of 1.6 years. The intrinsic value of outstanding restricted stock units as of December 31, 2012 was $253.1 million.

Cash-Based Long-Term Incentive Compensation

The Company has adopted a cash-based long-term incentive program in fiscal year 2013 for many of its employees as part of the Company's employee compensation program. In October 2012, the Company approved cash-based long-term incentive (“Cash LTI”) awards of $60.3 million under the Company's Cash Long-Term Incentive Plan (“Cash LTI Plan”). Cash LTI awards issued to employees under the Cash LTI Plan will vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under the Cash LTI Plan, participants must remain employed by the Company as of the applicable award vesting date. Executives and non-employee Board members are not participating in this program. During the three and six months ended December 31, 2012, the Company recognized $3.5 million in compensation expense under the Cash LTI program. As of December 31, 2012, the unrecognized compensation balance related to the Cash LTI program was $56.4 million, excluding the impact of estimated forfeitures.

Employee Stock Purchase Plan

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

Effective January 1, 2010, the offering period (or length of the look-back period) under the ESPP has a duration of six months, and the purchase price with respect to each offering period beginning on or after such date is, until otherwise amended, equal to 85% of the lesser of (i) the fair market value of the Company’s common stock at the commencement of the applicable six-month offering period or (ii) the fair market value of the Company’s common stock on the purchase date.

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

	Three months ended December 31,		Six months ended December 31,	
	2012	2011	2012	2011
Stock purchase plan:				
Expected stock price volatility	30.2 %	32.7 %	30.2 %	32.7 %
Risk-free interest rate	0.1 %	0.1 %	0.1 %	0.1 %
Dividend yield	3.3 %	3.4 %	3.3 %	3.4 %
Expected life of options (in years)	0.5	0.5	0.5	0.5

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

(In thousands, except for weighted-average fair value per share)	Three months ended December 31,		Six months ended December 31,	
	2012	2011	2012	2011
Total cash received from employees for the issuance of shares under the ESPP	$20,139	$19,195	$20,139	$19,195
Number of shares purchased by employees through the ESPP	496	545	496	545
Tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP	$68	$368	$674	$843
Weighted-average fair value per share based on Black-Scholes model	$10.54	$9.16	$10.54	$9.16

The ESPP shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. As of December 31, 2012, a total of 2.1 million shares were reserved and available for issuance under the ESPP. As of the date of this report, no additional shares have been added to the ESPP with respect to the fiscal year ending June 30, 2013.

NOTE 8 – STOCK REPURCHASE PROGRAM

Since July 1997, the Board of Directors has authorized the Company to systematically repurchase in the open market up to 80.8 million shares of its common stock under a repurchase program, including 8.0 million shares authorized in November 2012. The intent of this program is to offset the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, as well as to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases will be made from time to time in the open market in compliance with applicable securities laws, including the Securities Exchange Act of 1934 and the rules promulgated thereunder, such as Rule 10b-18. As of December 31, 2012, 8.4 million shares were available for repurchase under the Company's repurchase program.

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2012	2011	2012	2011
Number of shares of common stock repurchased	1,465	1,396	2,826	3,159
Total cost of repurchases	$68,283	$63,106	$136,600	$130,088

NOTE 9 – NET INCOME PER SHARE

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

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(In thousands, except per share amounts)	Three months ended December 31,		Six months ended December 31,	
	2012	2011	2012	2011
Numerator:				
Net income	$106,630	$110,797	$241,997	$302,792
Denominator:				
Weighted-average shares-basic, excluding unvested restricted stock units	166,268	166,343	166,632	166,513
Effect of dilutive options and restricted stock units	2,808	2,760	3,070	3,137
Weighted-average shares-diluted	169,076	169,103	169,702	169,650
Basic net income per share	$0.64	$0.67	$1.45	$1.82
Diluted net income per share	$0.63	$0.66	$1.43	$1.78
Anti-dilutive securities excluded from the computation of diluted net income per share	1,618	3,610	1,830	4,338

The total amount of dividends paid during the three months ended December 31, 2012 and 2011 was $66.5 million and $58.1 million, respectively. The total amount of dividends paid during the six months ended December 31, 2012 and 2011 was $133.2 million and $116.6 million, respectively.

NOTE 10 – INCOME TAXES

The following table provides details of income taxes:

(Dollar amounts in thousands)	Three months ended December 31,		Six months ended December 31,	
	2012	2011	2012	2011
Income before income taxes	$144,874	$146,907	$321,416	$394,169
Provision for income taxes	$38,244	$36,110	$79,419	$91,377
Effective tax rate	26.4 %	24.6 %	24.7 %	23.2 %

The Company’s estimated annual effective tax rate for the fiscal year ending June 30, 2013 is approximately 26.0%. Tax expense, as a percentage of income, was substantially equivalent during the three months ended December 31, 2012 to the Company's estimated annual effective tax rate.

Tax expense was higher as a percentage of income during the three months ended December 31, 2012 compared to the three months ended December 31, 2011 primarily due to the tax impact of the following items:

- The U.S. federal research credit expired on December 31, 2011. The federal research credit decreased tax expense by $2.6 million during the three months ended December 31, 2011;
- Tax expense was increased by $8.7 million during the three months ended December 31, 2012 due to a decrease in the proportion of the Company's earnings generated in jurisdictions with tax rates lower than the U.S. statutory tax rate; and
- Tax expense was decreased by $8.6 million during the three months ended December 31, 2012 related to windfalls from employee stock activity. The Company incurred a tax benefit of $3.5 million due to windfalls from employee stock activity during the three months ended December 31, 2012 compared to a tax expense of $5.1 million due to shortfalls from employee stock activity during the three months ended December 31, 2011.

Tax expense was higher as a percentage of income during the six months ended December 31, 2012 compared to the six months ended December 31, 2011 primarily due to the tax impact of the following items:

- The U.S. federal research credit expired on December 31, 2011. The federal research credit decreased tax expense by $5.8 million during the six months ended December 31, 2011;
- Tax expense was increased by $7.9 million during the six months ended December 31, 2012 due to a decrease in the proportion of the Company's earnings generated in jurisdictions with tax rates lower than the U.S. statutory tax rate;
- Tax expense was decreased by $8.7 million during the six months ended December 31, 2012 related to windfalls from employee stock activity. The Company incurred a tax benefit of $3.5 million due to windfalls from employee stock activity during the six months ended December 31, 2012 compared to a tax expense of $5.2 million due to shortfalls from employee stock activity during the six months ended December 31, 2011;

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- Tax expense was decreased by $4.7 million during the six months ended December 31, 2012 related to a non-taxable increase in the value of the assets held within the Company's Executive Deferred Savings Plan. The Company incurred a tax benefit of $2.2 million due to a non-taxable increase in the value of the assets held within that plan during the six months ended December 31, 2012 compared to a tax expense of $2.5 million due to a non-deductible decrease in the value of the assets held within the plan during the six months ended December 31, 2011;
- Tax expense was decreased by $18.3 million during the six months ended December 31, 2011 resulting from a decrease in the Company's unrecognized tax benefits due to the settlement of a U.S. federal income tax examination;
- Tax expense was decreased by $18.0 million during the six months ended December 31, 2011 resulting from a decrease in reserves for uncertain tax positions taken in prior years; and
- Tax expense was increased by $23.6 million during the six months ended December 31, 2011 related to a migration of a portion of the Company's manufacturing to Singapore.

On January 2, 2013, President Barack Obama signed into law the American Taxpayer Relief Act of 2012, which reinstated the research tax credit retroactive to January 1, 2012 and extended the credit through December 31, 2013. As a result of the new legislation, the Company expects to recognize a tax benefit of $16.4 million during the three months ending March 31, 2013.

In the normal course of business, the Company is subject to examination by tax authorities throughout the world. The Company is subject to U.S. federal income tax examination for all years beginning from the fiscal year ended June 30, 2010. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2007. The Company is also subject to examinations in other major foreign jurisdictions, including Singapore, for all years beginning from the fiscal year ended June 30, 2007. It is possible that certain examinations may be concluded in the next twelve months. The Company believes it is possible that it may recognize up to $1.7 million of its existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of examinations with various tax authorities.

NOTE 11 – LITIGATION AND OTHER LEGAL MATTERS

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

NOTE 12 – COMMITMENTS AND CONTINGENCIES

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

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2012	2011	2012	2011
Receivables sold under factoring agreements	$37,026	$81,606	$85,560	$250,330
Proceeds from sales of LCs	$—	$—	$—	$4,510

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

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Facilities. KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was $2.4 million and $2.2 million for the three months ended December 31, 2012 and 2011, respectively. Rent expense was $4.6 million and $4.5 million for the six months ended December 31, 2012 and 2011, respectively.
The following is a schedule of expected operating lease payments:

Fiscal year ending June 30,	Amount (In thousands)
2013 (remaining 6 months)	$4,364
2014	7,021
2015	4,494
2016	3,631
2017	3,139
2018 and thereafter	2,879
Total minimum lease payments	$25,528

Purchase Commitments. KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply for key components. The Company’s liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company’s open inventory purchase commitments were approximately $179.4 million as of December 31, 2012 and are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.
Cash Long-Term Incentive Plan. As of December 31, 2012, the Company had committed $60.3 million to future payment obligations under its Cash LTI program. The calculation of compensation expense related to the Cash LTI Plan will include estimated forfeiture rate assumptions. Cash LTI awards issued to employees under the Cash LTI Plan will vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under the Cash LTI Plan, participants must remain employed by the Company as of the applicable award vesting date.
Guarantees. KLA-Tencor provides standard warranty coverage on its systems for 40 hours per week for 12 months, providing labor and parts necessary to repair the systems during the warranty period. The Company accounts for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. Utilizing actual service records, the Company calculates the average service hours and parts expense per system and applies the actual labor and overhead rates to determine the estimated warranty charge. The Company updates these estimated charges on a quarterly basis. The actual product performance and/or field expense profiles may differ, and in those cases the Company adjusts its warranty accruals accordingly.
The following table provides the changes in the product warranty accrual for the indicated periods:

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2012	2011	2012	2011
Beginning balance	$46,192	$43,603	$46,497	$41,528
Accruals for warranties issued during the period	9,862	10,110	20,508	21,402
Changes in liability related to pre-existing warranties	(620)	540	1,732	2,930
Settlements made during the period	(13,516)	(10,777)	(26,819)	(22,384)
Ending balance	$41,918	$43,476	$41,918	$43,476

The Company maintains guarantee arrangements available through various financial institutions for up to $25.0 million, of which $23.1 million had been issued as of December 31, 2012, primarily to fund guarantees to customs authorities for value-added tax (“VAT”) and other operating requirements of the Company’s subsidiaries in Europe and Asia.

KLA-Tencor is a party to a variety of agreements pursuant to which it may be obligated to indemnify the other party with respect to certain matters. Typically, these obligations arise in connection with contracts and license agreements or the sale of assets, under which the Company customarily agrees to hold the other party harmless against losses arising from, or provides customers with other remedies to protect against, bodily injury or damage to personal property caused by the Company's

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

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

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

NOTE 13 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

KLA-Tencor’s foreign subsidiaries operate and sell KLA-Tencor’s products in various global markets. As a result, KLA-Tencor is exposed to risks relating to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts and option contracts to hedge against future movements in foreign exchange rates that affect certain existing and forecasted foreign currency denominated sales and purchase transactions, such as the Japanese yen, the euro and the Israeli new shekel. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes. The Company routinely hedges its exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations. These currency forward exchange contracts and options, designated as cash flow hedges, generally have maturities of less than 18 months. Cash flow hedges are evaluated for effectiveness monthly, based on changes in total fair value of the derivatives. If a financial counterparty to any of the Company’s hedging arrangements experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, the Company may experience material losses.

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

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

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Derivatives in Cash Flow Hedging Relationships: Foreign Exchange Contracts

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

(In thousands)	Location in Financial Statements	Three months ended December 31, 2012	Three months ended December 31, 2011	Six months ended December 31, 2012	Six months ended December 31, 2011
Derivatives Designated as Hedging Instruments					
Gains (losses) in accumulated OCI on derivatives (effective portion)	Accumulated OCI	$2,242	$(223)	$2,001	$(1,417)
Gains (losses) reclassified from accumulated OCI into income (effective portion):	Revenues	$(82)	$(689)	$(574)	$(973)
	Costs of revenues	210	(13)	(390)	48
	Total gains (losses) reclassified from accumulated OCI into income (effective portion)	$128	$(702)	$(964)	$(925)
Gains (losses) recognized in income on derivatives (ineffectiveness portion and amount excluded from effectiveness testing)	Interest income and other, net	$(40)	$57	$11	$99
Derivatives Not Designated as Hedging Instruments					
Gains (losses) recognized in income	Interest income and other, net	$9,220	$758	$9,894	$(11,810)

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

(In thousands)	As of December 31, 2012	As of June 30, 2012
Cash flow hedge contracts		
Purchase	$14,722	$14,689
Sell	$30,752	$29,362
Other foreign currency hedge contracts		
Purchase	$118,588	$121,965
Sell	$94,406	$126,827

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

	Asset Derivatives			Liability Derivatives		
	Balance Sheet Location	As of December 31, 2012	As of June 30, 2012	Balance Sheet Location	As of December 31, 2012	As of June 30, 2012
(In thousands)		Fair Value			Fair Value	
Derivatives designated as hedging instruments						
Foreign exchange contracts	Other current assets	$2,322	$128	Other current liabilities	$—	$736
Total derivatives designated as hedging instruments		$2,322	$128		$—	$736
Derivatives not designated as hedging instruments						
Foreign exchange contracts	Other current assets	$3,847	$1,279	Other current liabilities	$870	$1,173
Total derivatives not designated as hedging instruments		$3,847	$1,279		$870	$1,173
Total derivatives		$6,169	$1,407		$870	$1,909

The following table provides the balances and changes in accumulated other comprehensive income (loss), before taxes, related to derivative instruments for the indicated periods:

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2012	2011	2012	2011
Beginning balance	$(111)	$(959)	$(962)	$12
Amount reclassified to income	(128)	702	964	925
Net change	2,242	(223)	2,001	(1,417)
Ending balance	$2,003	$(480)	$2,003	$(480)

NOTE 14 – RELATED PARTY TRANSACTIONS

During the three and six months ended December 31, 2012 and 2011, the Company purchased from, or sold to, several entities, where one or more executive officers of the Company or members of the Company's Board of Directors, or their immediate family members, also serves as an executive officer or board member, including Cisco Systems, Inc., Freescale Semiconductor, Inc. and Avago Technologies Ltd. The following table provides the transactions with these parties for the indicated periods (for the portion of such period that they were considered related):

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2012	2011	2012	2011
Total revenues	$1,899	$88	$4,771	$125
Total purchases	$69	$2,179	$2,452	$4,271

The Company had a receivable balance from these parties of $0.9 million and $1.9 million as of December 31, 2012 and June 30, 2012, respectively. Management believes that such transactions are at arm's length and on similar terms as would have been obtained from unaffiliated third parties.

NOTE 15 – SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

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

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The Company is engaged primarily in designing, manufacturing, and marketing process control and yield management solutions for the semiconductor and related nanoelectronics industries. All operating segments have been aggregated due to their inter-dependencies, commonality of long-term economic characteristics, products and services, the production processes, class of customer and distribution processes. The Company's service products are an extension of the system product portfolio and provide customers with spare parts and fab management services (including system preventive maintenance and optimization services) to improve yield, increase production uptime and throughput, and lower the cost of ownership. Since the Company operates in one segment, all financial segment information required by the authoritative guidance can be found in the condensed consolidated financial statements.
The Company's significant operations outside the United States include manufacturing facilities in Israel and Singapore, and sales, marketing and service offices in Western Europe, Japan and the Asia Pacific regions. For geographical revenue reporting, revenues are attributed to the geographic location in which the customer is located. Long-lived assets consist 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, based on ship-to location, for the indicated periods (as a percentage of total revenues):

	Three months ended December 31,						Six months ended December 31,					
(Dollar amounts in thousands)	2012			2011			2012			2011		
Revenues:												
United States	$169,629	25	%	$160,484	25	%	$319,617	23	%	$358,727	25	%
Taiwan	223,493	33	%	169,015	26	%	499,792	36	%	392,305	27	%
Japan	92,849	14	%	110,321	17	%	181,564	13	%	245,136	17	%
Europe & Israel	59,753	9	%	69,270	11	%	118,913	9	%	162,266	11	%
Korea	57,259	9	%	61,979	10	%	127,506	9	%	141,577	10	%
Rest of Asia	70,028	10	%	71,413	11	%	146,328	10	%	138,947	10	%
Total	$673,011	100	%	$642,482	100	%	$1,393,720	100	%	$1,438,958	100	%

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

	Three months ended December 31,						Six months ended December 31,					
(Dollar amounts in thousands)	2012			2011			2012			2011		
Revenues:												
Defect inspection	$367,696	55	%	$343,588	54	%	$756,184	54	%	$787,556	55	%
Metrology	116,600	17	%	131,621	20	%	259,083	19	%	313,298	22	%
Service	149,988	22	%	141,823	22	%	296,619	21	%	288,043	20	%
Other	38,727	6	%	25,450	4	%	81,834	6	%	50,061	3	%
Total	$673,011	100	%	$642,482	100	%	$1,393,720	100	%	$1,438,958	100	%

One customer accounted for greater than 10% of total revenues for the three months ended December 31, 2012. Two customers each accounted for greater than 10% of total revenues for the three months ended December 31, 2011 and six months ended December 31, 2012. Three customers each accounted for greater than 10% of total revenues for the six months ended December 31, 2011. Two customers each accounted for greater than 10% of net accounts receivable as of December 31, 2012 and June 30, 2012.

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

(In thousands)	As of December 31, 2012	As of June 30, 2012
Long-lived assets:		
United States	$211,275	$211,315
Japan	3,450	3,570
Europe & Israel	77,877	77,292
Korea	3,198	2,773
Singapore	44,685	43,528
Rest of Asia	4,324	3,887
Total	$344,809	$342,365

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

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward-looking statements. You can identify these and other forward-looking statements by the use of words such as “may,” “will,” “could,” “would,” “should,” “expects,” “plans,” “anticipates,” “relies,” “believes,” “estimates,” “predict “potential,” “continue,” “thinks,” “seeks,” or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Such forward-looking statements include, among others, forecasts of the future results of our operations; orders for our products and capital equipment generally; sales of semiconductors; the allocation of capital spending by our customers (and, in particular, the percentage of spending that our customers allocate to process control); growth of revenue in the semiconductor industry, the semiconductor capital equipment industry and our business; technological trends in the semiconductor industry; future developments or trends in the global capital and financial markets; our future product offerings and product features; the success and market acceptance of new products; timing of shipment of backlog; the future of our product shipments and our product and service revenues; our future gross margins; our future research and development expenses and selling, general and administrative expenses; our ability to successfully maintain cost discipline; international sales and operations; our ability to maintain or improve our existing competitive position; success of our product offerings; creation and funding of programs for research and development; attraction and retention of employees; results of our investment in leading edge technologies; the effects of hedging transactions; the effect of the sale of trade receivables and promissory notes from customers; our future income tax rate; future payments of dividends to our stockholders; 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 Part II, Item 1A, “Risk Factors” in this report as well as in Item 1, “Business” and Item 7, “Management's Discussion and Analysis of Financial Condition and Results of Operations” in our Annual Report on Form 10-K for the year ended June 30, 2012, filed with the Securities and Exchange Commission on August 6, 2012. You should carefully review these risks and also review the risks described in other documents we file from time to time with the Securities and Exchange Commission. You are cautioned not to place undue reliance on these forward-looking statements, and we expressly assume no obligation and do not intend to update the forward-looking statements in this report after the date hereof.

EXECUTIVE SUMMARY

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

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

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

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

During the three months ended December 31, 2012, our customers, particularly from the foundry market, resumed higher levels of purchases of process control and yield management equipment to achieve their technology and capacity plans, as the growth in the demand for mobile devices and new consumer products increases the demand for semiconductor products. While we expect that the resumption of higher levels of new orders in the three months ended December 31, 2012 is likely to generate increased revenue levels in the March quarter, revenues during the three months ended December 31, 2012 decreased compared to the prior quarter as a result of the low level of demand and new orders for process control and yield management equipment in the September quarter. We believe that, over the long term, our customers will continue to invest in advanced technologies and new materials to enable smaller design rules and new process technologies to deliver higher performance semiconductor capability at lower costs. We expect that these dynamics will drive long-term increased adoption of process control equipment and services that reduce semiconductor defectivity and improve manufacturing yields, leaving the longer-term drivers underlying growth in our industry intact.

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

	Three months ended					
(In thousands, except net income per share)	December 31, 2012	September 30, 2012	June 30, 2012	March 31, 2012	December 31, 2011	September 30, 2011
Total revenues	$673,011	$720,709	$892,465	$840,521	$642,482	$796,476
Total costs and operating expenses	$519,764	$534,152	$574,166	$556,247	$483,019	$542,187
Gross margin	$369,096	$403,484	$530,802	$485,372	$369,627	$456,127
Income from operations	$153,247	$186,557	$318,299	$284,274	$159,463	$254,289
Net income	$106,630	$135,367	$247,877	$205,346	$110,797	$191,995
Net income per share:						
Basic [(1)]	$0.64	$0.81	$1.48	$1.23	$0.67	$1.15
Diluted [(1)]	$0.63	$0.80	$1.46	$1.21	$0.66	$1.13

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

CRITICAL ACCOUNTING ESTIMATES AND POLICIES

The preparation of our Condensed Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions in applying our accounting policies that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. Note 1 to the Consolidated Financial Statements in our Annual Report on Form 10-K for the fiscal year ended June 30, 2012 describes the significant accounting policies and methods used in preparation of the Consolidated Financial Statements. We base these estimates and assumptions on historical experience, and evaluate them on an on-going basis to ensure that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed our related disclosure in this Quarterly Report on Form 10-Q. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

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- Revenue Recognition
- Inventories
- Warranty
- Allowance for Doubtful Accounts
- Equity and Long-Term Incentive Compensation Plans
- Contingencies and Litigation
- Goodwill and Intangible Assets
- Income Taxes

There were no significant changes in our critical accounting estimates and policies during the three months ended December 31, 2012. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our fiscal year ended June 30, 2012 for a more complete discussion of our critical accounting policies and estimates.

Valuation of Goodwill and Intangible Assets

We have four reporting units: Defect Inspection, Metrology, Service and Other. As of December 31, 2012, substantially all of the goodwill balance resided in the Defect Inspection reporting unit. The fair value of each of our reporting units was substantially in excess of its estimated carrying amount as of the most recent quantitative analysis of goodwill impairment performed in the three months ended December 31, 2010. There have been no triggering events or changes in circumstances since that quantitative analysis to indicate that the fair value of any of the Company's reporting units would be less than its carrying amount.

We performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2012 during the three months ended December 31, 2012 and concluded that there was no impairment. We assess goodwill for impairment annually as well as whenever events or changes in circumstances indicate that the carrying amount of goodwill in any reporting unit may not be recoverable. Long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that the assets' carrying amount may not be recoverable.

Our next annual evaluation of the goodwill by reporting unit will be performed during the three months ending December 31, 2013. If we were to encounter challenging economic conditions, such as a decline in our operating results, an unfavorable industry or macroeconomic environment, a substantial decline in our stock price, or any other adverse change in market conditions, we may be required to perform the two-step quantitative goodwill impairment analysis. In addition, if such conditions have the effect of changing one of the critical assumptions or estimates we use to calculate the value of our goodwill or intangible assets, we may be required to record goodwill and/or intangible asset impairment charges in future periods, whether in connection with our next annual impairment assessment in the second quarter of fiscal year 2014 or prior to that, if any triggering event occurs outside of the quarter during which the annual goodwill impairment assessment is performed. It is not possible at this time to determine if any such future impairment charge would result or, if it does, whether such charge would be material to our results of operations.

Revenue Recognition

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

Recent Accounting Pronouncements

In September 2011, the Financial Accounting Standards Board ("FASB") issued an accounting standard update intended to simplify testing goodwill for impairment. The amendments allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. An entity is no longer required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that the fair value of the reporting unit is less than its carrying amount. The amendment, by its terms, became effective for annual and interim goodwill impairment tests performed for our fiscal year ending June 30, 2013, and early adoption was

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permitted. We elected to early adopt this accounting guidance at the beginning of the three months ended December 31, 2011 (see Note 5, "Goodwill and Purchased Intangible Assets," to the Condensed Consolidated Financial Statements for a detailed description).

In June 2011, the FASB issued an accounting standard update requiring an increase in the prominence of items reported in other comprehensive income. The amendment eliminated the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity and required that the total of comprehensive income, the components of net income, and the components of other comprehensive income be presented in a single continuous statement of comprehensive income or in two separate but consecutive statements. The amendment also required presentation of adjustments for items that are reclassified from other comprehensive income in the statement where the components of net income and the components of other comprehensive income are presented, but that requirement was indefinitely deferred by the FASB in December 2011. The amendment (other than the portion regarding the presentation of reclassification adjustments which, as noted above, has been deferred indefinitely) became effective for our interim period ended September 30, 2012. The amendment did not have an impact on our financial position, results of operations or cash flows as it is disclosure-only in nature.

RESULTS OF OPERATIONS

Revenues and Gross Margin

(Dollar amounts in thousands)	Three months ended December 31, 2012	September 30, 2012	December 31, 2011	Q2 FY13 vs. Q1 FY13		Q2 FY13 vs. Q2 FY12	
Revenues:							
Product	$523,023	$574,078	$500,659	$(51,055)	(9)%	$22,364	4 %
Service	149,988	146,631	141,823	3,357	2 %	8,165	6 %
Total revenues	$673,011	$720,709	$642,482	$(47,698)	(7)%	$30,529	5 %
Costs of revenues	$303,915	$317,225	$272,855	$(13,310)	(4)%	$31,060	11 %
Gross margin percentage	55 %	56 %	58 %				

(Dollar amounts in thousands)	Six months ended December 31, 2012	December 31, 2011	Q2 FY13 YTD vs. Q2 FY12 YTD	
Revenues:				
Product	$1,097,101	$1,150,915	$(53,814)	(5)%
Service	296,619	288,043	8,576	3 %
Total revenues	$1,393,720	$1,438,958	$(45,238)	(3)%
Costs of revenues	$621,140	$613,204	$7,936	1 %
Gross margin percentage	55 %	57 %		

Product revenues

Our business is cyclical with respect to the capital equipment procurement practices of semiconductor manufacturers, with revenues impacted by the investment patterns of such manufacturers. Our product revenues in any particular quarter are significantly impacted by the amount of new orders that we receive during that quarter and, due to the duration of manufacturing and installation cycles, in the preceding quarters.

Product revenues decreased during the three months ended December 31, 2012 compared to the three months ended September 30, 2012, as customers reduced their purchases of process control and yield management equipment during the three months ended September 30, 2012 in response to the cyclical industry factors affecting our foundry and logic customers and the challenging demand environment for our memory customers. The reduction in demand for process control and yield management equipment during the three months ended September 30, 2012, and the consequent decline in backlog at the beginning of the three months ended December 31, 2012 compared to the prior quarter, resulted in a lower level of product revenues during the three months ended December 31, 2012 compared to the three months ended September 30, 2012.

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Product revenues increased during the three months ended December 31, 2012 compared to the three months ended December 31, 2011 as a result of strong foundry demand and higher level of products installed and accepted by customers in Taiwan during the three months ended December 31, 2012, as well as higher revenue deferrals associated with customers with liquidity challenges in the three months ended December 31, 2011.
Product revenues decreased during the six months ended December 31, 2012 compared to the six months ended December 31, 2011, primarily due to lower levels of revenue and shipment backlogs at the beginning of the period, as well as to a lower level of orders received within the period, as a result of a weaker demand environment.

Service revenues

Service revenues are generated from maintenance contracts, as well as billable time and material service calls made to our customers after the expiration of the warranty period. The amount of service revenues is typically a function of the number of post-warranty systems installed at our customers' sites and the utilization of those systems. Service revenues during the three and six months ended December 31, 2012 increased compared to the three months ended September 30, 2012 and three and six months ended December 31, 2011, respectively, primarily due to an increase in the number of post-warranty systems installed at our customers' sites.

Revenues by region

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

(Dollar amounts in thousands)	Three months ended								
	December 31, 2012			September 30, 2012			December 31, 2011		
United States	$169,629	25	%	$149,988	21	%	$160,484	25	%
Taiwan	223,493	33	%	276,299	38	%	169,015	26	%
Japan	92,849	14	%	88,715	12	%	110,321	17	%
Europe & Israel	59,753	9	%	59,160	8	%	69,270	11	%
Korea	57,259	9	%	70,247	10	%	61,979	10	%
Rest of Asia	70,028	10	%	76,300	11	%	71,413	11	%
Total	$673,011	100	%	$720,709	100	%	$642,482	100	%

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

Gross margin

Our gross margin fluctuates with revenue levels and product mix and is affected by variations in costs related to manufacturing and servicing our products, including our ability to scale our operations efficiently and effectively in response to prevailing business conditions. Over the past several years, we have embarked on various advanced product development, customer satisfaction improvement and globalization initiatives to improve our competitiveness and gross margins.

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

	Gross Margin Percentage	
	Three months ended	
September 30, 2012	56.0	%
Revenue volume of products and service	(1.0	)%
Mix of products and services sold	1.8	%
Manufacturing labor, overhead and efficiencies	0.3	%
Other service and manufacturing costs	(2.3	)%

	Gross Margin Percentage			
	Three months ended		Six months ended	
December 31, 2011	57.5	%	57.4	%
Revenue volume of products and service	(1.0	)%	(0.5	)%
Mix of products and services sold	0.1	%	(0.7	)%
Manufacturing labor, overhead and efficiencies	0.7	%	0.3	%
Other service and manufacturing costs	(2.5	)%	(1.1	)%

December 31, 2012	54.8	%	December 31, 2012	54.8	%	55.4	%

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

Our gross margin declined to 54.8% during the three months ended December 31, 2012 from 56.0% during the three months ended September 30, 2012, primarily due to lower revenue volume and an increase in inventory reserves, partially offset by a more favorable mix of products sold. The increase in inventory reserves was attributable to the acceleration of certain product transitions and higher inventory levels associated with faster product delivery lead times and service response time commitments to customers.

Our gross margin declined to 54.8% during the three months ended December 31, 2012 from 57.5% during the three months ended December 31, 2011, primarily due to lower revenue volume, in the form of slightly lower manufacturing capacity utilization, as well as an increase in inventory reserves attributable to the acceleration of certain product transitions and higher inventory levels associated with faster product delivery lead times and service response time commitments to customers.

Our gross margin declined to 55.4% during the six months ended December 31, 2012 from 57.4% during the six months ended December 31, 2011, primarily due to a less favorable mix of product and service sales and an increase in inventory reserves attributable to certain product transitions and higher inventory levels associated with faster product delivery lead times and service response time commitments to customers.

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

	Three months ended						
(Dollar amounts in thousands)	December 31, 2012	September 30, 2012	December 31, 2011	Q2 FY13 vs. Q1 FY13			Q2 FY13 vs. Q2 FY12
R&D expenses	$121,608	$ 119,742	$ 116,363	$1,866	2	%	$