

KLA TENCOR CORP  
Form 10-Q  
October 20, 2016  
Table of Contents

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

FORM 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2016

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

One Technology Drive, Milpitas, California 95035  
(Address of Principal Executive Offices) (Zip Code)  
(408) 875-3000  
(Registrant's telephone number, including area code)

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

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

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

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

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

As of October 10, 2016, there were 156,318,732 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

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Table of Contents

## INDEX

	Page Number
PART I FINANCIAL INFORMATION	
Item 1 <u>Financial Statements (Unaudited)</u>	
<u>Condensed Consolidated Balance Sheets as of September 30, 2016 and June 30, 2016</u>	<u>3</u>
<u>Condensed Consolidated Statements of Operations for the Three Months Ended September 30, 2016 and 2015</u>	<u>4</u>
<u>Condensed Consolidated Statements of Comprehensive Income for the Three Months Ended September 30, 2016 and 2015</u>	<u>5</u>
<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended September 30, 2016 and 2015</u>	<u>6</u>
<u>Notes to Condensed Consolidated Financial Statements</u>	<u>7</u>
Item 2 <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>33</u>
Item 3 <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>51</u>
Item 4 <u>Controls and Procedures</u>	<u>52</u>
PART II OTHER INFORMATION	
Item 1 <u>Legal Proceedings</u>	<u>53</u>
Item 1A <u>Risk Factors</u>	<u>53</u>
Item 2 <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>70</u>
Item 3 <u>Defaults Upon Senior Securities</u>	<u>70</u>
Item 4 <u>Mine Safety Disclosures</u>	<u>70</u>
Item 5 <u>Other Information</u>	<u>70</u>
Item 6 <u>Exhibits</u>	<u>71</u>
<u>SIGNATURES</u>	<u>72</u>
<u>EXHIBIT INDEX</u>	<u>73</u>

Table of Contents

## PART I. FINANCIAL INFORMATION

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

(In thousands)	September 30, 2016	June 30, 2016
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 966,325	\$ 1,108,488
Marketable securities	1,528,296	1,382,806
Accounts receivable, net	654,699	613,233
Inventories	703,262	698,635
Other current assets	76,580	64,870
Total current assets	3,929,162	3,868,032
Land, property and equipment, net	272,351	278,014
Goodwill	335,198	335,177
Deferred income taxes	267,793	302,219
Purchased intangibles, net	3,065	4,331
Other non-current assets	188,529	174,659
Total assets	\$ 4,996,098	\$ 4,962,432
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 105,066	\$ 106,517
Deferred system profit	185,640	174,551
Unearned revenue	54,841	59,147
Other current liabilities	629,194	662,208
Total current liabilities	974,741	1,002,423
Non-current liabilities:		
Long-term debt	3,018,567	3,057,936
Unearned revenue	60,279	56,336
Other non-current liabilities	161,002	156,623
Total liabilities	4,214,589	4,273,318
Commitments and contingencies (Note 11 and Note 12)		
Stockholders' equity:		
Common stock and capital in excess of par value	447,018	452,974
Retained earnings	381,124	284,825
Accumulated other comprehensive income (loss)	(46,633	) (48,685 )
Total stockholders' equity	781,509	689,114
Total liabilities and stockholders' equity	\$ 4,996,098	\$ 4,962,432

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

Table of Contents

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

(In thousands, except per share amounts)	Three months ended	
	2016	2015
Revenues:		
Product	\$561,753	\$460,739
Service	188,920	181,905
Total revenues	750,673	642,644
Costs and expenses:		
Costs of revenues	277,836	270,244
Research and development	129,233	119,943
Selling, general and administrative	94,388	91,663
Interest expense	30,732	30,564
Other expense (income), net	(3,736 )	(4,069 )
Income before income taxes	222,220	134,299
Provision for income taxes	44,119	29,402
Net income	\$178,101	\$104,897
Net income per share:		
Basic	\$1.14	\$0.67
Diluted	\$1.13	\$0.66
Cash dividends declared per share	\$0.52	\$0.52
Weighted-average number of shares:		
Basic	156,129	156,820
Diluted	157,021	157,984

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

Table of Contents

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

(In thousands)	Three months ended	
	September 30, 2016	2015
Net income	\$ 178,101	\$ 104,897
Other comprehensive income (loss):		
Currency translation adjustments:		
Change in currency translation adjustments	3,924	(6,124 )
Change in income tax benefit or expense	782	1,384
Net change related to currency translation adjustments	4,706	(4,740 )
Cash flow hedges:		
Change in net unrealized gains or losses	(1,838 )	(1,861 )
Reclassification adjustments for net gains or losses included in net income	1,379	(402 )
Change in income tax benefit or expense	165	814
Net change related to cash flow hedges	(294 )	(1,449 )
Net change related to unrecognized losses and transition obligations in connection with defined benefit plans	245	230
Available-for-sale securities:		
Change in net unrealized gains or losses	(2,877 )	481
Reclassification adjustments for net gains or losses included in net income	(204 )	(17 )
Change in income tax benefit or expense	476	(69 )
Net change related to available-for-sale securities	(2,605 )	395
Other comprehensive income (loss)	2,052	(5,564 )
Total comprehensive income	\$ 180,153	\$ 99,333

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

Table of Contents

## KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Cash Flows  
(Unaudited)

(In thousands)	Three months ended	
	September 30, 2016	2015
Cash flows from operating activities:		
Net income	\$ 178,101	\$ 104,897
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	14,422	19,735
Asset impairment charges	358	—
Non-cash stock-based compensation expense	11,478	12,248
Excess tax benefit from equity awards	—	(10,159 )
Net gain on sales of marketable securities and other investments	(204 )	(1,233 )
Changes in assets and liabilities:		
Decrease (increase) in accounts receivable, net	(38,241 )	124,925
Decrease (increase) in inventories	1,187	(31,243 )
Decrease in other assets	19,477	34,381
Increase (decrease) in accounts payable	(1,547 )	4,158
Increase (decrease) in deferred system profit	11,089	(14,504 )
Decrease in other liabilities	(26,343 )	(49,423 )
Net cash provided by operating activities	169,777	193,782
Cash flows from investing activities:		
Acquisition of non-marketable securities	(1,470 )	—
Capital expenditures, net	(9,883 )	(7,341 )
Purchases of available-for-sale securities	(457,512 )	(343,358 )
Proceeds from sale of available-for-sale securities	111,106	200,353
Proceeds from maturity of available-for-sale securities	197,100	184,973
Purchases of trading securities	(52,465 )	(18,267 )
Proceeds from sale of trading securities	45,301	15,540
Net cash provided by (used in) investing activities	(167,823 )	31,900
Cash flows from financing activities:		
Repayment of debt	(40,000 )	(40,000 )
Tax withholding payments related to vested and released restricted stock units	(17,376 )	(21,526 )
Common stock repurchases	—	(142,592 )
Payment of dividends to stockholders	(89,313 )	(101,674 )
Excess tax benefit from equity awards	—	10,159
Net cash used in financing activities	(146,689 )	(295,633 )
Effect of exchange rate changes on cash and cash equivalents	2,572	(4,377 )
Net decrease in cash and cash equivalents	(142,163 )	(74,328 )
Cash and cash equivalents at beginning of period	1,108,488	838,025
Cash and cash equivalents at end of period	\$ 966,325	\$ 763,697
Supplemental cash flow disclosures:		
Income taxes paid, net	\$ 39,411	\$ 7,844
Interest paid	\$ 3,243	\$ 3,149
Non-cash activities:		
Purchase of land, property and equipment - investing activities	\$ 1,974	\$ 1,490
Unsettled common stock repurchase - financing activities	\$ —	\$ 9,610
Dividends payable - financing activities	\$ 12,045	\$ 20,892

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

6

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Table of Contents

KLA-TENCOR CORPORATION

Notes to Condensed Consolidated Financial Statements  
(Unaudited)

NOTE 1 – DESCRIPTION OF BUSINESS AND BASIS OF PRESENTATION

Description of Business. KLA-Tencor Corporation (“KLA-Tencor” or the “Company”) is a leading supplier of process control and yield management solutions for the semiconductor and related nanoelectronics industries. KLA-Tencor’s broad portfolio of inspection and metrology products, and related service, software and other offerings primarily supports integrated circuit, which is referred to as an “IC” or “chip,” manufacturers throughout the entire semiconductor fabrication process, from research and development to final volume production. KLA-Tencor provides 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, KLA-Tencor also provides a range of technology solutions to a number of other high technology industries, including the LED and data storage industries, as well as general materials research. Headquartered in Milpitas, California, KLA-Tencor has subsidiaries both in the United States and in key markets throughout the world.

Merger Agreement. On October 20, 2015, the Company entered into an Agreement and Plan of Merger and Reorganization (the “Merger Agreement” or “Merger”) with Lam Research Corporation (“Lam Research”) which was subject to regulatory approvals. On October 5, 2016, the parties mutually agreed to terminate the Merger Agreement. See Note 17, “Subsequent Events” for additional details.

Basis of Presentation. The condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations, comprehensive income, and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, “Financial Statements and Supplementary Data” included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2016, filed with the SEC on August 5, 2016.

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

The results of operations for the three months ended September 30, 2016 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, 2017.

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 prior year’s Condensed Consolidated Statements of Operations, Comprehensive Income and Cash Flows.

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

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

• When the customer fab has previously accepted the same tool, with the same specifications, and when the Company can objectively demonstrate that the tool meets all of the required acceptance criteria.

• When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% of the payment is due based upon shipment.

• When the installation of the system is deemed perfunctory.

7

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Table of Contents

When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

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

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

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

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

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

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

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

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

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

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

## Table of Contents

### Recent Accounting Pronouncements.

#### Recently Adopted

In April 2015, the Financial Accounting Standards Board (“FASB”) issued an accounting standard update for customer’s cloud based fees. The guidance changes what a customer must consider in determining whether a cloud computing arrangement contains a software license. If the arrangement contains a software license, the customer would account for the fees related to the software license element in accordance with guidance related to internal use software; if the arrangement does not contain a software license, the customer would account for the arrangement as a service contract. The Company adopted this update beginning in the first quarter of its fiscal year ending June 30, 2017 on a prospective basis and there was no impact of adoption on its condensed consolidated financial statements.

In March 2016, the FASB issued an accounting standard update to simplify certain aspects of share-based payment awards to employees, including the accounting for income taxes, an option to recognize gross stock-based compensation expense with actual forfeitures recognized as they occur and statutory tax withholding requirements, as well as certain classifications in the statement of cash flows. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2018, with early adoption permitted and all of the guidance must be adopted in the same period. However, the Company elected to early-adopt this standard update beginning in the first quarter of its fiscal year ending June 30, 2017.

#### Impact to Condensed Consolidated Statements of Operations

The primary impact of adopting the standard update is a change in the recording of the excess tax benefits or deficiencies from share-based payments. Before adoption, the Company recognized the excess tax benefits or deficiencies related to stock-based compensation as a credit or charge to additional paid-in capital (“APIC”) in the Company’s Condensed Consolidated Balance Sheets. Under the standard update, these excess tax benefits or deficiencies are recognized as a discrete tax benefit or discrete tax expense in the income tax provision in the Company’s Condensed Consolidated Statement of Operations. For the three months ended September 30, 2016, the Company recognized a discrete tax benefit of \$5.7 million related to net excess tax benefits mainly from stock-based compensation and dividend equivalents. The standard update requires companies to adopt the amendment related to accounting for excess tax benefits or deficiencies on a prospective basis only and as a result, prior periods were not retrospectively adjusted.

#### Impact to Condensed Consolidated Statements of Cash Flows

In addition to the income tax consequence as described above, the standard update for share-based payment requires that cash flows from excess tax benefits related to share-based payments be reported as operating activities in the Condensed Consolidated Statements of Cash Flows. Previously, cash flows from excess tax benefit related to share-based payments were reported as financing activities. The standard update allows for two methods of adoption which are prospective or retrospective application. The Company elected to adopt this amendment on a prospective basis and as a result, prior periods were not retrospectively adjusted.

#### Updates Not Yet Effective

In May 2014, the FASB issued an accounting standard update regarding revenue from customer contracts to transfer goods and services or non-financial assets unless the contracts are covered by other standards (for example, insurance or lease contracts). Under the new guidance, an entity should recognize revenue in connection with the transfer of promised goods or services to customers in an amount that reflects the consideration that the entity expects to be entitled to receive in exchange for those goods or services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued an amendment to defer the effective date of the update by one year, with early adoption on the original effective date permitted. With this amendment, the updates are effective for the Company beginning in the first quarter of the fiscal year ending June 30, 2019, with early adoption permitted beginning in the first quarter of the fiscal year ending June 30, 2018. Subsequent to this amendment, the FASB has issued additional clarifying implementation guidance. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.



Table of Contents

In July 2015, the FASB issued an accounting standard update for the subsequent measurement of inventory. The amended guidance requires entities to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The requirement would replace the current lower of cost or market evaluation and the accounting guidance is unchanged for inventory measured using last-in, first-out (“LIFO”) or the retail inventory method. The update is effective for the Company beginning in the first quarter of the Company’s fiscal year ending June 30, 2018 and should be applied prospectively with early adoption permitted as of the beginning of an interim or annual reporting period. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In January 2016, the FASB issued an accounting standard update that changes the accounting for financial instruments primarily related to equity investments (other than those accounted for under the equity method of accounting or those that result in consolidation of the investee), financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. The accounting standard update is effective for the Company beginning in the first quarter of its fiscal year ending 2019, and early adoption is permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In February 2016, the FASB issued an accounting standard update which amends the existing accounting standards for leases. Consistent with current guidance, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification. Under the new guidance, a lessee will be required to recognize assets and liabilities for all leases with lease terms of more than 12 months. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2020 using a modified retrospective transition method. Early adoption is permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

In June 2016, the FASB issued an accounting standard update that changes the accounting for recognizing impairments of financial assets. Under the update, credit losses for certain types of financial instruments will be estimated based on expected losses. The update also modifies the impairment models for available-for-sale debt securities and for purchased financial assets with credit deterioration since their origination. The update is effective for the Company beginning in the first quarter of its fiscal year ending June 30, 2021, with early adoption permitted starting in the first quarter of fiscal year ending 2020. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.

**NOTE 2 – FAIR VALUE MEASUREMENTS**

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

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

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

Level 1 Valuations based on quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.

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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.

10

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Table of Contents

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

The Company's financial instruments were classified within Level 1 or Level 2 of the fair value hierarchy as of September 30, 2016, because they were valued using quoted market prices, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency. As of September 30, 2016, the types of instruments valued based on quoted market prices in active markets included money market funds, U.S. Treasury securities, certain U.S.

Government agency securities and certain sovereign securities. Such instruments are generally classified within Level 1 of the fair value hierarchy.

As of September 30, 2016, the types of instruments valued based on other observable inputs included corporate debt securities, certain U.S. Government agency securities, municipal securities, and certain 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 generally are large financial institutions. The Company's foreign currency contracts' valuation inputs are based on quoted prices and quoted pricing intervals from public data sources and do not involve management judgment. These contracts are typically classified within Level 2 of the fair value hierarchy.

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

As of September 30, 2016 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
<b>Assets</b>			
<b>Cash equivalents:</b>			
U.S. Treasury securities	\$ 12,699	\$ 12,699	\$ —
Corporate debt securities	28,748	—	28,748
Money market and other	581,240	581,240	—
<b>Marketable securities:</b>			
U.S. Treasury securities	259,269	259,269	—
U.S. Government agency securities	424,018	404,022	19,996
Municipal securities	3,009	—	3,009
Corporate debt securities	812,577	—	812,577
Sovereign securities	21,971	1,004	20,967
Total cash equivalents and marketable securities <sup>(1)</sup>	2,143,531	1,258,234	885,297
<b>Other current assets:</b>			
Derivative assets	692	—	692
<b>Other non-current assets:</b>			
Executive Deferred Savings Plan	174,752	133,380	41,372
Total financial assets <sup>(1)</sup>	\$ 2,318,975	\$ 1,391,614	\$ 927,361
<b>Liabilities</b>			
<b>Other current liabilities:</b>			
Derivative liabilities	\$ (7,637 )	\$ —	\$ (7,637 )
Total financial liabilities	\$ (7,637 )	\$ —	\$ (7,637 )

(1) Excludes cash of \$320.5 million held in operating accounts and time deposits of \$30.5 million as of September 30, 2016.





Table of Contents

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

As of June 30, 2016 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
<b>Assets</b>			
<b>Cash equivalents:</b>			
U.S. Treasury securities	\$68,748	\$ 68,748	\$ —
Corporate debt securities	20,569	—	20,569
Money market and other	626,156	626,156	—
<b>Marketable securities:</b>			
U.S. Treasury securities	258,754	258,754	—
U.S. Government agency securities	405,705	385,731	19,974
Municipal securities	5,016	—	5,016
Corporate debt securities	657,905	—	657,905
Sovereign securities	41,257	6,426	34,831
Total cash equivalents and marketable securities <sup>(1)</sup>	2,084,110	1,345,815	738,295
<b>Other current assets:</b>			
Derivative assets	1,095	—	1,095
<b>Other non-current assets:</b>			
Executive Deferred Savings Plan	162,160	106,149	56,011
Total financial assets <sup>(1)</sup>	\$2,247,365	\$ 1,451,964	\$ 795,401
<b>Liabilities</b>			
<b>Other current liabilities:</b>			
Derivative liabilities	\$(11,647 )	\$ —	\$ (11,647 )
Total financial liabilities	\$(11,647 )	\$ —	\$ (11,647 )

(1) Excludes cash of \$330.1 million held in operating accounts and time deposits of \$77.1 million as of June 30, 2016. There were no transfers between Level 1 and Level 2 fair value measurements during the three months ended September 30, 2016. 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 September 30, 2016 or June 30, 2016.

Table of Contents

## NOTE 3 – FINANCIAL STATEMENT COMPONENTS

## Balance Sheet Components

(In thousands)	As of September 30, 2016	As of June 30, 2016
Accounts receivable, net:		
Accounts receivable, gross	\$ 676,366	\$ 634,905
Allowance for doubtful accounts	(21,667 )	(21,672 )
	\$ 654,699	\$ 613,233
Inventories:		
Customer service parts	\$ 245,105	\$ 234,712
Raw materials	207,080	208,689
Work-in-process	188,909	187,733
Finished goods	62,168	67,501
	\$ 703,262	\$ 698,635
Other current assets:		
Prepaid expenses	\$ 38,111	\$ 37,127
Income tax related receivables	29,753	18,190
Other current assets	8,716	9,553
	\$ 76,580	\$ 64,870
Land, property and equipment, net:		
Land	\$ 40,606	\$ 40,603
Buildings and leasehold improvements	314,649	313,239
Machinery and equipment	510,763	507,378
Office furniture and fixtures	21,287	21,737
Construction-in-process	5,810	5,286
	893,115	888,243
Less: accumulated depreciation and amortization	(620,764 )	(610,229 )
	\$ 272,351	\$ 278,014
Other non-current assets:		
Executive Deferred Savings Plan <sup>(1)</sup>	\$ 174,752	\$ 162,160
Other non-current assets	13,777	12,499
	\$ 188,529	\$ 174,659
Other current liabilities:		
Compensation and benefits	\$ 179,452	\$ 224,496
Executive Deferred Savings Plan <sup>(1)</sup>	175,211	162,289
Customer credits and advances	80,734	81,994
Interest payable	46,208	19,395
Warranty	36,967	34,773
Income taxes payable	21,513	27,964
Other accrued expenses	89,109	111,297
	\$ 629,194	\$ 662,208
Other non-current liabilities:		
Pension liabilities	\$ 71,349	\$ 69,418
Income taxes payable	54,671	50,365
Other non-current liabilities	34,982	36,840
	\$ 161,002	\$ 156,623



Table of Contents

KLA-Tencor has a non-qualified deferred compensation plan (known as “Executive Deferred Savings Plan”) under which 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 the Company. The Company invests these funds in certain mutual funds and such investments are classified as trading securities in the condensed consolidated balance sheets. Distributions from the Executive Deferred Savings Plan commence following a participant’s retirement or termination of employment or on a specified date allowed per the Executive Deferred Savings Plan provisions, except in cases where such distributions are required to be delayed in order to avoid a prohibited distribution under Internal Revenue Code Section 409A. Participants can generally elect the (1) distributions to be paid in lump sum or quarterly cash payments over a scheduled period for up to 15 years and are allowed to make subsequent changes to their existing elections as permissible under the Executive Deferred Savings Plan provisions. Changes in the Executive Deferred Savings Plan liability are recorded in selling, general and administrative expense in the condensed consolidated statements of operations. The expense (benefit) associated with changes in the liability included in selling, general and administrative expense was \$5.8 million and \$(10.2) million during the three months ended September 30, 2016 and 2015, respectively. Changes in the Executive Deferred Savings Plan assets are recorded as gains (losses), net in selling, general and administrative expense in the condensed consolidated statements of operations. The amount of net gains (losses), net included in selling, general and administrative expense was \$5.9 million and \$(10.0) million during the three months ended September 30, 2016 and 2015, respectively.

**Accumulated Other Comprehensive Income (Loss)**

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

(In thousands)	Currency Translation Adjustments	Unrealized Gains (Losses) on Available-for-Sale Securities	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total
Balance as of September 30, 2016	\$ (27,718 )	\$ 846	\$ 481	\$ (20,242 )	\$(46,633)
Balance as of June 30, 2016	\$ (32,424 )	\$ 3,451	\$ 775	\$ (20,487 )	\$(48,685)

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

Accumulated OCI Components	Location in the Condensed Consolidated Statements of Operations	Three months ended September 30, 2016	2015
Unrealized gains (losses) on cash flow hedges from foreign exchange and interest rate contracts	Revenues	\$(1,481)	\$685
	Costs of revenues	(87 )	(472 )
	Interest expense	189	189
	Net gains (losses) reclassified from accumulated OCI	\$(1,379)	\$402
Unrealized gains (losses) on available-for-sale securities	Other expense (income), net	\$204	\$17

The amounts reclassified out of accumulated OCI related to the Company’s defined benefit pension plans, which were recognized as a component of net periodic cost for the three months ended September 30, 2016 and 2015 were \$0.4 million and \$0.3 million, respectively. For additional details, refer to Note 10, “Employee Benefit Plans” in the

Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2016.

14

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Table of Contents

## NOTE 4 – MARKETABLE SECURITIES

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

As of September 30, 2016 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	\$271,546	\$ 514	\$ (92 )	\$271,968
U.S. Government agency securities	423,741	426	(149 )	424,018
Municipal securities	3,008	1	—	3,009
Corporate debt securities	840,857	1,067	(599 )	841,325
Money market and other	581,240	—	—	581,240
Sovereign securities	21,972	3	(4 )	21,971
Subtotal	2,142,364	2,011	(844 )	2,143,531
Add: Time deposits <sup>(1)</sup>	30,546	—	—	30,546
Less: Cash equivalents	645,783	—	(2 )	645,781
Marketable securities	\$1,527,127	\$ 2,011	\$ (842 )	\$1,528,296

  

As of June 30, 2016 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	\$326,321	\$ 1,181	\$ —	\$327,502
U.S. Government agency securities	404,889	830	(14 )	405,705
Municipal securities	5,014	2	—	5,016
Corporate debt securities	676,259	2,372	(157 )	678,474
Money market and other	626,156	—	—	626,156
Sovereign securities	41,224	38	(5 )	41,257
Subtotal	2,079,863	4,423	(176 )	2,084,110
Add: Time deposits <sup>(1)</sup>	77,131	—	—	77,131
Less: Cash equivalents	778,451	1	(17 )	778,435
Marketable securities	\$1,378,543	\$ 4,422	\$ (159 )	\$1,382,806

(1) Time deposits excluded from fair value measurements.

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

As of September 30, 2016 (In thousands)	Fair Value	Gross Unrealized Losses <sup>(1)</sup>
Corporate debt securities	\$ 372,827	\$ (597 )
U.S. Government agency securities	126,547	(149 )
U.S. Treasury securities	44,791	(92 )
Sovereign securities	13,036	(4 )
Municipal securities	2,006	—
Total	\$ 559,207	\$ (842 )

(1) As of September 30, 2016, the amount of total gross unrealized losses related to investments that had been in a continuous loss position for 12 months or more was immaterial.





Table of Contents

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

As of September 30, 2016 (In thousands)	Amortized Cost	Fair Value
Due within one year	\$531,572	\$531,730
Due after one year through three years	995,555	996,566
	\$1,527,127	\$1,528,296

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Realized gains and losses on available-for-sale securities for the three months ended September 30, 2016 and 2015 were immaterial.

**NOTE 5 – GOODWILL AND PURCHASED INTANGIBLE ASSETS****Goodwill**

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in prior business combinations. The Company has four reporting units: Wafer Inspection, Patterning, Global Service and Support, and Others. The following table presents goodwill balances and movements by reporting unit during the three months ended September 30, 2016:

(In thousands)	Wafer Inspection	Patterning	Others	Total
Balance as of June 30, 2016	\$ 281,026	\$ 53,255	\$ 896	\$ 335,177
Goodwill adjustment	21	—	—	21
Balance as of September 30, 2016	\$ 281,047	\$ 53,255	\$ 896	\$ 335,198

Goodwill is net of accumulated impairment losses of \$277.6 million, which were recorded prior to the fiscal year ended June 30, 2014. The changes in the gross goodwill balance during the three months ended September 30, 2016 resulted from foreign currency translation adjustments.

The Company performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2015 during the three months ended December 31, 2015 as part of its annual goodwill impairment assessment and concluded that it was more likely than not that the fair value of each of the reporting units exceeded its carrying amount. As of December 31, 2015, the Company's assessment indicated that goodwill in the reporting units was not impaired. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to the qualitative assessment performed in the second quarter of the fiscal year ended June 30, 2016. The next annual assessment of goodwill by reporting unit is scheduled to be performed in the second quarter of the fiscal year ending June 30, 2017.

**Purchased Intangible Assets**

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

Category	Range of Useful Lives	As of September 30, 2016			As of June 30, 2016		
		Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount
Existing technology	4-7 years	\$141,659	\$ 138,660	\$ 2,999	\$141,659	\$ 138,160	\$ 3,499
Trade name/Trademark	4-10 years	19,893	19,893	—	19,893	19,743	150
Customer relationships	6-7 years	54,980	54,914	66	54,980	54,298	682
Total		\$216,532	\$ 213,467	\$ 3,065	\$216,532	\$ 212,201	\$ 4,331

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.

Table of Contents

For the three months ended September 30, 2016 and 2015, amortization expense for purchased intangible assets was \$1.3 million and \$3.7 million, respectively. Based on the intangible assets recorded as of September 30, 2016, 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)
2017 (remaining 9 months)	\$ 1,540
2018	1,525
Total	\$ 3,065

## NOTE 6 – DEBT

The following table summarizes the debt of the Company as of September 30, 2016 and June 30, 2016:

	As of September 30, 2016		As of June 30, 2016	
	Amount (In thousands)	Effective Interest Rate	Amount (In thousands)	Effective Interest Rate
Fixed-rate 2.375% Senior notes due on November 1, 2017	\$250,000	2.396 %	\$250,000	2.396 %
Fixed-rate 3.375% Senior notes due on November 1, 2019	250,000	3.377 %	250,000	3.377 %
Fixed-rate 4.125% Senior notes due on November 1, 2021	500,000	4.128 %	500,000	4.128 %
Fixed-rate 4.650% Senior notes due on November 1, 2024 <sup>(1)</sup>	1,250,000	4.682 %	1,250,000	4.682 %
Fixed-rate 5.650% Senior notes due on November 1, 2034	250,000	5.670 %	250,000	5.670 %
Term loans	536,250	1.890 %	576,250	1.714 %
Total debt	3,036,250		3,076,250	
Unamortized discount	(3,209 )		(3,312 )	
Unamortized debt issuance costs	(14,474 )		(15,002 )	
Total long-term debt	\$3,018,567		\$3,057,936	

The effective interest rate disclosed above for this series of Senior Notes excludes the impact of the treasury rate (1)lock hedge discussed below. The effective interest rate including the impact of the treasury rate lock hedge was 4.626%.

As of September 30, 2016, future principal payments for the long-term debt are summarized as follows. There are no scheduled payment for the term loans for fiscal years ending 2017 and 2018, since the Company made \$148.1 million of principal prepayments as of September 30, 2016.

	Amount
Fiscal year ending June 30:	(In thousands)
2017 (remaining 9 months)	\$—
2018	250,000
2019	30,000
2020	756,250
2021	—
Thereafter	2,000,000
Total payments	\$3,036,250

Table of Contents

## Senior Notes:

In November 2014, the Company issued \$2.50 billion aggregate principal amount of senior, unsecured long-term notes (collectively referred to as “Senior Notes”). The Company issued the Senior Notes as part of the leveraged recapitalization plan under which the proceeds from the Senior Notes in conjunction with the proceeds from the term loans (described below) and cash on hand were used (x) to fund a special cash dividend of \$16.50 per share, aggregating to approximately \$2.76 billion, (y) to redeem \$750.0 million of 2018 Senior Notes, including associated redemption premiums, accrued interest and other fees and expenses and (z) for other general corporate purposes, including repurchases of shares pursuant to the Company’s stock repurchase program. The interest rate specified for each series of the Senior Notes will be subject to adjustments from time to time if Moody’s Investor Service, Inc. (“Moody’s”) or Standard & Poor’s Ratings Services (“S&P”) or, under certain circumstances, a substitute rating agency selected by us as a replacement for Moody’s or S&P, as the case may be (a “Substitute Rating Agency”), downgrades (or subsequently upgrades) its rating assigned to the respective series of Senior Notes such that the adjusted rating is below investment grade. If the adjusted rating of any series of Senior Notes from Moody’s (or, if applicable, any Substitute Rating Agency) is decreased to Ba1, Ba2, Ba3 or B1 or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively (“bps” refers to Basis Points and 1% is equal to 100 bps). If the rating of any series of Senior Notes from S&P (or, if applicable, any Substitute Rating Agency) with respect to such series of Senior Notes is decreased to BB+, BB, BB- or B+ or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively. The interest rates on any series of Senior Notes will permanently cease to be subject to any adjustment (notwithstanding any subsequent decrease in the ratings by any of Moody’s, S&P and, if applicable, any Substitute Rating Agency) if such series of Senior Notes becomes rated “Baa1” (or its equivalent) or higher by Moody’s (or, if applicable, any Substitute Rating Agency) and “BBB+” (or its equivalent) or higher by S&P (or, if applicable, any Substitute Rating Agency), or one of those ratings if rated by only one of Moody’s, S&P and, if applicable, any Substitute Rating Agency, in each case with a stable or positive outlook. In October 2014, the Company entered into a series of forward contracts to lock the 10-year treasury rate (“benchmark rate”) on a portion of the Senior Notes with a notional amount of \$1.00 billion in aggregate. For additional details, refer to Note 14, “Derivative Instruments and Hedging Activities.”

The original discount on the Senior Notes amounted to \$4.0 million and is being amortized over the life of the debt. Interest is payable semi-annually on May 1 and November 1 of each year. The debt indenture (the “Indenture”) includes covenants that limit the Company’s ability to grant liens on its facilities and enter into sale and leaseback transactions, subject to certain allowances under which certain sale and leaseback transactions are not restricted. As of September 30, 2016, the Company was in compliance with all of its covenants under the Indenture associated with the Senior Notes.

In certain circumstances involving a change of control followed by a downgrade of the rating of a series of Senior Notes by at least two of Moody’s, S&P and Fitch Inc., unless the Company has exercised its right to redeem the Senior Notes of such series, the Company will be required to make an offer to repurchase all or, at the holder’s option, any part, of each holder’s Senior Notes of that series pursuant to the offer described below (the “Change of Control Offer”). In the Change of Control Offer, the Company will be required to offer payment in cash equal to 101% of the aggregate principal amount of Senior Notes repurchased plus accrued and unpaid interest, if any, on the Senior Notes repurchased, up to, but not including, the date of repurchase.

Based on the trading prices of the Senior Notes on the applicable dates, the fair value of the Senior Notes as of September 30, 2016 and June 30, 2016 was approximately \$2.71 billion and \$2.68 billion, respectively. While the Senior Notes are recorded at cost, the fair value of the long-term debt was determined based on quoted prices in markets that are not active; accordingly, the long-term debt is categorized as Level 2 for purposes of the fair value measurement hierarchy.

Table of Contents

## Credit Facility (Term Loans and Unfunded Revolving Credit Facility):

In November 2014, the Company entered into \$750.0 million of five-year senior unsecured prepayable term loans and a \$500.0 million unfunded revolving credit facility (collectively, the “Credit Facility”) under the Credit Agreement (the “Credit Agreement”). The interest under the Credit Facility will be payable on the borrowed amounts at the London Interbank Offered Rate (“LIBOR”) plus a spread, which is currently 125 bps, and this spread is subject to adjustment in conjunction with the Company’s credit rating downgrades or upgrades. The spread ranges from 100 bps to 175 bps based on the Company’s then effective credit rating. The Company is also obligated to pay an annual commitment fee of 15 bps on the daily undrawn balance of the revolving credit facility, which is also subject to an adjustment in conjunction with the Company’s credit rating downgrades or upgrades by Moody’s and S&P. The annual commitment fee ranges from 10 bps to 25 bps on the daily undrawn balance of the revolving credit facility, depending upon the then effective credit rating. Principal payments with respect to the term loans will be made on the last day of each calendar quarter, and any unpaid principal balance of the term loans, including accrued interest, shall be payable on November 14, 2019 (the “Maturity Date”). The Company may prepay the term loans and unfunded revolving credit facility at any time without a prepayment penalty. During the first quarter of the fiscal year ending June 30, 2017, the Company made term loan principal payments of \$40.0 million.

Future principal payments for the Company’s term loans (without giving effect to \$148.1 million of principal prepayments as of September 30, 2016 that shall be applied to the future scheduled quarterly payments) as of September 30, 2016, are as follows:

Fiscal Quarters Ending	Quarterly Payment (In thousands)
December 31, 2016	\$ 9,375
March 31, 2017 through December 31, 2017	\$ 14,063
March 31, 2018 through September 30, 2019	\$ 18,750
December 31, 2019	\$ 487,500

The Credit Facility requires the Company to maintain an interest expense coverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters of no less than 3.50 to 1.00. In addition, the Company is required to maintain the maximum leverage ratio as described in the Credit Agreement, on a quarterly basis, covering the trailing four consecutive fiscal quarters for the fiscal quarters as described below.

Fiscal Quarters Ending	Maximum Leverage Ratio
September 30, 2016	3.75:1.00
December 31, 2016 and March 31, 2017	3.50:1.00
Thereafter	3.00:1.00

The Company was in compliance with the financial covenants under the Credit Agreement as of September 30, 2016 and had no outstanding borrowings under the unfunded revolving credit facility.

**NOTE 7 – EQUITY AND LONG-TERM INCENTIVE COMPENSATION PLANS**

## Equity Incentive Program

As of September 30, 2016, the Company had two plans under which the Company was able to issue equity incentive awards, such as restricted stock units and stock options, to its employees, consultants and members of its Board of Directors: the 2004 Equity Incentive Plan (the “2004 Plan”) and the 1998 Director Plan (the “Outside Director Plan”).

## 2004 Plan:

The 2004 Plan provides for the grant of options to purchase shares of the Company’s common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to the Company’s employees, consultants and members of its Board of Directors. As of September 30, 2016, 4.1 million shares were available for issuance under the 2004 Plan.

Table of Contents

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

In addition, the plan administrator has the ability to grant “dividend equivalent” rights in connection with awards of restricted stock units, performance shares, performance units and deferred stock units before they are fully vested. The plan administrator, at its discretion, may grant a right to receive dividends on the aforementioned awards which may be settled in cash or Company stock at the discretion of the plan administrator subject to meeting the vesting requirement of the underlying awards.

**Outside Director Plan**

The Outside Director Plan only permits the issuance of stock options to the non-employee members of the Board of Directors. As of September 30, 2016, 1.7 million shares were available for grant under the Outside Director Plan.

**Equity Incentive Plans - General Information**

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

(In thousands)	Available For Grant <sup>(1)</sup>
Balance as of June 30, 2016	6,778
Restricted stock units granted	(1,031 )
Restricted stock units canceled	35
Balance as of September 30, 2016	5,782

<sup>(1)</sup> The number of restricted stock units reflects the application of the award multiplier as described above (1.8x or 2.0x depending on the grant date of the applicable award).

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. For restricted stock units granted without “dividend equivalent” rights, fair value is calculated using the closing price of the Company’s common stock on the grant date, adjusted to exclude the present value of dividends which are not accrued on those restricted stock units. The fair value for restricted stock units granted with “dividend equivalent” rights is determined using the closing price of the Company’s common stock on the grant date. As of September 30, 2016, the Company accrued \$12.0 million of dividends payable, which included both a special cash dividend and quarterly cash dividends for the unvested restricted stock units outstanding as of the dividend record date. The fair value for purchase rights under the Company’s Employee Stock Purchase Plan is determined using a Black-Scholes valuation model.

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

(In thousands)	Three months ended September 30, 2016    2015	
Stock-based compensation expense by:		
Costs of revenues	\$1,262	\$1,464
Research and development	2,021	2,492
Selling, general and administrative	8,195	8,292
Total stock-based compensation expense	\$11,478	\$12,248

As a result of the early adoption of the accounting standard update on accounting for share-based payment awards in the three months ended September 30, 2016, the Company recorded excess tax benefits of \$5.7 million in the provision for income taxes. See Note 1, “Description of Business and Basis of Presentation” for additional details.



Table of Contents

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

	As of September 30, 2016	As of June 30, 2016
Inventory	\$ 2,714	\$2,685

## Restricted Stock Units

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value for restricted stock units granted, vested and released, withheld for taxes, and forfeited during the three months ended September 30, 2016 and restricted stock units outstanding as of September 30, 2016 and June 30, 2016:

Restricted Stock Units	Shares <sup>(1)</sup> (In thousands)	Weighted-Average Grant Date Fair Value
Outstanding restricted stock units as of June 30, 2016 <sup>(2)</sup>	1,849	\$ 56.41
Granted	515	\$ 68.74
Vested and released	(324 )	\$ 52.05
Withheld for taxes	(237 )	\$ 52.05
Forfeited	(18 )	\$ 62.65
Outstanding restricted stock units as of September 30, 2016 <sup>(2)</sup>	1,785	\$ 61.28

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

(2) Includes outstanding restricted stock units granted to senior management with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of September 30, 2016, 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 during the three months ended September 30, 2016 did not contain performance-based vesting criteria.

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

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

Three months  
ended  
September 30,

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(In thousands, except for weighted-average grant date fair value)	2016	2015
Weighted-average grant date fair value per unit	\$68.74	\$50.44
Tax benefits realized by the Company in connection with vested and released restricted stock units	\$13,929	\$23,517

As of September 30, 2016, the unrecognized stock-based compensation expense balance related to restricted stock units was \$81.7 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 1.8 years. The total grant date fair value of vested restricted stock units was \$29.2 million and \$45.7 million in the three months ended September 30, 2016 and 2015, respectively. The intrinsic value of outstanding restricted stock units as of September 30, 2016 was \$124.4 million.



Table of Contents**Cash-Based Long-Term Incentive Compensation**

The Company has adopted a cash-based long-term incentive (“Cash LTI”) program for many of its employees as part of the Company’s employee compensation program. During the three months ended September 30, 2016 and 2015, the Company approved Cash LTI awards of \$1.6 million and \$0.3 million, respectively 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 anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date. Executives and non-employee Board members are not participating in this program. During the three months ended September 30, 2016 and 2015, the Company recognized \$12.2 million and \$9.9 million, respectively, in compensation expense under the Cash LTI Plan. As of September 30, 2016, the unrecognized compensation balance (excluding the impact of estimated forfeitures) related to the Cash LTI Plan was \$75.4 million.

**Employee Stock Purchase Plan**

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

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

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

	Three months ended September 30, 2016 2015	
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**Stock purchase plan:**

Expected stock price volatility	20.6 %	23.9 %
Risk-free interest rate	0.4 %	0.1 %
Dividend yield	2.9 %	3.7 %
Expected life (in years)	0.5	0.5

The following table shows the tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP and the weighted-average fair value per share for the indicated periods:

	Three months ended September 30, 2016 2015	
(In thousands, except for weighted-average fair value per share)		
Tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP	\$704	\$380
Weighted-average fair value per share based on Black-Scholes model	\$14.06	\$11.34

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 September 30, 2016, a total of 1.4 million shares were reserved and available for issuance under the ESPP.



Table of Contents

## Quarterly cash dividends

On August 4, 2016, the Company's Board of Directors declared a regular quarterly cash dividend of \$0.52 per share on the outstanding shares of the Company's common stock, which was paid on September 1, 2016 to the stockholders of record as of the close of business on August 15, 2016. The total amount of regular quarterly cash dividends paid by the Company during each of the three months ended September 30, 2016 and 2015 was \$81.6 million. The amount of accrued dividends payable for regular quarterly cash dividends on unvested restricted stock units with dividend equivalent rights was \$2.7 million as of September 30, 2016 and June 30, 2016. These amounts will be paid upon vesting of the underlying unvested restricted stock units.

## Special cash dividend

On November 19, 2014, the Company's Board of Directors declared a special cash dividend of \$16.50 per share on our outstanding common stock, which was paid on December 9, 2014 to the stockholders of record as of the close of business on December 1, 2014. The declaration and payment of the special cash dividend was part of the Company's leveraged recapitalization transaction under which the special cash dividend was financed through a combination of existing cash and proceeds from the debt financing disclosed in Note 6, "Debt" that was completed during the three months ended December 31, 2014. As of the declaration date, the total amount of the special cash dividend accrued by the Company was approximately \$2.76 billion, substantially all of which was paid out during the three months ended December 31, 2014, except for the aggregate special cash dividend of \$43.0 million that was accrued for the unvested restricted stock units. As of September 30, 2016 and June 30, 2016, the Company had a total of \$9.3 million and \$16.9 million, respectively, of accrued dividends payable for the special cash dividend with respect to outstanding unvested restricted stock units, which will be paid when such underlying unvested restricted stock units vest. The Company paid a special cash dividend with respect to vested restricted stock units during the three months ended September 30, 2016 and 2015 of \$7.7 million and \$20.0 million, respectively. Other than the special cash dividend declared during the three months ended December 31, 2014, the Company historically has not declared any special cash dividends.

## NOTE 8 – STOCK REPURCHASE PROGRAM

The Company's Board of Directors has authorized a program for the Company to repurchase shares of the Company's common stock. The intent of this program is to offset the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, as well as to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases were made 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 September 30, 2016, an aggregate of approximately 5.9 million shares were available for repurchase under the Company's repurchase program.

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

	Three months ended September 30, 2016
(In thousands)	2015
Number of shares of common stock repurchased	—2,877
Total cost of repurchases	\$—146,234

As of September 30, 2015, the Company had repurchased 197,339 shares for \$9.6 million, which repurchases had not settled prior to September 30, 2015. The amount was recorded as a component of other current liabilities for the period presented.

## 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 restricted stock units and stock options had been issued. The dilutive effect of outstanding restricted stock units and options 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.

Table of Contents

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

(In thousands, except per share amounts)	Three months ended September 30,	
	2016	2015
Numerator:		
Net income	\$178,101	\$104,897
Denominator:		
Weighted-average shares-basic, excluding unvested restricted stock units	156,129	156,820
Effect of dilutive restricted stock units and options <sup>(1)</sup>	892	1,164
Weighted-average shares-diluted	157,021	157,984
Basic net income per share	\$1.14	\$0.67
Diluted net income per share	\$1.13	\$0.66
Anti-dilutive securities excluded from the computation of diluted net income per share	45	307

(1) There were no outstanding stock options as of September 30, 2016.

## NOTE 10 – INCOME TAXES

The following table provides details of income taxes:

(Dollar amounts in thousands)	Three months ended September 30,	
	2016	2015
Income before income taxes	\$222,220	\$134,299
Provision for income taxes	\$44,119	\$29,402
Effective tax rate	19.9	% 21.9

Tax expense was lower as a percentage of income before taxes during the three months ended September 30, 2016 compared to the three months ended September 30, 2015 primarily due to the impact of the following items:

Tax expense decreased by \$5.7 million during the three months ended September 30, 2016 related to the recognition of excess tax benefits in the provision for income taxes as a result of early adoption of the accounting standard update on accounting for share-based payments. See Note 1, “Description of Business and Basis of Presentation” for additional details;

Tax expense decreased by \$2.6 million during the three months ended September 30, 2016 when the Protecting Americans from Tax Hikes (PATH) Act of 2015 permanently reinstated the research credit on December 18, 2015 retroactively to January 1, 2015. Tax expense was not reduced by the research credit during the three months ended September 30, 2015 as the research credit had expired on December 31, 2014;

Tax expense decreased by \$5.7 million during the three months ended September 30, 2016 related to a non-taxable increase in the value of the assets held within the Company's Executive Deferred Savings Plan; partially offset by

Tax expense decreased by \$8.2 million during the three months ended September 30, 2015 related to a decrease in the Company's unrecognized tax benefits from the expiration of the statute of limitations.

In the normal course of business, the Company is subject to examination by tax authorities throughout the world. The Company is subject to United States federal income tax examination for all years beginning from the fiscal year ended June 30, 2014. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2012. 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, 2012. It is possible that certain examinations may be concluded in the next twelve months. The Company believes that it may recognize up to \$3.9 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.

Table of Contents

NOTE 11 – LITIGATION AND OTHER LEGAL MATTERS

Litigation Related to Proposed Merger with Lam Research.

The California Class Actions. In connection with the October 21, 2015 announcement of the Merger transaction, four purported KLA-Tencor stockholders filed putative class actions on behalf of all KLA-Tencor stockholders. Three actions were filed in the California Superior Court for Santa Clara County and are captioned, Hedgecock v.

KLA-Tencor Corp., et al., Case No. 115CV287329, Karr v. KLA-Tencor Corporation, et al., Case No. 115CV287331, (both filed on October 28, 2015) and Spoleto Corp. v. Wallace, et al., Case No. 115CV289552 (filed on December 29, 2015) (collectively, the “California Class Actions”). Plaintiffs in the Hedgecock and Karr actions filed amended complaints on December 21, 2015. The California Class Actions all name KLA-Tencor, the members of the KLA-Tencor Board, Lam Research, Merger Sub 1, and Merger Sub 2 (together with Merger Sub 1 and Lam Research, the “Lam Group”) as defendants. The California Class Actions allege that the members of the KLA-Tencor Board breached their fiduciary duties by, among other things, causing KLA-Tencor to agree to a merger transaction with the Lam Group at an unfair price and pursuant to an unfair process, and by making disclosures concerning the transaction that are materially misleading. Plaintiffs allege that the Lam Group aided and abetted such breaches. Plaintiffs seek to enjoin or rescind KLA-Tencor’s transaction with the Lam Group, as applicable, as well as an award of damages and attorneys’ fees, in addition to other relief.

The Delaware Chancery Court Class Action. One putative class action was filed on November 10, 2015, in the Court of Chancery in the State of Delaware and is captioned, Rooney v. Wallace, et al., Case No. 11700. On December 23, 2015, plaintiff Rooney filed an amended complaint. The Rooney action was filed against the members of the KLA-Tencor Board and similar to the California Class Actions alleges that the members of the KLA-Tencor Board breached their fiduciary duties by, among other things, causing KLA-Tencor to agree to a merger transaction with Lam Research at an unfair price and pursuant to an unfair process, and by making disclosures concerning the transaction that are materially misleading. Plaintiff Rooney seeks to enjoin or rescind KLA-Tencor’s transaction with Lam Research, as applicable, as well as an award of attorneys’ fees, in addition to other relief.

Agreement in Principle to Resolve Merger-Related Litigation. On or about December 29, 2015, plaintiffs in all four actions agreed to coordinate and proceed in the California Superior Court. On February 5, 2016, an agreement in principle was reached with the plaintiffs in the Rooney Action, Hedgecock Action, and Spoleto Action to settle those actions. Pursuant to the agreement in principle, as set forth in a signed memorandum of understanding, the parties agreed to resolve disputed legal claims and KLA-Tencor and Lam agreed to make certain supplemental disclosures regarding the proposed Merger, as set forth in the Form 8-K filed by KLA-Tencor on February 5, 2016. None of the defendants in these actions has admitted wrongdoing of any kind, including that there were any inadequacies in any disclosure, any breach of any fiduciary duty, or aiding or abetting any of the foregoing. On February 17, 2016, the California Superior Court dismissed the Karr action pursuant to a stipulation by the parties.

In light of the termination of the Merger Agreement, KLA-Tencor has discussed dismissal of the Rooney, Hedgecock, and Spoleto actions with the plaintiffs.

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

Employee Retention Commitments. In connection with the retention program adopted at the time the Company entered into the Merger Agreement with Lam Research, the Company has an estimated \$24.1 million of employee-related retention commitments as of September 30, 2016 which are expected to be paid during the quarter ended December 31, 2017.

25

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Table of Contents

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:

(In thousands)	Three months ended	
	September 30, 2016	2015
Receivables sold under factoring agreements	\$56,733	\$33,844
Proceeds from sales of LCs	\$3,408	\$—

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

Facilities. KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was \$2.4 million and \$2.1 million for the three months ended September 30, 2016 and 2015, respectively.

The following is a schedule of expected operating lease payments:

Fiscal year ending June 30,	Amount (In thousands)
2017 (remaining 9 months)	\$ 6,312
2018	5,719
2019	2,893
2020	2,068
2021	544
2022 and thereafter	3,343
Total minimum lease payments	\$ 20,879

Purchase Commitments. KLA-Tencor maintains commitments to purchase inventory from its suppliers as well as goods and services in the ordinary course of business. The Company’s liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company’s estimate of its significant purchase commitments is approximately \$340.6 million as of September 30, 2016 which are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

Cash Long-Term Incentive Plan. As of September 30, 2016, the Company had committed \$121.0 million for future payment obligations under its Cash LTI Plan. The calculation of compensation expense related to the Cash LTI Plan includes estimated forfeiture rate assumptions. Cash LTI awards issued to employees under the Cash LTI Plan vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date.

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



Company adjusts its warranty accruals accordingly.

26

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Table of Contents

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

(In thousands)	Three months ended	
	September 30, 2016	2015
Beginning balance	\$34,773	\$36,413
Accruals for warranties issued during the period	10,902	9,039
Changes in liability related to pre-existing warranties	(445 )	(183 )
Settlements made during the period	(8,263 )	(9,377 )
Ending balance	\$36,967	\$35,892

The Company maintains guarantee arrangements available through various financial institutions for up to \$22.5 million, of which \$19.2 million had been issued as of September 30, 2016, primarily to fund guarantees to customs authorities for value-added tax (“VAT”) and other operating requirements of the Company’s subsidiaries in Europe and Asia.

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

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

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

In addition, the Company may in limited circumstances enter into agreements that contain customer-specific commitments on pricing, tool reliability, spare parts stocking levels, response time and other commitments.

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

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

**NOTE 13 — RESTRUCTURING CHARGES**

The Company has in recent years undertaken a number of cost reduction activities, including workforce reductions, in an effort to lower its ongoing expense run rate. The program in the United States is accounted for in accordance with the authoritative guidance related to compensation for non-retirement post-employment benefits, whereas the programs in the Company's international locations are accounted for in accordance with the authoritative guidance for contingencies.

27

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Table of Contents

During the fourth quarter of fiscal year ended 2015, the Company implemented a plan to reduce its global employee workforce to streamline the organization and business processes in response to changing customer requirements in the industry. The goals of this reduction were to enable continued innovation, direct the Company's resources toward its best opportunities and lower its ongoing expense run rate. The Company substantially completed its global workforce reduction during the fiscal year ended June 30, 2016. Restructuring charges for the three months ended September 30, 2015 were \$7.1 million, of which \$2.8 million was recorded to costs of revenues, \$1.0 million to research and development expense and \$3.3 million to selling, general and administrative expense lines in the condensed consolidated statements of operations. Restructuring charges for the three months ended September 30, 2016 were immaterial.

The following table shows the activity which is primarily related to accrued severance and benefits for the three months ended September 30, 2016 and 2015:

	Three months ended September 30,	
(In thousands)	2016	2015
Beginning balance	\$587	\$24,887
Restructuring costs	—	7,066
Adjustments	(26 )	373
Cash payments	(274 )	(19,265 )
Ending balance	\$287	\$13,061

The remaining accrual for severance and benefits as of September 30, 2016 is expected to be substantially paid out by the end of the Company's quarter ending December 31, 2016.

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

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

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

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

For derivative instruments that are not designated as accounting hedges, gains and losses are recognized in other expense (income), 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.

28

---

Table of Contents

In October 2014, in anticipation of the issuance of the Senior Notes, the Company entered into a series of forward contracts (“Rate Lock Agreements”) to lock the benchmark rate on a portion of the Senior Notes. The objective of the Rate Lock Agreements was to hedge the risk associated with the variability in interest rates due to the changes in the benchmark rate leading up to the closing of the intended financing, on the notional amount being hedged. The Rate Lock Agreements had a notional amount of \$1.00 billion in aggregate which matured in the second quarter of the fiscal year ended June 30, 2015. The Company designated each of the Rate Lock Agreements as a qualifying hedging instrument and accounted for as a cash flow hedge, under which the effective portion of the gain or loss on the close out of the Rate Lock Agreements was initially recognized in accumulated other comprehensive income (loss) as a reduction of total stockholders’ equity and subsequently amortized into earnings as a component of interest expense over the term of the underlying debt. The ineffective portion, if any, was recognized in earnings immediately. The Rate Lock Agreements were terminated on the date of pricing of the \$1.25 billion of 4.650% Senior Notes due in 2024 and the Company recorded the fair value of \$7.5 million as a gain within accumulated other comprehensive income (loss) as of December 31, 2014. The Company recognized \$0.2 million for each of the three months ended September 30, 2016 and 2015 for the amortization of the gain recognized in accumulated other comprehensive income (loss), which amount reduced the interest expense. As of September 30, 2016, the unamortized portion of the fair value of the forward contracts for the rate lock agreements was \$6.1 million.

**Derivatives in Cash Flow Hedging Relationships: Foreign Exchange and Interest Rate Contracts**

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

(In thousands)	Location in Financial Statements	Three months ended September 30, 2016    2015	
<b>Derivatives Designated as Hedging Instruments</b>			
Losses in accumulated OCI on derivatives (effective portion)	Accumulated OCI	\$(1,838)	\$(1,861)
Gains (losses) reclassified from accumulated OCI into income (effective portion):	Revenues	\$(1,481)	\$685
	Costs of revenues	(87 )	(472 )
	Interest expense	189	189
	Net gains (losses) reclassified from accumulated OCI into income (effective portion)	\$(1,379)	\$402
Losses recognized in income on derivatives (ineffective portion and amount excluded from effectiveness testing)	Other expense (income), net	\$(11 )	\$(126 )
<b>Derivatives Not Designated as Hedging Instruments</b>			
Losses recognized in income	Other expense (income), net	\$(164 )	\$(6,382)

The U.S. dollar equivalent of all outstanding notional amounts of hedge contracts, with maximum remaining maturities of approximately seven months as of September 30, 2016 and June 30, 2016 was as follows:

(In thousands)	As of September 30, 2016	As of June 30, 2016
<b>Cash flow hedge contracts</b>		
Purchase	\$ 8,058	\$7,591
Sell	\$ 98,256	\$91,793
<b>Other foreign currency hedge contracts</b>		
Purchase	\$ 113,793	\$ 122,275
Sell	\$ 114,506	\$ 115,087



Table of Contents

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

	Asset Derivatives		Liability Derivatives			
	Balance Sheet Location	As of September 30, 2016 Fair Value	As of June 30, 2016 Fair Value	Balance Sheet Location	As of September 30, 2016 Fair Value	As of June 30, 2016 Fair Value
(In thousands)						
Derivatives designated as hedging instruments						
Foreign exchange contracts	Other current assets	\$571	\$342	Other current liabilities	\$3,104	\$4,736
Total derivatives designated as hedging instruments		\$571	\$342		\$3,104	\$4,736
Derivatives not designated as hedging instruments						
Foreign exchange contracts	Other current assets	\$121	\$753	Other current liabilities	\$4,533	\$6,911
Total derivatives not designated as hedging instruments		\$121	\$753		\$4,533	\$6,911
Total derivatives		\$692	\$1,095		\$7,637	\$11,647

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

(In thousands)	Three months ended September 30,	
	2016	2015
Beginning balance	\$1,210	\$7,110
Amount reclassified to income	1,379	(402 )
Net change in unrealized gains or losses	(1,838 )	(1,861 )
Ending balance	\$751	\$4,847

## Offsetting of Derivative Assets and Liabilities

KLA-Tencor presents derivatives at gross fair values in the Condensed Consolidated Balance Sheets. The Company has entered into arrangements with each of its counterparties, which reduce credit risk by permitting net settlement of transactions with the same counterparty under certain conditions. As of September 30, 2016 and June 30, 2016, information related to the offsetting arrangements was as follows (in thousands):

Description	Gross Amounts of Derivatives	Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets	Net Amount of Derivatives Presented in the Condensed Consolidated Balance	Gross Amounts of Derivatives Not Offset in the Condensed Consolidated Balance Sheets		
				Financial Instruments	Cash Collateral Received	Net Amount
As of September 30, 2016						



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		Sheets				
Derivatives - Assets	\$ 692	\$	—\$ 692	\$ (172 )	\$	—\$520
Derivatives - Liabilities	\$(7,637 )	\$	—\$ (7,637 )	\$ 172	\$	—\$(7,465)
Gross Amounts of						
Derivatives Not						
Offset in the						
Condensed						
Consolidated Balance						
Sheets						
As of June 30, 2016						
Description	Gross Amounts of Derivatives	Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets	Net Amount of Derivatives Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	Net Amount
Derivatives - Assets	\$1,095	\$	—\$ 1,095	\$ (843 )	\$	—\$252
Derivatives - Liabilities	\$(11,647 )	\$	—\$ (11,647 )	\$ 843	\$	—\$(10,804)

Table of Contents

## NOTE 15 – RELATED PARTY TRANSACTIONS

During the three months ended September 30, 2016 and 2015, the Company purchased from, or sold to, several entities, where one or more executive officers of the Company or members of the Company's Board of Directors, or their immediate family members, also serves as an executive officer or a board member, including Citrix Systems, Inc., Keysight Technologies, Inc., MetLife Insurance K.K. and NetApp, Inc. The following table provides the transactions with these parties for the indicated periods (for the portion of such period that they were considered related):

Three  
months  
ended  
September  
30,

(In thousands) 2016 2015

Total purchases \$357 \$404

The receivable and payable balances from these parties were immaterial at September 30, 2016 and June 30, 2016. Management believes that such transactions are at arm's length and on similar terms as would have been obtained from unaffiliated third parties.

## NOTE 16 – SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

KLA-Tencor reports one reportable segment in accordance with the provisions of the authoritative guidance for segment reporting. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. KLA-Tencor's chief operating decision maker is its Chief Executive Officer. The Company is engaged primarily in designing, manufacturing, and marketing process control and yield management solutions for the semiconductor and related nanoelectronics industries.

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

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

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

	Three months ended September 30,					
(Dollar amounts in thousands)	2016		2015			
Revenues:						
Taiwan	\$273,692	35 %	\$254,047	40 %		
Korea	135,089	18 %	73,433	11 %		
Japan	104,784	14 %	71,618	11 %		
North America	87,266	12 %	109,208	17 %		
China	85,689	12 %	75,352	12 %		
Europe & Israel	34,848	5 %	39,846	6 %		
Rest of Asia	29,305	4 %	19,140	3 %		

Total \$750,673 100% \$642,644 100%

31

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Table of Contents

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

(Dollar amounts in thousands)	Three months ended September			
	30, 2016		2015	
Revenues:				
Wafer Inspection	\$359,009	48 %	\$227,783	35 %
Patterning	172,614	23 %	198,085	31 %
Global Service and Support <sup>(1)</sup>	203,130	27 %	199,871	31 %
Other	15,920	2 %	16,905	3 %
Total	\$750,673	100%	\$642,644	100%

(1) The Global Service and Support revenues includes service revenues as presented in the condensed consolidated statements of operations as well as certain product revenues, primarily revenues from the Company's K-T Certified business.

In the three months ended September 30, 2016, three customers accounted for approximately 29%, 13%, and 11% of total revenues. In the three months ended September 30, 2015, one customer accounted for approximately 23% of total revenues. Four customers and two customers on an individual basis accounted for greater than 10% of net accounts receivables as of September 30, 2016 and June 30, 2016, respectively.

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

(In thousands)	As of September 30, 2016	As of June 30, 2016
Long-lived assets:		
United States	\$ 176,342	\$ 182,597
Singapore	41,508	41,658
Israel	31,079	30,844
Europe	13,182	13,347
Rest of Asia	10,240	9,568
Total	\$ 272,351	\$ 278,014

## NOTE 17 – SUBSEQUENT EVENT

On October 5, 2016, the Company and Lam Research entered into an agreement terminating the Merger Agreement. The termination agreement provides that no termination fees will be payable by either party.

Table of Contents

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

## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward-looking statements. You can identify these and other forward-looking statements by the use of words such as "may," "will," "could," "would," "should," "expects," "plans," "anticipates," "relies," "believes," "estimates," "predicts," "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, including profitability; orders for our products and capital equipment generally; sales of semiconductors; the investments by our customers in advanced technologies and new materials; the allocation of capital spending by our customers (and, in particular, the percentage of spending that our customers allocate to process control); growth of revenue in the semiconductor industry, the semiconductor capital equipment industry and our business; technological trends in the semiconductor industry; future developments or trends in the global capital and financial markets; our future product offerings and product features; the success and market acceptance of new products; timing of shipment of backlog; our future product shipments and product and service revenues; our future gross margins; our future research and development expenses and selling, general and administrative expenses; our ability to successfully maintain cost discipline; international sales and operations; our ability to maintain or improve our existing competitive position; success of our product offerings; creation and funding of programs for research and development; attraction and retention of employees; results of our investment in leading edge technologies; the effects of hedging transactions; the effect of the sale of trade receivables and promissory notes from customers; our future effective income tax rate; our recognition of tax benefits; 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, cash generated from operations and unfunded revolving line of credit under a Credit Agreement (the "Credit Agreement") to meet our operating and working capital requirements, including debt service and payment thereof; future dividends, and stock repurchases; our compliance with the financial covenants under the Credit Agreement; the expected timing of the completion of our global employee workforce reduction; the additional charges that we may incur in connection with our global employee workforce reduction; the expected cost savings that we expect to recognize as a result of such workforce reduction; the adoption of new accounting pronouncements; and our repayment of our outstanding indebtedness.

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, 2016, filed with the Securities and Exchange Commission on August 5, 2016. 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 related service, software and other offerings primarily supports integrated circuit ("IC" or "chip") manufacturers throughout the entire semiconductor fabrication process, from research and development to final volume production. We provide leading-edge equipment, software and support that enable IC manufacturers to identify, resolve and manage significant advanced technology manufacturing process challenges and obtain higher finished product yields at lower overall cost. In addition to serving the semiconductor industry, we also provide a range of technology solutions to a number of other high technology industries, including the LED and data storage industries, as well as general materials research.



Table of Contents

Our products and services are used by the vast majority of bare wafer, IC, lithography reticle (“reticle” or “mask”) and disk manufacturers around the world. Our products, services and expertise are used by our customers to measure, detect, analyze and resolve critical product defects that arise in that environment in order to control nanometric level manufacturing processes. 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, particularly in the foundry and logic markets, which have higher levels of process control adoption than the memory market.

As we are a supplier to the global semiconductor and semiconductor-related industries, our customer base continues to become more highly concentrated over time, thereby increasing the potential impact of a sudden change in capital spending by a major customer on our revenues and profitability. As our customer base becomes increasingly more concentrated, large orders from a relatively limited number of customers account for a substantial portion of our sales, which potentially exposes us to more volatility for revenues and earnings. We are also subject to the cyclical capital spending that has historically characterized the semiconductor and semiconductor-related industries. The timing, length, intensity and volatility of the capacity-oriented capital spending cycles of our customers are unpredictable. The semiconductor industry has also been characterized by constant technological innovation. The growing use of increasingly sophisticated semiconductor devices in mobile consumer products has caused many of our customers to invest in additional semiconductor manufacturing capabilities and capacity. On the other hand, higher design costs for the most advanced ICs could economically constrain leading-edge manufacturing technology customers to focus their resources on only the large technologically advanced products and applications. We believe that, over the long term, our customers will continue to invest in advanced technologies and new materials to enable smaller design rules and higher density applications that fuel demand for process control equipment, although the growth for such equipment may be adversely impacted by higher design costs for advanced ICs, reuse of installed products, and delays in production ramps by our customers in response to higher costs and technical challenges at more advanced technology nodes.

The demand for our products and our revenue levels are driven by our customers’ needs to solve the process challenges that they face as they adopt new technologies required to fabricate advanced ICs that are incorporated into sophisticated mobile devices. The timing for our customers in ordering and taking delivery of process control and yield management equipment is also determined by our customers’ requirements to meet the next generation production ramp schedules, and the timing for capacity expansion to meet end customer demand. During the three months ended September 30, 2016, our revenue was lower than the prior quarter, as expected. Our earnings will depend not only on our revenue levels, but also on the amount of research and development spending required to meet our customers’ technology roadmaps. We have maintained production volumes and capacity to meet anticipated customer requirements and remain at risk of incurring significant inventory-related and other restructuring charges if business conditions deteriorate. Over the past year, our customers have taken delivery of higher volumes of process control equipment than they did in the previous year. However, any delay or push out by our customers in taking delivery of process control and yield management equipment may cause earnings volatility, due to increases in the risk of inventory related charges as well as timing of revenue recognition.

**Proposed Merger with Lam Research**

On October 20, 2015, we entered into an Agreement and Plan of Merger and Reorganization (the “Merger Agreement” or “Merger”) with Lam Research Corporation (“Lam Research”) which was subject to regulatory approvals. On October 5, 2016, we mutually agreed to terminate the Merger Agreement. No termination fees are payable by either party in connection with the termination.





Table of Contents

The following table sets forth some of our key quarterly unaudited financial information:

(In thousands, except net income per share)	Three months ended				
	September 30, 2016	June 30, 2016	March 31, 2016	December 31, 2015	September 30, 2015
Total revenues	\$750,673	\$919,171	\$712,433	\$710,245	\$642,644
Gross margin	\$472,837	\$581,603	\$437,834	\$429,265	\$372,400
Net income	\$178,101	\$271,541	\$175,777	\$152,207	\$104,897
Net income per share:					
Basic <sup>(1)</sup>	\$1.14	\$1.74	\$1.13	\$0.98	\$0.67
Diluted <sup>(1)</sup>	\$1.13	\$1.73	\$1.12	\$0.98	\$0.66

(1) Basic and diluted net income 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 net income per share information may not equal annual (or other multiple-quarter calculations of) basic and diluted net income 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, 2016 describes the significant accounting policies and methods used in preparation of the condensed consolidated financial statements. We base these estimates and assumptions on historical experience, and evaluate them on an ongoing basis to ensure that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed our related disclosure in this Quarterly Report on Form 10-Q. The accounting policies that reflect our more significant estimates, judgments and assumptions and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results include the following:

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

Other than the impact of the early adoption of the accounting standard update on accounting for share-based payment awards (see “Recent Accounting Pronouncements” below), there were no significant changes in our critical accounting estimates and policies during the three months ended September 30, 2016. 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, 2016 for a more complete discussion of our critical accounting policies and estimates.

**Revenue Recognition**

We recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the selling price is fixed or determinable, and collectibility is reasonably assured. We derive revenue from three sources—sales of systems, spare parts and services. In general, we recognize revenue for systems when the

system has been installed, is operating according to predetermined specifications and is accepted by the customer. When we have demonstrated a history of successful installation and acceptance, we recognize revenue upon delivery and customer acceptance.

35

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## Table of Contents

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

• When the customer has previously accepted the same tool, with the same specifications, and when we can objectively demonstrate that the tool meets all of the required acceptance criteria.

• When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% of the payment is due based upon shipment.

• When the installation of the system is deemed perfunctory.

• When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

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

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

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

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

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

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

We also defer the fair value of non-standard warranty bundled with equipment sales as unearned revenue.

Non-standard warranty includes services incremental to the standard 40-hour per week coverage for 12 months.

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

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



## Table of Contents

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

### Valuation of Goodwill and Intangible Assets

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. We made certain organizational changes and consolidated our product divisions effective in the first quarter of fiscal year 2016, in response to changing customer requirements in the industry. The Company has four reporting units: Wafer Inspection, Patterning, Global Services and Support, and Others. See Note 5, “Goodwill and Purchased Intangible Assets” to the Condensed Consolidated Financial Statements for additional details.

We performed our annual qualitative assessment of the goodwill by reporting unit in our second quarter of fiscal year ended June 30, 2016 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 value may not be recoverable. Long-lived intangible assets are tested for impairment whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to our annual impairment test.

The next annual evaluation of the goodwill by reporting unit will be performed during the three months ending December 31, 2016. 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. It is not possible at this time to determine if any such future impairment charge would occur or, if it does, whether such charge would be material to our results of operations.

### Accounting for Stock-Based Compensation

We account for stock-based awards granted to employees for services based on the fair value of those awards. The fair value of stock-based awards is measured at the grant date and is recognized as expense over the employee’s requisite service period. The fair value for restricted stock units granted without “dividend equivalent” rights is determined using the closing price of our 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 fair value for restricted stock units granted with “dividend equivalent” rights is determined using the closing price of our common stock on the grant date. The award holder is not entitled to receive payments under dividend equivalent rights unless the associated restricted stock unit award vests (i.e., the award holder is entitled to receive credits, payable in cash or shares of our common stock, equal to the cash dividends that would have been received on the shares of our common stock underlying the restricted stock units had the shares been issued and outstanding on the dividend record date, but such dividend equivalents are only paid subject to the recipient satisfying the vesting requirements of the underlying award). The fair value is determined using a Black-Scholes valuation model for purchase rights under our Employee Stock Purchase Plan. 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. The expected stock price volatility assumption is based on the market-based historical implied volatility from traded options of our common stock.

### Recent Accounting Pronouncements

#### Recently Adopted

In April 2015, the Financial Accounting Standards Board (“FASB”) issued an accounting standard update for customer’s cloud based fees. The guidance changes what a customer must consider in determining whether a cloud computing arrangement contains a software license. If the arrangement contains a software license, the customer would account for the fees related to the software license element in accordance with guidance related to internal use software; if the arrangement does not contain a software license, the customer would account for the arrangement as a service contract. We adopted this update beginning in the first quarter of our fiscal year ending June 30, 2017 on a prospective basis and there was no impact of adoption on our condensed consolidated financial statements.

## Table of Contents

In March 2016, the FASB issued an accounting standard update to simplify certain aspects of share-based payment awards to employees, including the accounting for income taxes, an option to recognize gross stock-based compensation expense with actual forfeitures recognized as they occur and statutory tax withholding requirements, as well as certain classifications in the statement of cash flows. The update is effective for us beginning in the first quarter of its fiscal year ending June 30, 2018, with early adoption permitted and all of the guidance must be adopted in the same period. However, we elected to early-adopt this standard update beginning in the first quarter of its fiscal year ending June 30, 2017.

### Impact to Condensed Consolidated Statements of Operations

The primary impact of adopting the standard update is a change in the recording of the excess tax benefits or deficiencies from share-based payments. Before adoption, we recognized the excess tax benefits or deficiencies related to stock-based compensation as a credit or charge to additional paid-in capital (“APIC”) in our Condensed Consolidated Balance Sheets. Under the standard update, these excess tax benefits or deficiencies are recognized as a discrete tax benefit or discrete tax expense in the income tax provision in our Condensed Consolidated Statement of Operations. For the three months ended September 30, 2016, we recognized a discrete tax benefit of \$5.7 million related to net excess tax benefits mainly from stock-based compensation and dividend equivalents. The standard update requires companies to adopt the amendment related to accounting for excess tax benefits or deficiencies on a prospective basis only and as a result, prior periods were not retrospectively adjusted.

### Impact to Condensed Consolidated Statements of Cash Flows

In addition to the income tax consequence as described above, the standard update for share-based payment requires that cash flows from excess tax benefits related to share-based payments be reported as operating activities in the Condensed Consolidated Statements of Cash Flows. Previously, cash flows from excess tax benefit related to share-based payments were reported as financing activities. The standard update allows for two methods of adoption which are prospective or retrospective application. We elected to adopt this amendment on a prospective basis and as a result, prior periods were not retrospectively adjusted.

### Updates Not Yet Effective

In May 2014, the FASB issued an accounting standard update regarding revenue from customer contracts to transfer goods and services or non-financial assets unless the contracts are covered by other standards (for example, insurance or lease contracts). Under the new guidance, an entity should recognize revenue in connection with the transfer of promised goods or services to customers in an amount that reflects the consideration that the entity expects to be entitled to receive in exchange for those goods or services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. In August 2015, the FASB issued an amendment to defer the effective date of the update by one year, with early adoption on the original effective date permitted. With this amendment, the updates are effective for us beginning in the first quarter of our fiscal year ending June 30, 2019, with early adoption permitted beginning in the first quarter of our fiscal year ending June 30, 2018. Subsequent to this amendment, the FASB has issued additional clarifying implementation guidance. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. We are currently evaluating the impact of this accounting standard update on our condensed consolidated financial statements.

In July 2015, the FASB issued an accounting standard update for the subsequent measurement of inventory. The amended guidance requires entities to measure inventory at the lower of cost or net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. The requirement would replace the current lower of cost or market evaluation and the accounting guidance is unchanged for inventory measured using last-in, first-out (“LIFO”) or the retail inventory method. The update is effective for us beginning in the first quarter of our fiscal year ending June 30, 2018 and should be applied prospectively with early adoption permitted as of the beginning of an interim or annual reporting period. We are currently evaluating the impact of this accounting standard update on our condensed consolidated financial statements.

In January 2016, the FASB issued an accounting standard update that changes the accounting for financial instruments primarily related to equity investments (other than those accounted for under the equity method of accounting or those

that result in consolidation of the investee), financial liabilities under the fair value option, and the presentation and disclosure requirements for financial instruments. The accounting standard update is effective for us beginning in the first quarter of our fiscal year ending 2019, and early adoption is permitted. We are currently evaluating the impact of this accounting standard update on our condensed consolidated financial statements.



Table of Contents

In February 2016, the FASB issued an accounting standard update which amends the existing accounting standards for leases. Consistent with current guidance, the recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification. Under the new guidance, a lessee will be required to recognize assets and liabilities for all leases with lease terms of more than 12 months. The update is effective for us beginning in the first quarter of our fiscal year ending June 30, 2020 using a modified retrospective transition method. Early adoption is permitted. We are currently evaluating the impact of this accounting standard update on our condensed consolidated financial statements.

In June 2016, the FASB issued an accounting standard update that changes the accounting for recognizing impairments of financial assets. Under the update, credit losses for certain types of financial instruments will be estimated based on expected losses. The update also modifies the impairment models for available-for-sale debt securities and for purchased financial assets with credit deterioration since their origination. The update is effective for us beginning in the first quarter of our fiscal year ending June 30, 2021, with early adoption permitted starting in the first quarter of fiscal year ending 2020. We are currently evaluating the impact of this accounting standard update on our condensed consolidated financial statements.

**RESULTS OF OPERATIONS****Revenues and Gross Margin**

(Dollar amounts in thousands)	Three months ended		September 30, 2015	Q1 FY17 vs. Q4 FY16	Q1 FY17 vs. Q1 FY16
	September 30, 2016	June 30, 2016			
Revenues:					
Product	\$561,753	\$731,118	\$460,739	\$(169,365) (23)%	\$101,014 22%
Service	188,920	188,053	181,905	867 — %	7,015 4 %
Total revenues	\$750,673	\$919,171	\$642,644	\$(168,498) (18)%	\$108,029 17%
Costs of revenues	\$277,836	\$337,568	\$270,244	\$(59,732) (18)%	\$7,592 3 %
Gross margin percentage	63	% 63	% 58	%	

**Product revenues**

Our business is affected by the concentration of our customer base and our customers' capital equipment procurement schedules as a result of their investment plans. Our product revenues in any particular quarter are significantly impacted by the amount of new orders that we receive during that quarter and, depending upon the duration of manufacturing and installation cycles, in the preceding quarters.

Product revenues decreased during the three months ended September 30, 2016 compared to the three months ended June 30, 2016, primarily due to lower product revenues from China, North America, Japan, Europe & Israel and Rest of Asia regions, partially offset by higher product revenues from Taiwan and Korea regions. We had strong product revenues during the three months ended June 30, 2016 because of the introduction of our new generation inspection products and the expansion of semiconductor investments in Asia, particularly in China and Taiwan from our foundry customers relative to the three months ended September 30, 2016.

Product revenues increased during the three months ended September 30, 2016 compared to the three months ended September 30, 2015, primarily as a result of higher shipment backlog for systems at the beginning of the period, relative to the three months ended September 30, 2015. Our product revenues increased across all regions in Asia, partially offset by decreased product revenues from North America and Europe & Israel regions during the three months ended September 30, 2016 compared to the three months ended September 30, 2015.

**Service revenues**

Service revenues are generated from maintenance contracts, as well as billable time and material service calls made to our customers after the expiration of the warranty period. The amount of our service revenues is typically a function of the number of post-warranty systems installed at our customers' sites and the utilization of those systems, but it is also impacted by other factors, such as our rate of service contract renewals, the types of systems being serviced and fluctuations in foreign exchange rates. Service revenues during the three months ended September 30, 2016 compared to the three months ended June 30, 2016 remained relatively unchanged. Service revenues during the three months ended September 30, 2016 increased compared to the three months September 30, 2015, primarily due to an increase

over time in the number of post-warranty systems installed at our customers' sites.

39

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Table of Contents

## Revenues by region

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

(Dollar amounts in thousands)	Three months ended					
	September 30, 2016		June 30, 2016		September 30, 2015	
Taiwan	\$273,692	35 %	\$241,573	26 %	\$254,047	40 %
Korea	135,089	18 %	130,253	14 %	73,433	11 %
Japan	104,784	14 %	119,238	13 %	71,618	11 %
North America	87,266	12 %	131,422	15 %	109,208	17 %
China	85,689					