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

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended: December 31, 2005**

**or**

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

**For the transition period from ________ to ________**

**Commission File Number 0-9992**

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes ☒ No ☐

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

Large accelerated filer Act). ☒ Accelerated filer ☐ Non-accelerated filer ☐

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

Yes ☐ No ☒

As of January 30, 2006 there were 199,527,802 shares of the Registrant's Common Stock, $0.001 par value, outstanding.

## INDEX


| | | Page Number |
|---|---|---|
| **PART I** | **FINANCIAL INFORMATION** | |
| Item 1 | Financial Statements (Unaudited) | |
| | Condensed Consolidated Balance Sheets at December 31, 2005 and June 30, 2005 | 3 |
| | Condensed Consolidated Statements of Operations for the Three and Six Months Ended December 31, 2005 and 2004 | 4 |
| | Condensed Consolidated Statements of Cash Flows for the Six Months Ended December 31, 2005 and 2004 | 5 |
| | Notes to Condensed Consolidated Financial Statements | 6 |
| Item 2 | Management's Discussion and Analysis of Financial Condition and Results of Operations | 24 |
| Item 3 | Quantitative and Qualitative Disclosures About Market Risk | 47 |
| Item 4 | Controls and Procedures | 47 |
| **PART II** | **OTHER INFORMATION** | |
| Item 1 | Legal Proceedings | 49 |
| Item 2 | Unregistered Sales of Equity Securities and Use of Proceeds | 49 |
| Item 4 | Submission of Matters to a Vote of Security Holders | 50 |
| Item 6 | Exhibits | 50 |
| **SIGNATURES** | | 51 |
| **EXHIBIT INDEX** | | 52 |

## PART I. FINANCIAL INFORMATION

**ITEM 1. FINANCIAL STATEMENTS (Unaudited)**

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

| *(in thousands)* | December 31, 2005 | June 30, 2005 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 964,188 | $ 874,509 |
| Marketable securities | 1,263,042 | 1,320,677 |
| Accounts receivable, net | 371,873 | 333,218 |
| Inventories | 411,796 | 358,339 |
| Deferred income taxes | 288,456 | 265,467 |
| Other current assets | 49,119 | 50,435 |
| Total current assets | 3,348,474 | 3,202,645 |
| Land, property and equipment, net | 387,839 | 385,222 |
| Other assets | 428,223 | 398,505 |
| Total assets | $ 4,164,536 | $ 3,986,372 |
| **LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 79,142 | $ 67,717 |
| Deferred system profit | 163,967 | 209,899 |
| Unearned revenue | 74,701 | 80,122 |
| Other current liabilities | 541,911 | 574,124 |
| Total current liabilities | 859,721 | 931,862 |
| Commitments and contingencies (Note 10) | | |
| Minority interest in subsidiary | $ 8,831 | $ 9,253 |
| Stockholders' equity: | | |
| Common stock and capital in excess of par value | 1,098,263 | 943,322 |
| Retained earnings | 2,189,515 | 2,083,638 |
| Accumulated other comprehensive income | 8,206 | 18,297 |
| Total stockholders' equity | 3,295,984 | 3,045,257 |
| Total liabilities, minority interest and stockholders' equity | $ 4,164,536 | $ 3,986,372 |

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

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

| *(in thousands except per share data)* | Three months ended December 31, 2005 | Three months ended December 31, 2004 | Six months ended December 31, 2005 | Six months ended December 31, 2004 |
|---|---|---|---|---|
| Revenues: | | | | |
| Product | $ 401,720 | $ 454,945 | $ 801,670 | $ 897,241 |
| Service | 86,250 | 77,908 | 170,160 | 154,385 |
| Total revenues | 487,970 | 532,853 | 971,830 | 1,051,626 |
| Costs and operating expenses: | | | | |
| Costs of revenues* | 217,103 | 217,735 | 431,323 | 433,204 |
| Engineering, research and development* | 98,327 | 87,161 | 195,078 | 164,308 |
| Selling, general and administrative* | 96,025 | 72,449 | 188,076 | 141,639 |
| Total costs and operating expenses | 411,455 | 377,345 | 814,477 | 739,151 |
| Income from operations | 76,515 | 155,508 | 157,353 | 312,475 |
| Interest income and other, net | 16,685 | 7,777 | 31,461 | 14,762 |
| Income before income taxes and minority interest | 93,200 | 163,285 | 188,814 | 327,237 |
| Provision for income taxes* | 17,806 | 42,443 | 37,487 | 89,990 |
| Income before minority interest | 75,394 | 120,842 | 151,327 | 237,247 |
| Minority interest | 1,255 | 1,235 | 2,000 | 1,235 |
| Net income | $ 76,649 | $ 122,077 | $ 153,327 | $ 238,482 |
| Net income per share: | | | | |
| Basic | $ 0.39 | $ 0.62 | $ 0.78 | 1.22 |
| Diluted | $ 0.38 | $ 0.61 | $ 0.76 | 1.19 |
| Weighted average number of shares: | | | | |
| Basic | 198,236 | 195,681 | 197,824 | 195,976 |
| Diluted | 203,345 | 200,946 | 203,043 | 200,477 |

*includes the following amounts related to equity awards

| | Three months ended December 31, 2005 | Three months ended December 31, 2004 | Six months ended December 31, 2005 | Six months ended December 31, 2004 |
|---|---|---|---|---|
| Costs of revenues | $ 6,612 | $ — | $ 13,423 | $ — |
| Engineering, research and development | 12,023 | 498 | 23,033 | 498 |
| Selling, general and administrative | 17,619 | 621 | 34,626 | 621 |
| Provision for income taxes | (10,442) | (414) | (21,098) | (414) |
| Total | $ 25,812 | $ 705 | $ 49,984 | $ 705 |

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

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

| *(in thousands)* | Six months ended December 31, 2005 | 2004 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 153,327 | $ 238,482 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 34,866 | 36,659 |
| Non-cash stock-based compensation | 71,082 | 1,119 |
| Tax benefit from equity awards | 31,086 | — |
| Gross tax windfall from stock-based compensation | (10,791) | — |
| Minority interest | (2,000) | (1,235) |
| Net (gain) loss on sale of marketable securities and other investments | 1,195 | 1,939 |
| Changes in assets and liabilities, net of effect of acquisitions of businesses: | | |
| Accounts receivable, net | (52,921) | (60,020) |
| Inventories | (49,939) | (11,354) |
| Other assets | (7,795) | (26,786) |
| Accounts payable | 11,828 | (20,767) |
| Deferred system profit | (45,932) | (16,654) |
| Other current liabilities | (63,000) | 30,100 |
| Net cash provided by operating activities | 71,006 | 171,483 |
| Cash flows from investing activities: | | |
| Acquisitions of businesses, net of cash received | (7,664) | (44,628) |
| Capital expenditures, net | (38,785) | (47,086) |
| Purchase of available-for-sale securities | (1,470,421) | (1,145,835) |
| Proceeds from sale of available-for-sale securities | 1,414,077 | 825,687 |
| Proceeds from maturity of available-for-sale securities | 97,291 | 220,341 |
| Net cash used in investing activities | (5,502) | (191,521) |
| Cash flows from financing activities: | | |
| Issuance of common stock | 136,340 | 70,876 |
| Stock repurchases | (84,362) | (111,122) |
| Payment of dividends to stockholders | (47,450) | — |
| Proceeds from sale of minority interest in subsidiary | 1,579 | 10,000 |
| Gross tax windfall from stock-based compensation | 10,791 | — |
| Net cash provided by (used in) in financing activities | 16,898 | (30,246) |
| Effect of exchange rate changes on cash and cash equivalents | 7,277 | 5,202 |
| Net increase(decrease) in cash and cash equivalents | 89,679 | (45,082) |
| Cash and cash equivalents at beginning of period | 874,509 | 598,698 |
| Cash and cash equivalents at end of period | $ 964,188 | $ 553,616 |
| Supplemental cash flow disclosures: | | |
| Income taxes paid, net | $ 12,434 | $ 80,917 |
| Interest paid | $ 600 | $ 501 |

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

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

## NOTE 1 – BASIS OF PRESENTATION

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

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

The results of operations for the three month and six month periods ended December 31, 2005 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2006.

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

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

**Recent Accounting Pronouncements** In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment." SFAS No. 123(R) which requires the Company to measure all employee stock-based compensation awards using a fair value method and record such expense in its consolidated financial statements. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107, which provides the Staff's views regarding interactions between SFAS No. 123(R) and certain SEC rules and regulations and provides interpretations of the valuation of share-based payments for public companies. The adoption of SFAS No. 123(R) requires additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. The adoption of SFAS No. 123(R) in the fiscal quarter ended September 30, 2005, had a material impact on the Company's consolidated results of operations, financial position and statement of cash flows. For more information on stock-based compensation costs during the three months and six months ended December 31, 2005, refer to Note 6 - "Stock-Based Compensation."

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

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

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

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

**NOTE 2 – BALANCE SHEET COMPONENTS**

| ***(in thousands)*** | **December 31, 2005** | **June 30, 2005** |
|---|---|---|
| Cash equivalents and marketable securities | | |
| U.S. Treasuries | $ 141,069 | $ 42,582 |
| Mortgage-backed securities | 271,567 | 34,798 |
| Municipal bonds | 1,076,381 | 1,455,848 |
| Corporate equity securities | 8,548 | 11,887 |
| Money market bank deposits and other | 576,027 | 520,124 |
| | $ 2,073,592 | $ 2,065,239 |
| Less: Cash equivalents | 810,550 | 744,562 |
| Short-term marketable securities | $ 1,263,042 | $ 1,320,677 |

Prior to the third fiscal quarter of 2005, the Company classified auction rate securities with reset dates of 90 days or less, as cash equivalents on the Consolidated Balance Sheets. In the third fiscal quarter of 2005, the Company classified all auction rate securities as short-term investments. There was no impact on the Consolidated Statements of Operations as a result of the reclassification for the three months and six months ended December 31, 2004. The impact on the Consolidated Statement of Cash Flows was an increase of $234.4 million in cash used in investing activities for the six months ended December 31, 2004 from the amounts previously reported.

| *(in thousands)* | December 31, 2005 | June 30, 2005 |
|---|---|---|
| Accounts receivable, net | | |
| Accounts receivable, gross | $ 383,976 | $ 345,443 |
| Allowance for doubtful accounts | (12,103) | (12,225) |
| | $ 371,873 | $ 333,218 |
| Inventories | | |
| Customer service parts | $ 140,097 | $ 124,631 |
| Raw materials | 91,476 | 87,298 |
| Work-in-process | 77,722 | 64,388 |
| Finished goods and demonstration equipment | 102,501 | 82,022 |
| | $ 411,796 | $ 358,339 |
| Property and equipment | | |
| Land | $ 84,548 | $ 84,548 |
| Buildings and improvements | 154,405 | 154,405 |
| Machinery and equipment | 364,304 | 348,145 |
| Office furniture and fixtures | 41,376 | 41,480 |
| Leasehold improvements | 139,010 | 138,787 |
| Construction in process | 18,517 | 6,276 |
| | 802,160 | 773,641 |
| Less: accumulated depreciation | (414,321) | (388,419) |
| | $ 387,839 | $ 385,222 |
| Other assets | | |
| Goodwill & other intangibles, net | $ 71,487 | $ 58,670 |
| Long-term investments | 155,437 | 137,143 |
| Deferred tax assets – long-term | 192,550 | 192,613 |
| Other | 8,749 | 10,079 |
| | $ 428,223 | $ 398,505 |
| Other current liabilities | | |
| Warranty and retrofit | $ 49,891 | $ 52,845 |
| Compensation and benefits | 234,648 | 251,060 |
| Income taxes payable | 156,708 | 142,855 |
| Other accrued expenses | 100,664 | 127,364 |
| | $ 541,911 | $ 574,124 |

## NOTE 3 – GOODWILL AND OTHER INTANGIBLE ASSETS

### Goodwill

The carrying value of goodwill was $49.2 million and $47.4 million as of December 31, 2005 and June 30, 2005, respectively, and was allocated to KLA-Tencor's reporting units pursuant to SFAS No. 142. In accordance with SFAS No. 142, KLA-Tencor completed its annual evaluation of the goodwill by reporting unit during the quarter ended December 31, 2005, and concluded that there was no impairment.

### Other Intangible Assets

The components of other intangible assets as of December 31, 2005 (in thousands) were as follows:

| | Gross Carrying Amount | Accumulated Amortization | Net Amount |
|---|---|---|---|
| Existing technology | $ 12,537 | $ 3,930 | $ 8,607 |
| Patents | 18,161 | 4,923 | 13,238 |
| Trademark | 1,225 | 732 | 493 |
| Other | 200 | 200 | — |
| Total | $ 32,123 | $ 9,785 | $ 22,338 |

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

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

During the quarter ended September 30, 2005, the Company entered into an agreement to license certain patents for approximately $14 million which will be amortized over a period of 10 years. For the three month periods ended December 31, 2005 and 2004, amortization expense for other intangible assets was $1.1 million and $1.0 million, respectively. For the six month periods ended December 31, 2005 and 2004, amortization expense for other intangible assets was $2.3 million and $1.4 million, respectively. Based on the intangible assets recorded at December 31, 2005, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated amortization expense is expected to be as follows (in thousands):

| Fiscal year ending June 30: | Amount |
|---|---|
| 2006 (remaining 6 months) | $ 1,830 |
| 2007 | 3,293 |
| 2008 | 2,922 |
| 2009 | 2,798 |
| 2010 | 2,798 |
| Thereafter | 8,697 |
| Total | $ 22,338 |

**NOTE 4 – BUSINESS COMBINATIONS**

During the three months ended December 31, 2005, the Company completed the acquisition of one business for net cash consideration of $2.2 million. The business combinations completed during fiscal year 2005 are disclosed in Note 5 of Notes to Consolidated Financial Statements included in Item 8 of the Company's Annual Report on Form 10-K for the year ended June 30, 2005.

In connection with the acquisitions completed during fiscal year 2005, KLA-Tencor is subject to a $9.1 million contingent cash payment based on the continued employment of certain employees over two years. During the three months ended December 31, 2005, $5.4 million of this amount was paid. The contingency is accounted for as compensation expense over the contingent employment period.

**NOTE 5 – EARNINGS PER SHARE**

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

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

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Numerator: | | | | |
| Net Income[1] | $ 76,649 | $ 122,077 | $ 153,327 | $ 238,482 |
| Denominator: | | | | |
| Weighted average shares outstanding, excluding unvested restricted stock units | 198,236 | 195,681 | 197,824 | 195,976 |
| Effect of dilutive options and restricted stock units | 5,109 | 5,265 | 5,219 | 4,501 |
| Denominator for diluted earnings per share | 203,345 | 200,946 | 203,043 | 200,477 |
| Basic earnings per share[1] | $ 0.39 | $ 0.62 | $ 0.78 | $ 1.22 |
| Diluted earnings per share[1] | $ 0.38 | $ 0.61 | $ 0.76 | $ 1.19 |

[1] Net income for the three months and six months ended December 31, 2005 includes $25.8 million and $50.0 million of stock-based compensation expense, net of tax, respectively. The effect of recording stock-based compensation expense on basic and diluted earnings per share was $0.13 and $0.25 per share for the three months and six months ended December 31, 2005, respectively.

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

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Number of shares | 17,470 | 7,682 | 16,285 | 9,837 |

During the third fiscal quarter of 2005, the Company's Board of Directors authorized a quarterly cash dividend of $0.12 per share. The total amount of dividends paid during the three months and six months ended December 31, 2005 was $23.7 and $47.5 million, respectively.

**NOTE 6 – STOCK-BASED COMPENSATION**

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

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

Prior to the adoption of SFAS No. 123(R), the Company provided the disclosures required under SFAS No. 123, "Accounting for Stock-Based Compensation," as amended by SFAS No. 148, "Accounting for Stock-Based Compensation – Transition and Disclosures."

The pro-forma information for the three months and six months ended December 31, 2004 was as follows:

| | Three months ended December 31, 2004 | Six months ended December 31, 2004 |
|---|---|---|
| Net income – as reported | $ 122,077 | $ 238,482 |
| Add: | | |
| Stock-based compensation expense included in reported net income, net of tax | 705 | 705 |
| Deduct: | | |
| Total stock-based compensation expense determined under fair value based method for all awards, net of tax | (21,782) | (42,235) |
| Net income – pro forma | $ 101,000 | $ 196,952 |
| Earnings per share: | | |
| As reported | | |
| Basic | $ 0.62 | $ 1.22 |
| Diluted | $ 0.61 | $ 1.19 |
| Pro forma | | |
| Basic | $ 0.52 | $ 1.00 |
| Diluted | $ 0.50 | $ 0.98 |

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

The Company elected to adopt the modified prospective application method as provided by SFAS No. 123(R). Accordingly, during the period ended December 31, 2005, the Company recorded stock-based compensation cost totaling the amount that would have been recognized had the fair value method been applied since the effective date of SFAS No. 123. Previously reported amounts have not been restated. The effect of recording stock-based compensation for the three months and six months ended December 31, 2005 was as follows:

| | Three months ended December 31, 2005 | Six months ended December 31, 2005 |
|---|---|---|
| Stock-based compensation expense by type of award: | | |
| Employee stock options | $ 30,985 | $ 61,009 |
| Employee stock purchase plan | 6,172 | 12,516 |
| Restricted stock units[1] | 1,374 | 2,468 |
| Amounts capitalized as inventory and deferred system profit | (2,277) | (4,911) |
| Total stock-based compensation | 36,254 | 71,082 |
| Tax effect on stock-based compensation | (10,442) | (21,098) |
| Net effect on net income | $ 25,812 | $ 49,984 |
| Tax effect on: | | |
| Cash flows from operations | (5,773) | (10,791) |
| Cash flows from financing activities | 5,773 | 10,791 |
| Effect on earnings per share: | | |
| Basic | $ 0.13 | $ 0.25 |
| Diluted | $ 0.13 | $ 0.25 |

[1] Stock-based compensation expense of $1.4 million and $2.5 million for the three months and six months ended December 31, 2005, respectively, related to restricted stock units would have been recorded under the provisions of APB No. 25.

As of July 1, 2005, the Company had an unrecorded deferred stock-based compensation balance related to stock options of $288.1 million after estimated forfeitures. In the Company's pro forma disclosures prior to the adoption of SFAS No. 123(R), the Company accounted for forfeitures upon occurrence. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised if necessary in subsequent periods if actual forfeitures differ from those estimates.

During the six months ended December 31, 2005, the Company granted approximately 4.1 million stock options with an estimated total grant-date fair value of $44.7 million after estimated forfeitures. During the six months December 31, 2005, the Company recorded stock-based compensation related to stock options of $61.0 million.

As of December 31, 2005, the unrecorded deferred stock-based compensation balance related to stock options was $271.8 million after estimated forfeitures and will be recognized over an estimated weighted average amortization period of 3.0 years.

Approximately $4.1 million and $0.8 million of stock-based compensation was capitalized as inventory and deferred system profit, respectively, at December 31, 2005. The Company elected not to capitalize any stock-based compensation to inventory or deferred system profit at July 1, 2005 when the provisions of SFAS No. 123(R) were initially adopted.

**Valuation Assumptions**

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

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Stock option plan: | | | | |
| Expected stock price volatility | 31% | 57% | 29% | 58% |
| Risk free interest rate | 4.2% | 3.8% | 4.0% | 3.6% |
| Dividend yield | 1.0% | — | 1.0% | — |
| Expected life of options (in years) | 4.3 | 5.5 | 4.7 | 5.8 |
| Stock purchase plan: | | | | |
| Expected stock price volatility | 33% | 42% | 33% | 42% |
| Risk free interest rate | 3.5% | 2.8% | 3.5% | 2.8% |
| Dividend yield | 1.1% | — | 1.1% | — |
| Expected life of options (in years) | 1.3 | 1.3 | 1.3 | 1.3 |

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

**Equity Incentive Program**

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

The following table summarizes our equity compensation plans as of December 31, 2005:

| | Number of securities to be issued upon exercise of outstanding options, warrants and rights[1] | Weighted-average exercise price of outstanding options, warrants and rights. | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column 1)[2] |
|---|---|---|---|
| Equity compensation plans approved by stockholders | 25,988,304 | $ 39.31 | 9,300,595 |
| Equity compensation plans not approved by stockholders | 6,487,804 | $ 38.73 | — |
| Total | 32,476,108 | $ 39.19 | 9,300,595 |

(1) Amounts shown are for options granted only. There were 956,360 shares of restricted stock units outstanding under the 2004 Equity Incentive Plan as of December 31, 2005.

(2) Any 2004 Equity Incentive Plan awards of restricted stock, performance shares, performance units or deferred stock units with a per share or unit purchase price lower than 100% of fair market value on the grant date shall be counted against the total number of shares issuable under the plan as 1.8 shares for every one share subject thereto. Including the restricted stock units issued, and applying the 1.8 ratio as required by the 2004 Equity Incentive Plan, and including the 2,294,082 shares reserved for issuance under the employee stock purchase plan, the number of shares remaining available for future issuance under our equity compensation plans was 9,300,595 shares as of December 31, 2005.

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

| | Awards Available For Grant | Options Outstanding | Weighted-Average Exercise Price |
|---|---|---|---|
| Balances at June 30, 2003 | 16,919,718 | 29,733,958 | $ 29.94 |
| Additional shares reserved | 5,751,033 | — | — |
| Options granted | (6,298,343) | 6,298,343 | $ 52.09 |
| Options canceled/expired/forfeited | 978,478 | (978,478) | $ 38.66 |
| Options exercised | — | (5,357,878) | $ 25.74 |
| Balances at June 30, 2004 | 17,350,886 | 29,695,945 | $ 35.11 |
| Additional shares reserved | 18,369,456 | — | — |
| Plan shares expired | (15,814,111) | — | — |
| Options granted [1] | (9,625,481) | 9,625,481 | $ 40.31 |
| Restricted stock units granted[2] | (732,528) | — | — |
| Options canceled/expired/forfeited | 2,267,362 | (2,267,362) | $ 41.84 |
| Options exercised | — | (3,675,077) | $ 26.56 |
| Balances at June 30, 2005 | 11,815,584 | 33,378,987 | $ 37.08 |
| Additional shares reserved | 34,147 | — | — |
| Plan shares expired | (783,093) | — | — |
| Options granted | (4,125,420) | 4,125,420 | $ 48.00 |
| Restricted stock units granted[2] | (1,000,620) | — | — |
| Restricted stock units cancelled[2] | 11,700 | — | — |
| Options canceled/expired/forfeited | 1,054,215 | (1,054,215) | $ 43.33 |
| Options exercised | — | (3,974,084) | $ 29.58 |
| Balances at December 31, 2005 | 7,006,513 | 32,476,108 | $ 39.19 |

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

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

The options outstanding and exercisable at December 31, 2005 were in the following exercise price ranges:

| | Options Outstanding | | | | Options Exercisable | | | |
|---|---|---|---|---|---|---|---|---|
| Range of Exercise Prices | Number of Shares Outstanding | Weighted Average Remaining Contractual Term (in years) | Weighted Average Exercise Price | Aggregate Intrinsic Value (in thousands) | Number Vested and Exercisable | Weighted Average Remaining Contractual Term (in years) | Weighted Average Exercise Price | Aggregate Intrinsic Value (in thousands) |
| $5.95-$9.53 | 102,457 | 1.1 | $ 9.00 | $ 4,132 | 102,457 | 1.1 | $ 9.00 | $ 4,132 |
| $9.53-$19.88 | 1,939,971 | 2.6 | $ 11.79 | $ 72,828 | 1,939,971 | 2.6 | $ 11.79 | $ 72,828 |
| $19.88-$29.96 | 4,706,104 | 5.4 | $ 28.68 | $ 97,203 | 3,603,977 | 5.3 | $ 28.47 | $ 75,187 |
| $29.96-$39.35 | 11,140,809 | 7.2 | $ 36.98 | $ 137,591 | 4,931,199 | 5.9 | $ 35.18 | $ 69,782 |
| $39.35-$49.99 | 10,196,608 | 7.0 | $ 45.56 | $ 38,461 | 3,692,502 | 5.8 | $ 44.94 | $ 16,197 |
| $49.99-$59.44 | 4,373,354 | 7.5 | $ 54.04 | — | 2,153,050 | 7.4 | $ 54.17 | — |
| $59.44-$68.00 | 16,805 | 4.1 | $ 68.00 | — | 16,805 | 4.1 | $ 68.00 | — |
| $5.95-$68.00 | 32,476,108 | 6.6 | $ 39.19 | $ 350,215 | 16,439,961 | 5.5 | $ 35.50 | $ 238,126 |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company's closing stock price of $49.33 as of December 31, 2005, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of December 31, 2005 was 14.0 million.

The weighted average grant date fair value of options, as determined under SFAS No. 123(R), granted during the six months ended December 31, 2005 and 2004 was $13.78 and $22.67 per share, respectively.

The total intrinsic value of options exercised during the six months ended December 31, 2005 and 2004 was $84.0 million and $34.9 million, respectively. The total cash received from employees as a result of employee stock option exercises during the six months ended December 31, 2005 was approximately $117.6 million. In connection with these exercises, the tax benefits realized by the Company for the six months ended December 31, 2005 was $31.1 million.

The total fair value of shares vested during the six months ended December 31, 2005 and 2004 was $72.3 million and $64.3 million, respectively.

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

**Restricted Stock Units**

As of July 1, 2005, the Company had a deferred stock-based compensation balance related to restricted stock units of $14.1 million after estimated forfeitures.

During the six months ended December 31, 2005, the Company's Board of Directors approved the grant of 555,900 shares of restricted stock units to selected members of the Company's senior management. These restricted stock units generally vest in two equal installments on the fourth and fifth anniversaries of the date of grant. The value of the restricted stock units was based on the closing market price of the Company's common stock on the date of award. The total grant date fair value of the restricted stock units granted during the six months ended December 31, 2005 was $20.3 million after estimated forfeitures. At December 31, 2005, the company increased its forfeiture rate estimate and therefore reduced the unrecorded deferred stock based compensation balance by $3.3 million. Stock-based compensation cost for restricted stock units for the six months ended December 31, 2005 was $2.5 million.

As of December 31, 2005, there was $28.6 million of total deferred stock-based compensation after estimated forfeitures related to nonvested restricted stock units granted under the Equity Incentive Program. That cost is expected to be recognized over an estimated weighted average amortization period of 4.3 years.

**Employee Stock Purchase Plan**

KLA-Tencor's employee stock purchase plan provides that eligible employees may contribute up to 10% of their eligible earnings toward the semi-annual purchase of KLA-Tencor's common stock. The employee's purchase price is derived from a formula based on the fair market value of the common stock at the time of enrollment into the offering period versus the fair market value on the date of purchase. Offering periods are generally two years in length. The compensation cost in connection with the plan for the six months ended December 31, 2005 was $12.5 million. The total cash received from employees for the issuance of shares under the employee stock purchase plan was approximately $18.8 million during the six months ended December 31, 2005.

The plan shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2,000,000 shares or the number of shares which the KLA-Tencor estimates will be required to issue under the plan during the forthcoming fiscal year. At December 31, 2005, a total of 2,294,082 shares were reserved and available for issuance under this plan.

**NOTE 7 – STOCK REPURCHASE PROGRAM**

In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. This plan was put into place to reduce the dilution from KLA-Tencor's employee benefit and incentive plans such as the stock option and employee stock purchase plans, and to return excess cash to the Company's shareholders. Since the inception of the repurchase program in 1997 through December 31, 2005 the Board of Directors had authorized KLA-Tencor to repurchase a total of 27.8 million shares, including 10 million shares authorized in February 2005.

Share repurchases for the three months and six months ended December 31, 2005 and 2004 were as follows (in thousands):

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Number of shares of common stock repurchased | 997 | 775 | 1,736 | 2,813 |
| Total cost of repurchase | $ 48,874 | $ 34,068 | $ 84,362 | $ 111,122 |

As of December 31, 2005 and 2004, the amount related to unsettled share repurchases was $2.0 million, and $1.4 million respectively.

**NOTE 8 – COMPREHENSIVE INCOME**

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

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Net Income [1] | $ 76,649 | $ 122,077 | $ 153,327 | $ 238,482 |
| Other comprehensive income (loss): | | | | |
| Currency translation adjustments | (2,792) | 15,962 | (6,909) | 15,294 |
| Gain (loss) on cash flow hedging instruments, net | (190) | (10,733) | 1,834 | (6,533) |
| Unrealized gains (losses) on investments, net of taxes (benefits) of $(397) and $(2,984) for the three months and six months ended December 31, 2005 and $(645) and $1,795 for the three and six months ended December 31, 2004 | (667) | (1,022) | (5,016) | 2,842 |
| Other comprehensive income(loss) | $ (3,649) | $ 4,207 | $ (10,091) | $ 11,603 |
| Total comprehensive income | $ 73,000 | $ 126,284 | $ 143,236 | $ 250,085 |

[1] Net income for the three months and six months ended December 31, 2005 includes $25.8 million and $50.0 million of stock-based compensation expense, net of tax, respectively. The effect of recording stock-based compensation expense on basic and diluted earnings per share was $0.13 and $0.25 per share for the three months and six months ended December 31, 2005, respectively.

**NOTE 9 – EMPLOYEE BENEFIT PLANS**

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

Net periodic pension cost, determined in accordance with SFAS No. 87, for KLA-Tencor's defined benefit retirement plans for the three months and six months ended December 31, 2005 and 2004 include the following components (in thousands):

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Service Cost | $ 514 | $ 608 | $ 1,048 | $ 1,181 |
| Interest Cost | 123 | 98 | 250 | 191 |
| Expected Return on Assets | (42) | (37) | (85) | (72) |
| Amortization of Net Transitional Obligation | 38 | 65 | 78 | 127 |
| Amortization of Net Gain | 45 | 17 | 92 | 34 |
| Net periodic pension cost | $ 678 | $ 751 | $ 1,383 | $ 1,461 |

KLA-Tencor contributed $178,000 and $351,000 to its foreign subsidiary defined benefit pension plans for the three months and six months ended December 31, 2005, respectively, and expects to contribute $525,000 during the remainder of fiscal year 2006.

**NOTE 10 – COMMITMENTS AND CONTINGENCIES**

**Factoring** KLA-Tencor has agreements with financial institutions to sell certain of its trade receivables and promissory notes from customers without recourse. During the three months ended December 31, 2005 and 2004, approximately $56.6 million and $63.8 million of receivables were sold under these arrangements, respectively. During the six months ended December 31, 2005 and 2004, approximately $111.2 million and $130.1 million of receivables were sold under these arrangements, respectively. KLA-Tencor does not believe it is at risk for any material losses as a result of these agreements.

In addition, from time to time KLA-Tencor will discount without recourse Letters of Credit ("LCs") received from customers in payment of goods. During the three months ended December 31, 2005, several LCs were sold with proceeds totaling $16.0 million. No LCs were sold during the three months ended December 31, 2004. Discounting fees of $146,000 for the three months ended December 31, 2005 were equivalent to interest expense and were recorded in interest and other income net. During the six months ended December 31, 2005 and 2004, several LCs were sold with proceeds totaling $33.7 million and $10.0 million, respectively. Discounting fees were $291,000 and $44,000 for the six months ended December 31, 2005 and 2004, respectively.

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

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

| Fiscal year ended June 30, | Amount |
|---|---|
| 2006 (remaining 6 months) | $ 4,026 |
| 2007 | 6,381 |
| 2008 | 4,128 |
| 2009 | 2,901 |
| 2010 | 1,755 |
| 2011 | 1,103 |
| Thereafter | 1,948 |
| Total minimum lease payments | $ 22,242 |

**Purchase Commitments** KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply chain for key components. KLA-Tencor's liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. The Company's open inventory purchase commitments were approximately $133.9 million as of December 31, 2005. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or cancelled. Certain agreements provide for potential cancellation penalties.

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

The following table provides the changes in the product warranty accrual for the three months and six months ended December 31, 2005 and 2004 (in thousands):

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Beginning balance | $ 44,846 | $ 47,821 | $ 46,647 | $ 38,865 |
| Accruals for warranties issued during the period | 10,996 | 17,238 | 20,965 | 30,407 |
| Changes in liability related to pre-existing warranties | (1,809) | (5,812) | (2,781) | (4,759) |
| Settlements made during the period | (10,680) | (7,672) | (21,478) | (12,938) |
| Ending balance | $ 43,353 | $ 51,575 | $ 43,353 | $ 51,575 |

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

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

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

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

**NOTE 11 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES**

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts to hedge against future movements in foreign exchange rates that affect certain existing and anticipated foreign currency denominated sales and purchase transactions. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes. At December 31, 2005, KLA-Tencor had foreign exchange forward contracts maturing throughout calendar year 2006 to sell $421.2 million and purchase $84.8 million, in foreign currency, primarily Japanese Yen. At June 30, 2005, KLA-Tencor had foreign exchange forward contracts maturing throughout fiscal year 2006 to sell $365.2 million and purchase $76.4 million, in foreign currency, primarily Japanese yen.

**NOTE 12 – SEGMENT REPORTING AND GEOGRAPHIC INFORMATION**

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

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

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

The following is a summary of revenues by geographic region for three months and six months ended December 31, 2005 and 2004 (in thousands).

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Revenue: | | | | |
| United States | $ 85,689 | $ 131,593 | $ 184,138 | $ 259,477 |
| Europe & Israel | 63,841 | 63,702 | 135,142 | 121,912 |
| Japan | 157,851 | 101,747 | 269,478 | 178,347 |
| Taiwan | 91,219 | 115,787 | 172,370 | 235,261 |
| Korea | 61,675 | 40,037 | 146,350 | 65,944 |
| Asia Pacific | 27,695 | 79,987 | 64,352 | 190,685 |
| Total | $ 487,970 | $ 532,853 | $ 971,830 | $ 1,051,626 |

Long-lived assets by geographic region as of December 31, 2005 and June 30, 2005 were as follows (in thousands):

| | December 31, 2005 | June 30, 2005 |
|---|---|---|
| Long-lived assets: | | |
| United States | $ 363,545 | $ 372,425 |
| Europe & Israel | 9,613 | 9,074 |
| Japan | 3,847 | 4,350 |
| Taiwan | 2,115 | 2,356 |
| Korea | 5,141 | 4,849 |
| Asia Pacific | 12,327 | 2,247 |
| Total | $ 396,588 | $ 395,301 |

The following is a summary of revenues by major products for three months and six months ended December 31, 2005 and 2004 (as a percentage of total revenue).

| | Three months ended December 31, | | Six months ended December 31, | |
|---|---|---|---|---|
| | 2005 | 2004 | 2005 | 2004 |
| Revenue: | | | | |
| Defect inspection | 60% | 67% | 61% | 66% |
| Metrology | 17% | 15% | 17% | 16% |
| Service | 17% | 14% | 16% | 14% |
| Other | 6% | 4% | 6% | 4% |
| Total | 100% | 100% | 100% | 100% |

For the three months ended December 31, 2005, no customer accounted for greater than 10% of revenue. For the three months ended December 31, 2004, one customer accounted for 11% of revenue. For the six months ended December 31, 2005, two customers each accounted for 10% of revenue, respectively. For the six months ended December 31, 2004, one customer accounted for 11% of revenue. As of December 31, 2005, one customer accounted for 16% of net accounts receivable. As of June 30, 2005 one customer accounted for 12% of net accounts receivable.

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

### FORWARD-LOOKING STATEMENTS

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

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

**EXECUTIVE SUMMARY**

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

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

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

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

| | Fiscal year 2006 | | Fiscal year 2005 | | | |
|---|---|---|---|---|---|---|
| | First Quarter | Second Quarter | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| Revenues | $ 484 | $ 488 | $ 519 | $ 533 | $ 541 | $ 492 |
| Income from operations (1) | $ 81 | $ 77 | $ 157 | $ 156 | $ 155 | $ 115 |
| Net income (2) | $ 77 | $ 77 | $ 117 | $ 122 | $ 123 | $ 105 |
| Net orders | $ 440 | $ 513 | $ 529 | $ 479 | $ 422 | $ 426 |

(1) includes stock-based compensation of $35 million and $36 million during the first quarter and second quarter of fiscal year 2006, respectively and $1 million during the second, third, and fourth fiscal quarters of fiscal year 2005, respectively.

(2) includes stock-based compensation of $24 million and $26 million during the first quarter and second quarter of fiscal year 2006, respectively, and $1 million during the second, third, and fourth fiscal quarters of fiscal year 2005, respectively.

**Outlook**

The semiconductor industry grew 7% while the semiconductor equipment industry declined approximately 4% in calendar year 2005. Industry analysts are predicting semiconductor revenues and semiconductor equipment revenues to grow in the ranges of 8% to 10% and 5% to 10% respectively in calendar year 2006. Net orders, which consist of new system and service orders net of cancellations, increased sequentially by approximately $73 million or 17% in the quarter ended December 31, 2005, compared to the previous fiscal quarter. Net orders increased by approximately $34 million or 7% in the quarter ended December 31, 2005, compared to the same period in the previous fiscal year.

Over the longer term, we expect process control to continue to represent a higher percentage of our customers' capital spending. We believe this percentage increase in process control spending will be driven by the demand for more precise diagnostics capabilities to address multiple new defects as a result of further shrinking of device feature sizes, the transition to new materials, and fab process innovation. We anticipate these factors will drive increased demand for our products and services. The key drivers for growth in the semiconductor equipment industry in calender year 2006 are the transition to 300 millimeter fabs, the increased demand for consumer electronics and the strength of the NAND flash market.

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

| | Fiscal year 2006 | | Fiscal year 2005 | | | |
|---|---|---|---|---|---|---|
| | First Quarter | Second Quarter | First Quarter | Second Quarter | Third Quarter | Fourth Quarter |
| United States | $ 120 | $ 105 | $ 107 | $ 98 | $ 96 | $ 135 |
| Europe & Israel | 59 | 65 | 79 | 53 | 36 | 43 |
| Japan | 98 | 105 | 123 | 157 | 121 | 139 |
| Taiwan | 110 | 89 | 90 | 66 | 104 | 48 |
| Korea | 24 | 99 | 91 | 57 | 58 | 37 |
| Asia Pacific | 29 | 50 | 39 | 48 | 7 | 24 |
| Total orders | $ 440 | $ 513 | $ 529 | $ 479 | $ 422 | $ 426 |

Orders received in a particular quarter affect revenue recognized in subsequent quarters. Net orders become revenue upon positive affirmation by the customer that the system has been installed and is operating according to predetermined specifications. Our backlog for unshipped system orders as of December 31, 2005 was approximately $755 million, a majority of which we expect to ship over the next three to six months. In addition, as of December 31, 2005 the Company had $412 million related to products that have been delivered and invoiced but are awaiting written acceptance from the customer.

**RESULTS OF OPERATIONS**

**Revenues and Gross Margin**

| *(in millions)* | Three months ended | | | Six months ended | |
|---|---|---|---|---|---|
| | December 31, 2005 | September 30, 2005 | December 31, 2004 | December 31, 2005 | December 31, 2004 |
| Revenues: | | | | | |
| Product | $ 402 | $ 400 | $ 455 | $ 802 | $ 897 |
| Service | 86 | 84 | 78 | 170 | 155 |
| Total revenues | $ 488 | $ 484 | $ 533 | $ 972 | $ 1,052 |
| Costs of revenues | $ 217 | $ 214 | $ 218 | $ 431 | $ 433 |
| Stock-based compensation expense | 7 | 7 | — | 14 | — |
| Total costs of revenues excluding stock-based compensation expense | $ 210 | $ 207 | $ 218 | $ 417 | $ 433 |
| Gross margin percentage | 56% | 56% | 59% | 56% | 59% |
| Gross margin percentage excluding stock-based compensation expense | 57% | 57% | 59% | 57% | 59% |

**Product revenues**

Product revenues increased $2 million or less than 1% to $402 million during the second quarter of fiscal year 2006 from $400 million during the first quarter of fiscal year 2006. Product revenues decreased $53 million or 12% to $402 million during the second quarter of fiscal year 2006 from $455 million during the same period in the previous fiscal year. Product revenues decreased by $95 million or 11% to $802 million during the six months ended December 31, 2005 from $897 million during the six months ended December 31, 2004. Product revenue decreases were primarily the result of a lower level of orders received in prior quarters.

Total revenue recognized under conditions where we deviate from the need for a written acceptance by the customer were approximately 2.6%, 3.2% and 9.4% of total revenue for the three months ended December 31, 2005, September 30, 2005 and December 31, 2004, respectively, and 2.9% and 7.9% for the six months ended December 31, 2005 and 2004, respectively.

For the three months ended December 31, 2005, no customer accounted for greater than 10% of revenue. For the three months ended December 31, 2004, one customer accounted for 11% of revenue. For the six months ended December 31, 2005, two customers each accounted for 10% of revenue. For the six months ended December 31, 2004, one customer accounted for 11% of revenue.

**Service revenues**

Service revenue is generated from maintenance service contracts, as well as time and material billable service calls made to our customers after the expiration of the warranty period. Service revenues increased by $2 million or 3% to $86 million during the second quarter of fiscal year 2006 from $84 million during the first quarter of fiscal year 2006. Service revenues increased by $8 million or 11% to $86 million during the three months ended December 31, 2005 from $78 million during the three months ended December 31, 2004. Service revenues increased by $15 million or 10% to $170 million during the six months ended December 31, 2005 from $155 million during the six months ended December 31, 2004. The increase in service revenue is due to an increase in the number of post-warranty systems installed at our customers' sites and the degree of utilization of those systems.

**Revenues by region**

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

| | Three months ended | | | | | | Six months ended | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | December 31, 2005 | | September 30, 2005 | | December 31, 2004 | | December 31, 2005 | | December 31, 2004 | |
| United States | $ 86 | 17% | $ 98 | 20% | $ 131 | 25% | $ 184 | 19% | $ 259 | 25% |
| Europe & Israel | 64 | 13% | 71 | 15% | 64 | 12% | 135 | 14% | 122 | 12% |
| Japan | 158 | 32% | 112 | 23% | 102 | 19% | 270 | 27% | 179 | 17% |
| Taiwan | 91 | 19% | 81 | 17% | 116 | 22% | 172 | 18% | 235 | 22% |
| Korea | 62 | 13% | 85 | 17% | 40 | 7% | 147 | 15% | 66 | 6% |
| Asia Pacific | 27 | 6% | 37 | 8% | 80 | 15% | 64 | 7% | 191 | 18% |
| Total | $ 488 | 100% | $ 484 | 100% | $ 533 | 100% | $ 972 | 100% | $ 1,052 | 100% |

International revenues were 83%, 80%, and 75% of revenue during the three months ended December 31, 2005, September 30, 2005, and December 31, 2004, respectively. International revenues were 81% and 75% of revenue during the six months ended December 31, 2005 and 2004, respectively. A significant portion of our revenue continues to be generated in Asia where a substantial portion of the world's semiconductor manufacturing capacity is located.

**Gross margin**

Gross margin percentage remained flat at 56% during the second quarter of fiscal year 2006 compared to the first quarter of fiscal year 2006 and declined by 3 percentage points compared to 59% during the same period in the prior fiscal year. Of this decline, 2 percentage points is attributed to lower revenue levels; and 1 percentage point is attributed to stock-based compensation expense recorded during the second quarter of fiscal year 2006.

Stock-based compensation expense included in cost of revenues remained flat at $7 million or 1% of revenues during the second quarter of fiscal year 2006 compared to the first quarter of fiscal year 2006. There was no stock-based compensation expense included in cost of revenues during the same period in the previous fiscal year.

**Engineering, Research and Development**

| | Three months ended | | | Six months ended | |
|---|---|---|---|---|---|
| *(in millions)* | December 31, 2005 | September 30, 2005 | December 31, 2004 | December 31, 2005 | December 31, 2004 |
| Net research and development ('R&D') expenses | $ 98 | $ 97 | $ 87 | $ 195 | $ 164 |
| Stock-based compensation expense[1] | 12 | 11 | — | 23 | — |
| Net R&D expenses excluding stock-based compensation expense[1] | $ 86 | $ 86 | $ 87 | $ 172 | $ 164 |
| Percentage of total revenues | 20% | 20% | 16% | 20% | 16% |
| Percentage of total revenues excluding stock-based compensation expense | 18% | 18% | 16% | 18% | 16% |

(1) Stock-based compensation expense included in Net R&D expenses was approximately $0.5 million for the three months and six months ended December 31, 2004.

Net R&D expenses increased $1 million or 2% to $98 million during the second quarter of fiscal year 2006 from $97 million during the first quarter of fiscal year 2006. Net R&D expenses increased $11 million or 13% to $98 million during the second quarter of fiscal year 2006 from $87 million during the same period in the previous fiscal year. Net R&D expenses increased by $31 million or 19% to $195 million during the six months ended December 31, 2005 from $164 million during the six months ended December 31, 2004. The increase in Net R&D expenses compared to the previous fiscal year is primarily attributed to stock-based compensation expenses recorded during the current fiscal year.

Net R&D expenses excluding stock-based compensation expense remained flat at $86 million during the second quarter of fiscal year 2006 compared to the first quarter of fiscal year 2006 and the same period in the previous fiscal year. Net R&D expenses excluding stock-based compensation expense increased by $8 million from $164 million during the six months ended December 31, 2004 to $172 million during the six months ended December 31, 2005 primarily due to the increased cost of engineering project materials. Stock-based compensation expense included in Net R&D expenses was $12 million or 2% of total revenues during the second quarter of fiscal year 2006 compared to $11 million or 2% of total revenues during the first quarter of fiscal year 2006 and $0.5 million or less than 1% of total revenues during the same period in the previous fiscal year.

The gross dollars for R&D investment were partially offset by $2 million, $3 million and $1 million of external funding received during the three months ended December 31, 2005, September 30, 2005, and December 31, 2004, respectively. The gross dollars for R&D investment were partially offset by $5 million and $3 million of external funding received during the six months ended December 31, 2005 and 2004, respectively. The external funding was received for certain strategic development programs conducted with several of our customers and from government grants.

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

**Selling, General and Administrative**

| | Three months ended | | | Six months ended | |
|---|---|---|---|---|---|
| *(in millions)* | December 31, 2005 | September 30, 2005 | December 31, 2004 | December 31, 2005 | December 31, 2004 |
| Selling, general and administrative ('SG&A') expenses | $ 96 | $ 92 | $ 72 | $ 188 | $ 141 |
| Stock-based compensation expense[(1)] | 18 | 17 | 1 | 35 | 1 |
| SG&A expenses excluding stock-based compensation expense[(1)] | $ 78 | $ 75 | $ 71 | $ 153 | $ 140 |
| Percentage of total revenues | 20% | 19% | 14% | 19% | 13% |
| Percentage of total revenues excluding stock-based compensation expense | 16% | 16% | 13% | 16% | 13% |

(1) Stock-based compensation expense included in SG&A expenses was approximately $0.6 million for the three months and six months ended December 31, 2004.

SG&A expenses increased $4 million or 4% to $96 million during the second quarter of fiscal year 2006 from $92 million during the first quarter of fiscal year 2006. SG&A expenses increased $24 million or 33% to $96 million during the second quarter of fiscal year 2006 from $72 million during the same period in the previous fiscal year. SG&A expenses increased by $47 million or 33% to $188 million during the six months ended December 31, 2005 from $141 million during the six months ended December 31, 2004. The increase in SG&A expenses compared to the previous fiscal year is primarily attributed to stock-based compensation expenses recorded during the current fiscal year.

SG&A expenses excluding stock-based compensation expense increased $3 million or 4% to $78 million during the second quarter of fiscal year 2006 from $75 million during the first quarter of fiscal year 2006. SG&A expenses excluding stock-based compensation expense increased $6 million or 9% to $78 million during the second quarter of fiscal year 2006 from $72 million during the same period in the previous fiscal year. SG&A expenses excluding stock-based compensation expense increased by $12 million or 9% to $153 million during the six months ended December 31, 2005 from $141 million during the six months ended December 31, 2004.

The increase in SG&A expenses excluding stock-based compensation expense compared to the previous fiscal quarter is primarily due to higher compensation costs associated with an increase in customer application support and increased staffing. The increase in SG&A expenses excluding stock-based compensation expense compared to the same period in the prior fiscal year is due to an increase in customer application support, increased staffing and consolidating the results of operations of the entities acquired during fiscal year 2005. The entities acquired during fiscal year 2005 contributed $3 million, $3 million and $3 million of the SG&A expenses for the three months ended December 31, 2005, September 30, 2005 and December 31, 2004, respectively. The businesses acquired during fiscal year 2005 contributed $6 million and $3 million of the SG&A expenses during the six months ended December 31, 2005 and 2004, respectively. For more information on the business combinations completed during fiscal year 2005, see Note 4 “Business Combinations” of the Notes to our Consolidated Financial Statements at Item 1 “Financial Statements and Supplementary Data” of this quarterly report.

Stock-based compensation expense included in SG&A expenses was $18 million or 4% of total revenues during the second quarter of fiscal year 2006 compared to $17 million, or 4% of total revenues during the first quarter of fiscal year 2006 and $0.6 million or less than 1% of total revenues during the same period in the previous fiscal year.

During November 2005, the Company announced that effective January 2006, Ken Schroeder, our then-chief executive officer, would be employed by the Company as a senior advisor and cease to be our chief executive officer. We and Mr. Schroeder also revised his prior agreement with the Company and defined the salary, bonus payout and equity award vesting during the period of his employment as a senior advisor. Mr. Schroeder continues to be an employee of the Company as determined by reference to common law and applicable Internal Revenue Service guidelines and we expect his employment to continue through January 1, 2011. Effective January 1, 2006, under the terms of our revised agreement with Mr. Schroeder, we determined that all service conditions associated with certain prior equity awards had been satisfied. Accordingly, we expect to record a non-cash stock compensation charge of approximately $13 million as a component of Selling, General and Administrative expense during the third quarter of fiscal 2006. We believe that the service conditions and service periods associated with other equity awards remain unchanged. We expect to record the non-cash stock-based compensation associated with those equity awards over the related service periods. However, should Mr. Schroeder’s employment terminate or if he ceases to satisfy the criteria to be considered an employee of the Company, we may be required to record a significant charge as a component of Selling, General and Administrative expense.

**Interest Income and Other, Net**

| | Three months ended | | | Six months ended | |
|---|---|---|---|---|---|
| ***(in millions)*** | **December 31, 2005** | **September 30, 2005** | **December 31, 2004** | **December 31, 2005** | **December 31, 2004** |
| Interest income and other, net | $ 16 | $ 15 | $ 8 | $ 31 | $ 15 |
| Percentage of total revenues | 3% | 3% | 1% | 3% | 1% |

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

**Provision for Income Taxes**

Our effective income tax rate, after deduction for stock based compensation, was 19.1% and 26.0% for the three months ended December 31, 2005 and 2004, respectively, and 19.9% and 27.5% for the six months ended December 31, 2005 and 2004, respectively. The current quarter decrease in the effective tax rate is primarily due to implementation of SFAS No. 123R, favorable adjustments due to statute of limitation expiration and adjustments to previously estimated tax liabilities. Excluding these items, our tax rate after stock-based compensation deduction for the three months ending December 31, 2005 would have been 31.2%. In general, our tax rate differs from the statutory rate of 35% largely due to benefits realized from Extraterritorial Income ("ETI") exclusion, research and development tax credits, reduced taxes on foreign earnings, tax exempt interest and domestic production deduction benefits.

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

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

**Stock-based Compensation**

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

We elected to adopt the modified prospective application method as provided by SFAS No. 123(R). Accordingly, during the period ended December 31, 2005, we recorded stock-based compensation cost totaling the amount that would have been recognized had the fair value method been applied since the effective date of SFAS No. 123. We did not restate previously reported amounts.

During the three months and six months ended December 31, 2005, we recorded stock-based compensation related to stock options of $31 million and $61 million, respectively. As of December 31, 2005, the unrecorded deferred stock-based compensation balance related to stock options was $272 million after estimated forfeitures and will be recognized over an estimated weighted average amortization period of 3.0 years.

The compensation cost in connection with the employee stock purchase plan for the three months and six months ended December 31, 2005 was $6 million, and $13 million, respectively.

Compensation cost for all restricted stock units for the three months and six months ended December 31, 2005 was $1 million and $3 million, respectively. As of December 31, 2005, there was $29 million of total deferred stock-based compensation after estimated forfeitures related to nonvested restricted stock units granted under the Equity Incentive Program. That cost is expected to be recognized over an estimated weighted average amortization period of 4.3 years.

Approximately $4 million and $1 million of stock-based compensation was capitalized as inventory and deferred system profit, respectively, at December 31, 2005. We elected not to capitalize any stock-based compensation to inventory or deferred system profit at July 1, 2005 when the provisions of SFAS No. 123(R) were initially adopted.

**LIQUIDITY AND CAPITAL RESOURCES**

| *(in millions)* | December 31, 2005 | June 30, 2005 | Change |
|---|---|---|---|
| Cash and cash equivalents | $ 964 | $ 875 | $ 89 |
| Marketable securities | 1,263 | 1,320 | (57) |
| Total cash, cash equivalents and marketable securities | $ 2,227 | $ 2,195 | $ 32 |
| Percentage of total assets | 53% | 55% | |

| *(in millions)* | Six months ended December 31, 2005 | Six months ended December 31, 2004 |
|---|---|---|
| Cash provided by operating activities[1] | $ 71 | $ 171 |
| Cash used in investing activities | (6) | (191) |
| Cash provided by (used in) financing activities[1] | 17 | (30) |
| Effect of exchange rate changes on cash and cash equivalents | 7 | 5 |
| Net increase in cash and cash equivalents | $ 89 | $ (45) |

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[1] Cash provided by financing activities during the six months ended December 31, 2005 includes $11 million of gross tax windfall from stock-based compensation which was previously recorded under cash provided by operating activities.

We have historically financed our operations through cash generated from operations. Cash provided by operating activities was $71 million and $171 million for the six months ended December 31, 2005 and 2004, respectively. Cash provided by operating activities during the six months ended December 31, 2005 consisted primarily of net income of $153 million increased by non-cash depreciation of $35 million and stock-based compensation of $71 million, offset by an increase in accounts receivable of $53 million, an increase in inventories of $50 million, a decrease in deferred system profit of $46 million, and a decrease in other current liabilities of $63 million. Net cash provided by operating activities during the six months ended December 31, 2004 consisted primarily of $238 million provided by net income, adjusted for $37 million of non-cash depreciation and amortization, an increase in other current liabilities of $30 million and partially offset by an increase in net accounts receivable balances by $60 million, an increase in inventory balances by $11 million, an increase in other asset balances by $27 million, a decrease in accounts payable balances by $21 million and a decrease in deferred profit balances by $17 million.

Cash used in investing activities was $6 million and $191 million during the six months ended December 31, 2005 and 2004, respectively. Investing activities typically consist of purchases and sales or maturities of marketable securities, purchases of capital assets to support long-term growth and acquisitions of technology or other companies to allow access to new market segments or emerging technologies.

We generated $17 million of cash in financing activities during the six months ended December 31, 2005, compared with $30 million of cash used in financing activities during the six months ended December 31, 2004. Issuance of common stock primarily through the exercise of employee stock options and purchased under our employee stock purchase plan provided $136 million and $71 million during the six months ended December 31, 2005 and 2004, respectively. We used $84 million and $111 million during the six months ended December 31, 2005 and 2004, respectively to repurchase shares of our common stock under the stock repurchase program initiated in 1997. During the third fiscal quarter of 2005, our Board of Directors also approved the initiation of a quarterly cash dividend and declared a dividend of 12 cents per share of our outstanding common stock. The total amount of dividend paid during the six months ended December 31, 2005 was $47 million. Further, the dividend for the third fiscal quarter of 2006 was declared on January 24, 2006 and is payable on March 1, 2006 to our stockholders of record on February 15, 2006. The total amount of dividend payable during the third quarter of fiscal year 2006 is approximately $24 million.

The following is a schedule summarizing our significant operating lease commitments as of December 31, 2005 (in millions):

| | Payments Due by Fiscal Year | | | | | | |
|---|---|---|---|---|---|---|---|
| | Total | 2006[(1)] | 2007 | 2008 | 2009 | 2010 | Thereafter |
| Operating leases | $ 22.2 | $ 4.0 | $ 6.4 | $ 4.1 | $ 2.9 | $ 1.8 | $ 3.0 |

(1) Remaining 6 months

We have agreements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. During the three months ended December 31, 2005 and 2004, approximately $57 million and $64 million of receivables were sold under these arrangements, respectively. During the six months ended December 31, 2005 and 2004, approximately $111 million and $130 million of receivables were sold under these arrangements, respectively.

In addition, from time to time we will discount without recourse, Letters of Credit (“LCs”) received from customers in payment of goods. During the three months ended December 31, 2005, several LCs were sold with proceeds totaling $16 million. Discounting fees were $146,000 for the three months ended December 31, 2005. No LCs were sold during the three months ended December 31, 2004. During the six months ended December 31, 2005 and 2004, several LCs were sold with proceeds totaling $34 million and $10 million. Discounting fees were $291,000 and $44,000 for the six months ended December 31, 2005 and 2004, respectively.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply chain for key components. Our liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. We estimate our open inventory purchase commitment as of December 31, 2005 to be approximately $134 million. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or cancelled. Certain agreements provide for potential cancellation penalties.

At December 31, 2005, our principal sources of liquidity consisted of $2.2 billion of cash, cash equivalents, and marketable securities. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, our management believes that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for at least the next twelve months.

**Off-Balance Sheet Arrangements**

We have no material off-balance sheet arrangements other than the significant contractual obligations fully disclosed in the Notes to our Condensed Consolidated Financial Statements.

**CRITICAL ACCOUNTING ESTIMATES**

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

**Revenue Recognition** We recognize revenue when persuasive evidence of an arrangement exists, the sale price is fixed or determinable, delivery has occurred or services rendered, and collectibility is reasonably assured. System revenue includes hardware and software that is incidental to the product. We generally recognize system revenue upon positive affirmation by the customer that the system has been installed and is operating according to pre-determined specifications. This positive affirmation is generally evidenced by an acceptance document signed by the customer. In certain cases, we deviate from the need for written acceptance and recognize system revenue upon shipment. Total revenue recognized under conditions where we deviate from the need for a written acceptance by the customer were approximately 2.6%, 3.2% and 9.4% of total revenue for the three months ended December 31, 2005, September 30, 2005 and December 31, 2004, respectively. Shipping charges billed to customers are included in system revenue and the related shipping costs are included in cost of revenues.

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

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

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

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

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

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

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

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

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

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

**Contingencies and Litigation** We are named from time to time as a party to various legal proceedings. While we currently believe the ultimate outcome of these proceedings will not have a material adverse effect on our financial position, results of operations or cash flows; the results of complex legal proceedings are difficult to predict. We would accrue the cost of an adverse judgment if, in our estimation, the adverse settlement is probable and we can reasonably estimate the ultimate cost to us. We have made no such accruals as of December 31, 2005.

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

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

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

**FACTORS AFFECTING RESULTS, INCLUDING RISKS AND UNCERTAINTIES**

*Fluctuations in Operating Results and Stock Price*

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

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

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

*Implementation of New Systems*

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

*Semiconductor Equipment Industry Volatility*

The semiconductor equipment industry is highly cyclical. The purchasing decisions of our customers are highly dependent on the economies of both the local markets in which they are located and the semiconductor industry worldwide. The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. This cyclical nature of the industry in which we operate affects our ability to accurately predict future revenue and, thus, future expense levels. When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During a down cycle, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles. If we fail to respond to industry cycles, our business could be seriously harmed.

*Global Economic Uncertainty*

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

*International Trade, Operations and Economic Conditions*

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

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

*Competition*

Our industry includes large manufacturers with substantial resources to support customers worldwide. Our future performance depends, in part, upon our ability to continue to compete successfully worldwide. Some of our competitors are diversified companies with greater financial resources and more extensive research, engineering, manufacturing, marketing and customer service and support capabilities than us. We face competition from companies whose strategy is to provide a broad array of products and services, some of which compete with the products and service that we offer. These competitors may bundle their products in a manner that may discourage customers from purchasing our products, including pricing such competitive tools significantly below our product offerings.

In addition, we face competition from smaller emerging semiconductor equipment companies whose strategy is to provide a portion of the products and services, similar to what we offer, using innovative technology to sell products into specialized markets. Loss of competitive position could negatively affect our prices, customer orders, revenue, gross margins, and market share, any of which would negatively affect our operating results and financial condition. Our failure to compete successfully with these other companies would seriously harm our business.

*Technological Change and Customer Requirements*

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

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

*Key Suppliers*

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

*Manufacturing Disruption*

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

*Reliance on services provided by third parties*

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

*Intellectual Property Obsolescence and Infringement*

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

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

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

As is typical in the semiconductor equipment industry, from time to time we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which they believe cover certain of our products, processes, technologies or information. Our customary practice is to evaluate such assertions and to consider whether to seek licenses where appropriate. However, we cannot ensure that licenses can be obtained or, if obtained, will be on acceptable terms or that costly litigation or other administrative proceedings will not occur. The inability to obtain necessary licenses or other rights on reasonable terms, or instigation of litigation or other administrative proceedings could seriously harm our operating results and financial condition.

*Key Employees*

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

*Acquisitions*

In addition to our efforts to develop new technologies from internal sources, we also seek to acquire new technologies from external sources. As part of this effort, we may make acquisitions of, or significant investments in, businesses with complementary products, services and/or technologies. Acquisitions involve numerous risks, including management issues and costs in connection with the integration of the operations and personnel, technologies and products of the acquired companies, the possible write-downs of impaired assets, and the potential loss of key employees of the acquired companies. The inability to manage these risks effectively could seriously harm our business.

*Litigation*

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

*Terrorism and Political Instability*

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

*Increasing Costs Associated with Securities Laws and Regulations Compliance*

Changes in and additions to the laws and regulations affecting public companies over the last four years, including the provisions of the Sarbanes-Oxley Act of 2002, have increased and will continue to increase our expenses as we evaluate the implications of these new rules and devote additional resources to comply with the new requirements. The Sarbanes- Oxley Act mandates, among other things, that companies adopt new and more extensive corporate governance measures and imposes comprehensive reporting and disclosure requirements, sets stricter independence and financial expertise standards for audit committee members and imposes increased civil and criminal penalties for companies, their chief executive officers and chief financial officers and directors for securities law violations. In particular, we will continue to incur additional administrative expense as we fulfill the requirements of Section 404 of the Sarbanes-Oxley Act, which requires management to report on, and our Independent Registered Public Accounting Firm to attest to, our internal control over financial reporting. In addition, The Nasdaq National Market, on which our common stock is listed, has also adopted comprehensive rules and regulations relating to corporate governance. These laws, rules and regulations have increased and will continue to increase the scope, complexity and cost of our corporate governance, reporting and disclosure practices, which could harm our results of operations and divert management's attention from business operations. We also expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance in the future, and we may be required to accept reduced coverage or incur substantially higher costs to obtain coverage. Further, our board members, Chief Executive Officer and Chief Financial Officer could face an increased risk of personal liability in connection with the performance of their duties. As a result, we may have difficultly attracting and retaining qualified board members and executive officers, which would adversely affect our business.

*Earthquake and Other Uninsured Risks*

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

*Future Changes in Accounting and Taxation Standards or Practices*

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

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

*Exposure to various risks related to the regulatory environment.*

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

*Exposure to fluctuations in foreign currency exchange rates*

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

*Computer viruses may disrupt our operations*

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

**Effects of Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS No. 123 (revised 2004), “Share-Based Payment.” SFAS No. 123(R) which requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements. In March 2005, the SEC issued SAB 107, which provides the Staff’s views regarding interactions between SFAS No. 123(R) and certain SEC rules and regulations and provides interpretations of the valuation of share-based payments for public companies. The adoption of SFAS No. 123(R) requires additional accounting related to the income tax effects and additional disclosure regarding the cash flow effects resulting from share-based payment arrangements. The adoption of SFAS No. 123(R) during the first quarter of fiscal year 2006 had a material impact on our consolidated results of operations, financial position and statement of cash flows. For more information on stock-based compensation costs during the three months and six months ended December 31, 2005, refer to Note 6 “Stock Based Compensation” of the Notes to the Condensed Consolidated Financial Statements included in Item 1 of this quarterly report.

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

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

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

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

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position at December 31, 2005. Actual results may differ materially.

As of December 31, 2005, we had an investment portfolio of fixed income securities of $1.3 billion, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of December 31, 2005, the fair value of the portfolio would have declined by $8 million.

As of December 31, 2005, we had net forward contracts to sell $336 million in foreign currency in order to hedge currency exposures (see Note 11 of the Notes to the Condensed Consolidated Financial Statements under “Derivative Instruments”). If we had entered into these contracts on December 31, 2005, the U.S. dollar equivalent would be $336 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by $45 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on net income or cash flows.

## ITEM 4. CONTROLS AND PROCEDURES

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

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

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

### Definition of Disclosure Controls

Disclosure Controls are controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms. Disclosure Controls are also designed to ensure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Our Disclosure Controls include components of our

internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the U.S. To the extent that components of our internal control over financial reporting are included within our Disclosure Controls, they are included in the scope of our quarterly controls evaluation.

**Limitations on the Effectiveness of Controls**

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

**Changes in internal controls over financial reporting**

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

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

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

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

Following is a summary of stock repurchases for the quarter ended December 31, 2005.[1]

| Period | Total Number of Shares (or Units) Purchased[2] | Average Price Paid per Share (or Unit) | Maximum Number of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs[3] |
|---|---|---|---|
| October 1, 2005 to October 31, 2005 | 455,000 | $ 47.78 | 7,156,500 |
| November 1, 2005 to November 30, 2005 | 330,000 | $ 48.98 | 6,826,500 |
| December 1, 2005 to December 31, 2005 | 212,000 | $ 51.75 | 6,614,500 |
| Total | 997,000 | $ 49.02 | |

(1) In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. This program was put into place in order to reduce the dilution that results from KLA-Tencor's issuance of its shares pursuant to its employee benefit and incentive plans such as the stock option and employee stock purchase plans. Since the inception of the repurchase program in 1997 through December 31, 2005, the Board of Directors has authorized KLA-Tencor to repurchase a total of 27.8 million shares. All such shares remain as treasury shares and are retired.

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

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

## ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Annual Meeting of Stockholders of KLA-Tencor Corporation was held on November 4, 2005 at the Company's offices in Milpitas, California. Of the 197,626,388 shares of Common Stock outstanding as of September 6, 2005 (the record date), 174,199,154 shares (88.14%) were present or represented by proxy at the meeting.

1. The table below presents the results of the election to the Company's board of directors.

| | Votes for | Votes Withheld |
|---|---|---|
| Kenneth Levy | 169,282,397 | 4,916,756 |
| Jon D. Tompkins | 172,140,045 | 2,059,108 |
| Lida Urbanek | 165,135,799 | 9,063,354 |

The terms of Kenneth Levy, Jon D. Tompkins and Lida Urbanek as directors of the Company, continued after the meeting.

2. The stockholders approved the Company's Performance Bonus Plan. This proposal received 168,988,721 votes for; 4,274,568 votes against and 935,863 abstentions.

3. The stockholders ratified the appointment of PricewaterhouseCoopers LLP as the Company's independent accountants for the fiscal year ended June 30, 2006. This proposal received 170,296,027 votes for, 3,025,446 votes against and 877,680 abstentions.

4. The stockholders approved the proposal for Majority Voting for Directors. This proposal received 94,154,544 votes for, 58,282,599 votes against and 1,308,286 abstentions.

## ITEM 6. EXHIBITS

10.14 Amended and restated agreement by and between KLA-Tencor Corporation and Kenneth L. Schroeder*

10.15 KLA-Tencor Corporation Performance Bonus Plan*

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

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

32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.

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* Denotes a management contract, plan or arrangement

**SIGNATURES**

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

**KLA-Tencor Corporation**
(Registrant)

February 1, 2006
(Date)

/s/ RICHARD P. WALLACE

Richard P. Wallace
Chief Executive Officer
(Principal Executive Officer)

February 1, 2006
(Date)

/s/ JEFFREY L. HALL

Jeffrey L. Hall
Senior Vice President and
Chief Financial Officer
(Principal Accounting Officer)

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

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

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|---|---|---|---|---|---|
| 10.9 | Severance Agreement and General Release | 10-K | No. 000-09992 | 10.9 | August 30, 2004 |
| 10.10 | 2004 Equity Incentive Plan* | Proxy | No. 000-09992 | Appendix A | September 9, 2004 |
| 10.11 | Form of Option Agreement under 1998 Outside Director Option Plan* | 8-K | No. 000-09992 | 10.1 | October 18, 2004 |
| 10.12 | Blue29 Corporation 2003 Stock Incentive Plan* | S-8 | No. 333-120218 | 10.1 | November 4, 2004 |
| 10.13 | Agreement by and between KLA-Tencor Corporation and Kenneth L. Schroeder* | 8-K | No. 000-09992 | 10.1 | February 23, 2005 |
| 10.14 | Amended and restated agreement by and between KLA-Tencor Corporation and Kenneth L. Schroeder* | | | | |
| 10.15 | KLA-Tencor Corporation Performance Bonus Plan* | | | | |
| 31.1 | Certification of Chief Executive Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934 | | | | |
| 31.2 | Certification of Chief Financial Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934 | | | | |
| 32 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 | | | | |

* Denotes a management contract, plan or arrangement

**Exhibit 10.14**

**AGREEMENT**

This amended and restated Agreement (the “Agreement”) is entered into by and between KLA-Tencor Corporation (the “Company”) and Kenneth L. Schroeder (“Executive”) effective as of December 21, 2005 (the “Effective Date”).

**Recitals:**

A. The Company desires to continue to retain the services of Executive as set forth in this Agreement and Executive desires to continue to provide services to the Company upon the terms and conditions set forth herein.

B. The Company desires to ensure that Executive does not compete with and is available to continue to provide services to the Company as set forth herein.

**Agreement:**

In consideration of the covenants and agreements contained herein, the parties agree as follows:

**1. Effectiveness of Agreement**. This Agreement shall become effective upon the Effective Date and amends and restates in its entirety the Agreement entered into by and between the Company and Executive dated February 23, 2005 (the “Prior Agreement”). The Company and Executive agree that this Agreement shall govern the terms and conditions of Executive’s provision of services to the Company from and after the Effective Date.

**2. Term**. This Agreement shall commence on the Effective Date and shall end on the date that all obligations hereunder have been fully discharged.

**3. Duties**.

**a. Responsibilities**. From and after the Effective Date until the earlier of the commencement of any Part-Time Employment Term (as defined in Section 7 of this Agreement) or termination of Executive’s full-time employment hereunder (the “Full-Time Employment Period”), the Company shall employ the Executive as Chief Executive Officer with such duties and responsibilities as are commensurate with such position. It is understood and agreed that Executive will be considered an employee of the Company for tax withholding and all other purposes for the duration of both the Full-Time Employment Period and the Part-Time Employment Term. Executive acknowledges that during the Part-Time Employment Term he shall not have the power to bind the Company.

**b.** **Board Membership**. If Executive is serving as a member of the Company's Board of Directors (the "Board") on the date of termination of the Full-Time Employment Period, he shall tender to the Board his resignation from the Board effective as of such date. The Board shall not be obligated to accept such resignation, unless Executive requires it.

**4.** **Obligations**. Executive agrees, during the Full-Time Employment Period, not to actively engage in any other employment, occupation or consulting activity for any direct or indirect remuneration without the prior approval of the Board; provided, however, that Executive may serve in any capacity with any civic, educational or charitable organization, or as a member of corporate Boards of Directors or committees thereof without the approval of the Board.

**5.** **Employee Benefits**. During the Full-Time Employment Period, Executive shall be eligible to participate in (i) all employee benefit plans currently and hereafter maintained by the Company for senior management according to their terms, and (ii) such other employee benefits as are set forth in this Agreement or as may otherwise be awarded by the Board or its Compensation Committee. During any Part-Time Employment Term, Executive shall only be eligible to participate in the Company's group health, vision and dental plans or in alternative arrangements providing at least the same level of benefits and shall not be eligible to participate in the Company's other employee benefit plans and arrangements. Subject to the other provisions hereof, Executive and his spouse shall, during the Full-Time Employment Period, the Part-Time Employment Term and thereafter, but no later than the earlier of Executive's death or his obtaining the age of 65, be entitled to the same medical and other health benefits as senior active executives (and their respective spouses) and on the same contribution basis as such senior active executives. Such benefits shall at all times be made available on a nontaxable basis to Executive and his spouse (except to the extent active senior executives (and their respective spouses) would be taxed on receipt of the same benefit as active executives (the "Retiree Health Benefit")). The standard form of indemnification agreement for officers and directors that Executive has entered into and any fiduciary insurance maintained by the Company shall remain in effect to the same extent that said indemnification or fiduciary insurance remains in effect for all officers and directors of the Company.

**6.** **Full Time Employment Period Compensation**.

**a.** **Base Salary**. During the Full-Time Employment Period, and during certain Part-Time Employment Terms as specified in Section 7 hereof, the Company shall pay the Executive as compensation for his services a base salary at an initial annualized rate (which initial rate shall in no event be less than the Executive's base salary as of the Effective Date) recommended by the Compensation Committee of the Board and approved by the Board, as may be increased (but not decreased) from time to time by the Board or its Compensation Committee (the "Base Salary"). The Base Salary shall be paid periodically in accordance with normal Company payroll practices and subject to the usual, required withholding. References to Base Salary herein as it relates to the Part-Time Employment Term shall mean the last full-time salary as of the beginning of the Part-Time Employment Term.

**b.** **Bonus**. During the Full-Time Employment Period and during certain Part-Time Employment Terms as specified in Section 7 hereof, Executive shall participate in bonus programs generally available to senior management of the Company and shall be eligible to receive bonuses as determined by the Board or its Compensation Committee. Subject to Section 7(c), the Company shall have the obligation to pay any and all bonuses referred to in this Agreement only at the same time as bonuses are normally paid to senior management of the Company and contingent in each case upon the Company's payment of bonuses to senior officers of the Company for such fiscal year; provided, however, that any bonus due Executive upon his transition to Part-Time Employment or becoming due in the six-month period thereafter shall be paid to Executive six months and one day following his transition to Part-Time Employment.

**7.** **Termination of Employment; Transition to Part-Time Employment**.

**a.** **Part-Time Employment Term Definition; Obligations**. The periods of part-time employment specified in this Section 7 shall be defined as the "Part-Time Employment Term" and Executive may be referred to as a "Part-Time Employee" while employed thereunder for the purposes of this Agreement. During any Part-Time Employment Term, Executive shall be required to devote such time in rendering services to the Company as shall be mutually agreed upon and acceptable to Executive and the Company; provided, however, that such services shall not include any service relating to the discharge of Executive's duties as a member of the Board. The parties expect the Company will utilize Executive's services during the Part-Time Employment Term between five to ten hours per month. Such services may be rendered by Executive at his residence, to the extent practicable. During the Part-Time Employment Term, Executive shall be free to serve as a director, employee, consultant or advisor to any other corporation or other business enterprise without the prior written consent of the Company so long as such activities do not interfere with his duties and obligations under this Agreement, including, without limitation, Executive's obligations under Section 8 hereof. In consideration of Executive's not working for a non-Competing Company or a Competing Company and being available to provide the mutually agreed upon services required hereunder during the Part-Time Employment Term, the Executive shall receive the compensation specified in this Section 7. At the end of such Part-Time Employment Term, the Executive's employment with the Company shall terminate.

**b.** **Termination of Full-Time Employment for Cause**. The Company may at any time terminate Executive's full-time employment hereunder for "Cause." For the purposes of this Agreement "Cause" shall mean (i) Executive's gross negligence or willful misconduct in connection with the performance of his duties, (ii) Executive's conviction of or plea of nolo contendere to, any felony in a court of competent jurisdiction, or (iii) Executive's embezzlement or misappropriation of Company property. If the Executive's full-time employment is terminated by the Company for Cause, then, subject to Executive entering into and not revoking a release of claims agreement with the Company substantially in the form attached hereto as Exhibit A (the "Release"), the Executive will receive a lump-sum payment equal to 25% of Base Salary and Executive shall not be entitled to any other benefits hereunder.

**c.** **Voluntary Termination of Full-Time Employment by Executive**. If the Executive desires to voluntarily terminate his full-time employment with the Company, then Executive shall provide the Company with written notice of such termination. Subject to Executive entering into and not revoking the Release, Executive shall remain employed by the Company as a Part-Time Employee on the terms described herein. The Part-Time Employment Term shall be 60 months. During such 60-month period, Executive shall be paid (i) Base Salary for the first 30 months,

paid in accordance with the Company's normal payroll practices (except as provided in the succeeding paragraph), (ii) a mutually agreeable level of compensation per month which is no lower than an hourly rate determined by dividing the annual Base Salary dollar amount by 2080 for the final 36 months, paid monthly, (iii) an annual bonus equal to the amount that would otherwise have been payable to Executive upon Executive's achievement of 100% of his individual bonus objectives (in distinction to Company bonus objectives, which shall be based upon actual Company performance for such fiscal year) for the Company's fiscal year in which Executive's transition to Part-Time Employment occurs (the "Target Bonus"), (iv) for the Company's fiscal year ending in the period between the first anniversary of the date of termination of Executive's full-time employment and the second anniversary of the date of termination of Executive's full-time employment with the Company, an amount equal to the amount that would otherwise have been payable to Executive upon Executive's achievement of 100% of his individual bonus objectives (in distinction to Company bonus objectives, which shall be based upon actual Company performance for such fiscal year) under the Company's bonus plan for such fiscal year (the "Second Year Bonus"), (v) for the Company's fiscal year ending in the period between the second anniversary of the date of termination of Executive's full-time employment and the third anniversary of the date of termination of Executive's full-time employment with the Company, an amount equal to the amount that would otherwise have been payable to Executive upon Executive's achievement of 100% of his individual bonus objectives (in distinction to Company bonus objectives, which shall be based upon actual Company performance for such fiscal year) under the Company's bonus plan for such fiscal year (the "Third Year Bonus"), and (vi) for the Company's fiscal year ending in the period between the third anniversary of the date of termination of Executive's full-time employment and the fourth anniversary of the date of termination of Executive's full-time employment with the Company, an amount equal to the amount that would otherwise have been payable to Executive upon Executive's achievement of 100% of his individual bonus objectives (in distinction to Company bonus objectives, which shall be based upon actual Company performance for such fiscal year) under the Company's bonus plan for such fiscal year (the "Fourth Year Bonus"). Executive will not be eligible to receive an annual bonus for the remainder of the Part-Time Employment Term. Any bonuses to be paid pursuant to clauses (iii), (iv), (v) and (vi) of this paragraph will be paid no later than the later of (A) two and one half months following the completion of the Company's relevant fiscal year, or (B) the date that is six months and one day following the commencement of the Part-Time Employment Term.

Any Base Salary to be paid pursuant to clause (i) of the preceding paragraph will not be paid during the six-month period following the commencement of the Part-Time Employment Term. Instead, on the first day following such six-month period, the Company will pay Executive a lump-sum amount equal to the cumulative amounts that would have otherwise been paid to Executive under clause (i) of the preceding paragraph. Thereafter, Executive will receive his Base Salary pursuant to clause (i) of the preceding paragraph in accordance with the Company's normal payroll practices.

With respect to any stock options held by Executive (or his affiliates) as of the commencement of the Part-Time Employment Period other than options granted on and after September 21, 2004 ("Prior Options"), such Prior Options shall terminate and be without further force and effect on the earliest of (i) December 31 of the calendar year in which falls the date that is thirty days following the third anniversary of the Part-Time Employment Period commencement date (the "37-Month Anniversary Date") , but only if Executive remains a Part-Time Employee through such third anniversary date, (ii) on the date specified in the relevant Prior Option agreement, in the event that Executive does not remain a Part-Time Employee through the third anniversary date, (iii) the last day of the original Prior Option term.

In the event that Executive remains a Part-Time Employee through October 1st of the calendar year in which falls the 37-Month Anniversary Date, then any then outstanding Prior Options shall have their vesting automatically accelerated as of such date to an additional twenty-one months' vesting, as measured from such October 1 date (but in no event as to more shares than are subject to each Prior Option).

In the event that Executive remains a Part-Time Employee through the end of the Part-Time Employment Period, then Option Nos. 70866 and 82422 shall have their vesting automatically accelerated as of such date to an additional six months' vesting (but in no event as to more shares than are subject to each option).

**d.** **Termination of Full-Time Employment by Company Other than for Cause**. If the Company desires to terminate Executive's full-time employment with the Company other than for Cause, then the Company shall provide Executive with written notice of such termination. If the Executive's full-time employment is terminated by the Company other than for Cause, then, subject to Executive entering into and not revoking a Release, Executive shall remain employed by the Company as a Part-Time Employee on the terms described herein and shall receive the same benefits as set forth in subsection (c) above.

**e.** **Reduction of Part-Time Employment Term Compensation and Benefits If Executive Becomes Employed by a Non-Competing Company**. If during the Part-Time Employment Term, Executive becomes a full-time employee (or equivalent thereof) of an entity that is not a "Competing Company" (as defined in Section 8 hereof), Executive (i) shall have his Base Salary reduced to a mutually agreeable amount per month (determined based on the level of services expected to be rendered to the Company) in exchange for Executive providing mutually agreed upon services to the Company, (ii) shall not be eligible to receive any Target Bonus, Second Year Bonus, Third Year Bonus or Fourth Year Bonus to the extent not already earned by Executive, and (iii) shall not be eligible to participate or receive benefits under any other employee benefit plans, policies, practices or arrangements of the Company or its predecessors (except that Executive and his spouse shall continue receiving the Retiree Health Benefit (as defined in Section 5), and subject to Section 7(f) below with respect to the vesting of Executive's equity awards and Section 11 hereof relating to the treatment of any Retention Option/SAR Grants and Retention Restricted Stock/Unit Grants, as such terms are defined in Section 11 hereof). For the purposes of the foregoing, the Target Bonus, Second Year Bonus, Third Year Bonus and Fourth Year Bonus shall be deemed earned, to the extent otherwise payable, if Executive is a Part-Time Employee and is not employed by a non-Competing Company as a full-time employee (or equivalent thereof) through the last day of the fiscal year to which such bonuses relate.

**f. Vesting of Equity Awards During Part-Time Employment Term**. Except as provided in Section 7(c) hereof, during the Part-Time Employment Term, all equity awards that were granted to Executive prior to the termination of Executive's full-time employment shall continue to vest in accordance with the terms and conditions of the original agreements relating to such awards, except any Retention Option/SAR Grants and Retention Restricted Stock/Unit Grants, as such terms are defined in Section 11 hereof, which shall be treated in accordance with Section 11 hereof. The term "equity award" as used herein does not include any right to participate in the employee stock purchase plans of the Company, which right shall terminate immediately upon the termination of the Full-Time Employment Period.

**g. Termination of Employment Relationship**. Executive's Part-Time Employment relationship with the Company may not be terminated by the Company prior to the end of the Part-Time Employment Term, except (i) upon the death or permanent disability of Executive, (ii) by written agreement between both of the parties hereto; provided, however, that Executive's employment with the Company, whether full-time or part-time, shall immediately and automatically terminate upon Executive's breach of Section 8 hereof. No additional benefits or payments will become payable to Executive hereunder upon a termination of Executive's Part-Time Employment Term in accordance with the prior sentence.

**h. Breach of Covenant Not to Compete**. Executive's employment with the Company hereunder, whether full-time or part-time, shall immediately and automatically terminate upon Executive's breach of Section 8 hereof. Notwithstanding anything to contrary set forth herein, no additional benefits or payments will become payable to Executive hereunder upon any such termination.

**i. Death or Disability**. Subject to Section 11 hereof relating to the treatment of any Retention Option/SAR Grants and the Retention Restricted Stock/Unit Grants, as such terms are defined in Section 11 hereof, in the event of Executive's death or permanent Disability, this Agreement shall terminate, unless otherwise decided by the Board.

**j. No Duty to Mitigate; No Right of Set-Off**. In the case of any claim or action by Executive as a result of the purported breach of this Agreement by the Company, Executive will not be required to mitigate the amount of any payments, benefits or rights contemplated by this Agreement (whether during the Full-Time Employment Period or Part-Time Employment Term), nor will any earnings that Executive may receive from any other source reduce any such payments, benefits or rights and the Company will have no right of set-off for amounts Executive may owe the Company against amounts the Company may owe Executive hereunder.

**8. Covenant Not to Compete**.

**a. Covenant Not to Compete**. During the Full-Time Employment Period and the Part-Time Employment Term, Executive will not render services as an employee, consultant, director, partner, owner to, or participate as more than a two percent shareholder in, any Competing Company in a Restricted Territory, as such terms are defined immediately below; provided, however, that (i) Executive shall be permitted to work for a division, entity, or subgroup of any of such Competing Company so long as such division, entity, or subgroup does not engage in a business (including, without limitation, development, manufacturing, marketing, sales or technical or sales support) that makes such entity a Competing Company, and (ii) Executive may also receive and hold in such situation equity in the Competing Company that he obtains in connection with such service on the same basis as other employees similarly situated to Executive.

**b.** **Competing Company**. "Competing Company" shall mean another semiconductor capital equipment company, partnership, limited liability corporation or other entity any portion of whose business, including, without limitation, development, manufacturing, marketing, sales or technical or sales support, competes with the Company's business at that time.

**c.** **Restricted Territory**. "Restricted Territory" means any county in the State of California, each state in the United States and each country in the world.

**9.** **Limitation on Payments**. If the benefits provided for in this Agreement or otherwise payable to the Executive (i) constitute "parachute payments" within the meaning of Section 280G of the Code and (ii) but for this Section 9, would be subject to the excise tax imposed by Section 4999 of the Code, then the Executive's benefits hereunder shall be either (i) delivered in full, or (ii) delivered as to such lesser extent which, or at such later time as, would result in no portion of such severance benefits being subject to excise tax under Section 4999 of the Code, whichever of the foregoing amounts, taking into account the applicable federal, state and local income taxes and the excise tax imposed by Section 4999, results in the receipt by the Executive on an after-tax basis, of the greatest amount of severance benefits, notwithstanding that all or some portion of such benefits may (or might otherwise) be taxable under Section 4999 of the Code. Unless the Company and the Executive otherwise agree in writing, any determination required under this Section 9 shall be made in writing by the Company's independent public accountants (the "Accountants"), whose determination shall be conclusive and binding upon the Executive and the Company for all purposes; provided that if benefits are reduced or deferred, the Executive shall choose the order in which such benefits are reduced or deferred. For purposes of making the calculations required by this Section 9, the Accountants may make reasonable assumptions and approximations concerning applicable taxes and may rely on reasonable, good faith interpretations concerning the application of Sections 280G and 4999 of the Code. The Company and the Executive shall furnish to the Accountants such information and documents as the Accountants may reasonably request in order to make a determination under this Section. In the event a determination is made under this Section 9, the Company shall also require the Accountants to furnish Executive with a tax opinion regarding the calculations performed under this Section 9. The Company shall bear all costs the Accountants may reasonably incur in connection with any calculations contemplated by this Section 9.

**10.** **Double-Trigger Option Vesting Acceleration**. If, on or after a Change of Control (as defined herein) or within 30 days prior to a Change of Control, Executive's employment with the Company terminates (whether during the Full-Time Employment Period or the Part-Time Employment Term) due to (i) a voluntary termination for "Good Reason" (as defined in Section 7(g) and this Section 10), or (ii) an involuntary termination by the Company other than for "Cause" (as defined in Section 7(b) hereof), then, subject to Executive executing and not revoking a Release and not breaching the terms of Section 8 hereof, all of Executive's Company stock options and other equity compensation awards shall immediately accelerate vesting as to 100% of the then unvested shares.

For purposes of this Agreement, "Change of Control" shall mean the occurrence of any of the following events:

(i) Any "person" (as such term is used in Sections 13(d) and 14(d) of the Securities Exchange Act of 1934, as amended) becomes the "beneficial owner" (as defined in Rule 13d-3 under said Act), directly or indirectly, of securities of the Company representing fifty percent (50%) or more of the total voting power represented by the Company's then outstanding voting securities; or

(ii) The consummation of the sale or disposition by the Company of all or substantially all the Company's assets; or

(iii) The consummation of a merger or consolidation of the Company with any other corporation, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity) at least fifty percent (50%) of the total voting power represented by the voting securities of the Company or such surviving entity outstanding immediately after such merger or consolidation; or

(iv) A change in the composition of the Board occurring within a two-year period, as a result of which fewer than a majority of the directors are Incumbent Directors. "Incumbent Directors" shall mean directors who either (A) are directors of the Company as of the date upon which this Agreement was entered into, or (B) are elected, or nominated for election, to the Board with the affirmative votes of at least a majority of those directors whose election or nomination was not in connection with any transaction described in subsections (i), (ii), or (iii) above, or in connection with an actual or threatened proxy contest relating to the election of directors to the Company.

For purposes of this Agreement, during the Full-Time Employment Period, "Good Reason" means, without Executive's express consent, (i) a material reduction of Executive's duties, title, authority or responsibilities, relative to Executive's duties, title, authority or responsibilities as in effect immediately prior to such reduction, or the assignment to Executive of such reduced duties, title, authority or responsibilities, (ii) a material reduction of the facilities and perquisites (including office space and location) available to Executive immediately prior to such reduction, other than a reduction generally applicable to all senior management of the Company; (iii) a reduction by the Company in the Base Salary of Executive as in effect immediately prior to such reduction; (iv) a material reduction by the Company in the aggregate level of employee benefits, including target bonuses, to which Executive was entitled immediately prior to such reduction with the result that Executive's aggregate benefits package is materially reduced (other than a reduction that generally applies to Company employees); (v) the relocation of Executive to a facility or a location more than thirty-five (35) miles from Executive's then present location; or (vi) any act or set of facts or circumstances which would, under California case law or statute constitute a constructive termination of Executive.

**11. Retention Awards**.

**(a) Retention Option/SAR Grants**. With respect to Company stock options or stock appreciation rights granted to Executive on and after September 21, 2004, other than (i) 75,800 shares subject to the September 21, 2004 stock option grant that are scheduled to vest as to 20% on September 21, 2008 and as to 1/48$^{th}$ of the remaining shares vesting monthly thereafter, and (ii) 75,800 shares subject to any stock option or stock appreciation right granted to Executive in 2005 vesting as to 20% four years after the date of grant and as to 1/48$^{th}$ of the remaining shares vesting monthly thereafter (the stock options and stock appreciation rights covered by this Section 11(a) are referred to herein as "Retention Option/SAR Grants"), notwithstanding any other provisions of this Agreement, including, without limitation, Section 7(f) hereof, the following terms shall apply:

**(i)** In the event that (i) Executive's full-time employment is terminated for Cause or breach of Section 8 hereof, or (ii) Executive's Part-Time Employment is terminated for breach of Section 8 hereof, then the Retention Option/SAR Grants shall immediately, to the extent then unvested, expire and become without further force and effect and Executive shall have thirty (30) days following the date of such termination (but in no event beyond an award's original term) in which to exercise any vested portion of the Retention Option/SAR Grants following which they shall expire and become without further force and effect.

**(ii)** Subject to Section 11(a)(ix), in the event that, prior to July 1, 2006, Executive voluntarily terminates his position as Chief Executive Officer other than for Good Reason, even if Executive remains a Service Provider, as such term is defined in the Company's 2004 Equity Incentive Plan ("Service Provider"), the Retention Option/SAR Grants shall immediately, to the extent then unvested, expire and become without further force and effect and Executive shall have thirty (30) days following the date of such termination (but in no event beyond an award's original term) in which to exercise any vested portion of the Retention Option/SAR Grants following which they shall expire and become without further force and effect.

**(iii)** Subject to Section 11(a)(ix), in the event that, on and after July 1, 2006 and prior to July 1, 2007, Executive voluntarily terminates as a Service Provider other than for Good Reason (whether during the Full-Time Employment Period or Part-Time Employment Term), the Retention Option/SAR Grants shall immediately, to the extent then unvested, expire and become without further force and effect and Executive shall have thirty (30) days following the date of such event (but in no event beyond an award's original term) in which to exercise any vested portion of the Retention Option/SAR Grants following which they shall expire and become without further force and effect.

**(iv)** Subject to Section 11(a)(ix), in the event that, on and after July 1, 2007, Executive (i) voluntarily terminates as a Service Provider other than for Good Reason (whether during the Full-Time Employment Period or Part-Time Employment Term), the Retention Option/SAR Grants shall immediately, to the extent then unvested, expire and become without further force and effect and Executive shall have five years following the date of such event (but in no event beyond an award's original term) in which to exercise any vested portion of the Retention Option/SAR Grants following which they shall expire and become without further force and effect.

**(v)** Subject to the other provisions of this Section 11(a), in the event that, on and after July 1, 2006, Executive transitions to a Part-Time Employee or otherwise remains a Service Provider and does not remain as Chief Executive Officer, the Retention Option/SAR Grants shall continue to vest according to their terms and the terms of this Agreement and, subject to Sections 11(a)(iii), (ix) and (x), Executive shall have five years from the date his employment as a Part-Time Employee terminates (but in no event beyond an award's original term) to exercise the Retention Option/SAR Grants, after which period they shall expire and become without further force and effect. In the event that Executive remains as Chief Executive Officer, the Retention Option/SAR Grants shall also continue to vest according to their terms and the terms of this Agreement.

**(vi)** In the event that (i) Executive's full-time employment is terminated without Cause and other than for breach of Section 8 hereof, or (ii) Executive voluntarily terminates his full-time employment for Good Reason, then Executive shall become a Part-Time Employee (pursuant to Sections 7(c) or (d), respectively) and any Retention Option/SAR Grants shall continue to vest according to their terms and the terms of this Agreement. Subject to Sections 11(a)(iii), (ix) and (x), Executive shall have five years from the date his employment as a Part-Time Employee terminates (but in no event beyond an award's original term) in which to exercise the Retention Option/SAR Grants, after which period they shall expire and become without further force and effect.

**(vii)** Subject to Section 11(a)(ii), in the event Executive's status as a Part-Time Employee terminates for any reason (including, without limitation, upon Executive's voluntary termination for any reason) other than (A) upon the death or permanent Disability of Executive, (B) upon Executive's breach of Section 8, or (C) by written agreement between both parties hereto, all of the Retention Option/SAR Grants shall immediately accelerate vesting as to 100% of the then unvested shares. Notwithstanding the accelerated vesting provided for in the previous sentence, any such Retention Option/SAR Grants will not become exercisable (though they will be vested) until they would have otherwise become exercisable pursuant to their original vesting terms. Subject to Sections11(a)(iii), (ix) and (x), Executive shall have five years from the date his employment as a Part-Time Employee terminates (but in no event beyond an award's original term) in which to exercise the Retention Option/SAR Grants, after which period they shall expire and become without further force and effect.

**(viii)** In the event that Executive's employment terminates due to the Executive's death or Disability (as defined herein) (whether during the Full-Time Employment Period or Part-Time Employment Term), then (A) the Retention Option/SAR Grants shall have their vesting accelerated as to a pro rata fraction of the initially covered shares less any shares that have already vested, which pro rata fraction shall be determined by dividing the number of days elapsed from the grant date to the employment termination date by the number of days between the grant date and July 1, 2007, and (B) Executive (or his estate or personal representative) shall have five years from the date of such employment termination (but in no event beyond an award's original term) in which to exercise the Retention Option/SAR Grants, after which period they shall expire.

For the purposes of this Agreement, "Disability" means that Executive has been unable to perform his employment duties as the result of his incapacity due to physical or mental illness, and such inability, at least twenty-six (26) weeks after its commencement, is determined to be total and permanent by a physician selected by the Company or its insurers and acceptable to Executive or his legal representative (such agreement as to acceptability not to be unreasonably withheld).

**(ix)** In the event of a Change of Control occurring during the Full-Time Employment Period, then Executive may at his election transition to Part-Time Employment and continue to vest in his Retention Stock Option/SAR Grants during such period of Part-Time Employment. In the event of a Change of Control occurring while Executive is a Service Provider, then the Retention Option/SAR Grants shall remain exercisable, to the extent they are or become vested, through July 1, 2012 (but in no event beyond an award's original term).

**(x)** Notwithstanding any other provisions of this Agreement, in the event that Executive renders services as an employee, consultant, director, partner, owner to, or participates as more than a two percent shareholder in, any Competing Company in a Restricted Territory, as such terms are defined in Section 8 hereof, then Executive shall promptly notify the Company in writing of such competitive activity. The Company, at any time following it first becoming aware of such competitive activity, shall deliver a notice to Executive specifying the reasons for its belief that Executive is engaging in such competitive activity. Executive shall have thirty (30) days following the receipt of such notice in which to cease such competitive activity to the Company's satisfaction. In the event Executive fails to cease such activity to the Company's satisfaction within the thirty-day notice period, then any five (5) year post-termination exercise period for the Retention Option/SAR Grants to which Executive would otherwise be entitled shall be shortened to thirty (30) days following the date upon which the thirty-day notice period expires (but in no event beyond an award's original term), following which period such Retention Option/SAR grants shall expire and be without further force and effect. However, this Section 11(a)(x) limitation shall not apply to the extended post-termination exercise provisions arising pursuant to a Change of Control under Section 11(a)(ix) hereof.

**(b)** **Retention Grants – Restricted Stock Units**. With respect to the 100,000 share restricted stock unit award granted to Executive effective October 18, 2004 and any award of restricted stock, restricted stock units or other similar award granted on or after such date (awards of restricted stock, restricted stock units or other similar awards covered by this Section 11(b) are referred to herein as "Retention Restricted Stock/Unit Grants"), notwithstanding any other provisions of this Agreement, the following terms shall apply:

**(i)** In the event that (i) Executive's full-time employment is terminated for Cause or breach of Section 8 hereof, or (ii) Executive's Part-Time Employment is terminated for breach of Section 8 hereof, then any Retention Restricted Stock/Unit Grants shall immediately, to the extent then unvested, be forfeited to the Company.

**(ii)** Subject to Section 11(b)(ix), in the event that, prior to July 1, 2006, Executive voluntarily terminates his position as Chief Executive Officer other than for Good Reason, even if Executive remains a Service Provider, any Retention Restricted Stock/Unit Grants shall immediately be forfeited to the Company.

**(iii)** Subject to Section 11(b)(ix), in the event that, on and after July 1, 2006 and prior to July 1, 2007, Executive voluntarily terminates as a Service Provider other than for Good Reason (whether during the Full-Time Employment Period or Part-Time Employment Term), any Retention Restricted Stock/Unit Grants shall immediately be forfeited to the Company.

**(iv)** In the event that, on and after July 1, 2007, Executive voluntarily terminates as a Service Provider other than for Good Reason (whether during the Full-Time Employment Period or Part-Time Employment Term), any Retention Restricted Stock/Unit Grants shall immediately, but only if then unvested, be forfeited to the Company.

**(v)** Subject to the other provisions of this Section 11(b), in the event that, on and after July 1, 2006, Executive transitions to a Part-Time Employee or otherwise remains a Service Provider and does not remain as Chief Executive Officer, any Retention Restricted Stock/Unit Grants shall continue to vest according to its terms and the terms of this Agreement. In the event that Executive remains as Chief Executive Officer, any Retention Restricted Stock/Unit Grants shall also continue to vest according to its terms and the terms of this Agreement.

**(vi)** In the event that (i) Executive's full-time employment is terminated without Cause and other than for breach of Section 8 hereof, or (ii) Executive voluntarily terminates his full-time employment for Good Reason, then Executive shall become a Part-Time Employee (pursuant to Sections 7(c) or (d), respectively) and any Retention Restricted Stock/Unit Grants shall continue to vest according to its terms and the terms of this Agreement.

**(vii)** Subject to Section 11(b)(ii), in the event Executive's status as a Part-Time Employee terminates for any reason (including, without limitation, upon Executive's voluntary termination for any reason) other than (A) upon the death or permanent Disability of Executive, (B) upon Executive's breach of Section 8, or (C) by written agreement between both parties hereto, any Retention Restricted Stock/Unit Grants shall immediately accelerate vesting as to 100% of the then unvested shares.

**(viii)** In the event that Executive's employment terminates due to the Executive's death or Executive's becoming "disabled," as such term is defined in Code Section 409A(c) and proposed or final Treasury Regulations (as applicable) promulgated thereunder (a "409A Disability"), then any Retention Restricted Stock/Unit Grants shall have their vesting accelerated as to a pro rata fraction of the initially covered shares, which pro rata fraction shall be determined by dividing the number of days elapsed from the grant date to the employment termination date by the number of days between the grant date and July 1, 2007.

**(ix)** In the event of a Change of Control occurring during the Full-Time Employment Period, then Executive may at his election transition to the Part-Time Employment Period and continue to vest in his Retention Restricted Stock/Unit Grants during such period of Part-Time Employment.

**(x)** Any vested Retention Restricted Stock/Unit Grants shall be delivered to Executive (or, in the event of Executive's death or 409A disability, as defined below, his estate or personal representative) on the earliest to occur of (i) July 1, 2007, (ii) Executive's death, or (iii) Executive's 409A Disability.

**12.** **Attorneys' Fees**. The Company will pay all of Executive's reasonable attorneys' fees in connection with the negotiation, preparation and execution of this Agreement (including the November, 2005 restatement thereof) with the Company.

**13.** **Assignment**. Executive's rights and obligations under this Agreement shall not be assignable by Executive. The Company's rights and obligations under this Agreement shall not be assignable by the Company except as incident to the transfer, by merger, liquidation, or otherwise, of all or substantially all of the business of the Company. Any such assignee of the Company shall deliver Executive a written confirmation confirming its assumption of this Agreement.

**14.** **Notices**. Any notice required or permitted under this Agreement shall be given in writing and shall be deemed to have been effectively made or given if personally delivered, or if sent by facsimile, or mailed or sent via Federal Express to the other party at its address set forth below in this Section 14, or at such other address as such party may designate by written notice to the other party hereto. Any effective notice hereunder shall be deemed given on the date personally delivered or on the date sent by facsimile or deposited in the United States mail (sent by certified mail, return receipt requested), as the case may be, at the following addresses:

If to the Company: KLA-Tencor Corporation
160 Rio Robles
San Jose, CA 95134
Attn: General Counsel

If to Executive: Kenneth L. Schroeder
at the last primary residential address known to the Company

**15.** **Arbitration**. The parties hereto agree that any dispute or controversy arising out of, relating to, or in connection with this Agreement, or the interpretation, validity, construction, performance, breach, or termination thereof, shall be finally settled by binding arbitration to be held in Santa Clara County, California under the Employment Dispute Resolution Rules of the American Arbitration Association as then in effect (the "Rules"). The arbitrator may grant injunctions or other relief in such dispute or controversy. The decision of the arbitrator shall be final, conclusive and binding on the parties to the arbitration, and judgment may be entered on the decision of the arbitrator in any court having jurisdiction.

The arbitrator shall apply California law to the merits of any dispute or claim, without reference to rules of conflicts of law, and the arbitration proceedings shall be governed by federal arbitration law and by the Rules, without reference to state arbitration law.

The Company shall pay the costs and expenses of such arbitration, and each party shall pay its own counsel fees and expenses.

**THE PARTIES HERETO HAVE READ AND UNDERSTAND THIS SECTION 15, WHICH DISCUSSES ARBITRATION. THE PARTIES HERETO UNDERSTAND THAT BY SIGNING THIS AGREEMENT, THEY AGREE TO SUBMIT ANY CLAIMS ARISING OUT OF, RELATING TO, OR IN CONNECTION WITH THIS AGREEMENT, OR THE INTERPRETATION, VALIDITY, CONSTRUCTION, PERFORMANCE, BREACH OR TERMINATION THEREOF TO BINDING ARBITRATION, AND THAT THIS ARBITRATION CLAUSE CONSTITUTES A WAIVER OF EACH PARTY'S RIGHT TO A JURY TRIAL AND RELATES TO THE RESOLUTION OF ALL DISPUTES RELATING TO EXECUTIVE'S RELATIONSHIP WITH THE COMPANY.**

**16.** **Withholding**. The Company shall be entitled to withhold, or cause to be withheld, from payment any amount of withholding taxes required by law with respect to payments made to Executive in connection with his employment hereunder.

**17.** **Severability**. If any term or provision of this Agreement shall to any extent be declared illegal or unenforceable by arbitrator(s) or by a duly authorized court of competent jurisdiction, then the remainder of this Agreement or the application of such term or provision in circumstances other than those as to which it is so declared illegal or unenforceable, shall not be affected thereby, each term and provision of this Agreement shall be valid and enforceable to the fullest extent permitted by law and the illegal or unenforceable term or provision shall be deemed replaced by a term or provision that is valid and enforceable and that comes closest to expressing the intention of the invalid or unenforceable term of provision.

**18.** **Entire Agreement**. This Agreement and the agreements relating to the Retention Option/SAR Grants, the Retention Restricted Stock/Unit Grants and any other equity compensation agreements represent the entire agreement of the parties with respect to the matters set forth herein, and to the extent inconsistent with other prior contracts, arrangements or understandings between the parties, supersedes all such previous contracts, arrangements or understandings between the Company and Executive, including without limitation the Prior Agreement. The Agreement may be amended at any time only by mutual written agreement signed by the parties hereto.

**19.** **Governing Law**. This Agreement shall be construed, interpreted, and governed in accordance with the laws of the State of California without reference to rules relating to conflict of law (other than any such rules directing application of California law).

**20.** **Headings**. The headings of sections herein are included solely for convenience of reference and shall not control the meaning or interpretation of any of the provisions of this Agreement.

**21.** **Counterparts**. This Agreement may be executed by either of the parties hereto in counterparts, each of which shall be deemed to be an original, but all such counterparts shall together constitute one and the same instrument.

**22.** **<u>Code Section 409A</u>**. This Agreement will be deemed amended to the extent necessary to avoid imposition of any additional tax or income recognition prior to actual payment to Executive under Code section 409A and any proposed or final Treasury Regulations and guidance promulgated thereunder.

| **EXECUTIVE** | **KLA-TENCOR CORPORATION** |
| --- | --- |
| /s/ Kenneth L. Schroeder | /s/ Stuart J. Nichols |
| Kenneth L. Schroeder | Stuart J. Nichols<br>Vice-President, General Counsel |

**EXHIBIT A**

**RELEASE OF CLAIMS**

This Release of Claims ("Release") is made by and between KLA-Tencor Corporation (the "Company"), and _______________ ("Employee").

WHEREAS, Employee has agreed to enter into a release of claims in favor of the Company in return for obtaining certain severance benefits specified in the agreement by and between the Company and Employee dated November __, 2005 which amended and restated in its entirety that Agreement dated February 23, 2005 (the "Agreement").

NOW THEREFORE, in consideration of the mutual promises made herein, the Parties hereby agree as follows:

**1.** Termination. Employee's employment from the Company terminated on ________________ (the "Termination Date").

**2.** Consideration. Pursuant to the terms of Section __ of the Agreement, upon the Effective Date of this Release, Executive will be entitled to severance payments and benefits as provided therein.

**3.** Confidential Information. Employee shall continue to maintain the confidentiality of all confidential and proprietary information of the Company and shall continue to comply with the terms and conditions of the **[Confidentiality Agreement]** between Employee and the Company. Employee shall return all the Company property and confidential and proprietary information in his possession to the Company on the Effective Date of this Release.

**4.** Payment of Salary. Employee acknowledges and represents that the Company has paid all severance, salary, wages, bonuses, accrued vacation, commissions and any and all other benefits due to Employee as of the date hereof.

**5.** Release of Claims. Employee agrees that the foregoing consideration represents settlement in full of all outstanding obligations owed to Employee by the Company. Employee, on behalf of himself, and his respective heirs, family members, executors and assigns, hereby fully and forever releases the Company and its past, present and future officers, agents, directors, employees, investors, shareholders, administrators, affiliates, divisions, subsidiaries, parents, predecessor and successor corporations, and assigns, from, and agrees not to sue or otherwise institute or cause to be instituted any legal or administrative proceedings concerning any claim, duty, obligation or cause of action relating to any matters of any kind, whether presently known or unknown, suspected or unsuspected, that he may possess arising from any omissions, acts or facts that have occurred up until and including the Effective Date of this Release including, without limitation,

**a.** any and all claims relating to or arising from Employee's employment relationship with the Company and the termination of that relationship;

**b.** any and all claims relating to, or arising from, Employee's right to purchase, or actual purchase of shares of stock of the Company, including, without limitation, any claims for fraud, misrepresentation, breach of fiduciary duty, breach of duty under applicable state corporate law, and securities fraud under any state or federal law;

**c.** any and all claims for wrongful discharge of employment; termination in violation of public policy; discrimination; breach of contract, both express and implied; breach of a covenant of good faith and fair dealing, both express and implied; promissory estoppel; negligent or intentional infliction of emotional distress; negligent or intentional misrepresentation; negligent or intentional interference with contract or prospective economic advantage; unfair business practices; defamation; libel; slander; negligence; personal injury; assault; battery; invasion of privacy; false imprisonment; and conversion;

**d.** any and all claims for violation of any federal, state or municipal statute, including, but not limited to, Title VII of the Civil Rights Act of 1964, the Civil Rights Act of 1991, the Age Discrimination in Employment Act of 1967, the Americans with Disabilities Act of 1990, the Fair Labor Standards Act, the Employee Retirement Income Security Act of 1974, The Worker Adjustment and Retraining Notification Act, the California Fair Employment and Housing Act, and Labor Code section 201, *et seq.* and section 970, *et seq.* and all amendments to each such Act as well as the regulations issued thereunder;

**e.** any and all claims for violation of the federal, or any state, constitution;

**f.** any and all claims arising out of any other laws and regulations relating to employment or employment discrimination; and

**g.** any and all claims for attorneys' fees and costs.

Employee agrees that the release set forth in this section shall be and remain in effect in all respects as a complete general release as to the matters released. Notwithstanding the previous sentence, the Parties agree that Employee will continue to be covered by the terms and conditions of the [Indemnity Release] entered into between Employee and the Company on [DATE] (the "Indemnity Release") and the terms of the Company's D&O insurance policy for claims against Employee that arise out of matters or events that occurred prior to the Termination Date. This release does not extend to any severance benefits due Employee under the Agreement or any rights to indemnification Employee may have under the Indemnification Release or the Company's D&O insurance policy.

**6.** Acknowledgment of Waiver of Claims under ADEA. Employee acknowledges that he is waiving and releasing any rights he may have under the Age Discrimination in Employment Act of 1967 ("ADEA") and that this waiver and release is knowing and voluntary. Employee and the Company agree that this waiver and release does not apply to any rights or claims that may arise under the ADEA after the Effective Date of this Release. Employee acknowledges that the consideration given for this Release is in addition to anything of value to which Employee was already entitled. Employee further acknowledges that he has been advised by this writing that (a) he should consult with an attorney prior to executing this Release;

(b) he has at least twenty-one (21) days within which to consider this Release; (c) he has seven (7) days following the execution of this Release by the parties to revoke the Release; (d) this Release shall not be effective until the revocation period has expired; and (e) nothing in this Release prevents or precludes Employee from challenging or seeking a determination in good faith of the validity of this waiver under the ADEA, nor does it impose any condition precedent, penalties or costs for doing so, unless specifically authorized by federal law. Any revocation should be in writing and delivered to the General Counsel at the Company by close of business on the seventh day from the date that Employee signs this Release.

**7.** Civil Code Section 1542. Employee represents that he is not aware of any claims against the Company other than the claims that are released by this Release. Employee acknowledges that he has been advised by legal counsel and is familiar with the provisions of California Civil Code 1542, below, which provides as follows:

> **A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM MUST HAVE MATERIALLY AFFECTED HIS SETTLEMENT WITH THE DEBTOR.**

Employee, being aware of said code section, agrees to expressly waive any rights he may have thereunder, as well as under any statute or common law principles of similar effect.

**8.** No Pending or Future Lawsuits. Employee represents that he has no lawsuits, claims, or actions pending in his name, or on behalf of any other person or entity, against the Company or any other person or entity referred to herein. Employee also represents that he does not intend to bring any claims on his own behalf or on behalf of any other person or entity against the Company or any other person or entity referred to herein.

**9.** Application for Employment. Employee understands and agrees that, as a condition of this Release, he shall not be entitled to any employment with the Company, its subsidiaries, or any successor, and he hereby waives any right, or alleged right, of employment or re-employment with the Company.

**10.** No Cooperation. Employee agrees that he will not counsel or assist any attorneys or their clients in the presentation or prosecution of any disputes, differences, grievances, claims, charges, or complaints by any third party against the Company and/or any officer, director, employee, agent, representative, shareholder or attorney of the Company, unless under a subpoena or other court order to do so.

**11.** Costs. The Parties shall each bear their own costs, expert fees, attorneys' fees and other fees incurred in connection with this Release.

**12.** Authority. Employee represents and warrants that he has the capacity to act on his own behalf and on behalf of all who might claim through him to bind them to the terms and conditions of this Release.

**13.** No Representations. Employee represents that he has had the opportunity to consult with an attorney, and has carefully read and understands the scope and effect of the provisions of this Release. Neither party has relied upon any representations or statements made by the other party hereto which are not specifically set forth in this Release.

**14.** Severability. In the event that any provision hereof becomes or is declared by a court of competent jurisdiction to be illegal, unenforceable or void, this Release shall continue in full force and effect without said provision.

**15.** Entire Release. This Release, along with the Agreement, the Employee Proprietary Information and Investors Agreement and the Indemnification Agreement, represents the entire agreement and understanding between the Company and Employee concerning Employee's separation from the Company.

**16.** No Oral Modification. This Release may only be amended in writing signed by Employee and the Chairman of the Board of Directors of the Company.

**17.** Governing Law. This Release shall be governed by the internal substantive laws, but not the choice of law rules, of the State of California.

**18.** Effective Date. This Release is effective after it has been signed by both Parties, but no sooner than seven (7) days have passed since Employee has signed the Release (the "Effective Date"), unless revoked by Employee prior to the Effective Date.

**19.** Counterparts. This Release may be executed in counterparts, and each counterpart shall have the same force and effect as an original and shall constitute an effective, binding agreement on the part of each of the undersigned.

**20.** Voluntary Execution of Release. This Release is executed voluntarily and without any duress or undue influence on the part or behalf of the Parties hereto, with the full intent of releasing all claims. The Parties acknowledge that:

**a.** They have read this Release;

**b.** They have been represented in the preparation, negotiation, and execution of this Release by legal counsel of their own choice or that they have voluntarily declined to seek such counsel;

**c.** They understand the terms and consequences of this Release and of the releases it contains; and

**d.** They are fully aware of the legal and binding effect of this Release.

IN WITNESS WHEREOF, the Parties have executed this Release on the respective dates set forth below.

KLA-Tencor Corporation

Dated: __________, 20__

By ___________________________

Dated: __________, 20__

___________________________

Kenneth L. Schroeder

**Exhibit 10.15**

**KLA-TENCOR CORPORATION**

**PERFORMANCE BONUS PLAN**

1) Purposes of the Plan. The Plan is intended to increase stockholder value and the success of the Company by motivating Participants (1) to perform to the best of their abilities, and (2) to achieve the Company's objectives. The Plan's goals are to be achieved by offering Participants the opportunity to earn incentive awards for the achievement of goals relating to the performance of the Company. The Plan is intended to permit the payment of bonuses that qualify as performance-based compensation under section 162(m) of the Code.

2) Definitions.

(a) "Actual Award" means as to any Performance Period, the actual cash award (if any) payable to the Participant for a Performance Period. Each Actual Award is determined by a Payout Formula for a Performance Period, subject to the Committee's authority under Section 8(a) to eliminate or reduce the Actual Award otherwise payable.

(b) "Base Salary" means any Performance Period, the Participant's earned salary during that Performance Period. Such Base Salary shall be before both (a) deductions for taxes or benefits, and (b) deferrals of compensation pursuant to Company-sponsored plans.

(c) "Board" means the Board of Directors of the Company.

(d) "Bookings" means net purchase orders received from third parties.

(e) "Cash Flow" means cash generated from operating activities.

(f) "Code" means the Internal Revenue Code of 1986, as amended.

(g) "Committee" means the Compensation Committee of the Board, or a sub-committee of the Compensation Committee, which shall consist solely of two or more members of the Board who are not employees of the Company and who otherwise qualify as "outside directors" within the meaning of Section 162(m).

(h) "Company" means KLA-Tencor Corporation.

(i) "Determination Date" means the latest possible date that will not jeopardize a Target Award or Actual Award's qualification as Performance-Based Compensation.

(j) "Fiscal Year" means a fiscal year of the Company.

(k) "Maximum Award" means as to any Participant for any Performance Period, $4 million.

(l) "Participant" means an eligible executive or key employee of the Company participating in the Plan for a Performance Period.

(m) "Payout Formula" means as to any Performance Period, the formula or payout matrix established by the Committee pursuant to Section 7 in order to determine the Actual Awards (if any) to be paid to Participants. The formula or matrix may differ from Participant to Participant.

(n) "Performance-Based Compensation" means compensation that is intended to qualify as "performance-based compensation" within the meaning of Section 162(m).

(o) "Performance Goals" means the goal(s) (or combined goal(s)) determined by the Committee (in its discretion) to be applicable to a Participant for a Target Award for a Performance Period. As determined by the Committee, the Performance Goals applicable to an Actual Award and/or Target Award may provide for a targeted level or levels of achievement using one or more of the following measures: (i) Bookings, (ii) Cash Flow, (iii) Pre-Tax Margin, (iv) Profit, (v) Return on Assets, (vi) Return on Invested Capital, and/or (vii) Revenue. Performance Goals may differ from Participant to Participant, Performance Period to Performance Period and from award to award. Any Performance Goal may be tested or measured, as applicable, (1) in absolute terms, (2) in relative terms (including, but not limited, the passage of time and/or against other companies or financial metrics), (3) on a per share and/or share per capita basis, (4) against the performance of the Company as a whole or against particular segments or products of the Company, and/or (5) on a pre-tax or after-tax basis. On or prior to the Determination Date, the Committee shall determine whether any element(s) (for example, but not by way of limitation, the effect of mergers or acquisitions) shall be included in or excluded from the calculation of any Performance Goal with respect to any Participants (whether or not such determinations result in any Performance Goal being measured on a basis other than generally accepted accounting principles).

(p) "Performance Period" means any Fiscal Year or such other period shorter or longer than a Fiscal Year, as determined by the Committee in its sole discretion. However, no Performance Period shall have a duration longer than three Fiscal Years. Also, with respect to any Participant, no more than three Performance Periods shall exist at any one time.

(q) "Plan" means this Performance Bonus Plan, as amended from time to time.

(r) "Pre-Tax Margin" means the percentage equal to Profit, divided by Revenue.

(s) "Profit" means net income.

(t) "Return on Assets" means the percentage equal to Profit, divided by average net assets.

(u) "Return on Invested Capital" means the percentage equal to Profit, divided by average invested capital.

(v) "Revenue" means net sales to third parties.

(w) "Section 162(m)" means Section 162(m) of the Code, or any successor to Section 162(m), as that Section may be interpreted from time to time by the Internal Revenue Service, whether by regulation, notice or otherwise.

(x) "Target Award" means the target award payable under the Plan to a Participant for the Performance Period, expressed as a percentage of his or her Base Salary or a specific dollar amount, as determined by the Committee in accordance with Section 6.

3) Plan Administration.

a) The Committee shall be responsible for the general administration and interpre-tation of the Plan and for carrying out its provisions. Subject to the requirements for qualifying compensation as Performance-Based Compensation, the Committee may delegate specific administrative tasks to Company employees or others as appropriate for proper administra-tion of the Plan. Subject to the limitations on Committee discretion imposed under Section 162(m), the Committee shall have such powers as may be necessary to discharge its duties hereunder, including, but not by way of limitation, the following powers and duties, but subject to the terms of the Plan:

i) discretionary authority to construe and interpret the terms of the Plan, and to determine eligibility, Actual Awards and the amount, manner and time of payment of any Actual Awards hereunder;

ii) to prescribe forms and procedures for purposes of Plan participation and distribution of Actual Awards; and

iii) to adopt rules, regulations and bylaws and to take such actions as it deems necessary or desirable for the proper administration of the Plan.

b) Any rule or decision by the Committee that is not inconsistent with the provisions of the Plan shall be conclusive and binding on all persons, and shall be given the maximum deference permitted by law.

4) Eligibility. The employees eligible to participate in the Plan for a given Performance Period shall be employees of the Company who are designated by the Committee in its sole discretion. No person shall be automatically entitled to participate in the Plan.

5) Performance Goal Determination. The Committee, in its sole discretion, shall establish the Performance Goals for each Participant for the Performance Period. Such Performance Goals shall be set forth in writing on or prior to the Determination Date.

6) Target Award Determination. The Committee, in its sole discretion, shall establish a Target Award for each Participant. Each Participant's Target Award shall be determined by the Committee in its sole discretion, and each Target Award shall be set forth in writing prior to the Determination Date.

7) Determination of Payout Formula or Formulae. On or prior to the Determination Date, the Committee, in its sole discretion, shall establish a Payout Formula or Formulae for purposes of determining the Actual Award (if any) payable to each Participant. Each Payout Formula shall (a) be set forth in writing prior to the Determination Date, (b) be based on a comparison of actual performance to the Performance Goals, (c) provide for the payment of a Participant's Target Award if the Performance Goals for the Performance Period are achieved, and (d) provide for an Actual Award greater than or less than the Participant's Target Award, depending upon the extent to which actual performance exceeds or falls below the Performance Goals. Notwithstanding the preceding, in no event shall a Participant's Actual Award for any Performance Period exceed the Maximum Award.

8) Determination of Awards; Award Payment.

a) Determination and Certification. After the end of each Performance Period, the Committee shall certify in writing (for example, in its meeting minutes) the extent to which the Performance Goals applicable to each Participant for the Performance Period were achieved or exceeded. The Actual Award for each Participant shall be deter-mined by applying the Payout Formula to the level of actual performance that has been certified by the Committee. Notwithstanding any contrary provision of the Plan, the Committee, in its sole discretion, may (a) eliminate or reduce the Actual Award payable to any Participant below that which other-wise would be payable under the Payout Formula, and (b) determine whether or not a Participant will receive an Actual Award in the event the Participant incurs terminates his or her employment with the Company prior to the date the Actual Award otherwise is to be paid.

(b) Right to Receive Payment. Each Actual Award that may become payable under the Plan shall be paid solely from the general assets of the Company. Nothing in this Plan shall be construed to create a trust or to establish or evidence any Participant's claim of any right to payment of an Actual Award other than as an unsecured general creditor with respect to any payment to which he or she may be entitled.

(c) Form of Payment. The Company shall pay all Actual Awards in cash paid to the Participant.

(d) Timing of Payments. Except as provided in Section 8(e), the Company shall distribute amounts payable to Participants as soon as is practicable following the determination and written certification of the Actual Award for a Performance Period, but in no event later than 90 days after the end of the applicable Performance Period.

(e) Deferral. The Committee may defer payment of, and apply a vesting schedule to, one or more Actual Awards, or any portion(s) thereof, as the Committee (in its sole discretion) determines, except that no such vesting schedule may exceed four years. In addition, the Committee, in its sole discretion, may permit a Participant to defer receipt of the payment of cash that would otherwise be delivered to a Participant under the Plan. Any such deferral elections shall be subject to such rules and procedures as shall be determined by the Committee in its sole discretion.

9) Term of Plan. Subject to approval of the Company's stockholders at the Company's 2005 Annual Meeting, the Plan shall become effective on July 1, 2005. The Plan shall continue until terminated under Section 10 of the Plan.

10) Amendment and Termination of the Plan. The Committee may amend, modify, suspend or terminate the Plan, in whole or in part, at any time, including the adoption of amendments deemed necessary or desirable to correct any defect or to supply omitted data or to reconcile any inconsistency in the Plan or in any Actual Award granted hereunder; provided, however, that no amend-ment, alteration, suspension or discontinuation shall be made that would (i) impair any payments to Participants made prior to such amendment, modification, suspension or termination, unless the Committee has made a determination that such amendment or modification is in the best interests of all persons to whom Actual Awards have theretofore been granted; provided further, however, that in no event may such an amendment or modification result in an increase in the amount of compensation payable pursuant to such Actual Award or (ii) cause compensation that is, or may become, payable here-under to fail to qualify as Performance-Based Compensation. To the extent necessary or advisable under applicable law, including Section 162(m), Plan amendments shall be subject to stockholder approval. At no time before the actual distribution of funds to Participants under the Plan shall any Participant accrue any vested interest or right whatsoever under the Plan except as otherwise stated in this Plan.

11) Withholding. Distributions pursuant to this Plan shall be subject to all applicable federal and state tax and withholding requirements.

12) Employment. This Plan does not constitute a contract of employment or compensa-tion or impose on either the Participant or the Company any obligation to retain the Participant as an employee. This Plan does not change the status of the Participant as an employee at will, the policies of the Company regarding termination of employment, nor guarantee further continuing participation in the Plan.

13) Successors. All obligations of the Company under the Plan, with respect to awards granted hereunder, shall be binding on any successor to the Company, whether the existence of such successor is the result of a direct or indirect purchase, merger, consolidation, or otherwise, of all or substantially all of the business or assets of the Company.

14) Indemnification. Each person who is or shall have been a member of the Committee, or of the Board, shall be indemnified and held harmless by the Company against and from (a) any loss, cost, liability, or expense that may be imposed upon or reasonably incurred by him or her in connection with or resulting from any claim, action, suit, or proceeding to which he or she may be a party or in which he or she may be involved by reason of any action taken or failure to act under the Plan or any award, and (b) from any and all amounts paid by him or her in settlement thereof, with the Company's approval, or paid by him or her in satisfaction of any judgment in any such claim, action, suit, or proceeding against him or her, provided he or she shall give the Company an opportunity, at its own expense, to handle and defend the same before he or she undertakes to handle and defend it on his or her own behalf. The foregoing right of indemnification shall not be exclusive of any other rights of indemnification to which such persons may be entitled under the Company's Certificate of Incorporation or Bylaws, by contract, as a matter of law, or otherwise, or under any power that the Company may have to indemnify them or hold them harmless.

15) Nonassignment. The rights of a Participant under this Plan shall not be assignable or transferable by the Participant except by will or the laws of intestacy.

16) Governing Law. The Plan shall be governed by the laws of the State of California (without regard to its conflict of laws provisions).

**EXHIBIT 31.1**

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

I, Richard P. Wallace, certify that:

1. I have reviewed this quarterly report on Form 10-Q of KLA-Tencor Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 3, 2006
(Date)

/s/ RICHARD P. WALLACE

Richard P. Wallace
Chief Executive Officer
(Principal Executive Officer)

**EXHIBIT 31.2**

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

I, Jeffrey L. Hall, certify that:

1. I have reviewed this quarterly report on Form 10-Q of KLA-Tencor Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 1, 2006
(Date)

/s/ JEFFREY L. HALL

Jeffrey L. Hall
Senior Vice President and
Chief Financial Officer
(Principal Accounting Officer)

**Exhibit 32**

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

I, Richard P. Wallace, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended December 31, 2005, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

February 1, 2006
Dated

By: /s/ Richard P. Wallace

Name: Richard P. Wallace
Title: Chief Executive Officer

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

I, Jeffrey L. Hall, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended December 31, 2005, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

February 1, 2006
Dated

By: /s/ Jeffrey L. Hall

Name: Jeffrey L. Hall
Title: Senior Vice President and
Chief Financial Officer