KLA TENCOR CORP
Form 10-K
August 07, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the Fiscal Year Ended June 30, 2008

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 No. 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 Number)**
One Technology Drive, Milpitas, California	**95035**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s Telephone Number, Including Area Code: (408) 875-3000

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	**Name of Each Exchange on Which Registered**
Common Stock, $0.001 par value per share	**The NASDAQ Stock Market LLC**
Common Stock Purchase Rights	**The NASDAQ Stock Market LLC**

Securities Registered Pursuant to Section 12(g) of the Act:

None

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer x	Accelerated filer ¨

Non-accelerated filer ¨ (Do not check if a smaller reporting company) Smaller reporting company ¨
Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The aggregate market value of the voting and non-voting common stock held by non-affiliates of the registrant based upon the closing price of the registrant s stock, as of December 31, 2007, was $7.2 billion. Shares of common stock held by each officer and director and by each person or group who owns 5% or more of the outstanding common stock have been excluded in that such persons or groups may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The registrant had 173,222,800 shares of common stock outstanding as of July 22, 2008.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2008 Annual Meeting of Stockholders to be held on November 13, 2008 (Proxy Statement), and to be filed pursuant to Regulation 14A within 120 days after the registrant s fiscal year ended June 30, 2008, are incorporated by reference into Part III of this report.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements other than statements of historical fact may be forward-looking statements. You can identify these and other forward-looking statements by the use of words such as may, will, could, would, should, expects, plans, anticipates, relies, believes, estimates, predicts, intends, potential, continue, thinks, seeks, or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Such forward-looking statements include, among others, forecasts of the future results of our operations; the percentage of spending that our customers allocate to process control; orders for our products 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; the future impact of the restatement of our historical financial statements, shareholder litigation and related matters arising from the discovery that we had retroactively priced stock options (primarily from July 1, 1997 to June 30, 2002) and had not accounted for them correctly; our future product offerings and product features; the success and market acceptance of new products; timing of shipment of backlog; the future of our product shipments and our product and service revenues; our future gross margins; the future of our selling, general and administrative expenses; international sales and operations; 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; the completion of any acquisitions of third parties, or the technology or assets thereof; benefits to be received from any acquisitions and development of acquired technologies; sufficiency of our existing cash balance, investments and cash generated from operations to meet our operating and working capital requirements; and the adoption of new accounting pronouncements.

Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in Item 1A, Risk Factors as well as in Item 1, Business and Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations in this Annual Report on Form 10-K. You should carefully review these risks and also review the risks described in other documents we file from time to time with the Securities and Exchange Commission, including the Quarterly Reports on Form 10-Q that we will file in the fiscal year ending June 30, 2009. You are cautioned not to place undue reliance on these forward-looking statements, and we expressly assume no obligation to update the forward-looking statements in this report after the date hereof.

PART I

ITEM 1. BUSINESS

The Company

KLA-Tencor Corporation (KLA-Tencor or the Company and also referred to as we or our) is the world s leading supplier of process control ar yield management solutions for the semiconductor and related microelectronics industries. Our products are also used in a number of other industries, including light emitting diode (LED) and data storage manufacturing, and solar process development and control.

Within our primary area of focus, our comprehensive portfolio of products, services, software and expertise helps integrated circuit (IC or chip) manufacturers manage yield throughout the entire fabrication process from research and development to final volume production. These products and solutions are designed to help customers accelerate their development and production ramp cycles, to achieve higher and more stable semiconductor die yields and to improve overall profitability.

KLA-Tencor s products and services are used by the vast majority of wafer, IC, disk and reticle manufacturers in the world. These customers turn to us for inline wafer and IC defect monitoring, review and classification; reticle defect inspection; packaging and interconnect inspection; critical dimension (CD) metrology; pattern overlay metrology; film thickness, surface topography and composition measurements; measurement of in-chamber process conditions, wafer shape and stress metrology; computational lithography tools; and overall yield and fab-wide data management and analysis systems. Our advanced products, coupled with our unique yield management services, allow us to deliver the solutions our customers need to accelerate their yield learning rates and significantly reduce their risks and costs.

KLA-Tencor Corporation was formed in April 1997 through the merger of KLA Instruments Corporation and Tencor Instruments, two long-time leaders in the semiconductor equipment industry that had originally begun operations in 1975 and 1976, respectively.

Additional information about KLA-Tencor is available on our web site at www.kla-tencor.com. We make available free of charge on our web site our Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file them with or furnish them to the Securities and Exchange Commission (SEC). Information contained on our web site is not part of this Annual Report on Form 10-K or our other filings with the SEC. Additionally, these filings may be obtained by visiting the Public Reference Room of the SEC at 100 F Street, NE, Washington, DC 20549, by mailing a request to the United States Securities and Exchange Commission, Office of Investor Education and Advocacy, 100 F Street, NE, Washington, DC 20549-0213, by sending an electronic message to the SEC at publicinfo@sec.gov or by sending a fax to the SEC at 1-202-772-9295. In addition, the SEC maintains a website (www.sec.gov) that contains reports, proxy and information statements, and other information regarding issuers that file electronically.

Industry

General Background

The semiconductor or chip industry is KLA-Tencor s core focus. The semiconductor fabrication process begins with a bare silicon wafer a round disk that is six, eight or twelve inches in diameter, about as thick as a credit card and gray in color. The process of manufacturing wafers is itself highly sophisticated, involving the creation of large ingots of silicon by pulling them out of a vat of molten silicon. The ingots are then sliced into wafers and polished to a mirror finish.

The manufacturing cycle of an IC is grouped into three phases: design, fabrication and testing. IC design involves the architectural layout of the circuit, as well as design verification and reticle generation. The fabrication of a chip is accomplished by depositing a series of film layers that act as conductors, semiconductors or insulators. The deposition of these film layers is interspersed with numerous other process steps that create circuit patterns, remove portions of the film layers, and perform other functions such as heat treatment, measurement and inspection. Most advanced chip designs require hundreds of individual steps, many of which are performed multiple times. Most chips consist of two main structures: the lower structure, typically consisting of transistors or capacitors which perform the smart functions of the chip; and the upper interconnect structure, typically consisting of circuitry which connects the components in the lower structure. When all of the layers on the wafer have been fabricated, each die on the wafer is then tested for functionality.

Current Trends

Companies that anticipate future market demands by developing and refining new technologies and manufacturing processes are better positioned to lead in the semiconductor market. During past industry cycles, semiconductor manufacturers generally contended with a few key new technologies or market trend, such as a specific design rule shrink. In today s market, driven by consumer demand for low-cost electronic goods from cell phones and MP3 players to laptops and portable devices, the leading semiconductor manufacturers are investing in bringing a multitude of new technologies into production at the same time, including new substrate and film materials and advanced lithography techniques.

While many of these technologies have been adopted at the development and pilot production stages, significant challenges and risks associated with each technology have affected their adoption into full-volume production. For example, as design rules decrease, yields become more sensitive to the size and density of defects, while device performance characteristics (namely speed or capacity) become more sensitive to such parameters as linewidth and film thickness variation. New process materials, such as high-k dielectrics, silicon-on-insulator (SOI) wafers and immersion lithography-capable photoresists require extensive characterization before they can be used in the manufacturing process. Moving several of these advanced technologies into production at once only adds to the risks that chipmakers face.

The continuing evolution of semiconductor devices to smaller geometries and more complex multi-level circuitry has significantly increased the cost and performance requirements of the capital equipment used to manufacture these devices. Construction of an advanced wafer fabrication facility today can cost over $5 billion, substantially more than previous generation facilities. As a result, chipmakers are demanding increased productivity and higher returns from their manufacturing equipment.

By developing new process control and yield management tools that help chipmakers accelerate the adoption of these new technologies into volume production, we enable our customers to better leverage these increasingly expensive facilities and significantly improve their return on investment (ROI). Once customers production lines are operating at high volume, our tools help ensure that yields are stable and process excursions are identified for quick resolution. In addition, the move to each new generation s smaller design rules, coupled with new materials and device innovation has increased in-process variability which requires an increase in inspection and metrology sampling.

With our broad portfolio of application-focused technologies and our dedicated yield technology expertise, we are in position to be a key supplier of comprehensive yield management solutions for customers next-generation products, including those required for the 45nm chip generation and beyond.

Our Process Control and Yield Acceleration Solutions

Accelerating the yield ramp and maximizing production yields of high-performance devices are key goals of modern semiconductor manufacturing. Ramping to high-volume production ahead of competitors can

dramatically increase the revenue an IC manufacturer realizes for a given product. KLA-Tencor systems not only analyze defectivity and metrology issues at critical points in the wafer, reticle and IC manufacturing processes, but also provide information to our customers so that they can identify and address the underlying process problems. The ability to locate the source of defects and resolve the underlying process issues enables our customers to improve control over their manufacturing processes, so they can increase their yield of high-performance parts thus maximizing their profit.

Products

KLA-Tencor operates primarily in one segment for the design, manufacture and marketing of process control and yield management systems for the semiconductor and related microelectronics industry. We design, market, manufacture and sell our equipment consisting of patterned and unpatterned wafer inspection, defect review and classification; reticle defect inspection; packaging and interconnect inspection; critical dimension metrology; pattern overlay metrology; film thickness, surface topography and composition measurement; measurement of in-chamber process conditions, wafer shape and stress metrology; computational lithography tools and overall yield and fab-wide data management and analysis. We also currently offer products that serve the wafer and reticle manufacturing, data storage, solar, and other industries.

In June 2008, KLA-Tencor completed its acquisition of ICOS Vision Systems Corporation NV (ICOS). Based in Leuven, Belgium, ICOS is a leading supplier of packaging and interconnect inspection solutions for the semiconductor industry, and also has a market leadership position in the inspection of photovoltaic solar technologies and LED wafers. ICOS and KLA-Tencor are highly complementary and there is virtually no product overlap. This acquisition enhances KLA-Tencor s position in semiconductor inspection by expanding its capabilities to back-end markets. Additionally, this acquisition provides KLA-Tencor entry into the potentially high-growth solar market.

KLA-Tencor s ICOS designs and manufactures three main product lines: (1) Component Inspection, which is used for inspection of semiconductor IC packaging; (2) Wafer Inspection systems that perform two-and three-dimensional (2D and 3D) inspection of semiconductor or LED wafers, both whole and diced; and (3) Solar Inspection, where KLA-Tencor s ICOS is a leading provider of systems that inspect photovoltaic solar wafers and solar cells during solar PV cell manufacturing. These systems help solar wafer and solar cell makers accept or reject products, as well as improve production yield, drive down costs and improve cell efficiency.

Our offerings can be broadly categorized into four groups: Defect Inspection; Metrology; Product related services; and Software. For our customers manufacturing larger design-rule devices, we provide refurbished KLA-Tencor Certified tools along with service and support.

Defect Inspection

KLA-Tencor s defect inspection tools allow our customers to detect, count, classify and characterize yield failures caused by particles, residues and other contaminants, as well as pattern defects, surface anomalies and electrical issues during all stages of the IC manufacturing process. Our portfolio of tools enables our customers to ramp their production lines faster by finding new defect types during development and ramp, and to maintain high and stable yields by monitoring defect count by type during production.

The number of yield-relevant defects increases as semiconductor process tolerances (process windows) become tighter, a result of smaller, more densely packed semiconductor circuit patterns. Also, new defect types and yield issues arise from the necessary introduction of innovative materials, device structures and lithography techniques. As a result, chip manufacturers need to inspect more wafers per lot, more process layers and more area on the wafer, at higher sensitivities. KLA-Tencor supplies a wide portfolio of high performance inspection, review, classification and analysis systems that enable our customers to solve their toughest yield issues.

High-Sensitivity Broadband Brightfield Inspection

Brightfield inspection systems provide benchmark sensitivity to small defects, and capture a large range of defect types, which becomes increasingly important as our customers move to 45nm and smaller production. Our 28xx brightfield inspection systems have been widely adopted at leading-edge memory, logic and foundry fabs worldwide, because they deliver the sensitivity and production-worthy performance that chipmakers need to produce market-leading devices. Key to the 28xx inspection system s success is the full-spectrum broadband light source, spanning deep ultraviolet to visible wavelengths. With the ability to tune its wavelength and employ various optical modes and algorithms, the 28xx inspection systems provide sensitivity to a broad range of defect types throughout the chip manufacturing process.

High-Performance Darkfield Inspection

Darkfield inspection systems are used to cost effectively monitor process tools for defect yield excursions. Our widely-adopted Puma 91xx darkfield imaging inspection systems leverage our patented Streak laser imaging technology to produce the high sensitivities at production throughputs. Combining advanced UV-laser illumination optics with a solid-state sensor to image the scattered light, Streak is scalable for multiple technology generations.

Electron-Beam Inspection

For advanced IC manufacturing, e-beam inspection is essential not only during IC development, where the highest sensitivity is needed to discover defects, but also in production, where dedicated systems are required to monitor key process steps for defect excursions. E-beam technology is often used to find small physical defects that are not detected optically. In addition only e-beam inspection can detect the subtle electrical defects that plague our customers as they introduce new materials and device structures. In July 2008, we launched our latest e-beam inspection system, the eS35, featuring improved sensitivity and throughput, and on-board review and classification.

High Resolution Electron Beam Review and Classification

Once a defect has been identified, a chipmaker must be able to review and classify the defect in order to identify and address the cause of the defect. Our eDR-5200 defect review and classification system features a lens that delivers a significant improvement in resolution, meeting production and process development requirements for advanced design-rule semiconductor devices. Unique connectivity technology between the eDR -5200 and our market-leading inspection systems provides additional benefits to our customers with respect to defect re-detection, classification and speed.

Reticle Inspection

Reticles are high-precision quartz plates that contain microscopic images of electronic circuits. Placed into steppers or scanners, reticles are used to transfer circuit patterns onto wafers to fabricate ICs. It is extremely important that these features are printed correctly on the reticles; very small variations in line width or placement, or defects within or adjacent to these structures, can cause devastating yield loss in the printed die.

TeraScanHR reticle inspection system provides unique defect-detection and productivity features that facilitate the production of defect-free reticles. The system includes higher resolution optical imaging and several new inspection modes that enable the system to find all types of reticle defects. The TeraScanHR system s high sensitivity, improved productivity, and flexible configurations make it a cost-effective solution that meets the needs of reticle manufacturers. In April 2008, we introduced our latest reticle inspection capability, Wafer Plane Inspection (WPI), on the TeraScanHR platform. This new capability, for the development of 32nm reticles, identifies critical defects that will print on the wafer.

In February 2008, we launched a new family of three reticle inspection systems, called TeraFab, based on the TeraScanHR platform. Targeting IC fabs, the TeraFab systems offer a variety of options to qualify incoming reticles and inspect production reticles for contaminants that reduce yield and increase production risk.

Unpatterned Wafer Surface Inspection

Having a defect-free wafer substrate is essential, since defects on the surface of the wafer can adversely affect subsequent semiconductor processes, and ultimately impact IC performance. The Surfscan SP2^{XP} inspection system has the speed and sensitivity of the Surfscan SP2, plus a new optical subsystem that allows the tool to distinguish between inherent defects in the silicon crystal which can kill transistors and thus require scrapping the wafer and other defect types that may be eliminated through cleaning or re-polishing the wafer. The Surfscan SP2^{XP} provides wafer manufacturers with the ability to scrap fewer wafers, enhancing their profitability.

For the qualification of new or recently serviced process tools, or for monitoring contamination from process tools already in production, chipmakers may prefer to use bare or blanket-film monitor wafers instead of patterned wafers. The Surfscan SP2 family provides benchmark inspection sensitivity on IC films or bare substrates. To add to the Surfscan SP2 family s capability, an innovative module called SURFmonitor was introduced in July 2007. SURFmonitor utilizes background scattering (haze) data from Surfscan® SP2 family systems to monitor process drift and capture low-contrast defects, without affecting inspection throughput.

Macro Defect Inspection for Wafer Dispositioning

Advanced fabs require accurate and rapid disposition decision making during manufacturing, as well as quick assessment of tool and process module output. Our automated wafer and tool dispositioning system captures a broad range of defect types at very high throughput enabling inspection of 100% of wafer lots.

Wafer Edge Inspection

As customers move to smaller design rules and new, more complex material stacks, the high stress wafer edge region has become a source of yield-limiting defects. Material at the edge of the wafer can flake off and fall onto the regions where the chips are being built, causing loss of yield. The recent introduction of immersion lithography adds to the potential for flakes to migrate and cause yield loss, since the flakes can be transported by the immersion fluid.

To help customers identify and fix these edge-related yield issues, KLA-Tencor offers the VisEdge CV300 system. The tool s unique optics design and advanced defect classification capabilities allow IC manufacturers to capture a wide range of wafer-edge defect types with high sensitivity.

Component Inspection

Our component inspection systems inspect various components that are handled in trays, most commonly semiconductor chips. They inspect for 3D planarity, evenness of contacts and 2D surface aspects, as well as identification marks and orientation. After inspection, the systems can sort the components and even tape them.

We manufacture a range of component inspection systems. The ICOS CI-T120 features the latest innovations in vision technology and component handling. The ICOS CI-T120S and ICOS CI-T130S systems offer 2D and 3D metrology and inspection for Flip-Chip packaging, combining bump inspection, substrate top and bottom surface inspection and substrate warpage inspection in one system. The ICOS CI-9x50 is a fully automatic system for the final inspection of tray-based semiconductor components; it moves the components to the inspection stations, sorts them and, if required, transfers them to tape. The ICOS CI-3050 is a component inspector for inspecting small lots and QA samples, performing 2D and 3D inspections.

Back-End Wafer Inspection

Back-end wafer inspection is performed either before or after the chips are cut (diced) from the wafer. Two main versions of the wafer inspection systems are the ICOS WI-2200/2300, which perform 100% automated optical inspection and metrology of microelectronic devices on a variety of wafer substrates. This inspection system combines surface inspection and 2D bump inspection for semiconductor ICs, optoelectronics, advanced packaging, and MEMS. The ICOS WI-3200/3300 Wafer Inspector combines surface inspection and 2D/3D bump inspection in one high speed pass.

Solar Inspection Systems

Our solar inspection modules, manufactured through our ICOS subsidiary, are used in various stages of the solar cell production line, and monitor various stages of the production process including wafer contour integrity, wafer geometry and surface inspection. They are designed for high speed automated optical in-line inspection of the front- and backside of solar wafers and cells (mono-and polycrystalline) up to 8-inch. They provide fast, efficient and reliable optical classification of solar cells at the different stages of the production flow.

Transparent Film and Opaque Substrate Inspection

Understanding the optical surface properties of modern materials has become a critical part of manufacturing. With the increasing complexity of manufacturing processes and products comes the need for precise analysis and control of surface properties such as film thickness uniformity, contamination and defectivity, often in real time and online. The Candela CS20 Optical Surface Analyzer automatically detects and classifies surface defects on optoelectronic and semiconductor wafers, including wafers made of transparent materials such as sapphire and glass. By simultaneously measuring reflectivity and topographic variations on the surface, these systems enable customers to inspect epitaxial layers and film coatings for uniformity issues and defects. In substrate and media manufacturing, the Candela 6100 and 6300 Series patented X-beam optical surface analyzers enable defect detection and characterization for magnetic disk media inspection.

Metrology

Metrology is a critical discipline in the production of high performance, reliable devices. Whether verifying that a design will be manufacturable, characterizing a new process, or monitoring high-volume manufacturing processes, our comprehensive set of metrology, analysis and process window optimization products gives IC manufacturers the ability to maintain tight control of their processes.

Optical Overlay Metrology

Decreasing linewidths, larger die sizes and increasing chip density all affect the tolerances for layer-to-layer alignment, or *overlay*. Mis-registration errors represent a crucial cause of yield loss. Today s lithography scanners or steppers require precise monitoring to ensure layer-to-layer alignment is within-specifications. These advanced lithography systems also require regular maintenance and performance tests to ensure they are meeting process requirements. Overlay metrology systems verify scanner or stepper performance by measuring the pattern alignment between adjacent layers of the chip as it is built.

In June 2008, we introduced the Archer 200 Overlay Control System, based on the industry-proven Archeplatform. Redesigned optics and performance improvements combine to deliver the high levels of overlay measurement performance and productivity needed for 32nm double-patterning lithography.

CD Metrology

The critical dimension is the smallest intended linewidth for a given device. While a useful measurement for previous-generation devices, traditional CD measurements no longer provide all the information that chipmakers need to accurately predict yield and transistor performance. Instead, complete

profile information, including the width at the top and bottom of the feature, the sidewall angle and the height or depth of the feature, are needed. For this reason, CD control in the fab is increasingly changing from traditional CD-SEM (scanning electron microscope) measurements to optical CD.

The SpectraCD-XT is our fourth-generation of inline optical CD metrology systems for advanced patterning process control. The SpectraCD-XT is a non-destructive, dedicated CD and profile metrology system built on our high-throughput, production-proven Archer platform.

Film Measurement

Our film metrology systems measure a variety of optical and electrical properties of thin films deposited on a wafer. These systems are used to control a wide range of wafer fabrication steps, where both within-wafer and wafer-to-wafer process uniformity are critical to achieving high device performance at low cost. Our systems use a range of optical and electrical measurement technologies to monitor such critical parameters as film thickness, charge, composition, stress and electrical interface quality.

In December 2007, we introduced a significant advancement in films metrology with the Aleris product line, followed by the introduction of additional Aleris systems in January 2008. Our single-tool solution allows for production monitoring of critical gate applications at 45nm and beyond and is designed to meet tighter process tolerances for thickness, refractive index, and stress measurements over a broad range of applications, including diffusion, chemical vapor disposition (CVD), etch and others.

Implant Metrology

KLA-Tencor offers implant and anneal micro-uniformity monitoring with the Therma-Probe® solution. Therma-Probe is the industry standard for implant dose metrology. With its advances in modulated optical reflectance, Therma-Probe provides dose measurements for in-line monitoring, including anneal and ultra-shallow junction depth profiling. The system contributes to higher yield by monitoring for process excursions.

Substrate & Surface Metrology

At the 45nm node and below, small deviations in wafer shape such as bow warp and edge roll-off can translate to intolerable errors in the IC s critical dimensions and layer-to-layer alignment. WaferSight2 is an optical interferometry-based metrology system that enables wafer suppliers and chipmakers to measure bare wafer dimensional parameters such as flatness, shape, edge roll-off and nanotopography in one system. With industry-leading flatness and nanotopography precision, plus improved tool-to-tool matching, WaferSight2 enables leading-edge production of next-generation wafers by wafer suppliers, and higher confidence of incoming wafer quality for IC makers.

Our stylus profilers measure the surface topography of films and etched surfaces, and are used in basic research and development as well as semiconductor production and quality control. In July 2007 we introduced a high-resolution surface profiler, the HRP® -350, extending critical measurement capability to the 45nm semiconductor device generation. We also offer the P-16+ benchtop contact stylus profiler, designed for automated step height, surface contour, waviness and roughness measurements, with detailed 2D and 3D topographic analysis of a variety of surfaces and materials.

SensorWafers

KLA-Tencor offers specialized, instrumented substrates that measure a wafer s response to the conditions inside the process chamber, while the process is occurring. These wafer-level metrology tools measure the temperature variation of the process over time to optimize, troubleshoot and monitor complex processes, such as plasma etch and lithography. Other measurement parameters are also available, including

plasma monitoring. To support the troubleshooting process, an advanced diagnostic module is also offered. Both chipmakers and process equipment manufacturers use these wafers to visualize, diagnose and control their processes and process tools in a wide variety of applications.

Services

KLA-Tencor enables customers to achieve their required productivity with a low overall cost for inspection and metrology systems over the lifecycle of the tools. We deliver yield management expertise spanning advanced technology nodes, and collaborate with customers to determine the best products and services to meet technology requirements and optimize cost of ownership. Our customers can achieve their production goals through a menu of K-T support services, unique expertise from local service engineers, worldwide spare parts depots, and round-the-clock tech support experts in our Online Support Centers. KLA-Tencor s Technology Engagement Services (TES) collaborates with customers to use effective recipes to improve baseline performance and avoid costly process errors, as well as extend the life of their installed base and determine when new tools and upgrades would be beneficial.

Software and Other

Our productivity and analysis solutions translate inspection and metrology data into consolidated information that can reveal process problems and help semiconductor manufacturers develop long-term yield improvement strategies.

Klarity Solutions form a fab-wide yield acceleration solution that automatically reduces defect inspection, classification and review data to relevant root-cause and yield-analysis information. Using this information, manufacturers can take corrective action sooner and improve yield more quickly at a low cost-of-ownership.

K-T Analyzer software provides critical post processing of overlay data into information which indicates appropriate corrective action for the relevant process tool. This function is increasing in importance with sub-65nm design rules, immersion lithography and double patterning lithography.

FabVision is a real-time, fab-wide data management system that continuously monitors, reports and manages product quality information at wafer manufacturing facilities. Alerts on process excursions, daily reports and selected data are generated and sent automatically to better manage operations at the fab, process or customer level.

Our ProDATA lithography data analysis tool, along with our PROLITH lithography and etch optimization tool, helps manufacturers reduce their advanced lithography development time and cost, as well as optimize their design-for-manufacturing (DFM) efforts.

LithoWare is a Linux-based lithography optimization tool that enables engineers to begin their Optical Proximity Correction (OPC)/reticle enhancement technique (RET) development without the need to wait for a mature silicon process. LithoWare also dramatically reduces the time and cost to develop RET and OPC recipes.

Process window qualification (PWQ) application enables device manufacturers to identify reticle design marginalities by examining the wafer for poorly printed features using their KLA-Tencor broadband brightfield wafer inspection systems.

Customers

To support our growing, global customer base, we maintain a significant presence throughout the United States, Europe, Asia-Pacific and Japan, staffed with local sales and applications engineers, customer and field service engineers and yield management consultants. We count among our largest customers the leading semiconductor manufacturers from each of these regions. In each of the fiscal years ended June 30, 2008, 2007 and 2006, no customer accounted for more than 10% of our total revenues.

Our business depends upon the capital expenditures of semiconductor manufacturers, which in turn is driven by the current and anticipated market demand for ICs and products utilizing ICs. We do not consider our business to be seasonal in nature, but it is cyclical with respect to the capital equipment procurement practices of semiconductor manufacturers, and it is impacted by the investment patterns of such manufacturers in different global markets. Downturns in the semiconductor industry or slowdowns in the worldwide economy could have a material adverse effect on our future business and financial results.

Sales, Service and Marketing

Our sales, service and marketing efforts are aimed at building long-term relationships with our customers. We focus on providing a single and comprehensive resource for the full breadth of process control and yield management products and services. Customers benefit from the simplified planning and coordination, as well as the increased equipment compatibility that are realized as a result of dealing with a single supplier. Our revenues are derived primarily from product sales, mostly through our direct sales force.

We believe that the size and location of our field sales, service and applications engineering, and marketing organizations represent a competitive advantage in our served markets. We have direct sales forces in the United States, Europe, Asia-Pacific and Japan. We maintain an export compliance program that is designed to fully meet the requirements of the United States Departments of Commerce and State.

As of June 30, 2008, we employed approximately 2,500 sales and related personnel, service engineers and applications engineers. In addition to sales and service offices in the United States, we conduct sales, marketing and services out of wholly-owned subsidiaries or branches in other countries, including Belgium, China, France, Germany, Hong Kong, India, Israel, Italy, Japan, Malaysia, Singapore, South Korea, Taiwan, Thailand and the United Kingdom. International revenues accounted for approximately 79%, 76%, and 80% of our total revenues in the fiscal years ended June 30, 2008, 2007 and 2006, respectively. Additional information regarding our revenues from foreign operations for our last three fiscal years can be found in Note 15, Segment Reporting and Geographic Information to the Consolidated Financial Statements.

We believe that sales outside the United States will continue to be a significant percentage of our total revenues. Our future performance will depend, in part, on our ability to continue to compete successfully in Asia, one of the largest markets for our equipment. Our ability to compete in this area is dependent upon the continuation of favorable trading relationships between countries in the region and the United States, and our continuing ability to maintain satisfactory relationships with leading semiconductor companies in the region.

International sales and operations may be adversely affected by the imposition of governmental controls, restrictions on export technology, political instability, trade restrictions, changes in tariffs and the difficulties associated with staffing and managing international operations. In addition, international sales may be adversely affected by the economic conditions in each country. The revenues from our international business may also be affected by fluctuations in currency exchange rates. Although we attempt to manage the currency risk inherent in non-dollar product sales through hedging activities, there can be no assurance that such efforts will be adequate. These factors could have a material adverse effect on our future business and financial results.

Backlog

Our backlog for system shipments and associated warranty totaled $715 million and $1,061 million as of June 30, 2008 and 2007, respectively, and includes sales orders where written customer requests have been received and the delivery is anticipated within the next 12 months. We make backlog adjustments for backlog obtained from acquired companies, cancellations, customer delivery date changes and currency adjustments. Orders for service contracts and unreleased products are excluded from backlog. All orders are subject to cancellation or delay by the customer, with limited or no penalties. Due to possible customer changes in delivery schedules or cancellation of orders and as some orders are received and shipped within the same quarter, our backlog at any particular date is not necessarily indicative of business volumes or actual sales for any succeeding period.

Research and Development

The market for yield management and process monitoring systems is characterized by rapid technological development and product innovation. These technical innovations are inherently complex and require long development cycles and appropriate professional staffing. We believe that continued and timely development of new products and enhancements to existing products are necessary to maintain our competitive position. Accordingly, we devote a significant portion of our human and financial resources to research and development programs and seek to maintain close relationships with customers to remain responsive to their needs. As part of our customer relationships, we may enter into certain strategic development and engineering programs whereby our customers offset certain of our research and development costs. As of June 30, 2008, we employed approximately 1,300 research and development personnel.

Our key research and development activities during fiscal year 2008 involved development of process control and yield management equipment for sub-65nm processing. For information regarding our research and development expenses during the last three fiscal years, including costs offset by our strategic development and engineering programs, see Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations in this Annual Report on Form 10-K.

In order to make continuing developments in the semiconductor industry, we are committed to significant engineering efforts toward both product improvement and new product development. New product introductions may contribute to fluctuations in operating results, since customers may defer ordering existing products. If new products have reliability or quality problems, those problems may result in reduced orders, higher manufacturing costs, delays in acceptance of and payment for new products, and additional service and warranty expenses. There can be no assurance that we will successfully develop and manufacture new products, or that new products introduced by us will be accepted in the marketplace. If we do not successfully introduce new products, our results of operations will be adversely affected.

Manufacturing, Raw Materials and Supplies

We perform system design, assembly and testing in-house and utilize an outsourcing strategy for the manufacture of components and major subassemblies. Our in-house manufacturing activities consist primarily of assembling and testing components and subassemblies that are acquired through third-party vendors and integrating those subassemblies into our finished products. Our principal manufacturing activities take place in San Jose and Milpitas, California, with additional significant operations in Singapore, Israel, China and Belgium. As of June 30, 2008, we employed approximately 1,000 manufacturing personnel.

Many of the parts, components and subassemblies (collectively parts) that we use are standard commercial products, although certain parts are made to our specifications. We use numerous vendors to supply parts for the manufacture and support of our products. Although we make reasonable efforts to ensure that these parts are available from multiple suppliers, this is not always possible and certain parts included in our systems may be obtained only from a single supplier or a limited group of suppliers. We endeavor to minimize the risk of production interruption by selecting and qualifying alternative suppliers for key parts, by monitoring the financial condition of key suppliers, and by ensuring adequate inventories of key parts are available to maintain manufacturing schedules.

Although we seek to reduce our dependence on sole and limited source suppliers, in some cases the partial or complete loss of certain of these sources could disrupt scheduled deliveries to customers, damage customer relationships and have a material adverse effect on our results of operations.

Competition

The worldwide market for process control and yield management systems is highly competitive. In each of our product markets, we face competition from established and potential competitors, some of which may have greater financial, research, engineering, manufacturing and marketing resources than we have, such as Applied Materials, Inc. and Hitachi Electronics Engineering Co., Ltd. We may also face future competition from new

market entrants from other overseas and domestic sources. We expect our competitors to continue to improve the design and performance of their current products and processes and to introduce new products and processes with improved price and performance characteristics. We believe that to remain competitive, we will require significant financial resources to offer a broad range of products, to maintain customer service and support centers worldwide, and to invest in product and process research and development.

Significant competitive factors in the market for process control and yield management systems include system performance, ease of use, reliability, installed base and technical service and support. We believe that, while price and delivery are important competitive factors, the customers overriding requirement is for systems that easily and effectively incorporate automated and highly accurate inspection and metrology capabilities into their existing manufacturing processes to enhance productivity.

Management believes that we are well positioned in the market with respect to both our products and services. However, any loss of competitive position could negatively impact our prices, customer orders, revenues, gross margins and market share, any of which would negatively impact our operating results and financial condition.

Acquisitions and Alliances

We continuously evaluate strategic acquisitions and alliances to expand our technologies, product offerings and distribution capabilities. Acquisitions involve numerous risks, including management issues and costs in connection with integration of the operations, technologies and products of the acquired companies, and the potential loss of key employees of the acquired companies. The inability to manage these risks effectively could negatively impact our operating results and financial condition. Additional information regarding our business combinations during the fiscal year ended June 30, 2008 can be found in Note 4, Business Combinations to the Consolidated Financial Statements.

Patents and Other Proprietary Rights

We protect our proprietary technology through reliance on a variety of intellectual property laws, including patent, copyright and trade secret. We have filed and obtained a number of patents in the United States and abroad and intend to continue pursuing the legal protection of our technology through intellectual property laws. In addition, from time to time we acquire license rights under United States and foreign patents and other proprietary rights of third parties.

Although we consider patents and other intellectual property significant to our business, due to the rapid pace of innovation within the process control and yield management systems industry, we believe that our protection through patent and other intellectual property rights is less important than factors such as our technological expertise, continuing development of new systems, market penetration, installed base and the ability to provide comprehensive support and service to customers worldwide.

No assurance can be given that patents will be issued on any of our applications, that license assignments will be made as anticipated, or that our patents, licenses or other proprietary rights will be sufficiently broad to protect our technology. No assurance can be given that any patents issued to or licensed by us will not be challenged, invalidated or circumvented or that the rights granted thereunder will provide us with a competitive advantage. In addition, there can be no assurance that we will be able to protect our technology or that competitors will not be able to independently develop similar or functionally competitive technology.

Employees

As of June 30, 2008, we employed approximately 6,000 people. None of our employees are represented by a labor union. We have not experienced work stoppages and believe that our employee relations are good.

Competition is intense in the recruiting of personnel in the semiconductor and semiconductor equipment industry. We believe that our future success will depend, in part, on our continued ability to hire and retain qualified management, marketing and technical employees.

ITEM 1A. RISK FACTORS

Risks Associated with Our Industry and Market Conditions

The semiconductor equipment industry is highly cyclical. The purchasing decisions of our customers are highly dependent on the economies of both the local markets in which they are located and the semiconductor industry worldwide. If we fail to respond to industry cycles, our business could be seriously harmed.

The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. This cyclical nature of the industry in which we operate affects our ability to accurately predict future revenue, and in some cases, future expense levels. In the current environment, our ability to accurately predict our future operating results is particularly low. During down cycles in our industry, the financial results of our customers may be negatively impacted, which could result not only in a decrease in orders but also a weakening of their financial condition that could impair our ability to recognize revenue from certain customers. Furthermore, in the current credit environment, it may be more difficult for our customers to raise capital, whether debt or equity, to finance their purchases of capital equipment, including the products we sell. If our customers experience persistent difficulties in raising capital for equipment financing, we could experience a decrease in orders for our products. When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During periods of declining revenues, such as in the current environment, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. If we fail to respond, then our business could be seriously harmed. In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles. Each of these factors could adversely impact our operating results and financial condition.

Our business is ultimately driven by the global demand for electronic devices by consumers and businesses. The vast 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. A protracted global economic slowdown may adversely affect our business and results of operations.

The vast 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, legal or regulatory changes 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.

Our future performance depends, in part, upon our ability to continue to compete successfully worldwide.

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

equipment companies whose strategy is to provide a portion of the products and services that we offer, using innovative technology to sell products into specialized markets. 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.

Risks Related to Our Business

If we do not develop and introduce new products and technologies in a timely manner in response to changing market conditions or customer requirements, our business could be seriously harmed.

Success in the semiconductor equipment industry depends, in part, on continual improvement of existing technologies and rapid innovation of new solutions. For example, the size of semiconductor devices continues to shrink and the industry is currently transitioning to the use of new materials and innovative fab processes. While we expect these trends will increase our customers reliance on our diagnostic products, we cannot be sure 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 and services that successfully address changing customer needs, to win market acceptance of these new products and services and to manufacture these new products in a timely and cost-effective manner.

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

Our business would be harmed if we do not receive sufficient parts to meet our production requirements in a timely and cost-effective manner.

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers to supply these materials. We generally do not have guaranteed supply arrangements with our suppliers. Because of the variability and uniqueness of customers orders, we do not maintain an extensive inventory of materials for manufacturing. 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 operating results and business may be adversely impacted if we are unable to obtain parts to meet our production requirements, or if we are only able to do so on unfavorable terms.

Disruption of our manufacturing facilities due to earthquake, flood, other natural catastrophic events or terrorism could result in cancellation of orders or loss of customers and could seriously harm our business.

Most of our manufacturing facilities are located in the United States, with additional operations located in Israel and Singapore. 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.

We outsource a number of services to third-party service providers, which decreases our control over the performance of these functions. Disruptions or delays at our third-party service providers could adversely impact our operations.

We outsource a number of services, including our transportation and logistics management of spare parts, 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 or political events, information technology system failures or military actions could adversely impact our operations and our ability to ship products, manage our product inventory or record and report financial and management information on a timely and accurate basis.

Our success is dependent in part on our technology and other proprietary rights. If we are unable to maintain our lead or protect our proprietary technology, we may lose valuable assets and market share.

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

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 have also published internal policies that set forth how employees and contractors are to handle our proprietary information. 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 policies, and we may not have adequate remedies for wrongdoing. In addition, the laws of certain territories in which we develop, manufacture or sell our products may not protect our intellectual property rights to the same extent as do the laws of the United States. In any event, the extent to which we can protect our trade secrets through the use of confidentiality agreements is limited, and our success will depend to a significant extent on our ability to innovate ahead of our competitors.

We might be involved in intellectual property disputes or other intellectual property infringement claims that may be costly to resolve, prevent us from selling or using the challenged technology and seriously harm our operating results and financial condition.

As is typical in the semiconductor equipment industry, from time to time we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual

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

We depend on key personnel to manage our business effectively, and if we are unable to attract, retain and motivate our key employees, our sales and product development could be harmed.

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

Acquisitions are an important element of our strategy but, because of the uncertainties involved, we may not find suitable acquisition candidates and we may not be able to successfully integrate and manage acquired businesses.

In addition to our efforts to develop new technologies from internal sources, part of our growth strategy is to pursue acquisitions and acquire new technologies from external sources. As part of this effort, we may make acquisitions of, or significant investments in, businesses with complementary products, services and/or technologies. There can be no assurance that we will find suitable acquisition candidates or that acquisitions we complete will be successful. In addition, we may use equity to finance future acquisitions, which would increase our number of shares outstanding and be dilutive to current shareholders.

If we are unable to successfully integrate and manage acquired businesses or if acquired businesses perform poorly, then our business and financial results may suffer. It is possible that the businesses we have acquired, as well as businesses that we may acquire in the future, may perform worse than expected or prove to be more difficult to integrate and manage than expected. In addition, we may lose key employees of the acquired companies. As a result, risks associated with acquisition transactions may give rise to a material adverse effect on our business and financial results for a number of reasons, including:

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

we may incur unforeseen obligations or liabilities in connection with acquisitions.

Compliance with federal securities laws, rules and regulations, as well as NASDAQ requirements, is becoming increasingly complex, and the significant attention and expense we must devote to those areas may have an adverse impact on our business.

Federal securities laws, rules and regulations, as well as NASDAQ rules and regulations, require companies to maintain extensive corporate governance measures, impose comprehensive reporting and disclosure requirements, set strict independence and financial expertise standards for audit and other committee members and impose civil and criminal penalties for companies and their chief executive officers, chief financial officers and directors for securities law violations. These laws, rules and regulations have increased and 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 are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war. If international political instability continues or increases, our business and results of operation could be harmed.

The threat of terrorism targeted at the regions of the world in which we do business increases the uncertainty in our markets. Any act of terrorism which affects the economy or the semiconductor industry could adversely affect our business. Increased international political instability, disruption in air transportation and further enhanced security measures as a result of 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.

We self insure certain risks including earthquake risk. If one or more of the uninsured events occurs, we could suffer major financial loss.

We purchase insurance to help mitigate the economic impact of certain insurable risks; however, certain other risks are uninsurable or are insurable only at significant cost 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 a prudent financial decision based on our large cash reserves and the high cost and limited coverage available in the earthquake insurance market. Certain other risks are also self insured either based on a similar cost benefit analysis, or based on the unavailability of insurance. If one or more of the uninsured events occurs, we could suffer major financial loss.

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 reporting of transactions completed before the change is effective.

New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation rules have occurred and 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 Statement of Financial Accounting Standards (SFAS) No. 123(R), *Share-Based Payment* 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, has had a material impact on our consolidated financial statements, as reported under accounting principles generally accepted in the United States of America.

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

A number of factors may harm our future effective tax rates such as the jurisdictions in which profits are determined to be earned and taxed, the resolution of issues arising from tax audits with various tax authorities, changes in the valuation of our deferred tax assets and liabilities, adjustments to estimated taxes upon finalization of various tax returns, increases in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with acquisitions, changes in available tax credits, changes in share-based compensation expense, changes in tax laws or the interpretation of such tax laws and changes in generally accepted accounting principles and the repatriation of non-U.S. earnings for which we have not previously provided for U.S. taxes. A change in the effective tax rate can adversely impact our results from operations.

We are exposed to various risks related to the regulatory environments where we perform our operations and conduct our business.

We are subject to various risks related to existing, new, different, inconsistent or even conflicting laws, rules and regulations enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply, including environmental, safety, antitrust and export control regulations. Failure to comply with existing laws, rules or regulations, or changes, some of which may result in inconsistent or conflicting laws, rules or regulations, in the countries in which we operate could result in violations of contractual or regulatory obligations that may adversely affect our reported financial results or our ability to conduct our business.

We are exposed to foreign currency exchange rate fluctuations; although we hedge certain currency risks, we may still be adversely affected by changes in foreign currency exchange rates or declining economic conditions in these countries.

We have some exposure to fluctuations in foreign currency exchange rates, primarily the Japanese Yen. 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 rate fluctuations, but these hedges may be inadequate to protect us from currency rate fluctuations. To the extent that these hedges are inadequate, our reported financial results or the way we conduct our business could be adversely affected.

There are risks associated with our outstanding indebtedness.

As of June 30, 2008, we had $750 million aggregate principal amount of outstanding indebtedness represented by our senior notes that will mature in 2018, and we may incur additional indebtedness in the future. Our ability to pay interest and repay the principal for our indebtedness is dependent upon our ability to manage our business operations and the other factors discussed in this section. There can be no assurance that we will be able to manage any of these risks successfully. In addition, changes by any rating agency to our outlook or credit rating could negatively affect the value and liquidity of both our debt and equity securities.

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

We are exposed to fluctuations in the market values of our portfolio investments and in interest rates; impairment of our investments could harm our earnings.

Our investment portfolio consists of both corporate and government securities that have a maximum effective maturity of 10 years. The longer the duration of these securities, the more susceptible they are to changes in market interest rates and bond yields. As yields increase, those securities with a lower yield-at-cost show a mark-to-market unrealized loss. We have the ability to realize the full value of all these investments upon maturity. Unrealized losses are due to changes in interest rates and bond yields.

Auction rate securities backed by student loans which are collateralized, insured and guaranteed by the United States Federal Department of Education are also included in our investment portfolio. Due to the current illiquidity in the auction rate security market, the funds associated with these failed auctions may not be accessible until the issuer calls the security, a successful auction occurs, a buyer is found outside of the auction process, or the security matures. Although we believe our auction rate securities continue to represent sound investments due to the AAA/Aaa credit ratings of the underlying investments, we may be forced to sell some of our auction rate securities portfolio under illiquid market conditions, which could result in our recognizing a loss on such sales.

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

Our global operations are linked by information systems, including telecommunications, the internet, our corporate intranet, network communications, email and various computer hardware and software applications. Despite our implementation of network security measures, our tools and servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems and tools located at customer sites. Any such event could have an adverse effect on our business, operating results and financial condition.

We may experience difficulties with our new customer relationship management (CRM) system or existing enterprise resource planning (ERP) system and other IT systems. System failure or malfunctioning may result in a disruption of operations or the inability to process transactions, and this could adversely affect our financial results.

We may experience difficulties with our new CRM system implemented in fiscal year 2008 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. System failure or malfunctioning could disrupt our ability to timely and accurately process and report key components of our results of operations, financial position and cash flows. Any disruptions or difficulties that may occur in connection with our ERP system or other systems could also adversely affect our ability to complete important business processes such as the evaluation of our internal control over financial reporting and attestation activities pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. If we encounter unforeseen problems with regard to our ERP system or other systems, our business could be adversely affected.

Risks Related to the Restatement of Our Prior Financial Results

Our efforts to correct past material weaknesses in our internal control over financial reporting may not have been sufficient, and we may discover additional material weaknesses in our internal controls.

As previously disclosed in prior filings by the Company with the SEC, including the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2007 which was filed with the SEC on August 20, 2007 (the 2007 Form 10-K), the Company has undergone an investigation of the Company s historical stock option practices by the Special Committee of the Company s Board of Directors (for more information regarding the

Special Committee investigation and its findings, please refer to Item 3, Legal Proceedings of the 2007 Form 10-K). As a result of that Special Committee investigation and our management s internal review of our historical stock option practices and related matters, we identified past material weaknesses in our internal controls and procedures (see Item 9A, Controls and Procedures in the 2007 Form 10-K). A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company s annual or interim financial statements will not be prevented or detected on a timely basis. We believe that we have remedied the past material weaknesses in our internal controls and procedures, but there can be no assurance that our corrections were sufficient or fully effective, or that we will not discover additional material weaknesses in our internal controls and procedures in the future.

The Special Committee investigation of our historical stock option practices and the resulting restatements have been time consuming and expensive, and have had a material adverse effect on us.

The Special Committee investigation and the resulting restatement activities have required us to expend significant management time and incur significant accounting, legal and other expenses. In addition, we have established a Special Litigation Committee to oversee the litigation matters that have arisen out of the investigation and the restatements, and we cannot predict what additional actions may be required by these Committees. The period of time that will be necessary to resolve these matters is uncertain, and these matters could require significant additional attention and resources.

The ongoing government inquiry relating to our historical stock option practices, as well as any other inquiries that may be started by other governmental or regulatory agencies, may be time consuming and expensive and may have a material adverse effect on our financial condition, results of operations and cash flow.

On July 25, 2007, we announced that the Company had reached a settlement with the SEC by consenting to the entry of a permanent injunction against future violations of the reporting, books and records, and internal controls provisions of the federal securities laws. The settlement resolves completely the SEC investigation into the Company s historical stock option granting practices. KLA-Tencor was not charged by the SEC with fraud, nor was the Company required to pay any civil penalty, fine or money damages as part of the settlement. In addition, the United States Attorney s Office for the Northern District of California (USAO) informed us in July 2008 that it had closed its investigation into our historical stock option practices and was not bringing any charges against us. While the investigations by the SEC and USAO have been completed, the Company is responding to inquiries from the U.S. Department of Labor, which is conducting an examination of the Company s 401(k) Savings Plan prompted by the Company s stock option issues. The Company is cooperating fully with this examination and intends to continue to do so. This inquiry may require us to continue to expend significant management time and incur significant legal and other expenses, which could have a material adverse effect on our financial condition, results of operations and cash flow. Also, there can be no assurance that other inquiries, investigations or actions will not be started by other United States federal or state regulatory agencies or by foreign governmental agencies, any of which could have a material adverse effect on our financial condition, results of operations and cash flow.

We have been named as a party to a number of shareholder derivative and class action lawsuits relating to our historical stock option practices, and we may be named in additional lawsuits in the future. This litigation could become time consuming and expensive and could result in the payment of significant judgments and settlements, which could have a material adverse effect on our financial condition and results of operations.

In connection with our historical stock option practices and resulting restatements, a number of derivative actions were filed against certain of our current and former directors and officers purporting to assert claims on the Company s behalf. In addition, a number of securities class action complaints were filed against us and

certain of our current and former directors and officers seeking damages related to our historical stock option practices and the resulting investigation, inquiries and restatements. There may be additional lawsuits of this nature filed in the future. We cannot predict the outcome of these lawsuits, other than the shareholder class action for which we have entered into a settlement that is subject to court approval (as described in Note 13, Litigation and Other Legal Matters to the Consolidated Financial Statements), nor can we predict the amount of time and expense that will be required to resolve these lawsuits. If these lawsuits become time consuming and expensive, or if there are unfavorable outcomes in any of these cases, there could be a material adverse effect on our business, financial condition and results of operations.

Our insurance coverage will not cover our total liabilities and expenses in these lawsuits, in part because we have a significant deductible on certain aspects of the coverage. In addition, subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees in connection with the investigation of our historical stock option practices and the related litigation and ongoing government inquiry. We currently hold insurance policies for the benefit of our directors and officers, although our insurance coverage may not be sufficient in some or all of these matters. Furthermore, the insurers may seek to deny or limit coverage in some or all of these matters, in which case we may have to self-fund all or a substantial portion of our indemnification obligations.

We are subject to the risks of additional government actions, shareholder lawsuits and other legal proceedings related to our historical stock option practices, the resulting restatements, and the remedial measures we have taken.

It is possible that there may be additional governmental actions, shareholder lawsuits and other legal proceedings brought against us in connection with our historical stock option practices. In addition, we may be sued or taken to arbitration by former officers and employees in connection with their stock options, employment terminations and other matters. These proceedings may require us to expend significant management time and incur significant accounting, legal and other expenses, and may divert attention and resources from the operation of our business. These expenditures and diversions, as well as the adverse resolution of any specific lawsuit, could have a material adverse effect on our business, financial condition and results of operations.

Failure to maintain effective internal controls may cause us to delay filing our periodic reports with the SEC, affect our NASDAQ listing, and adversely affect our stock price.

The Securities and Exchange Commission, as directed by Section 404 of the Sarbanes-Oxley Act of 2002, adopted rules requiring public companies to include a report of management on internal control over financial reporting in their annual reports on Form 10-K that contain an assessment by management of the effectiveness of the Company s internal control over financial reporting. In addition, our independent registered public accounting firm reports on the effectiveness of the internal control over financial reporting. The Company has in prior periods identified certain material weaknesses in its internal control over financial reporting. However, we believe the Company remediated those past material weaknesses, and we have not identified any material weaknesses in our internal control over financial reporting for the fiscal year ended June 30, 2008. Although we review our internal control over financial reporting in order to ensure compliance with the Section 404 requirements, if our independent registered public accounting firm is not satisfied with our internal control over financial reporting or the level at which these controls are documented, designed, operated or reviewed, or if our independent registered public accounting firm interprets the requirements, rules and/or regulations differently from our interpretation, then they may issue a report that is qualified. This could result in an adverse reaction in the financial marketplace due to a loss of investor confidence in the reliability of our financial statements, which ultimately could negatively impact our stock price.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Information regarding our principal properties as of June 30, 2008 is set forth below:

Location	Type	Principal Use	Square Footage	Ownership
Tucson, AZ	Office and plant	Engineering and Manufacturing	60,000	Owned
Fremont, CA(1)	Office and plant	Research, Engineering, Marketing, Manufacturing, Service and Sales Administration	117,637	Leased
Milpitas, CA	Office, plant and warehouse	Principal Executive Offices, Research, Engineering, Marketing, Manufacturing, Service and Sales Administration	727,302	Owned
San Jose, CA	Office and plant	Research, Engineering and Manufacturing	133,196	Leased
San Jose, CA	Office, plant and warehouse	Research, Engineering, Marketing, Manufacturing, Service and Sales Administration	434,653	Owned
Santa Clara, CA	Office, plant and warehouse	Research, Engineering, Marketing, Manufacturing and Service	54,789	Leased
Westwood, MA(1)	Office and plant	Research, Engineering, Marketing, Manufacturing and Service	116,908	Leased
Leuven, Belgium	Office, plant and warehouse	Research, Engineering, Marketing, Manufacturing and Service and Sales Administration	102,220	Owned
Shanghai, China	Office, plant and warehouse	Sales, Service, Engineering and Warehouse	50,354	Leased
Shenzhen, China	Office and plant	Sales, Service and Manufacturing	34,034	Leased
Chennai, India	Office	Engineering	79,668	Owned
Migdal Ha Emek and Herzliya, Israel	Office and plant	Research, Engineering, Marketing, Manufacturing and Service and Sales Administration	64,584	Owned
Serangoon, Singapore(2)	Office and plant	Manufacturing	185,809	Owned
Hsinchu, Taiwan(1)	Office	Sales and Service	97,215	Leased
Yokohama, Japan	Office and warehouse	Sales, Service and Warehouse	41,771	Leased

(1) Portions of certain properties are sublet or are vacant and marketed to sublease.

(2) The land on which the Serangoon, Singapore building resides is leased.

As of June 30, 2008, we owned or leased a total of approximately 2.6 million square feet of space worldwide, including the locations listed above and office space for smaller sales and service offices in several locations throughout the world. Our operating leases expire at various times through June 30, 2018 with renewal

options at the fair market value for additional periods up to five years. Additional information regarding these leases is incorporated by reference from Note 12, Commitments and Contingencies to the Consolidated Financial Statements. We believe our properties are adequately maintained and suitable for their intended use and that our production facilities have capacity adequate for our current needs, even after giving effect to the sale of certain properties as noted above.

ITEM 3. LEGAL PROCEEDINGS

Special Committee Investigation of Historical Stock Option Practices

On May 22, 2006, the Wall Street Journal published an article about stock option backdating that questioned the stock option practices at several companies, including KLA-Tencor. On May 23, 2006, we received a subpoena from the United States Attorney s Office for the Northern District of California (USAO) and a letter of inquiry from the United States Securities and Exchange Commission (SEC) regarding our stock option practices. Later on May 23, 2006, our Board of Directors appointed a Special Committee composed solely of independent directors to conduct a comprehensive investigation of our historical stock option practices. The Special Committee promptly engaged independent legal counsel and accounting experts to assist with the investigation. The investigation included an extensive review of our historical stock option practices, accounting policies, accounting records, supporting documentation, email communications and other documentation, as well as interviews of a number of current and former directors, officers and employees. On September 27, 2006, the Special Committee reported the bulk of its findings and recommendations to our Board of Directors.

Government Inquiries and SEC Settlement Relating to Historical Stock Option Practices

On May 23, 2006, we received a subpoena from the United States Attorney s Office (USAO) requesting information relating to our past stock option grants and related accounting matters. Also on May 23, 2006, we received a letter from the SEC making an informal inquiry and request for information on the same subject matters. We learned on February 2, 2007 that the SEC had opened a formal investigation into these matters. We cooperated fully with the SEC investigation. On July 25, 2007, we announced that we had reached a settlement with the SEC by consenting to the entry of a permanent injunction against future violations of the reporting, books and records, and internal controls provisions of the federal securities laws. The settlement resolves completely the SEC investigation into our historical stock option granting practices. We were not charged by the SEC with fraud, nor were we required to pay any civil penalty, fine or money damages as part of the settlement. The USAO informed us in July 2008 that it had closed its investigation and was not bringing any charges against us.

We are responding to inquiries from the U.S. Department of Labor, which is conducting an examination of our 401(k) Savings Plan prompted by our stock option issues. We are cooperating fully with this examination and intend to continue to do so.

We cannot predict how long it will take, or how much more time and resources will be required, to resolve these government inquiries, nor can it predict the outcome of these inquiries. Also, there can be no assurance that other inquiries, investigations or actions will not be started by other United States federal or state regulatory agencies or by foreign governmental agencies.

Shareholder Derivative Litigation Relating to Historical Stock Option Practices

Beginning on May 22, 2006, several persons and entities identifying themselves as shareholders of KLA-Tencor filed derivative actions purporting to assert claims on behalf of and in the name of the Company against several of our current and former directors and officers relating to its accounting for stock options issued from 1994 to the present. The complaints in these actions allege that the individual defendants breached their fiduciary duties and other obligations us and violated state and federal securities laws in connection with our

historical stock option granting process, its accounting for past stock options, and historical sales of stock by the individual defendants. Three substantially similar actions are pending, one in the U.S. District Court for the Northern District of California (which consists of three separate lawsuits consolidated into one action, hereafter the Federal Action); one in the California Superior Court for Santa Clara County; and one in the Delaware Chancery Court.

The plaintiffs in the derivative actions have asserted claims for violations of Sections 10(b) (including Rule 10b-5 thereunder), 14(a), and 20(a) of the Securities Exchange Act of 1934, unjust enrichment, breach of fiduciary duty and aiding and abetting such breach, negligence, misappropriation of information, abuse of control, gross mismanagement, waste of corporate assets, breach of contract, constructive fraud, rescission, and violations of California Corporations Code section 25402, as well as a claim for an accounting of all stock option grants made to the named defendants. KLA-Tencor is named as a nominal defendant in these actions. On behalf of KLA-Tencor, the plaintiffs seek unspecified monetary and other relief against the named defendants. The plaintiffs are James Ziolkowski, Mark Ziering, Alaska Electrical Pension Fund, Jeffrey Rabin and Benjamin Langford. The individual named defendants are current directors and officers Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Jeffrey L. Hall, Stephen P. Kaufman, John H. Kispert, Lida Urbanek and Richard P. Wallace; and former directors and officers Robert J. Boehlke, Leo Chamberlain, Gary E. Dickerson, Richard J. Elkus, Jr., Dennis J. Fortino, Kenneth Levy, Michael E. Marks, Stuart J. Nichols, Arthur P. Schnitzer, Kenneth L. Schroeder and Jon D. Tompkins. Current director David C. Wang and former director Dean O. Morton were originally named as defendants in one of the derivative actions filed in the U.S. District Court for the Northern District of California, but were dropped as named defendants as of December 22, 2006 upon the filing of a consolidated complaint in the Federal Action.

The derivative actions are at an early stage. The individual defendants are not yet required to respond to the complaints in the actions pending in California, and the defendants have moved to dismiss or stay the action pending in Delaware. Our Board of Directors appointed a Special Litigation Committee (SLC) composed solely of independent directors to conduct an independent investigation of the claims asserted in the derivative actions and to determine our position with respect to those claims. On March 25, 2008, the SLC filed a motion to terminate the Federal Action and to approve certain settlements with individuals as identified below. Plaintiff filed an opposition to the motion to terminate the Federal Action in July 2008. The motion to terminate is set for hearing in October 2008. We have also moved to dismiss or stay the action pending in Delaware. That motion is set for hearing in August 2008.

During the year ended June 30, 2008, we, acting through the SLC, entered into settlement agreements with each of Gary E. Dickerson, Kenneth Levy, Kenneth Schroeder and Jon D. Tompkins related to the claims brought against such individuals in connection with the derivative actions. Each of these agreements is subject to court approval. The agreements, individually and in the aggregate, do not involve amounts that are material to us. As of June 30, 2008, we have not recorded the gain contingency arising from the settlement agreements as the gain is not certain. We will record any gain upon receiving the applicable court approval.

In addition, during the year ended June 30, 2008, we entered into an agreement with Kenneth Schroeder to resolve all claims arising from his employment agreement and departure from us. The terms of this agreement are subject to court approval of the above-described settlement agreement with Mr. Schroeder relating to the claims brought against him in the derivative actions.

Shareholder Class Action Litigation Relating to Historical Stock Option Practices

KLA-Tencor and various current and former directors and officers of the Company were named as defendants in putative securities class action filed on June 29, 2006 in the U.S. District Court for the Northern District of California. Two similar actions were filed later in the same court, and all three cases have been consolidated into one action (the Northern District Litigation). The consolidated complaint alleges claims

under Section 10(b) and Rule 10b-5 thereunder, Section 14(a), Section 20(a), and Section 20A of the Securities Exchange Act of 1934 as a result of our past stock option grants and related accounting and reporting, and seeks unspecified monetary damages and other relief. The plaintiffs seek to represent a class consisting of purchasers of our stock between June 30, 2001 and May 22, 2006 who allegedly suffered losses as a result of material misrepresentations in our SEC filings and public statements during that period. The lead plaintiffs, who seek to represent the class, are the Police and Fire Retirement System of the City of Detroit, the Louisiana Municipal Police Employees Retirement System, and the City of Philadelphia Board of Pensions and Retirement. The defendants are KLA-Tencor, Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Gary E. Dickerson, Richard J. Elkus, Jr., Jeffrey L. Hall, Stephen P. Kaufman, John H. Kispert, Kenneth Levy, Michael E. Marks, Stuart J. Nichols, Kenneth L. Schroeder, Jon D. Tompkins, Lida Urbanek and Richard P. Wallace. This litigation is at an early stage. Discovery has not commenced, and the court has not yet determined whether the plaintiffs may sue on behalf of any class of purchasers. We and all other defendants filed motions to dismiss these cases in June 2007. However, our motions to dismiss have been taken off calendar and stayed due to the agreement between the parties to settle the litigation, as described below.

On June 5, 2008, the court granted preliminary approval to a settlement between the parties to resolve the Northern District Litigation. Under the terms of the settlement, we will be required to make a payment of $65.0 million to the settlement class. The settlement, which is subject to final court approval at a hearing now scheduled to occur in September 2008, provides for the dismissal with prejudice of the Northern District Litigation and a full release of KLA-Tencor and the other named defendants in connection with the allegations raised in the lawsuit by the plaintiffs and all members of the settlement class. An amount of $65.0 million was accrued by a charge to selling, general and administrative expenses during the year ended June 30, 2008 on account of this settlement.

As part of a derivative lawsuit filed in the Delaware Chancery Court on July 21, 2006 (described above), a plaintiff claiming to be a KLA-Tencor shareholder also asserted a separate putative class action claim against us and certain of our current and former directors and officers alleging that shareholders incurred damage due to purported dilution of KLA-Tencor common stock resulting from historical stock option granting practices. We have moved to dismiss this claim.

Another plaintiff, Chris Crimi, filed a putative class action complaint in the Superior Court of the State of California for the County of Santa Clara on September 4, 2007 against us and certain of our current and former directors and officers. The plaintiff seeks to represent a class consisting of persons who held KLA-Tencor common stock between September 20, 2002 and September 27, 2006, alleges causes of action for breach of fiduciary duty and rescission based on alleged misstatements and omissions in our SEC filings concerning our past stock option grants, and seeks unspecified damages based upon purported dilution of our stock, injunctive relief, and rescission. The named defendants, in addition to us, are Edward W. Barnholt, H. Raymond Bingham, Robert T. Bond, Richard J. Elkus, Jr., Stephen P. Kaufman, Kenneth Levy, Michael E. Marks, Dean O. Morton, Kenneth L. Schroeder, Jon D. Tompkins, and Richard P. Wallace. This litigation is at an early stage, and discovery has not yet begun. We filed a motion to stay the case pending the resolution of other option-related litigation, as well as a demurrer asking the court to dismiss the case on the ground that the claims have no merit. On February 29, 2008, the Court sustained our demurrer and granted the plaintiff leave to file an amended complaint. Plaintiff filed an amended complaint reasserting the foregoing claims and adding a claim under section 1507 of the California Corporations Code on April 1, 2008. On April 30, 2008, we removed this action to Federal Court in the Northern District of California and thereafter renewed our motion to dismiss the action. The plaintiff has since amended his complaint, and we expect to file a further motion to dismiss to be heard in September 2008. We intend to vigorously defend this action.

We cannot predict the outcome of the shareholder class action cases (described above), and we cannot estimate the likelihood or potential dollar amount of any adverse results, other than the Northern District Litigation. However, an unfavorable outcome in any of these cases could have a material adverse impact upon the financial position, results of operations or cash flows for the period in which the outcome occurs and in future periods.

Indemnification Obligations

Subject to certain limitations, we are obligated to indemnify our current and former directors, officers and employees in connection with the investigation of our historical stock option practices and the related litigation and ongoing government inquiries. These obligations arise under the terms of our certificate of incorporation, our bylaws, applicable contracts, and Delaware and California law. The obligation to indemnify generally means that we are required to pay or reimburse the individuals reasonable legal expenses and possibly damages and other liabilities incurred in connection with these matters. We are currently paying or reimbursing legal expenses being incurred in connection with these matters by a number of our current and former directors, officers and employees. Although the maximum potential amount of future payments we could be required to make under these agreements is theoretically unlimited, we believe the fair value of this liability, to the extent estimable, is appropriately considered within the reserve we have established for currently pending legal proceedings.

Other Legal Matters

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 legal proceedings are difficult to predict, and the costs incurred in litigation can be substantial, regardless of outcome.

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

None.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is listed and traded on the NASDAQ Global Select Market under the symbol KLAC.

The prices per share reflected in the following table represent the high and low closing prices for our common stock on the NASDAQ Global Select Market for the periods indicated.

	Year ended June 30, 2008		Year ended June 30, 2007	
	High	Low	High	Low
First Fiscal Quarter	$ 62.46	$ 55.10	$ 46.29	$ 39.05
Second Fiscal Quarter	$ 57.54	$ 47.19	$ 52.43	$ 43.85
Third Fiscal Quarter	$ 46.54	$ 35.61	$ 54.42	$ 46.97
Fourth Fiscal Quarter	$ 46.27	$ 38.91	$ 56.92	$ 53.09

We paid dividends to holders of our common stock during each of the quarters in the fiscal years ended June 30, 2008 and 2007. The total amount of dividends paid during the fiscal years ended June 30, 2008 and 2007 was $108.5 million and $95.1 million, respectively. During the first quarter of the fiscal year ending June 30, 2009, our Board of Directors authorized a quarterly cash dividend of $0.15 per share, which was declared on August 6, 2008 and will be paid on September 2, 2008 to our stockholders of record on August 18, 2008.

As of July 22, 2008, there were 717 holders of record of our common stock.

Equity Repurchase Plans

Following is a summary of stock repurchases for each month during the fourth quarter of the fiscal year ended June 30, 2008:(1)

Period	Total Number of Shares Purchased	Average Price Paid per Share	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs(3)
April 1, 2008 April 30, 2008(2)	630,000	$ 42.27	3,541,000
May 1, 2008 May 31, 2008(2)	960,000	$ 45.08	2,581,000
June 1, 2008 June 30, 2008(2)	1,340,000	$ 41.83	16,241,000(4)
Total	2,930,000	$ 42.99	

(1) In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase up to 17.8 million 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. The Board of Directors has authorized KLA-Tencor to repurchase additional shares of its common stock under the repurchase program in February 2005 (up to 10.0 million shares), February 2007 (up to 10.0 million shares), August 2007 (up to 10.0 million shares) and June 2008 (up to 15.0 million shares), in each case in addition to the 17.8 million shares described in the first sentence of this footnote.

(2) All shares were purchased pursuant to the publicly announced repurchase programs described in footnote 1 above.

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

(4) In June 2008, the Board of Directors authorized KLA-Tencor to repurchase up to an additional 15.0 million shares of its common stock under the repurchase program.

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Stock Performance Graph and Cumulative Total Return

The following graph compares the cumulative 5-year total return attained by shareholders on our common stock relative to the cumulative total returns of the S&P 500 Index (as required by SEC regulations) and the Philadelphia Semiconductor Index. The graph tracks the performance of a $100 investment in our common stock and in each of the indices (with the reinvestment of all dividends) from June 30, 2003 to June 30, 2008.

	6/03	6/04	6/05	6/06	6/07	6/08
KLA-Tencor Corporation	**100.00**	**106.28**	**94.30**	**90.61**	**120.98**	**90.74**
S&P 500	**100.00**	**119.11**	**126.64**	**137.57**	**165.90**	**144.13**
Philadelphia Semiconductor	**100.00**	**130.28**	**124.05**	**117.71**	**139.37**	**117.17**

* Assumes $100 invested on June 30, 2003 in stock or index-including reinvestment of dividends.
Our fiscal year ends June 30. The comparisons in the graph above are based upon historical data and are not necessarily indicative of, nor intended to forecast, future stock price performance.

ITEM 6. SELECTED FINANCIAL DATA

The following tables include selected consolidated summary financial data for each of our last five fiscal years. This data should be read in conjunction with Item 8, Financial Statements and Supplementary Data, and Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations in this Annual Report on Form 10-K.

(in thousands, except per share data)

Year ended June 30,	2008	2007	2006	2005	2004
Consolidated Statements of Operations:					
Revenues	$ 2,521,716	$ 2,731,229	$ 2,070,627	$ 2,081,878	$ 1,497,218
Income from operations	$ 499,376	$ 589,868	$ 309,791	$ 545,120	$ 243,630
Net income	$ 359,083	$ 528,098	$ 380,452	$ 445,049	$ 212,476
Dividends paid per share	$ 0.60	$ 0.48	$ 0.48	$ 0.12	$
Net Income per share:					
Basic	$ 1.99	$ 2.68	$ 1.92	$ 2.27	$ 1.09
Diluted	$ 1.95	$ 2.61	$ 1.86	$ 2.21	$ 1.05

As of June 30,	2008	2007	2006	2005	2004
Consolidated Balance Sheets:					
Cash, cash equivalents and marketable securities	$ 1,579,383	$ 1,710,629	$ 2,325,796	$ 2,195,186	$ 1,876,356
Working capital	$ 2,085,432	$ 2,247,209	$ 2,594,512	$ 2,265,202	$ 1,279,821
Total assets	$ 4,848,390	$ 4,623,249	$ 4,575,911	$ 4,040,603	$ 3,598,880
Long-term debt(1)	$ 744,661	$	$	$	$
Stockholders equity	$ 2,981,730	$ 3,550,042	$ 3,567,991	$ 3,096,670	$ 2,680,417

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

Effective in the fiscal year ended June 30, 2006, we implemented SFAS No. 123(R), *Share-Based Payment*. It requires us to measure all employee stock-based compensation awards using a fair value method and record such expense in our consolidated financial statements.

The Company adopted the provisions of FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, on July 1, 2007. As a result of the adoption of FIN 48, the Company increased the liability for net unrecognized tax benefits by $8.4 million, and accounted for the increase as a cumulative effect of change in accounting principle that resulted in a reduction of retained earnings of $8.4 million at July 1, 2007.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion of our financial condition and results of operations should be read in conjunction with our Consolidated Financial Statements and the related notes included in Item 8, Financial Statements and Supplementary Data, in this Annual Report on Form 10-K. This discussion contains forward-looking statements, which involve risk and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of certain factors, including but not limited to those discussed in Item 1A, Risk Factors and elsewhere in this Annual Report on Form 10-K. (See Special Note Regarding Forward-Looking Statements.)

CRITICAL ACCOUNTING ESTIMATES AND POLICIES

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 that they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the Audit Committee of our Board of Directors on a quarterly basis, and the Audit Committee has reviewed the Company s related disclosure in this Annual Report on Form 10-K. 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, delivery has occurred or services have been rendered, the seller s price is fixed or determinable, and collectibility is reasonably assured. We derive revenue from three sources system sales, spare part sales and service contracts. We typically recognize revenue for system sales upon acceptance by the customer that the system has been installed and is operating according to predetermined specifications. We also recognize revenue prior to written acceptance from the customer, as follows:

- When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% payment is due upon shipment, revenue is recognized upon shipment;
- When the installation of the system is deemed perfunctory, revenue is recognized upon shipment. The portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation;
- When the customer fab has already accepted the same tool, with the same specifications, and it can be objectively demonstrated that the tool meets all of the required acceptance criteria upon shipment, revenue is recognized upon shipment. The portion of revenue associated with installation is deferred based on estimated fair value, and that revenue is recognized upon completion of the installation;
- When the customer withholds signature on our acceptance document due to issues unrelated to product performance, revenue is recognized when the system is performing as intended and meets all published and contractually agreed specifications;
- When the system is damaged during transit and title has passed to the customer, revenue is recognized upon receipt of cash payment from the customer.

Total revenue recognized without a written acceptance from the customer was approximately 16%, 14% and 4% of total revenues for the fiscal years ended June 30, 2008, 2007 and 2006, respectively. The increase in revenue recognized without a written acceptance is primarily driven by increased shipments of tools that have already met the required acceptance criteria at those customer fabs as well as an increase in sales of systems with perfunctory installation, primarily with respect to sales of products of companies that we have acquired during the past two fiscal years. Shipping charges billed to customers are included in system revenue, and the related shipping costs are included in costs of revenues.

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

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

Service and maintenance revenue is recognized ratably over the term of the maintenance contract. 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.

Software is incidental to our products as determined in accordance with AICPA Statement of Position (SOP) No. 97-2, *Software Revenue Recognition* and Emerging Issues Task Force (EITF) Issue No. 03-05, *Applicability of SOP 97-2 to Non-Software Deliverables in an Arrangement Containing More-Than-Incidental Software*. We periodically review the software element of our systems in accordance with SOP No. 97-2 and EITF Issue No. 03-05.

Inventories. Inventories are stated at the lower of cost (on a first-in, first-out basis) or market. Demonstration units are stated at their manufacturing cost, and reserves are recorded to state the demonstration units at their net realizable value. We review the adequacy of our inventory reserves on a quarterly basis.

We review and set standard costs semi-annually at current manufacturing costs in order to approximate actual costs. Our manufacturing overhead standards for product costs are calculated assuming full absorption of forecasted spending over projected volumes, adjusted for excess capacity. Abnormal inventory costs such as costs of idle facilities, excess freight and handling costs, and wasted materials (spoilage) are recognized as current period charges.

We write down inventory based on forecasted demand and technological obsolescence. These factors are impacted by market and economic conditions, technology changes, new product introductions and changes in strategic direction and require estimates that may include uncertain elements. Actual demand may differ from forecasted demand, and such differences may have a material effect on recorded inventory values.

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 costs 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 actual labor and overhead rates to determine the estimated warranty charge. We update these estimated charges on a quarterly basis. 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 as there is limited historical product performance to estimate warranty expense; more mature products with longer product performance histories tend to be more stable in our warranty charge estimates. See Note 12, Commitments and Contingencies to the Consolidated Financial Statements for a detailed description.

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 probable credit losses based upon our assessment of the expected collectibility of all accounts receivable. The allowance for doubtful accounts is reviewed on a quarterly basis 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 are adversely affected and they are unable to meet their financial obligations to us, we may need to take additional allowances, which would result in a reduction of our net income.

Stock-Based Compensation. Effective July 1, 2005, we adopted the modified prospective transition method as provided by provisions of SFAS No. 123(R), *Share-Based Payment*. SFAS No. 123(R) establishes accounting for stock-based awards exchanged for employee services. Accordingly, the fair value of stock-based awards is measured at the grant date and is recognized as expense over the employee s requisite service period. The fair value is determined using a Black-Scholes valuation model for stock options and for purchase rights under our Employee Stock Purchase Plan and using the closing price of our common stock on the grant date for restricted stock units. The Black-Scholes option-pricing model requires the input of highly subjective assumptions, including the option s expected life and the expected price volatility of the underlying stock. The expected stock price volatility assumption is based on the market-based implied volatility from traded options of our common stock. We believe that the implied volatility is reflective of market conditions. Prior to July 1, 2005, we applied Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees* and its related Interpretations and provided the required pro forma disclosures of SFAS No. 123, *Accounting for Stock-Based Compensation*.

Contingencies and Litigation. We are subject to the possibility of losses from various contingencies. Considerable judgment is necessary to estimate the probability and amount of any loss from such contingencies. An accrual is made when it is probable that a liability has been incurred or an asset has been impaired and the amount of loss can be reasonably estimated. We accrue a liability and charge operations for the estimated settlement costs expected to be incurred over the next twelve months of adjudication or settlement of asserted and unasserted claims existing as of the balance sheet date. See Item 3, Legal Proceedings and Note 12, Commitments and Contingencies to the Consolidated Financial Statements for a detailed description.

Goodwill and Intangible Assets. As required by SFAS No. 142, *Goodwill and Other Intangible Assets,* goodwill is not amortized but is subject to impairment tests annually, or earlier if indicators of potential impairment exist, using a fair-value-based approach. Purchased technology, patents, trademarks and other intangible assets are presented at cost, net of accumulated amortization. Intangible assets are amortized on a straight line basis which approximates their estimated useful lives and assessed for impairment under SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. See Note 5, Goodwill and Other Intangible Assets to the Consolidated Financial Statements for a detailed description. Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in each business combination. We completed our annual evaluation of goodwill by reporting unit during the quarter ended December 31, 2007, which evaluation indicated that there was no such impairment. There have been no significant events or circumstances affecting the valuation of goodwill subsequent to the impairment test performed in the second quarter of the fiscal year ended June 30, 2008.

Income Taxes. We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, 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 estimated 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. As a result of the implementation of FIN 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 , we recognize liabilities for uncertain tax positions based on the two-step process prescribed within the interpretation. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon ultimate settlement. We reevaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, and new audit activity. Any change in these factors could result in the recognition of a tax benefit or an additional charge to the tax provision.

We adopted FIN 48 on July 1, 2007. See Note 11, Income Taxes to the Condensed Consolidated Financial Statements for a detailed description.

Valuation of Marketable Securities. Our investments in available-for-sale securities are reported at fair value. Unrealized gains related to increases in the fair value of investments and unrealized losses related to decreases in the fair value are included in accumulated other comprehensive income, net of tax, as reported on our Consolidated Statements of Stockholders Equity. However, changes in the fair value of investments impact our net income only when such investments are sold or impairment is recognized. Realized gains and losses on the sale of securities are determined by specific identification of the security s cost basis. We periodically review our investment portfolio to determine if any investment is other-than-temporarily impaired due to changes in credit risk or other potential valuation concerns, which would require us to record an impairment charge in the period any such determination is made. In making this judgment, we evaluate, among other things, the duration and extent to which the fair value of an investment is less than its cost, the credit rating and any changes in credit rating for the investment, and our ability and intent to hold the investment until the earlier of market price recovery or maturity. Our assessment that an investment is not other-than-temporarily impaired could change in the future due to new developments or changes in our strategies or assumption related to any particular investment.

Effects of Recent Accounting Pronouncements.

In May 2008, the Financial Accounting Standards Board (FASB) issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*. This statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States. We do not expect that this Statement will result in a change in any of our current accounting practices.

In April 2008, the FASB adopted FASB Staff Position SFAS No. 142-3, *Determination of the Useful Life of Intangible Assets*, amending the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. This FASB Staff Position is effective for intangible assets acquired on or after July 1, 2009. We are currently evaluating the impact of the implementation of FASB Staff Position SFAS No. 142-3 on our consolidated financial position, results of operations and cash flows.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities an amendment of SFAS No. 133.* This statement changes the disclosure requirements for derivative instruments and hedging activities. SFAS No. 161 will require us to provide enhanced disclosures about (a) how and why we use derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect our financial position, financial performance, and cash flows. SFAS No. 161 is effective for our interim period beginning January 1, 2009. The adoption of SFAS No. 161 is not expected to have an effect on our consolidated financial position, results of operations or cash flows.

In February 2008, the FASB adopted FASB Staff Position SFAS No. 157-2, *Effective Date of FASB Statement No. 157,* delaying the effective date of SFAS No. 157 for one year for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We are currently evaluating the impact of the implementation of SFAS No. 157 on our consolidated financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), *Business Combinations*. SFAS No. 141(R) retains the fundamental requirements of the original pronouncement requiring that the purchase method be used for all business combinations. SFAS No. 141(R) defines the acquirer as the entity that obtains control of one or more businesses in the business combination, establishes the acquisition date as the date that the acquirer achieves control and requires the acquirer to recognize the assets acquired, liabilities assumed and any noncontrolling interest at their fair values as of the acquisition date. In addition, SFAS No. 141(R) requires expensing of acquisition-related and restructure-related costs, remeasurement of earn-out provisions at fair value, measurement of equity securities issued for purchase at the date of close of the transaction and non-expensing of in-process research and development related intangibles. SFAS No. 141(R) is effective for our business combinations for which the acquisition date is on or after July 1, 2009, except that resolution of certain tax contingencies and adjustments to valuation allowances related to business combinations, which previously were adjusted to goodwill, will be adjusted to income tax expense for all such adjustments after July 1, 2009, regardless of the date of the original business combination. We are currently evaluating the impact of the implementation of SFAS No. 141(R) on our consolidated financial position, results of operations and cash flows.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51*. This Statement amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. It requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest. This Statement establishes a single method of accounting for changes in a parent s ownership interest in a subsidiary that do not result in deconsolidation. SFAS No. 160 is effective for our fiscal year beginning July 1, 2009. We are currently evaluating the impact of the implementation of SFAS No. 160 on our consolidated financial position, results of operations and cash flows.

In June 2007, the FASB ratified EITF Issue No. 07-3, *Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities*. This issue provides that nonrefundable advance payments for goods or services that will be used or rendered for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. EITF Issue No. 07-3 is effective for our fiscal year beginning July 1, 2008. The adoption of EITF Issue No. 07-3 is not expected to have a material impact on our consolidated financial position, results of operations and cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*, which is effective for our fiscal year beginning July 1, 2008. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The adoption of SFAS No. 159 is not expected to have a material effect on our consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective for our fiscal year beginning July 1, 2008. We are currently evaluating the impact of the implementation of SFAS No. 157 on our consolidated financial position, results of operations and cash flows.

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. Within our primary area of focus, our comprehensive portfolio of products, services, software and expertise helps integrated circuit (IC or chip) manufacturers manage yield throughout the entire fabrication process from research and development to final volume production. Our products are also used in a number of other industries, including light emitting diode, data storage, and solar cell and wafer production.

Our products and services are used by the vast majority of wafer, IC, disk and reticle manufacturers in the world. Our revenues are driven largely by capital spending by our customers that operate in one or more of several key markets, including the memory, foundry and logic markets. Over the past few years, customers in the memory market have made significant increases in capital spending and, as a consequence, contributed an increased share of our revenues. These customers, however, have been adversely impacted by a challenging pricing environment in fiscal 2008 for their products, and consequently have scaled back their investments in new production capacity. Our customers purchase our products to either ramp up production in response to the need to drive advances in process technologies or to satisfy demand from industries such as communication, data processing, consumer electronics, automotive, and aerospace. Our customers today are investing in advanced technologies and new materials to enable smaller design rules and higher density applications, as well as reduced cost, which in turn are driving increased adoption of process control to reduce defectivity. While demand from various industries continues to steadily rise, the demand for our products is affected by profitability of our customers which is driven by capacity and market supply for their products as well as the global macroeconomic environment. Our revenues have declined sequentially over the past four quarters and reflect slowing worldwide demand for semiconductor equipment. Industry analysts expect demand for capital equipment to decline in calendar year 2008 compared to calendar year 2007. Such a decline would affect our revenue levels in future quarters. While capacity driven purchases by our customers are adversely impacted in environments such as the one we are currently in, the demand for technology driven purchases are less susceptible to business cycles.

As a supplier to the global semiconductor and semiconductor-related industries, we are subject to business cycles, the timing, length and volatility of which can be difficult to predict. The industries we serve have historically been cyclical due to sudden changes in demand and manufacturing capacity. We expect our customers capital spending on process control to constitute a higher portion of their capital spending over time. We believe that this increase in process control spending will be driven by the demand for more precise diagnostics capabilities to address multiple new defects as a result of further shrinking of device feature sizes, the transition to new materials, new devices and circuit architecture, new lithography challenges and fab process innovation. We anticipate that these factors will drive increased demand for our products and services such as ours over the coming years. The key drivers in the semiconductor equipment industry today are the competitive pressures for our customers to improve yields, lower their costs and get products to market more quickly in order to benefit from the increased demand for products from the consumer electronics, computing and communication industries.

We continuously evaluate strategic acquisitions and alliances to expand our technologies, product offerings and distribution capabilities. During the fiscal years ended June 30, 2008 and 2007, KLA-Tencor completed a number of acquisitions including ADE Corporation, OnWafer Technologies, Inc., SensArray Corporation, Japan ADE, Ltd, and Therma-Wave, Inc. Most recently, in June 2008, we completed the acquisition of ICOS Vision Systems Corporation NV primarily to expand our product portfolio in semiconductor packaging inspection and to gain entry into the solar cell inspection and light-emitting diode (LED) wafer inspection markets. ICOS is a leading supplier of packaging and interconnect inspection solutions for the back-end markets in semiconductor industry, and also has a market leadership position in the inspection of photovoltaic solar technologies and LED wafers. The results of operations of ICOS are included in the following table from the date of the acquisition of majority control on May 30, 2008.

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

(in thousands, except per share data)	First quarter ended September 30, 2007	Second quarter ended December 31, 2007	Third quarter ended March 31, 2008	Fourth quarter ended June 30, 2008
Total revenues	$ 693,020	$ 635,783	$ 602,219	$ 590,694
Total costs and operating expenses	515,742	542,296	477,019	487,283
Income from operations	177,278	93,487	125,200	103,411
Net income	88,158	83,935	110,980	76,010
Net income per share:				
Basic	$ 0.47	$ 0.46	$ 0.62	$ 0.43
Diluted	$ 0.46	$ 0.45	$ 0.61	$ 0.43

(in thousands, except per share data)	First quarter ended September 30, 2006	Second quarter ended December 31, 2006	Third quarter ended March 31, 2007	Fourth quarter ended June 30, 2007
Total revenues	$ 629,363	$ 649,270	$ 716,208	$ 736,388
Total costs and operating expenses	475,373	570,911	533,553	561,524
Income from operations	153,990	78,359	182,655	174,864
Net income	135,922	90,049	154,785	147,342
Net income per share:				
Basic	$ 0.68	$ 0.45	$ 0.78	$ 0.77
Diluted	$ 0.67	$ 0.44	$ 0.76	$ 0.75

Revenues and Gross Margin

(in thousands)	Year ended June 30, 2008	2007	2006	FY08 vs. FY07		FY07 vs. FY06	
Revenues:							
Product	$ 2,030,224	$ 2,308,942	$ 1,713,237	$ (278,718)	-12%	$ 595,705	35%
Service	491,492	422,287	357,390	69,205	16%	64,897	18%
Total revenues	$ 2,521,716	$ 2,731,229	$ 2,070,627	$ (209,513)		$ 660,602	
Costs of revenues	$ 1,145,416	$ 1,190,323	$ 942,091	$ (44,907)	-4%	$ 248,232	26%
Stock-based compensation expense included in costs of revenues	$ 22,041	$ 29,183	$ 29,620	$ (7,142)	-24%	$ (437)	-1%
Gross margin percentage	55%	56%	55%	-1%		1%	
Stock-based compensation expense included in costs of revenues as a percentage of total revenues	1%	1%	1%	0%		0%	

Product revenues

Product revenues decreased in the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 primarily as a result of reduced capital spending by our customers due to ongoing weakness in the semiconductor industry and a deteriorating macroeconomic environment. The decline in revenues reflects slowing worldwide demand for semiconductor equipment, as semiconductor companies reduce capital spending and conserve cash in response to their business environment, even as their need for more precise diagnostics capabilities increases with technological advances.

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Product revenues increased in the fiscal year ended June 30, 2007 compared to the fiscal year ended June 30, 2006 primarily as a result of a higher level of orders received due to our customers increased capital spending in the area of process control and yield management. The higher level of customer spending in the fiscal year ended June 30, 2007 was driven by our customers 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, new devices and circuit architecture, new lithography challenges and fab process innovation.

For each of the fiscal years ended June 30, 2008, 2007 and 2006, no customer accounted for more than 10% of total revenues. For each of the fiscal years ended June 30, 2008 and 2007, no customer accounted for more than 10% of net accounts receivable. For the fiscal year ended June 30, 2006, one customer accounted for 13% of net accounts receivable.

Service revenues

Service revenues are 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 continued to increase through the three year period disclosed in the table above as our installed base of equipment at our customers sites continued to grow. The amount of service revenues generated is generally a function of the number of post-warranty systems installed at our customers sites and the utilization of those systems.

Revenues by region

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

	Year ended June 30,					
	2008		2007		2006	
United States	$ 518,851	21%	$ 647,813	24%	$ 416,468	20%
Europe & Israel	305,350	12%	271,814	10%	287,562	14%
Japan	617,214	24%	600,861	22%	541,411	26%
Taiwan	570,904	23%	559,083	20%	363,014	18%
Korea	225,119	9%	288,756	11%	277,316	13%
Asia Pacific	284,278	11%	362,902	13%	184,856	9%
Total	$ 2,521,716	100%	$ 2,731,229	100%	$ 2,070,627	100%

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

Gross margin

Our gross margin fluctuates with revenue levels and product mix, and is affected by variations in costs related to manufacturing and servicing our products. The decrease in gross margin during the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 was primarily due to $21.4 million of inventory write downs related to disposal of service inventory as well as discontinued products in the fiscal year ended June 30, 2008. In addition, the following charges were recorded in the fiscal year ended June 30, 2008:

$41.0 million for amortization of intangibles, impairment of intangibles and fair value adjustment for inventory related to the acquisitions, of which $12.8 million was recorded in the fourth quarter of the fiscal year ended June 30, 2008; and

$3.2 million for severance and benefits related to an employee workforce reduction.

The increase in gross margin during the fiscal year ended June 30, 2007 compared to the fiscal year ended June 30, 2006 was primarily due to increased revenues and savings realized from our cost reduction initiatives during the fiscal year. In addition, the following charges were recorded in the fiscal year ended June 30, 2007:

- $33.9 million for amortization of intangibles and fair value adjustment for inventory related to the acquisitions completed as of June 30, 2007, of which $13.8 million was recorded in the fourth quarter of the fiscal year ended June 30, 2007;
- $4.9 million for severance and benefits related to an employee workforce reduction, of which $2.3 million was recorded in the fourth quarter of the fiscal year ended June 30, 2007; and
- An aggregate of $4.7 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payment to employees to compensate them for lost benefits resulting from the suspension of the Company s Employee Stock Purchase Plan (ESPP), which $4.7 million amount was recorded primarily in the second and third quarters of the fiscal year ended June 30, 2007.

Engineering, Research and Development (R&D)

(dollar amounts in thousands)	Year ended June 30,						
	2008	2007	2006	FY08 vs. FY07		FY07 vs. FY06	
R&D expenses	$ 409,973	$ 437,513	$ 393,823	$ (27,540)	-6%	$ 43,690	11%
Stock-based compensation expense included in R&D expenses	$ 32,623	$ 42,431	$ 49,509	$ (9,808)	-23%	$ (7,078)	-14%
R&D expenses as a percentage of total revenues	16%	16%	19%	0%		-3%	
Stock-based compensation expense included in R&D expense as a percentage of total revenues	1%	2%	2%	-1%		0%	

The decrease in R&D expenses during the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 is primarily attributable to the absence of any impairment charges and lower stock-based compensation expense due to our transition from granting stock options to our employees to granting restricted stock units, which carry with them lower stock-based compensation expense. The following charges were recorded in the fiscal year ended June 30, 2008:

- $22.7 million for in-process research and development (IPR&D) charges associated with the acquisitions that we had completed as of June 30, 2008, of which $18.5 million was recorded in the fourth quarter of the fiscal year ended June 30, 2008;
- $2.1 million for amortization of intangibles related to the acquisitions, of which $0.7 million was recorded in fourth quarter of the fiscal year ended June 30, 2008;
- $1.3 million for severance and benefits related to an employee workforce reduction; and
- $32.6 million for stock-based compensation expense for the fiscal year ended June 30, 2008 compared to $42.4 million for the fiscal year ended June 30, 2007. Of the $32.6 million recorded in the fiscal year ended June 30, 2008, $8.9 million was recorded in the fourth quarter of the fiscal year ended June 30, 2008.

The increase in R&D expenses during the fiscal year ended June 30, 2007 compared to the fiscal year ended June 30, 2006 primarily reflects additional expenses related to the following charges recorded in the fiscal year ended June 30, 2007:

$16.6 million for IPR&D charges associated with the acquisitions that we had completed as of June 30, 2007, of which $12.0 million was recorded in the fourth quarter of the fiscal year ended June 30, 2007;

$1.3 million for amortization of intangibles related to the acquisitions, of which $0.3 million was recorded in fourth quarter of the fiscal year ended June 30, 2007;

$10.0 million for impairment of certain patents, all of which was recorded in the fourth quarter of the fiscal year ended June 30, 2007;

An aggregate of $5.8 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits resulting from the suspension of the Company s ESPP, which $5.8 million amount was recorded primarily in the second and third quarters of the fiscal year ended June 30, 2007; and

$4.3 million for severance and benefits related to an employee workforce reduction, of which $2.2 million was recorded in the fourth quarter of the fiscal year ended June 30, 2007.

During the fiscal years ended June 30, 2008 and 2007, we expensed IPR&D of $22.7 million and $16.6 million, respectively, upon the completion of the acquisitions during the fiscal years in connection with acquired intellectual property for which technological feasibility has not been established and no future alternative uses exist. The fair value of the purchased IPR&D was determined using the income approach, which discounts expected future cash flows from projects to their net present value. Future cash flows were estimated, taking into account the expected life cycles of the products and the underlying technology, relevant market sizes and industry trends. We determined a discount rate for each project based on the relative risks inherent in the project s development horizon, the estimated costs of development, and the level of technological change in the project and the industry, among other factors. IPR&D was expensed upon acquisition because technological feasibility had not been achieved and no future alternative uses existed. The development of these technologies remains a risk due to the remaining efforts to achieve technological feasibility, rapidly changing customer markets, uncertain standards for new products, and significant competitive threats. The nature of the efforts to develop these technologies into commercially viable products consists primarily of planning, designing, experimenting, and testing activities necessary to determine that the technologies can meet market expectations, including functionality and technical requirements. As of June 30, 2008, there have been no material changes from the underlying assumptions that were used in the original computation of the value of the acquired IPR&D.

During the fiscal year ended June 30, 2007, we determined that we would not pursue future development of certain patents initially licensed to us during fiscal year 2006 for approximately $14.0 million. Since we did not have any alternative use for these patents and we believe the fair value to be $0, the carrying value of $10.7 million was written off. The write off was recorded as $10.0 million to R&D expense and $0.7 million to cost of revenues in the fiscal year ended June 30, 2007.

R&D expenses include the benefit of $20.4 million, $12.7 million and $11.4 million of external funding received during the fiscal years ended June 30, 2008, 2007 and 2006, respectively, for certain strategic development programs primarily from government grants. We expect our R&D expenses to increase in absolute dollars over the next several years as we accelerate our investments in critical programs focusing on new technologies and enhancements to existing products.

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

Selling, General and Administrative (SG&A)

(dollar amounts in thousands)	Year ended June 30,						
	2008	2007	2006	FY08 vs. FY07		FY07 vs. FY06	
SG&A expenses	$ 466,951	$ 513,525	$ 424,922	$ (46,574)	-9%	$ 88,603	21%
Stock-based compensation expense included in SG&A expenses	$ 51,806	$ 37,164	$ 85,613	$ 14,642	39%	$ (48,449)	-57%
SG&A expenses as a percentage of total revenues	19%	19%	21%	0%		-2%	
Stock-based compensation expense included in SG&A expenses as a percentage of total revenues	2%	1%	4%	1%		-3%	

The decrease in SG&A expenses during the fiscal year ended June 30, 2008 compared to the fiscal year ended June 30, 2007 is primarily attributable to gains recognized on sale of our certain real estate assets, lower severance and benefits related to employee workforce reduction, lower stock-based compensation expense and improvements in our operational efficiency. The following charges and gains were recorded in the fiscal year ended June 30, 2008:

$20.1 million gain on sale of our real estate assets, of which $2.5 million was recorded in the fourth quarter of the fiscal year ended June 30, 2008;

$4.0 million for severance and related benefits related to an employee workforce reduction;

$10.4 million for amortization of intangibles related to the acquisitions that we had completed as of June 30, 2008, of which $3.7 million was recorded in the fourth quarter of the fiscal year ended June 30, 2008;

$75.9 million charge to cover the $65.0 million settlement plus related litigation expenses for the pending shareholder class action litigation relating to the Company s historical stock option practices, as described in Note 13, Litigation and Other Legal Matters to our Consolidated Financial Statements; and

$51.8 million for stock-based compensation expense for the fiscal year ended June 30, 2008 compared to $37.2 million for the fiscal year ended June 30, 2007. Of the $51.8 million recorded in the fiscal year ended June 30, 2008, $15.0 million was recorded in the fourth quarter of the fiscal year ended June 30, 2008.

The increase in SG&A expenses during the fiscal year ended June 30, 2007 compared to the fiscal year ended June 30, 2006 primarily reflects additional charges recorded in SG&A as follows:

$56.8 million for impairment charges related to the write-down of buildings, which was recorded in the second quarter of the fiscal year ended June 30, 2007;

$11.3 million for severance and related benefits related to an employee workforce reduction, of which $6.1 million was recorded in the fourth quarter of the fiscal year ended June 30, 2007;

$12.3 million for amortization of intangibles related to the acquisitions that we had completed as of June 30, 2007, of which $1.7 million was recorded in the fourth quarter of the fiscal year ended June 30, 2007;

$15.8 million for legal and other expenses related to the stock options investigation, shareholder litigation and related matters, which charges were primarily recorded in the first three quarters of the fiscal year ended June 30, 2007; and

$8.0 million for reimbursement of taxes to employees, including management, related to IRC Section 409A and cash payments to employees to compensate them for lost benefits from the suspension of the Company s ESPP, which $8.0 million amount was recorded primarily in the second and third quarters of fiscal year ended June 30, 2007.

The cumulative increase in SG&A expenses in the fiscal year ended June 30, 2007 as compared to the fiscal year ended June 30, 2006 was partially offset by a decrease in stock-based compensation expense. The decrease

in stock-based compensation expense was primarily attributable to a reversal of $20.3 million in stock-based compensation expense related to the termination of employment of the Company s former Chief Executive Officer. The year-over-year decrease in stock-based compensation expense was also partially caused by the completion of vesting during the fiscal year ended June 30, 2007 of certain options granted in prior years, as well as our transition from granting stock options to our employees to granting restricted stock units, which carry with them lower stock-based compensation expense.

In November 2006, as part of our long-term business plan, we decided to sell certain real estate properties owned by the Company in San Jose, California and Livermore, California. Based on the valuation of these assets, we recorded an asset impairment charge of approximately $56.8 million, which has been included in SG&A during the fiscal year ended June 30, 2007. See Note 16, Sale and Impairment of Real Estate Assets to the Consolidated Financial Statements for more information.

During November 2005, we announced that effective January 1, 2006, Kenneth L. Schroeder would cease to be our Chief Executive Officer and would thereafter be employed as a Senior Advisor. The Company 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. Effective January 1, 2006, we determined that all service conditions associated with certain prior equity awards under the terms of the revised agreement with Mr. Schroeder had been satisfied; accordingly, we recorded at that time an additional non-cash, stock-based compensation charge of approximately $9.8 million relating to these equity awards. The above-mentioned charge is included as a component of SG&A expense during the fiscal year ended June 30, 2006.

On October 16, 2006, following the Special Committee investigation of our historical stock option practices, we terminated all aspects of Mr. Schroeder s employment relationship and agreement with the Company. As a result, vesting of Mr. Schroeder s then outstanding stock options and restricted stock awards immediately ceased, and the 0.9 million unvested option shares and 0.1 million unvested restricted stock award shares held by Mr. Schroeder at the time of termination were canceled. Accordingly, in the second quarter of the fiscal year ended June 30, 2007, the Company reversed $20.3 million of the non-cash, stock-based compensation charges in accordance with paragraphs 19 and 43 of SFAS No. 123(R), because Mr. Schroeder would no longer be able to fulfill his service obligations. The $20.3 million reversal related to the charges that had been recorded in prior periods related to unvested option shares and restricted stock award shares.

In December 2006, the Company canceled 0.6 million vested option shares held by Mr. Schroeder as of the time of termination, representing those shares that had been retroactively priced or otherwise improperly granted. In accordance with paragraph 57 of SFAS No. 123(R), previously recognized stock-based compensation expense related to these awards was not reversed upon cancellation.

Interest Income and Other, Net

	Year ended June 30,		
(dollar amounts in thousands)	**2008**	**2007**	**2006**
Interest income and other, net	$ 71,625	$ 90,148	$ 70,242
Interest expense	$ 10,767	$ 2,781	$ 2,175
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