# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

**x Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the quarterly period ended: September 30, 2006**

**or**

**¨ Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
**For the transition period from ______ to ______**

**Commission File Number 0-9992**

# KLA-Tencor Corporation

**(Exact name of registrant as specified in its charter)**

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

**160 Rio Robles**

**San Jose, California**

**95134**

**(Address of principal executive offices)**

**(Zip Code)**

**(408) 875-3000**

**(Registrant s telephone number, including area code)**

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

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

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

As of December 31, 2006 there were 199,725,957 shares of the Registrant s Common Stock, $0.001 par value, outstanding.

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## EXPLANATORY NOTE REGARDING RESTATEMENTS

This Quarterly Report on Form 10-Q for our quarter ended September 30, 2006 includes restatements of our condensed consolidated financial statements for our quarter ended September 30, 2005 (and related disclosures). See Note 2, Restatements of Consolidated Financial Statements and Special Committee and Company Findings, to Condensed Consolidated Financial Statements for a detailed discussion of the effect of the restatements.

As a result of an investigation of our historical stock option practices by a Special Committee of our Board of Directors, we discovered that certain of our stock options, primarily those granted from July 1, 1997 to June 30, 2002, had been retroactively priced for all employees who received these grants (less than 15% of these options were granted to executive officers). This means that the option exercise price was not the market price of the option shares on the actual grant date of the option, but instead was a lower market price on an earlier date. The actual grant date when the essential actions necessary to grant the option were completed, including the final determination of the number of shares to be granted to each employee and the exercise price is the correct measurement date to determine the market price of the option shares under the accounting rules in effect at the time. More than 95% of the total in-the-money value (market price on the actual grant date minus exercise price) of all of our retroactively priced options was attributable to those granted from July 1, 1997 to June 30, 2002.

We previously 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 Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation, through the fiscal year ended June 30, 2005. Under APB Opinion No. 25, a non-cash, stock-based compensation expense was recognized for any option for which the exercise price was below the market price on the actual grant date. Because each of our retroactively priced options had an exercise price below the market price on the actual grant date, there should have been a charge for each of these options under APB Opinion No. 25 equal to the number of option shares, multiplied by the difference between the exercise price and the market price on the actual grant date. That expense should have been amortized over the vesting period of the option. Starting in our fiscal year ended June 30, 2006, we adopted SFAS No. 123(R), Share-Based Payment. As a result, for fiscal year 2006, the additional stock-based compensation expense required to be recorded for each retroactively priced option was equal to the incremental fair value of these options on the actual grant date over the remaining vesting period of the option. We did not record these stock-based compensation expenses under APB Opinion No. 25 or SFAS No. 123(R) related to our retroactively priced options in our previously issued financial statements, and that is why we are restating them in this filing. To correct our past accounting for stock options, we recorded additional pre-tax, non-cash, stock-based compensation expense of (a) $348 million for the periods July 1, 1994 to June 30, 2005 under APB Opinion No. 25 and (b) $27 million for the period from July 1, 2005 through September 30, 2006 under SFAS No. 123(R). We expect to amortize an additional $1 million of such pre-tax charges under SFAS No. 123(R) in future periods to properly account for past retroactively priced option grants.

Management reviewed the findings of the Special Committee and conducted its own internal review of our past stock option grants and other aspects of our historical financial statements. Management agrees with the Special Committee that there was retroactive pricing of stock options granted to all option holders, primarily from July 1, 1997 to June 30, 2002. The restatements included in this Quarterly Report on Form 10-Q include adjustments arising from the Special Committee investigation and management s internal review.

Unless otherwise noted, all of the information in this Quarterly Report on Form 10-Q is as of September 30, 2006. This Report does not reflect any subsequent events that occurred after September 30, 2006 other than the Special Committee investigation, resulting restatements and related matters. We will later restate our previously filed financial statements for the quarters ended December 31, 2005 and March 31, 2006 when included in our Quarterly Reports on Form 10-Q for the quarters ended December 31, 2006 and March 31, 2007, respectively. We have not amended and do not intend to amend any of our previously filed Annual Reports on Form 10-K or Quarterly Reports on Form 10-Q for the periods affected by the restatements. Such previous filings should not be relied upon.

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## PART I. FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS (Unaudited)

KLA-TENCOR CORPORATION

Condensed Consolidated Balance Sheets

(Unaudited)

| *(in thousands)* | September 30, 2006 | June 30, 2006 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 1,199,969 | $ 1,129,191 |
| Marketable securities | 1,225,814 | 1,196,605 |
| Accounts receivable, net | 415,403 | 439,899 |
| Inventories | 490,988 | 449,156 |
| Deferred income taxes | 253,691 | 253,811 |
| Other current assets | 63,166 | 74,581 |
| Total current assets | 3,649,031 | 3,543,243 |
| Land, property and equipment, net | 394,239 | 395,412 |
| Other assets | 647,913 | 637,256 |
| Total assets | $ 4,691,183 | $ 4,575,911 |
| LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $ 107,247 | $ 95,192 |
| Deferred system profit | 218,589 | 226,142 |
| Unearned revenue | 81,448 | 80,543 |
| Other current liabilities | 534,673 | 600,604 |
| Total current liabilities | 941,957 | 1,002,481 |
| Commitments and contingencies (Note 11) | | |
| Minority interest in subsidiary | 4,086 | 5,439 |
| Stockholders equity: | | |
| Common stock and capital in excess of par value | 1,476,483 | 1,421,373 |
| Retained earnings | 2,249,472 | 2,137,710 |
| Accumulated other comprehensive income | 19,185 | 8,908 |
| Total stockholders equity | 3,745,140 | 3,567,991 |
| Total liabilities, minority interest and stockholders equity | $ 4,691,183 | $ 4,575,911 |

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

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Operations

(Unaudited)

| ***(in thousands except per share data)*** | **Three months ended September 30, 2006** | **2005 As restated (1)** |
|---|---|---|
| Revenues: | | |
| Product | $ 530,927 | $ 399,001 |
| Service | 98,436 | 85,260 |
| Total revenues | 629,363 | 484,261 |
| Costs and operating expenses: | | |
| Costs of revenues* | 270,119 | 215,137 |
| Engineering, research and development* | 99,293 | 98,770 |
| Selling, general and administrative* | 105,961 | 95,364 |
| Total costs and operating expenses | 475,373 | 409,271 |
| Income from operations | 153,990 | 74,990 |
| Interest income and other, net | 22,457 | 14,076 |
| Income before income taxes and minority interest | 176,447 | 89,066 |
| Provision for income taxes | 41,368 | 14,324 |
| Income before minority interest | 135,079 | 74,742 |
| Minority interest | 843 | 745 |
| Net income | $ 135,922 | $ 75,487 |
| Net income per share: | | |
| Basic | $ 0.68 | $ 0.38 |
| Diluted | $ 0.67 | $ 0.37 |
| Weighted-average number of shares: | | |
| Basic | 199,416 | 197,408 |
| Diluted | 203,323 | 203,292 |

* includes the following amounts related to equity awards

| | | |
|---|---|---|
| Costs of revenues | $ 8,587 | $ 7,178 |
| Engineering, research and development | 11,705 | 13,029 |
| Selling, general and administrative | 16,755 | 19,520 |

(1) See Note 2, Restatements of Consolidated Financial Statements and Special Committee and Company Findings, to Condensed Consolidated Financial Statements (unaudited)

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

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KLA-TENCOR CORPORATION

Condensed Consolidated Statements of Cash Flows

(Unaudited)

| | Three months ended September 30, | |
|---|---|---|
| | | 2005 |
| *(in thousands)* | **2006** | **As restated (1)** |
| Cash flows from operating activities: | | |
| Net income | $ 135,922 | $ 75,487 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 14,798 | 17,814 |
| Non-cash, stock-based compensation | 37,047 | 39,727 |
| Tax benefit from employee stock options | 465 | 7,354 |
| Excess tax benefit from stock-based compensation cost | (1,045) | (4,491) |
| Minority interest | (843) | (745) |
| Net loss (gain) on sale of marketable securities and other investments | 2,199 | (441) |
| Changes in assets and liabilities, net of effect of acquisitions of businesses: | | |
| Accounts receivable, net | 20,626 | 20,984 |
| Inventories | (43,104) | (37,967) |
| Other assets | 991 | (13,027) |
| Accounts payable | 12,209 | (9,288) |
| Deferred system profit | (7,553) | (27,631) |
| Other current liabilities | (64,744) | (55,287) |
| Net cash provided by operating activities | 106,968 | 12,489 |
| Cash flows from investing activities: | | |
| Capital expenditures, net | (12,313) | (18,049) |
| Purchase of available-for-sale securities | (1,156,837) | (1,236,258) |
| Proceeds from sale of available-for-sale securities | 1,001,712 | 1,260,882 |
| Proceeds from maturity of available-for-sale securities | 133,271 | 63,036 |
| Net cash (used in) provided by investing activities | (34,167) | 69,611 |
| Cash flows from financing activities: | | |
| Issuance of common stock | 18,600 | 56,142 |
| Stock repurchases | | (35,488) |
| Payment of dividends to stockholders | (24,160) | (23,709) |
| Proceeds from sale of minority interest in subsidiary | | 1,579 |
| Excess tax benefit from stock-based compensation cost | 1,045 | 4,491 |
| Net cash (used in) provided by financing activities | (4,515) | 3,015 |
| Effect of exchange rate changes on cash and cash equivalents | 2,492 | 244 |
| Net increase in cash and cash equivalents | 70,778 | 85,359 |
| Cash and cash equivalents at beginning of period | 1,129,191 | 663,163 |
| Cash and cash equivalents at end of period | $ 1,199,969 | $ 748,522 |

| | | | | |
|---|---|---|---|---|
| Supplemental cash flow disclosures: | | | | |
| Income taxes paid, net | $ | 83,868 | $ | 8,660 |
| Interest paid | $ | 737 | $ | 297 |

(1) See Note 2, Restatements of Consolidated Financial Statements and Special Committee and Company Findings, to Condensed Consolidated Financial Statements (unaudited)

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

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**KLA-TENCOR CORPORATION**

**Notes to Condensed Consolidated Financial Statements**

(Unaudited)

## NOTE 1 BASIS OF PRESENTATION

**Basis of Presentation.** The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation ( KLA-Tencor or the Company ) pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, Financial Statements and Supplementary Data included in the Company s Annual Report on Form 10-K for the fiscal year ended June 30, 2006, filed with the SEC on January 29, 2007.

The condensed consolidated financial statements include the accounts of KLA-Tencor and its majority-owned subsidiaries, and the ownership interests of minority investors are recorded as minority interests. All significant intercompany balances and transactions have been eliminated. The Company has included the results of operations of acquired companies from the date of acquisition. See Note 5 Business Combinations.

The results of operations for the three month period ended September 30, 2006 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2007.

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

**Recent Accounting Pronouncements.** In September 2006, the SEC staff issued Staff Accounting Bulletin ( SAB ) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB No. 108 was issued in order to eliminate the diversity of practice surrounding how public companies quantify financial statement misstatements. SAB No. 108 requires registrants to quantify the impact of correcting all misstatements using both the rollover method, which focuses primarily on the impact of a misstatement on the income statement and is the method that was previously used by the Company, and the iron curtain method, which focuses primarily on the effect of correcting the period-end balance sheet. The use of both of these methods is referred to as the dual approach and should be combined with the evaluation of qualitative elements surrounding the errors in accordance with SAB No. 99, Materiality. The provisions of SAB No. 108 are effective for the Company for fiscal years beginning July 1, 2006. The adoption of SAB No. 108 did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

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In September 2006, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standard ( 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 the Company for fiscal years beginning July 1, 2008. The Company is evaluating the impact of the provisions of this statement on its consolidated financial position, results of operations and cash flows.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans. SFAS No. 158 requires employers to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare and other post-retirement plans in their financial statements. The provisions of SFAS No. 158 are effective for the Company as of the end of the fiscal year ending June 30, 2007. The Company is evaluating the impact of the provisions of this statement on its consolidated financial position, results of operations and cash flows.

In June 2006, the FASB published FASB Interpretation No. 48 ( FIN ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. This Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. This Interpretation is effective for the Company in fiscal years beginning July 1, 2007. The Company is evaluating the impact of the provisions of this Interpretation on its consolidated financial position, results of operations and cash flows.

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This Statement permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. This Statement is effective for the Company for all financial instruments acquired or issued after July 1, 2007. The adoption of SFAS No. 155 is not expected to have a material effect on the Company s consolidated financial position, results of operations or cash flows.

In June 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and SFAS No. 3, Reporting Accounting Changes in Interim Financial Statements. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition via a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for the Company for accounting changes made in fiscal years beginning July 1, 2006; however, the Statement does not change the transition provisions of any existing accounting pronouncements. The adoption of SFAS No. 154 did not have a material effect on the Company s consolidated financial position, results of operations or cash flows.

In March 2005, the FASB published FIN No. 47, Accounting for Conditional Asset Retirement Obligations, which clarifies that the term, conditional asset retirement obligation, as used in SFAS No. 143, Accounting for Asset Retirement Obligations, refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The uncertainty about the timing and (or) method of settlement

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of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. The Interpretation also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The adoption of this Interpretation did not have a material effect on the Company s consolidated financial position, results of operations or cash flows.

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

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

**NOTE 2 RESTATEMENTS OF CONSOLIDATED FINANCIAL STATEMENTS AND SPECIAL COMMITTEE AND COMPANY FINDINGS**

*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, the Company 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 the Company s stock option practices. Later on May 23, 2006, the Board of Directors appointed a Special Committee composed solely of independent directors to conduct a comprehensive investigation of the 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 the Company s 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 the Board of Directors.

*Findings and Remedial Actions*

On September 28, 2006, the Company announced that it would have to restate its previously issued financial statements to correct its past accounting for stock options. As a result of the Special Committee investigation, the Company discovered that certain of its stock options, primarily those granted from July 1, 1997 to June 30, 2002, had been retroactively priced for all employees who received these grants. This means that the option exercise price was not the market price of the option shares on the actual grant date of the option, but instead was a lower market price on an earlier date. The actual grant date when the essential actions necessary to grant the option were completed, including the final determination of the number of shares to be granted to each employee and the

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exercise price is the correct measurement date to determine the market price of the option shares under the accounting rules in effect at the time. More than 95% of the total in-the-money value (market price on the actual grant date minus exercise price) of all of the Company s retroactively priced options was attributable to those granted from July 1, 1997 to June 30, 2002.

The Company previously 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 under Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation through its fiscal year ended June 30, 2005. Under APB Opinion No. 25, a non-cash, stock-based compensation expense was required to be recognized for any option for which the exercise price was below the market price on the actual grant date. Because each of the Company s retroactively priced options had an exercise price below the market price on the actual grant date, there should have been a non-cash charge for each of these options under APB Opinion No. 25 equal to the number of option shares, multiplied by the difference between the exercise price and the market price on the actual grant date. That expense should have been amortized over the vesting period of the option. Starting in its fiscal year ended June 30, 2006, the Company adopted SFAS No. 123(R), Share-Based Payment. As a result, beginning in fiscal year 2006, the additional stock-based compensation expense required to be recorded for each retroactively priced option is equal to the incremental fair value of the option on the actual grant date, amortized over the remaining vesting period of the option. The Company did not record these stock-based compensation expenses under APB Opinion No. 25 or SFAS No. 123(R) related to its retroactively priced options in the Company s previously issued financial statements, and that is why the Company is restating them in this filing. To correct the Company s past accounting for stock options, it recorded additional pre-tax, non-cash, stock-based compensation expense of (a) $348 million for the periods from July 1, 1994 to June 30, 2005 under APB Opinion No. 25 and (b) $27 million for the period from July 1, 2005 through September 30, 2006 under SFAS No. 123(R). The Company expects to amortize an additional $1 million of such pre-tax charges under SFAS No. 123(R) in future periods to properly account for past retroactively priced stock options.

By October 16, 2006, the Special Committee had substantially completed its investigation. The Special Committee concluded that (1) there was retroactive pricing of stock options granted to all employees who received options, primarily during the periods from July 1, 1997 to June 30, 2002 (less than 15% of these options were granted to executive officers), (2) the retroactively priced options were not accounted for correctly in the Company s previously issued financial statements, (3) the retroactive pricing of options was intentional, not inadvertent or through administrative error, (4) the retroactive pricing of options involved the selection of fortuitously low exercise prices by certain former executive officers, and other former executives may have been aware of this conduct, (5) the retroactive pricing of options involved the falsification of Company records, resulting in erroneous statements being made in financial and other reports previously filed with the SEC, as well as in information previously provided to the Company s independent registered public accounting firm, and (6) in most instances, the retroactive pricing of options violated the terms of the Company s stock option plans. Because virtually all holders of retroactively priced options issued by the Company were not involved in or aware of the retroactive pricing, the Board of Directors decided that the Company should continue to honor the options that violated the terms of the Company s stock option plans, except in certain individual cases as described below.

The Special Committee concluded that, with a few immaterial exceptions, the retroactive pricing of stock options stopped after June 30, 2002. After that time, there were procedures in place to provide reasonable assurance that stock options were priced on the grant date. The Special Committee also concluded that none of the Company s independent Directors was involved in or aware of the retroactive pricing of stock options. Based on the Special Committee s report, the Board of Directors concluded that no current members of management were involved in the retroactive pricing of stock options. During its investigation of the Company s historical stock option practices, the Special Committee did not find evidence of any other financial reporting or accounting issues.

As a result of the Special Committee investigation, on October 16, 2006, the Company terminated its employment relationship and agreement with Kenneth L. Schroeder, and the Company announced its intent to cancel all outstanding stock options held by

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Mr. Schroeder that were retroactively priced or otherwise improperly granted. Those options were canceled in December 2006. Mr. Schroeder was the Company s Chief Executive Officer and a member of its Board of Directors from mid-1999 until January 1, 2006, and was a member of the Company s stock option committee from 1994 until December 31, 2005. From January 1, 2006 to October 16, 2006, Mr. Schroeder was employed as a Senior Advisor to the Company. On November 10, 2006, Mr. Schroeder s counsel informed the Company that Mr. Schroeder contests the Company s right to terminate his employment relationship and agreement and to cancel any of his options. The Company intends to vigorously defend any claims that may be made by Mr. Schroeder regarding these matters, which could involve a material amount.

Also on October 16, 2006, Stuart J. Nichols, Vice President and General Counsel, resigned. Mr. Nichols and the Company entered into a Separation Agreement and General Release under which Mr. Nichols outstanding retroactively priced stock options have been re-priced by increasing the exercise price to the market price of the option shares on the actual grant date. Under SFAS No. 123(R), no incremental charge will be recognized in the financial statements for the quarter ended December 31, 2006.

On October 16, 2006, Kenneth Levy, Founder and Chairman of the Board of Directors of the Company, retired as a director and employee, and was named Chairman Emeritus by the Board of Directors. Mr. Levy and the Company entered into a Separation Agreement and General Release under which Mr. Levy s outstanding retroactively priced stock options have been re-priced by increasing the exercise price to the market price of the option shares on the actual grant date. Under SFAS No. 123(R), no incremental charge will be recognized in the financial statements for the quarter ended December 31, 2006. Mr. Levy was the Company s Chief Executive Officer from 1975 until mid-1999 (with the exception of mid-1997 to mid-1998), was a member of the Company s Board of Directors from 1975 until his retirement, was Chairman of the Board of Directors from 1999 until his retirement, and was a member of the Company s stock option committee from 1994 until use of that committee was suspended in the fall of 2006.

On December 21, 2006, Jon D. Tompkins resigned as a director of the Company, and the Company agreed to modify the outstanding options held by Mr. Tompkins (all of which were fully vested) to extend the post-termination exercisability period to December 31, 2007, which is the last day of the calendar year in which those options would have terminated in the absence of such extension. Mr. Tompkins, the Chief Executive Officer of Tencor Instruments before its merger into the Company in mid-1997, was the Company s Chief Executive Officer from mid-1997 to mid-1998, was a member of the Company s stock option committee from mid-1997 until mid-1999, and was a member of the Company s Board of Directors from mid-1997 until his resignation.

Although the Board of Directors concluded that John H. Kispert, the Company s President and Chief Operating Officer, was not involved in and was not aware of the improper stock option practices, based on the Special Committee s recommendation, his outstanding retroactively priced options have been re-priced because he served as Chief Financial Officer during part of the period in question. This re-pricing involved increasing the exercise price to the market price of the option shares on the actual grant date. Under SFAS No. 123(R), no incremental charge will be recognized in the financial statements for the quarter ended December 31, 2006.

*Restatement and Impact on Financial Statements*

In addition to restating the consolidated financial statements in response to the Special Committee s findings, the Company is recording additional non-cash adjustments that were previously considered to be immaterial relating primarily to the accounting for employee stock purchase plans, corrections for the recognition of deferred tax assets, the release of tax reserves, the timing of revenue recognition, gains and losses on hedging contracts and the calculation of minority interest. The Company has also corrected the classification of certain amounts presented as cash and cash equivalents and marketable securities relating to investments in Variable Rate Demand Notes. For the fiscal years ended June 30, 2004 and prior, the Company previously recorded no stock-based compensation expense; therefore, the additional stock-based compensation expense noted below represents the total stock-based compensation expense for these periods. For the year ended June 30, 2005, the Company recorded $2.9 million of stock-based compensation with a related tax benefit of $1.1 million in its previously reported financial statements. For fiscal 2005, total stock-based compensation was $37.0 million with a related tax benefit of $12.1 million. The income statement impact of the restatement is as follows (in thousands):

| Years ended June 30, | Total effect at June 30, 2005 | 2005 | 2004 | Cumulative effect at July 1, 2003 | 2003 | 2002 |
|---|---|---|---|---|---|---|
| Net income, as previously reported | | $ 466,695 | $ 243,701 | | | |
| Additional compensation expense resulting from improper measurement dates for stock option grants | $ (347,817) | (34,086) | (53,208) | $ (260,523) | (70,032) | (76,582) |
| Tax related effects | 117,776 | 12,149 | 22,320 | 83,307 | 22,866 | 25,009 |
| Additional compensation expense resulting from improper measurement dates for stock option grants, net of tax | (230,041) | (21,937) | (30,888) | (177,216) | (47,166) | (51,573) |
| Other adjustments, net of tax | (991) | 291 | (337) | (945) | | |
| Total decrease to net income | $ (231,032) | (21,646) | (31,225) | $ (178,161) | | |
| Net income, as restated | | $ 445,049 | $ 212,476 | | | |

| Years ended June 30, | 2001 | 2000 | 1999 | 1998 | 1997 | 1996 | 1995 |
|---|---|---|---|---|---|---|---|
| Additional compensation expense resulting from improper measurement dates for stock option grants | $ (59,261) | $ (23,296) | $ (17,630) | $ (5,219) | $ (2,852) | $ (2,747) | $ (2,904) |
| Tax related effects | 17,262 | 7,198 | 6,054 | 1,861 | 1,036 | 983 | 1,038 |
| Additional compensation expense resulting from improper measurement dates for stock option grants, net of tax | $ (41,999) | $ (16,098) | $ (11,576) | $ (3,358) | $ (1,816) | $ (1,764) | $ (1,866) |

The Company adopted SFAS No. 123(R) effective July 1, 2005. The grant date fair values of stock options granted prior to fiscal year 2006 were changed as a result of the findings that certain stock option grants were retroactively priced. This change resulted in additional stock-based compensation expense of $22 million (and a related tax benefit of $12 million) being recognized in fiscal year 2006 and $5 million (and a related tax benefit of $1.6 million) in the quarter ended September 30, 2006 under SFAS No. 123(R).

The cumulative effect of the restatements up through June 30, 2003 increased additional paid-in capital by $356 million from $815 million to $1.2 billion, increased deferred stock-based compensation from zero to $130 million, decreased retained earnings by $178 million from $1.4 billion to $1.2 billion, and increased total stockholders equity by $49 million from $2.2 billion to $2.3 billion.

Diluted shares in fiscal years 2004 and 2005 also increased as a result of the restatement adjustments to correct the past accounting for stock options that were retroactively priced. The Company uses the treasury stock method to calculate the weighted-average shares used in the diluted EPS calculation. As part of the restatement, the Company revised its treasury stock calculations in accordance with SFAS No. 128, Earnings Per Share. These calculations assume that (i) all retroactively priced options are exercised, (ii) the Company repurchases shares with the proceeds of these hypothetical exercises along with the tax benefit resulting from the hypothetical exercises, and (iii) any unamortized deferred stock-based compensation is also used to repurchase shares.

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In addition, the Company evaluated the impact of the restatement on its global tax provision. The Company and its subsidiaries file tax returns in multiple tax jurisdictions around the world. In certain jurisdictions, including, but not limited to, the United States and the United Kingdom, the Company is able to claim a tax deduction relative to stock options. In those jurisdictions, where a tax deduction is claimed, the Company has recorded deferred tax assets, totaling $51.6 million at June 30, 2005, to reflect future tax deductions to the extent the Company believes such assets to be recoverable. The Company also believes that it should not have taken a United States tax deduction in prior years for stock option related amounts pertaining to certain executives under Internal Revenue Code (IRC) Section 162 (m). Section 162 (m) limits the deductibility of compensation above certain thresholds. The Company has determined that excess deductions were taken on prior tax returns due to the finding that retroactive pricing of certain stock options occurred. As a result, the Company s tax liabilities have increased by approximately $8 million.

Because virtually all holders of retroactively priced options issued by the Company were not involved in or aware of the retroactive pricing, the Company has taken and intends to take certain actions to deal with the adverse tax consequences that may be incurred by the holders of retroactively priced options. The adverse tax consequences are that retroactively priced stock options vesting after December 31, 2004 ( 409A Affected Options ) subject the option holder to a penalty tax under IRC Section 409A (and, as applicable, similar penalty taxes under California and other state tax laws). One such action by the Company is to offer to amend the 409A Affected Options to increase the exercise price to the market price on the actual grant date or, if lower, the market price at the time of the amendment. The amended options would not be subject to taxation under IRC Section 409A. Under IRS regulations, these option amendments had to be completed by December 31, 2006 for anyone who was an executive officer when he or she received 409A Affected Options; the amendments for non-officers cannot be offered until after this Report is filed and do not need to be completed until December 31, 2007. Another action is to approve bonuses payable to holders of the amended options to compensate them for the resulting increase in their option exercise price. The amount of these bonuses would be effectively repaid to the Company if and when the options are exercised and the increased exercise price is paid (but there is no assurance that the options will be exercised). Finally, the Company intends to compensate certain option holders who have already exercised 409A Affected Options for the additional taxes they incur under IRC Section 409A (and, as applicable, similar state tax laws).

Three of the Company s option holders were subject to the December 31, 2006 deadline described above. Accordingly, in December 2006, the Company offered to amend the 409A Affected Options held by Mr. Wallace, the Company s Chief Executive Officer, and two former executive officers to increase the exercise price so that these options will not subject the option holder to a penalty tax under IRC Section 409A. All three individuals accepted the Company s offer. In addition, the Company agreed to pay each of the three individuals a cash bonus in January 2008 equal to the aggregate increase in the exercise prices for his amended options. For Mr. Wallace, the amount of this bonus is $0.4 million. To account for these actions, the Company will record a net charge of $0.3 million in the quarter ended December 31, 2006. The Company plans to take similar actions with respect to the outstanding 409A Affected Options granted to non-officers as soon as possible after the filing of this Report. The Company estimates that the total cash payments needed to deal with the adverse tax consequences of retroactively priced options granted to non-officers will be approximately $30 million.

With respect to the individuals whose options were canceled or re-priced by the Company following the Special Committee investigation, no bonuses of the type described above will be paid.

The following tables have been revised to reflect the impact of the additional non-cash charges for stock-based compensation expense and related tax effects as well as additional non-cash adjustments that were previously considered to be immaterial and the correct classification as marketable securities of Variable Rate Demand Notes on:

- the condensed consolidated statements of operations for the three months ended September 30, 2005.
- the condensed consolidated statements of cash flows for the three months ended September 30, 2005.

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Condensed Consolidated Statements of Operations

(Unaudited)

| *(In thousands, except per share data)* | Three Months Ended September 30, 2005 As previously reported | Adjustments | As restated |
|---|---|---|---|
| Revenues: | | | |
| Product | $ 399,950 | $ (949) | $ 399,001 |
| Service | 83,910 | 1,350 | 85,260 |
| Total revenues | 483,860 | 401 | 484,261 |
| Costs and operating expenses: | | | |
| Costs of revenues* | 214,220 | 917 | 215,137 |
| Engineering, research and development* | 96,751 | 2,019 | 98,770 |
| Selling, general and administrative* | 92,051 | 3,313 | 95,364 |
| Total costs and operating expenses | 403,022 | 6,249 | 409,271 |
| Income from operations | 80,838 | (5,848) | 74,990 |
| Interest income and other, net | 14,776 | (700) | 14,076 |
| Income before income taxes and minority interest | 95,614 | (6,548) | 89,066 |
| Provision for income taxes | 19,681 | (5,357) | 14,324 |
| Income before minority interest | 75,933 | (1,191) | 74,742 |
| Minority interest | 745 | | 745 |
| Net income | $ 76,678 | $ (1,191) | $ 75,487 |
| Net income per share: | | | |
| Basic | $ 0.39 | $ (0.01) | $ 0.38 |
| Diluted | $ 0.38 | $ (0.01) | $ 0.37 |
| Weighted-average number of shares: | | | |
| Basic | 197,408 | | 197,408 |
| Diluted | 202,715 | 577 | 203,292 |

* includes the following amounts related to equity awards

| | | | |
|---|---|---|---|
| Costs of revenues | $ 6,811 | $ 367 | $ 7,178 |
| Engineering, research and development | 11,010 | 2,019 | 13,029 |
| Selling, general and administrative | 17,007 | 2,513 | 19,520 |

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Condensed Consolidated Statements of Cash Flows

| *(in thousands)* | Three Months Ended September 30, 2005 | | |
|---|---|---|---|
| | **As previously reported** | **Adjustments** | **As restated** |
| Cash flows from operating activities: | | | |
| Net income | $ 76,678 | $ (1,191) | $ 75,487 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 17,114 | 700 | 17,814 |
| Non-cash, stock-based compensation | 34,828 | 4,899 | 39,727 |
| Minority interest | (745) | | (745) |
| Net gain on sale of marketable securities and other investments | (441) | | (441) |
| Tax benefit from employee stock options | 14,145 | (6,791) | 7,354 |
| Excess tax benefit from stock-based compensation cost | (5,018) | 527 | (4,491) |
| Changes in assets and liabilities: | | | |
| Accounts receivable, net | 21,141 | (157) | 20,984 |
| Inventories | (36,310) | (1,657) | (37,967) |
| Other assets | (15,085) | 2,058 | (13,027) |
| Accounts payable | (9,288) | | (9,288) |
| Deferred system profit | (29,552) | 1,921 | (27,631) |
| Other current liabilities | (55,505) | 218 | (55,287) |
| Net cash provided by operating activities | 11,962 | 527 | 12,489 |
| Cash flows from investing activities: | | | |
| Purchase of property, plant and equipment | (18,049) | | (18,049) |
| Purchase of available-for-sale securities | (1,236,258) | | (1,236,258) |
| Proceeds from sale of available-for-sale securities | 1,260,882 | | 1,260,882 |
| Proceeds from maturity of available-for-sale securities | 63,036 | | 63,036 |
| Net cash provided by investing activities | 69,611 | | 69,611 |
| Cash flows from financing activities: | | | |
| Issuance of common stock | 56,142 | | 56,142 |
| Payment of dividends to stockholders | (23,709) | | (23,709) |
| Excess tax benefit from stock-based compensation cost | 5,018 | (527) | 4,491 |
| Stock repurchases | (35,488) | | (35,488) |
| Proceeds from sale of minority interest in subsidiary | 1,579 | | 1,579 |
| Net cash provided by financing activities | 3,542 | (527) | 3,015 |
| Effect of exchange rate changes on cash and cash equivalents | 244 | | 244 |
| Net increase in cash and cash equivalents | 85,359 | | 85,359 |
| Cash and cash equivalents at beginning of period | 663,163 | | 663,163 |
| Cash and cash equivalents at end of period | $ 748,522 | $ | $ 748,522 |
| Supplemental cash flow disclosures: | | | |
| Income taxes paid, net | $ 8,660 | | $ 8,660 |
| Interest paid | $ 297 | | $ 297 |

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In the third quarter of fiscal 2006, the Company corrected the classification of its Variable Rate Demand Notes with reset dates of 90 days or less, moving them from cash equivalents to short-term investments on the Consolidated Balance Sheets. All Balance Sheets in these consolidated financial statements present Variable Rate Demand Notes in marketable securities.

Also, as a result of these changes, purchases and sales of Variable Rate Demand Notes are now presented as investing activities, rather than as changes in cash and cash equivalents. The impact of this change on the Consolidated Statement of Cash Flows was as follows:

| | Three months ended September 30, 2005 | |
|---|---|---|
| ***(in thousands)*** | **As originally reported** | **As restated** |
| Cash used for purchase of available-for-sale securities | $ (950,852) | $ (1,236,258) |
| Proceeds from sale of available-for-sale securities | $ 884,090 | $ 1,260,882 |
| Proceeds from maturity of available-for-sale securities | $ 58,336 | $ 63,036 |
| Net cash (used in) provided by investing activities | $ (26,475) | $ 69,611 |

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**NOTE 3 BALANCE SHEET COMPONENTS**

| *(in thousands)* | September 30, 2006 | June 30, 2006 |
|---|---|---|
| Cash equivalents and marketable securities | | |
| U.S. Treasuries | $ 13,989 | $ 25,908 |
| U.S. Government agency securities | 404,807 | 353,567 |
| Municipal bonds | 957,682 | 1,001,073 |
| Corporate debt securities | 4,012 | |
| Corporate equity securities | 358 | 362 |
| Money market, bank deposits and other | 864,666 | 804,017 |
| | 2,245,514 | 2,184,927 |
| Less: Cash equivalents | 1,019,700 | 988,322 |