KLA TENCOR CORP
Form 10-Q
January 23, 2015
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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 December 31, 2014

or

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

For the transition period from to

Commission File Number 000-09992

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

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

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

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

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

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

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

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

As of January 9, 2015, there were 162,664,930 shares of the registrant’s Common Stock, $0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

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

(In thousands)	December 31, 2014	June 30, 2014
ASSETS		
Current assets:		
Cash and cash equivalents	$584,865	$630,861
Marketable securities	1,781,968	2,521,776
Accounts receivable, net	632,089	492,863
Inventories	662,799	656,457
Deferred income taxes	258,392	215,676
Other current assets	126,135	69,197
Total current assets	4,046,248	4,586,830
Land, property and equipment, net	323,353	330,263
Goodwill	335,273	335,355
Purchased intangibles, net	19,551	27,697
Other non-current assets	262,941	258,519
Total assets	$4,987,366	$5,538,664
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$108,307	$103,422
Deferred system profit	168,086	147,923
Unearned revenue	64,257	59,176
Current portion of long-term debt	37,500	—
Other current liabilities	564,190	585,090
Total current liabilities	942,340	895,611
Non-current liabilities:		
Long-term debt	3,208,571	747,919
Unearned revenue	54,900	57,500
Other non-current liabilities	179,416	168,288
Total liabilities	4,385,227	1,869,318
Commitments and contingencies (Note 12 and Note 13)		
Stockholders’ equity:		
Common stock and capital in excess of par value	613,122	1,220,504
Retained earnings	24,770	2,479,113
Accumulated other comprehensive income (loss)	(35,753)	(30,271)
Total stockholders’ equity	602,139	3,669,346
Total liabilities and stockholders’ equity	$4,987,366	$5,538,664

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

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands, except per share amounts)	2014	2013	2014	2013
Revenues:				
Product	$503,884	$544,183	$980,482	$1,045,923
Service	172,473	160,946	338,776	317,543
Total revenues	676,357	705,129	1,319,258	1,363,466
Costs and operating expenses:				
Costs of revenues	283,213	285,814	571,680	563,471
Engineering, research and development	133,557	134,587	277,194	266,860
Selling, general and administrative	104,873	96,746	206,517	195,242
Total costs and operating expenses	521,643	517,147	1,055,391	1,025,573
Income from operations	154,714	187,982	263,867	337,893
Interest income and other, net	1,988	2,074	5,363	5,689
Interest expense	31,301	13,311	44,822	26,973
Loss on extinguishment of debt and other, net	131,669	—	131,669	—
Income (loss) before income taxes	(6,268)	176,745	92,739	316,609
Provision for (benefit from) income taxes	(26,536)	37,499	238	66,166
Net income	$20,268	$139,246	$92,501	$250,443
Net income per share:				
Basic	$0.12	$0.84	$0.56	$1.51
Diluted	$0.12	$0.83	$0.56	$1.49
Cash dividends declared per share (including a special cash dividend of $16.50 per share declared during the three months ended December 31, 2014)	$17.00	$0.45	$17.50	$0.90
Weighted-average number of shares:				
Basic	164,036	166,414	164,440	166,150
Diluted	165,317	168,206	165,950	168,478

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

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2014	2013	2014	2013
Net income	$20,268	$139,246	$92,501	$250,443
Other comprehensive income (loss):				
Currency translation adjustments:				
Change in currency translation adjustments	(9,333)	(1,189)	(17,069)	3,921
Change in income tax benefit or expense	3,101	541	5,973	(774)
Net change related to currency translation adjustments	(6,232)	(648)	(11,096)	3,147
Cash flow hedges:				
Change in net unrealized gains or losses	11,924	3,864	13,957	3,573
Reclassification adjustments for net gains or losses included in net income	(1,584)	(22)	(1,812)	(2,538)
Change in income tax benefit or expense	(3,727)	(1,377)	(4,377)	(371)
Net change related to cash flow hedges	6,613	2,465	7,768	664
Net change related to unrecognized losses and transition obligations in connection with defined benefit plans	580	200	1,313	400
Available-for-sale securities:				
Change in net unrealized gains or losses	(389)	659	(3,124)	4,797
Reclassification adjustments for gains or losses included in net income	(281)	(1,213)	(1,916)	(1,447)
Change in income tax benefit or expense	158	180	1,573	(1,163)
Net change related to available-for-sale securities	(512)	(374)	(3,467)	2,187
Other comprehensive income (loss)	449	1,643	(5,482)	6,398
Total comprehensive income	$20,717	$140,889	$87,019	$256,841

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

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

(In thousands)	Six months ended December 31, 2014	2013
Cash flows from operating activities:		
Net income	$92,501	$250,443
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	40,060	40,448
Asset impairment charges	—	1,374
Loss on extinguishment of debt and other, net	131,669	—
Non-cash stock-based compensation expense	30,331	34,089
Excess tax benefit from equity awards	(14,788)	(19,530)
Net gain on sale of marketable securities and other investments	(1,916)	(1,447)
Changes in assets and liabilities:		
Increase in accounts receivable, net	(161,021)	(50,791)
Increase in inventories	(12,743)	(32,743)
Increase in other assets	(82,588)	(39,993)
Increase in accounts payable	5,754	25,939
Increase in deferred system profit	20,163	85,638
Decrease in other liabilities	(1,412)	(908)
Net cash provided by operating activities	46,010	292,519
Cash flows from investing activities:		
Capital expenditures, net	(26,228)	(36,216)
Purchase of available-for-sale securities	(1,094,276)	(796,808)
Proceeds from sale of available-for-sale securities	1,441,460	520,575
Proceeds from maturity of available-for-sale securities	383,132	50,889
Purchase of trading securities	(39,566)	(32,107)
Proceeds from sale of trading securities	36,793	30,879
Net cash provided by (used in) investing activities	701,315	(262,788)
Cash flows from financing activities:		
Proceeds from issuance of debt, net of issuance costs	3,224,906	—
Repayment of debt	(877,367)	—
Issuance of common stock	29,403	78,766
Tax withholding payments related to vested and released restricted stock units	(27,800)	(49,209)
Common stock repurchases	(266,360)	(120,806)
Payment of dividends to stockholders	(2,879,152)	(149,600)
Excess tax benefit from equity awards	14,788	19,530
Net cash used in financing activities	(781,582)	(221,319)
Effect of exchange rate changes on cash and cash equivalents	(11,739)	(420)
Net decrease in cash and cash equivalents	(45,996)	(192,008)
Cash and cash equivalents at beginning of period	630,861	985,390
Cash and cash equivalents at end of period	$584,865	$793,382
Supplemental cash flow disclosures:		
Income taxes paid, net	$57,729	$67,241
Interest paid	$33,228	$26,301
Non-cash activities:		
Purchase of land, property and equipment - investing activities	$3,962	$5,923

Dividends payable - financing activities	$42,987	$—

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

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

NOTE 1 – BASIS OF PRESENTATION

Basis of Presentation. The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation ("KLA-Tencor" or the "Company") pursuant to the rules and regulations of the U.S. Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair statement of the financial position, results of operations, comprehensive income, and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with Item 8, "Financial Statements and Supplementary Data" included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2014, filed with the SEC on August 8, 2014.

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

The results of operations for the three and six months ended December 31, 2014, which include a pre-tax net loss of $131.7 million as a result of the net loss on extinguishment of debt (described further in detail below), 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, 2015. The Company classified such pre-tax net loss on extinguishment of debt as an adjustment to reconcile net income to net cash provided by operating activities and the gross redemption payments for the prepayment of the 6.900% senior, unsecured long-term notes due in 2018 (the "2018 Senior Notes") are classified as a cash outflow from financing activities in the condensed consolidated statements of cash flows.

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

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

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

- When the customer fab has previously accepted the same tool, with the same specifications, and when the Company can objectively demonstrate that the tool meets all of the required acceptance criteria.
- When system sales to independent distributors have no installation requirement, contain no acceptance agreement, and 100% payment is due based upon shipment.
- When the installation of the system is deemed perfunctory.
- When the customer withholds acceptance due to issues unrelated to product performance, in which case revenue is recognized when the system is performing as intended and meets predetermined specifications.

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

installation.

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

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

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

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

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

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

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

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

Recent Accounting Pronouncements.

Recently Adopted

In July 2013, the Financial Accounting Standards Board ("FASB") issued an accounting standard update that provides guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. Under the new standard, in most circumstances, an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the Company's financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss or a tax credit

carryforward. This accounting standard update became effective for the Company’s interim period ended September 30, 2014, and the adoption did not have a material impact on the Company’s condensed consolidated financial statements.

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Updates Not Yet Effective
In May 2014, the FASB issued an accounting standard update regarding revenue from customer contracts to transfer goods and services or enter into contracts for the transfer of non-financial assets (unless covered by other standards for example insurance or lease contracts). Under the new guidance, an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration which the entity expects to be entitled in exchange for those goods or services. In addition, the new standard requires that reporting companies disclose the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The updates are effective for the Company beginning the first quarter of the fiscal year ending June 30, 2018. Early adoption is not permitted. The new revenue standard may be applied retrospectively to each prior period presented or retrospectively with the cumulative effect recognized as of the date of adoption. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.
In June 2014, the FASB issued an accounting standard update regarding stock-based compensation that clarifies the accounting when terms of an award provide that a performance target could be achieved after the requisite service period. The amendments require that a performance target that affects vesting which could be achieved after the requisite service period be treated as a performance condition. The update is effective for the Company beginning in the first quarter of the Company's fiscal year ending June 30, 2017, with early adoption permitted. The Company is currently evaluating the impact of this accounting standard update on its condensed consolidated financial statements.
NOTE 2 – FAIR VALUE MEASUREMENTS
The Company's financial assets and liabilities are measured and recorded at fair value, except for certain equity investments in privately-held companies. These equity investments are generally accounted for under the cost method of accounting and are periodically assessed for other-than-temporary impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred. The Company's non-financial assets, such as goodwill, intangible assets, and land, property and equipment, are recorded at cost and are assessed for impairment when an event or circumstance indicates that an other-than-temporary decline in value may have occurred.
Fair Value of Financial Instruments. KLA-Tencor has evaluated the estimated fair value of financial instruments using available market information and valuations as provided by third-party sources. The use of different market assumptions and/or estimation methodologies could have a significant effect on the estimated fair value amounts. The fair value of the Company's cash equivalents, accounts receivable, accounts payable and other current liabilities approximate their carrying amounts due to the relatively short maturity of these items.
Fair Value Hierarchy. The authoritative guidance for fair value measurements establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are described below:

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

A financial instrument's level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement.
The Company's financial instruments were classified within Level 1 or Level 2 of the fair value hierarchy as of December 31, 2014, because they were valued using quoted market prices, broker/dealer quotes or alternative pricing sources with reasonable levels of price transparency. As of December 31, 2014, the types of instruments valued based on quoted market prices in active markets included money market funds, U.S. Treasury securities, certain sovereign

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

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As of December 31, 2014, the types of instruments valued based on other observable inputs included corporate debt securities, municipal securities and certain U.S. Government agency securities and sovereign securities. The market inputs used to value these instruments generally consist of market yields, reported trades and broker/dealer quotes. Such instruments are generally classified within Level 2 of the fair value hierarchy.

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

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

As of December 31, 2014 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
U.S. Government agency securities	$28,022	$12,022	$16,000
Corporate debt securities	14,997	—	14,997
Money market and other	414,875	414,875	—
Marketable securities:			
U.S. Treasury securities	314,722	314,722	—
U.S. Government agency securities	666,327	644,336	21,991
Municipal securities	33,032	—	33,032
Corporate debt securities	709,692	—	709,692
Sovereign securities	51,538	13,651	37,887
Total cash equivalents and marketable securities[1]	2,233,205	1,399,606	833,599
Other current assets:			
Derivative assets	11,584	—	11,584
Other non-current assets:			
Executive Deferred Savings Plan	166,305	95,404	70,901
Total financial assets[1]	$2,411,094	$1,495,010	$916,084
Liabilities			
Other current liabilities:			
Derivative liabilities	$(1,816)	$—	$(1,816)
Total financial liabilities	$(1,816)	$—	$(1,816)

(1) Excludes cash of $111.7 million held in operating accounts and time deposits of $21.9 million as of December 31, 2014.

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

As of June 30, 2014 (In thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Assets			
Cash equivalents:			
U.S. Government agency securities	$28,000	$8,000	$20,000
Municipal securities	2,891	—	2,891
Corporate debt securities	68,992	—	68,992
Money market and other	397,517	397,517	—
Marketable securities:			
U.S. Treasury securities	384,400	365,401	18,999
U.S. Government agency securities	839,843	811,841	28,002
Municipal securities	93,325	—	93,325
Corporate debt securities	1,155,176	—	1,155,176
Sovereign securities	42,264	9,253	33,011
Total cash equivalents and marketable securities[(1)]	3,012,408	1,592,012	1,420,396
Other current assets:			
Derivative assets	666	—	666
Other non-current assets:			
Executive Deferred Savings Plan	159,995	105,311	54,684
Total financial assets[(1)]	$3,173,069	$1,697,323	$1,475,746
Liabilities			
Other current liabilities:			
Derivative liabilities	$(898)	$—	$(898)
Total financial liabilities	$(898)	$—	$(898)

(1) Excludes cash of $106.7 million held in operating accounts and time deposits of $33.5 million as of June 30, 2014.
There were no transfers in and out of Level 1 and Level 2 fair value measurements during the three and six months ended December 31, 2014. The Company did not have significant assets or liabilities measured at fair value on a recurring basis within Level 3 fair value measurements as of December 31, 2014 or June 30, 2014.

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NOTE 3 – FINANCIAL STATEMENT COMPONENTS

Balance Sheet Components

(In thousands)	As of December 31, 2014	As of June 30, 2014
Accounts receivable, net:		
Accounts receivable, gross	$653,806	$514,690
Allowance for doubtful accounts	(21,717)	(21,827)
	$632,089	$492,863
Inventories:		
Customer service parts	$213,843	$203,194
Raw materials	253,242	221,612
Work-in-process	142,243	171,249
Finished goods	53,471	60,402
	$662,799	$656,457
Other current assets:		
Prepaid expenses	$41,963	$35,478
Income tax related receivables	66,745	27,452
Other current assets	17,427	6,267
	$126,135	$69,197
Land, property and equipment, net:		
Land	$41,831	$41,848
Buildings and leasehold improvements	312,141	302,537
Machinery and equipment	499,197	491,167
Office furniture and fixtures	21,139	20,945
Construction-in-process	4,646	8,945
	878,954	865,442
Less: accumulated depreciation and amortization	(555,601)	(535,179)
	$323,353	$330,263
Other non-current assets:		
Executive Deferred Savings Plan[(1)]	$166,305	$159,996
Deferred tax assets – long-term	64,341	75,138
Other non-current assets	32,295	23,385
	$262,941	$258,519
Other current liabilities:		
Warranty	$34,410	$37,746
Executive Deferred Savings Plan[(1)]	167,544	160,527
Compensation and benefits	130,533	203,990
Income taxes payable	13,587	15,283
Interest payable	19,179	8,769
Customer credits and advances	92,972	79,373
Other accrued expenses	105,965	79,402
	$564,190	$585,090
Other non-current liabilities:		
Pension liabilities	$54,480	$59,908
Income taxes payable	64,327	59,575
Other non-current liabilities	60,609	48,805
	$179,416	$168,288

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(1) KLA-Tencor has a non-qualified deferred compensation plan whereby certain executives and non-employee directors may defer a portion of their compensation. Participants are credited with returns based on their allocation of their account balances among measurement funds. The Company controls the investment of these funds, and the participants remain general creditors of KLA-Tencor. Distributions from the plan commence following a participant's retirement or termination of employment or on a specified date allowed per the plan provisions, except in cases where such distributions are required to be delayed in order to avoid a prohibited distribution under Internal Revenue Code Section 409A. As of December 31, 2014 and June 30, 2014, the Company had a deferred compensation plan related asset and liability included as a component of other non-current assets and other current liabilities on the Condensed Consolidated Balance Sheets. The plan assets are classified as trading securities.

Accumulated Other Comprehensive Income (Loss)

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

(In thousands)	Currency Translation Adjustments	Unrealized Gains (Losses) on Available-for-Sale Securities	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total
Balance as of December 31, 2014	$(28,367)	$ (667)	$7,756	$(14,475)	$(35,753)
Balance as of June 30, 2014	$(17,271)	$ 2,800	$(12)	$(15,788)	$(30,271)

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

Accumulated OCI Components	Location in the Condensed Consolidated Statements of Operations	Three months ended December 31, 2014	Three months ended December 31, 2013	Six months ended December 31, 2014	Six months ended December 31, 2013
Unrealized gains (losses) on cash flow hedges from foreign exchange and interest rate contracts	Revenues	$1,933	$(128)	$2,202	$2,322
	Costs of revenues	(475)	150	(516)	216
	Interest expense	126	—	126	—
	Net gains reclassified from accumulated OCI	$1,584	$22	$1,812	$2,538
Unrealized gains on available-for-sale securities	Interest income and other, net	$281	$1,213	$1,916	$1,447

The amounts reclassified out of accumulated OCI related to the Company's defined pension plans, which were recognized as a component of net periodic cost for the three and six months ended December 31, 2014 were $0.7 million and $1.5 million, respectively. The amounts reclassified out of accumulated OCI related to the Company's defined pension plans, which were recognized as a component of net periodic cost for the three and six months ended December 31, 2013, were $0.3 million and $0.6 million, respectively. For additional details, refer to Note 11, "Employee Benefit Plans" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2014.

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NOTE 4 – MARKETABLE SECURITIES

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

As of December 31, 2014 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$314,760	$106	$(144)	$314,722
U.S. Government agency securities	694,683	219	(553)	694,349
Municipal securities	33,057	8	(33)	33,032
Corporate debt securities	725,124	453	(888)	724,689
Money market and other	414,875	—	—	414,875
Sovereign securities	51,547	22	(31)	51,538
Subtotal	2,234,046	808	(1,649)	2,233,205
Add: Time deposits(1)	21,891	—	—	21,891
Less: Cash equivalents	473,132	—	(4)	473,128
Marketable securities	$1,782,805	$808	$(1,645)	$1,781,968

As of June 30, 2014 (In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasury securities	$384,165	$287	$(52)	$384,400
U.S. Government agency securities	867,309	651	(117)	867,843
Municipal securities	96,198	93	(75)	96,216
Corporate debt securities	1,220,794	3,526	(152)	1,224,168
Money market and other	397,517	—	—	397,517
Sovereign securities	42,227	46	(9)	42,264
Subtotal	3,008,210	4,603	(405)	3,012,408
Add: Time deposits(1)	33,509	—	—	33,509
Less: Cash equivalents	524,149	—	(8)	524,141
Marketable securities	$2,517,570	$4,603	$(397)	$2,521,776

(1) Time deposits excluded from fair value measurements.

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

As of December 31, 2014 (In thousands)	Fair Value	Gross Unrealized Losses(1)
U.S. Treasury securities	$218,222	$(144)
U.S. Government agency securities	392,285	(552)
Municipal securities	24,410	(33)
Corporate debt securities	420,180	(885)
Sovereign securities	32,865	(31)
Total	$1,087,962	$(1,645)

(1)

Of the total gross unrealized losses, the amount of total gross unrealized losses related to investments that had been in a continuous loss position for 12 months or more was immaterial.

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

As of December 31, 2014 (In thousands)	Amortized Cost	Fair Value
Due within one year	$666,565	$666,694
Due after one year through three years	1,116,240	1,115,274
	$1,782,805	$1,781,968

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Realized gains on available-for-sale securities for the three months ended December 31, 2014 and 2013 were $0.4 million and $1.2 million, respectively. Realized gains on available-for-sale securities for the six months ended December 31, 2014 and 2013 were $2.1 million and $1.5 million, respectively. Realized losses on available-for-sale securities for the three and six months ended December 31, 2014 and 2013 were immaterial.

NOTE 5 – BUSINESS COMBINATION

On March 28, 2014, the Company acquired certain assets and liabilities of a privately-held company that developed and sold software to mask manufacturers, semiconductor fabs and mask inspection and review equipment manufacturers, for a total purchase consideration of $18 million in cash.

The following table represents the preliminary purchase price allocation and summarizes the aggregate estimated fair values of the net assets acquired on the closing date of the acquisition:

(In thousands)	Preliminary Purchase Price Allocation	
Intangibles	$9,400	
Goodwill	8,730	
Liabilities assumed	(130	)
Cash consideration paid	$18,000	

Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired. The $8.7 million of goodwill was assigned to the Defect Inspection reporting unit.

NOTE 6 – GOODWILL AND PURCHASED INTANGIBLE ASSETS

Goodwill

The following table presents goodwill balances and the movements during the six months ended December 31, 2014:

(In thousands)		
As of June 30, 2014	$335,355	
Adjustments	(82	)
As of December 31, 2014	$335,273	

The changes in the gross goodwill balance since June 30, 2014 resulted from foreign currency translation adjustments. Goodwill represents the excess of the purchase price over the fair value of the net tangible and identifiable intangible assets acquired in prior business combinations. The Company has four reporting units: Defect Inspection, Metrology, Service and Other. As of December 31, 2014, substantially all of the goodwill balance resided within the Defect Inspection reporting unit.

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The Company performed a qualitative assessment of the goodwill by reporting unit as of November 30, 2014 during the three months ended December 31, 2014 and concluded that it was more likely than not that the fair value of each of the reporting units exceeded its carrying amount. As a result of the Company's determination following its qualitative assessment, it was not necessary to perform the two-step quantitative goodwill impairment test at this time. In assessing the qualitative factors, the Company considered the impact of key factors, including changes in the industry and competitive environment, market capitalization, stock price, earnings multiples, budgeted-to-actual revenue performance from prior year, gross margin and cash flows from operating activities.
Based on the Company's assessment, goodwill in the reporting units was not impaired as of December 31, 2014 or 2013.
Purchased Intangible Assets
The components of purchased intangible assets as of the dates indicated below were as follows:

(In thousands)		As of December 31, 2014			As of June 30, 2014		
Category	Range of Useful Lives	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Amount
Existing technology	4-7 years	$141,659	$130,671	$10,988	$141,659	$126,567	$15,092
Patents	6-13 years	57,648	55,698	1,950	57,648	54,398	3,250
Trade name/Trademark	4-10 years	19,893	18,177	1,716	19,893	17,427	2,466
Customer relationships	6-7 years	54,680	50,357	4,323	54,680	48,915	5,765
Other	0-1 year	17,599	17,025	574	17,599	16,475	1,124
Total		$291,479	$271,928	$19,551	$291,479	$263,782	$27,697

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable.
For the three months ended December 31, 2014 and 2013, amortization expense for intangible assets was $4.0 million and $3.9 million, respectively. For the six months ended December 31, 2014 and 2013, amortization expense for intangible assets was $8.1 million and $8.4 million, respectively. Based on the intangible assets recorded as of December 31, 2014, and assuming no subsequent additions to, or impairment of, the underlying assets, the remaining estimated amortization expense is expected to be as follows:

Fiscal year ending June 30:	Amortization (In thousands)
2015 (remaining 6 months)	$7,656
2016	7,564
2017	2,806
2018	1,525
Total	$19,551

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NOTE 7 – DEBT

The following table summarizes the debt of the Company as of December 31, 2014 and June 30, 2014:

	As of December 31, 2014		As of June 30, 2014	
	Amount (in thousands)	Effective Interest Rate	Amount (in thousands)	Effective Interest Rate
Fixed-rate 6.900% Senior notes due on May 1, 2018	$—		$750,000	7.001 %
Fixed-rate 2.375% Senior notes due on November 1, 2017	250,000	2.396 %	—	
Fixed-rate 3.375% Senior notes due on November 1, 2019	250,000	3.377 %	—	
Fixed-rate 4.125% Senior notes due on November 1, 2021	500,000	4.128 %	—	
Fixed-rate 4.650% Senior notes due on November 1, 2024[1]	1,250,000	4.682 %	—	
Fixed-rate 5.650% Senior notes due on November 1, 2034	250,000	5.670 %	—	
Term loans	750,000		—	
Total debt	3,250,000		750,000	
Unamortized discount	(3,929)		(2,081)	
Total debt	$3,246,071		$747,919	
Reported as:				
Current portion of long-term debt	$37,500		$—	
Long-term debt	3,208,571		747,919	
Total debt	$3,246,071		$747,919	

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

Debt Issuance - Senior Notes:

In November 2014, the Company issued $2.5 billion aggregate principal amount of senior, unsecured long-term notes (collectively referred to as “Senior Notes”). The Company issued the Senior Notes as part of the leveraged recapitalization plan whereby the proceeds from the Senior Notes in conjunction with the proceeds from the term loans (described below) and cash on hand were used (x) to fund a special cash dividend of $16.50 per share, aggregating to approximately $2.76 billion, (y) to redeem $750 million of 2018 Senior Notes, including associated redemption premiums, accrued interest and other fees and expenses and (z) for other general corporate purposes, including repurchases of shares pursuant to the Company’s stock repurchase program. The interest rate specified for each series of the Senior Notes will be subject to adjustments from time to time if Moody’s Investor Service, Inc. (“Moody’s”) or Standard & Poor’s Ratings Services (“S&P”) or, under certain circumstances, a substitute rating agency selected by us as a replacement for Moody’s or S&P, as the case may be (a “Substitute Rating Agency”), downgrades (or subsequently upgrades) its rating assigned to the respective series of Senior Notes such that the adjusted rating is below investment grade. If the adjusted rating of any series of Senior Notes from Moody’s (or, if applicable, any Substitute Rating Agency) is decreased to Ba1, Ba2, Ba3 or B1 or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively (“bps” refers to Basis Points and 1% is equal to 100 bps). If the rating of any series of Senior Notes from S&P (or, if applicable, any Substitute Rating Agency) with respect to such series of Senior Notes is decreased to BB+, BB, BB- or B+ or below, the stated interest rate on such series of Senior Notes as noted above will increase by 25 bps, 50 bps, 75 bps or 100 bps, respectively. The interest rates on any series of Senior Notes will permanently cease to be subject to any adjustment (notwithstanding any subsequent decrease in the ratings by any of Moody’s, S&P and, if applicable, any

Substitute Rating Agency) if such series of Senior Notes becomes rated “Baa1” (or its equivalent) or higher by Moody’s (or, if applicable, any Substitute Rating Agency) and “BBB+” (or its equivalent) or higher by S&P (or, if applicable, any Substitute Rating Agency), or one of those ratings if rated by only one of Moody’s, S&P and, if applicable, any Substitute Rating Agency, in each case with a stable or positive outlook. In October 2014, the Company entered into a series of forward contracts to lock the 10-year treasury rate (“benchmark rate”) on a portion of the Senior Notes with a notional amount of $1 billion in aggregate. For additional details, refer to Note 14, “Derivative Instruments and Hedging Activities.”

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The original discount on the Senior Notes amounted to $4.0 million and is being amortized over the life of the debt. Interest is payable semi-annually on May 1 and November 1 of each year, beginning, May 1, 2015. The debt indenture (the "Indenture") includes covenants that limit the Company's ability to grant liens on its facilities and enter into sale and leaseback transactions, subject to significant allowances under which certain sale and leaseback transactions are not restricted. As of December 31, 2014, the Company was in compliance with all of its covenants under the Indenture associated with the Senior Notes.

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

Based on the trading prices of the Senior Notes on the applicable dates, the fair value of the Senior Notes as of December 31, 2014 and June 30, 2014 was $2.6 billion and $893.7 million, respectively. While the Senior Notes are recorded at cost, the fair value of the long-term debt was determined based on quoted prices in markets that are not active; accordingly, the long-term debt is categorized as Level 2 for purposes of the fair value measurement hierarchy.

Refer to Contractual Obligations under Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" showing future payments of long-term debt at face value as well as payment of associated interest.

Debt Issuance - Credit Facility (Term Loans and Unfunded Revolving Credit Facility):

In November 2014, the Company entered into $750 million of five-year senior unsecured prepayable term loans and a $500 million unfunded revolving credit facility (collectively, the "Credit Facility") under the Credit Agreement (the "Credit Agreement"). The interest under the Credit Facility will be payable on the borrowed amounts at the London Interbank Offered Rate ("LIBOR") plus a spread, which is currently 125 bps, and this spread is subject to adjustment in conjunction with the Company's credit rating downgrades or upgrades. The spread could range from 100 bps to 175 bps based on the then effective credit rating. The Company is also obligated to pay an annual commitment fee of 15 bps on the daily undrawn balance of the revolving credit facility, which is also subject to an adjustment in conjunction with the Company's credit rating downgrades or upgrades by Moody's and S&P. The annual commitment fee could range from 10 bps to 25 bps on the daily undrawn balance of the revolving credit facility based on the then effective credit rating. Principal payments with respect to the term loans will be made on the last day of each calendar quarter, commencing with the quarter ending March 31, 2015 and any unpaid principal balance of the term loans, including accrued interest, shall be payable on November 14, 2019 (the "Maturity Date"). The Company may prepay the term loans and unfunded revolving credit facility at any time without a prepayment penalty.

Future principal payments for the Company's term loans as of December 31, 2014, are as follows:

Fiscal Quarters Ending	Quarterly Payment (in thousands)
March 31, 2015 through December 31, 2016	$9,375
March 31, 2017 through December 31, 2017	$14,063
March 31, 2018 through September 30, 2019	$18,750
December 31, 2019	$487,500

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

Fiscal Quarters Ending	Maximum Leverage Ratio
December 31, 2014	4.50:1.00
March 31, 2015 and June 30, 2015	4.25:1.00
September 30, 2015 and December 31, 2015	4.00:1.00

March 31, 2016 through September 30, 2016	3.75:1.00
December 31, 2016 and March 31, 2017	3.50:1.00
Thereafter	3.00:1.00

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As of December 31, 2014, the Company was in compliance with its financial covenants mentioned above under the Credit Agreement and had no outstanding borrowings under the unfunded revolving credit facility. Refer to Contractual Obligations under Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" showing future payments of term loans as well as payments of associated interest.

Debt Redemption:

In December 2014, the Company redeemed the $750 million aggregate principal amount of the 2018 Senior Notes. The redemption resulted in a pre-tax net loss on extinguishment of debt of $131.7 million for the three months ended December 31, 2014 after an offset of a $1.2 million gain upon the termination of the non-designated forward contract entered by the Company in November 2014. The objective of entering into the non-designated forward contract was to lock the treasury rate used to determine the redemption amount of the 2018 Senior Notes. The notional amount of the non-designated forward contract was $750 million. Refer to Note 14, "Derivative Instruments and Hedging Activities."

NOTE 8 – EQUITY AND LONG-TERM INCENTIVE COMPENSATION PLANS

Equity Incentive Program

As of December 31, 2014, the Company had two plans under which the Company was able to issue equity incentive awards, such as restricted stock units and stock options, to its employees, consultants and members of its Board of Directors: the 2004 Equity Incentive Plan (the "2004 Plan") and the 1998 Director Plan (the "Outside Director Plan").

2004 Plan:

The 2004 Plan provides for the grant of options to purchase shares of the Company's common stock, stock appreciation rights, restricted stock units, performance shares, performance units and deferred stock units to the Company's employees, consultants and members of its Board of Directors. As of December 31, 2014, 6.0 million shares were available for issuance under the 2004 Plan.

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

In addition, in November 2013, the Company's stockholders also approved amendments to the 2004 Plan that included, among other things, giving the plan administrator the ability to grant "dividend equivalent" rights in connection with awards of restricted stock units, performance shares, performance units and deferred stock units before they are fully vested. It allows the plan administrator, at its discretion, to grant a right to receive dividends on the aforementioned awards which may be settled in cash or Company stock at the discretion of the plan administrator subject to meeting the vesting requirement of the underlying awards.

Outside Director Plan

The Outside Director Plan only permits the issuance of stock options to the non-employee members of the Board of Directors. As of December 31, 2014, 1.7 million shares were available for grant under the Outside Director Plan.

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Equity Incentive Plans - General Information

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

(In thousands)	Available For Grant
Balances as of June 30, 2014	8,804
Restricted stock units granted[1][3]	(1,183)
Restricted stock units canceled[1]	77
Options granted/canceled/expired/forfeited	10
Plan shares expired[2]	(10)
Balances as of December 31, 2014[4]	7,698

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(1) The number of restricted stock units provided in this row reflects the application of the award multiplier as described above (1.8x or 2.0x depending on the grant date of the applicable award).

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

(3) Includes restricted stock units granted to senior management during the six months ended December 31, 2014 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2014, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units granted during the six months ended December 31, 2014, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum levels and all applicable service-based criteria are fully satisfied (i.e., 0.6 million shares for the six months ended December 31, 2014 after the application of 2.0x multiplier described above). The Company has granted only restricted stock units under its equity incentive program since October 2007, except the number of shares subject to outstanding options under the 2004 Plan were adjusted during the three months ended December 31, 2014 due to a proportionate and equitable adjustment under the 2004 Plan provisions as discussed below. For the preceding several years until October 31, 2007, stock options were granted at the market price of the Company's common stock on the date of grant generally with vesting period term ranging from one to five years. Restricted stock units may be granted with varying criteria such as service-based and/or performance-based vesting.

(4) During the three months ended December 31, 2014, the Company adjusted the number of shares subject to outstanding options under the 2004 Plan by an aggregate of 4,245 shares pursuant to a proportionate and equitable adjustment for the effect of the special cash dividend, as required by the 2004 Plan. The total number of outstanding options under the 2004 Plan as well as the associated exercise prices were adjusted to ensure the aggregate intrinsic value remained the same after considering the effect of the special cash dividend. As the adjustment was required by the 2004 Plan, the adjustment to the outstanding awards did not result in any incremental compensation expense due to modification of such awards, under the authoritative guidance. Additionally, the adjustment did not have an impact on the shares available for future issuance under the 2004 Plan.

The fair value of stock-based awards is measured at the grant date and is recognized as an expense over the employee's requisite service period. The fair value for purchase rights under the Company's Employee Stock Purchase Plan is determined using a Black-Scholes valuation model and for restricted stock units granted without "dividend equivalent" rights using the closing price of the Company's common stock on the grant date, adjusted to exclude the present value of dividends which are not accrued on those restricted stock units. In November 2013, the Company's stockholders approved amendments to the 2004 Plan that included, among other things, giving the plan administrator the ability to

grant “dividend equivalent” rights in connection with awards of restricted stock units, performance shares, performance units and deferred stock units before they are fully vested as discussed above. The fair value for restricted stock units granted with “dividend equivalent” rights is determined using the closing price of the Company’s common stock on the grant date. As of December 31, 2014, the Company accrued $43.0 million of dividends payable, substantially all of which is related to the special cash dividend for the unvested restricted stock units outstanding as of the dividend record date as well as restricted stock units granted with dividend equivalent rights during the six months ended December 31, 2014, which entitle the holders of such equity awards to the same dividend value per share as holders of common stock subject to meeting the vesting requirements of the underlying equity awards.

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2014	2013	2014	2013
Stock-based compensation expense by:				
Costs of revenues	$1,963	$2,321	$4,200	$5,498
Engineering, research and development	3,335	3,877	7,075	9,285
Selling, general and administrative	9,550	8,672	19,056	19,306
Total stock-based compensation expense	$14,848	$14,870	$30,331	$34,089

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

(In thousands)	As of December 31, 2014	As of June 30, 2014
Inventory	$3,389	$8,278

Stock Options

The following table summarizes the activity and weighted-average exercise price for stock options under all plans during the six months ended December 31, 2014:

Stock Options	Shares (In thousands)	Weighted-Average Exercise Price
Outstanding stock options as of June 30, 2014	141	$ 40.70
Granted	4	$ 32.11
Exercised	(113)	$ 40.67
Canceled/expired/forfeited	(10)	$ 40.07
Outstanding stock options as of December 31, 2014 (all outstanding and all vested and exercisable)	22	$ 32.13

The Company has not issued any stock options since October 2007. However, during the three months ended December 31, 2014, the Company adjusted the number of shares subject to outstanding options under the 2004 Plan by an aggregate of 4,245 shares pursuant to a proportionate and equitable adjustment for the effect of the special cash dividend, as required by the 2004 Plan. The total number of outstanding options under the 2004 Plan as well as the associated exercise prices were adjusted to ensure the aggregate intrinsic value remained the same after considering the effect of the special cash dividend. As the adjustment was required by the 2004 Plan, the adjustment to the outstanding awards did not result in any incremental compensation expense due to modification of such awards, under the authoritative guidance. Additionally, the adjustment did not have an impact on the shares available for future issuance under the 2004 Plan. As of December 31, 2014, the Company had no unrecognized stock-based compensation balance related to outstanding stock options. The weighted-average remaining contractual term for total options outstanding under all plans all of which were vested and exercisable as of December 31, 2014 was 0.3 years. The aggregate intrinsic value for total options outstanding under all plans (all of which were vested and exercisable as of December 31, 2014) was $0.8 million.

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2014	2013	2014	2013
Total intrinsic value of options exercised	$441	$3,431	$3,919	$11,314
Total cash received from employees and non-employee Board members as a result of stock option exercises	$540	$15,684	$5,217	$56,731
Tax benefits realized by the Company in connection with these exercises	$152	$1,061	$1,769	$3,678

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

Restricted Stock Units

The following table shows the applicable number of restricted stock units and weighted-average grant date fair value for restricted stock units granted, vested and released, withheld for taxes, and forfeited during the six months ended December 31, 2014 and restricted stock units outstanding as of December 31, 2014 and June 30, 2014:

Restricted Stock Units	Shares (In thousands) [1]	Weighted-Average Grant Date Fair Value
Outstanding restricted stock units as of June 30, 2014	3,356	$ 38.95
Granted[2]	591	$ 74.56
Vested and released	(696)	$ 31.84
Withheld for taxes	(366)	$ 31.84
Forfeited	(42)	$ 33.16
Outstanding restricted stock units as of December 31, 2014	2,843	$ 49.10

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

(2) Includes restricted stock units granted to senior management during the six months ended December 31, 2014 with performance-based vesting criteria (in addition to service-based vesting criteria for any of such restricted stock units that are deemed to have been earned). As of December 31, 2014, it had not yet been determined the extent to which (if at all) the performance-based vesting criteria of such restricted stock units had been satisfied. Therefore, this line item includes all such performance-based restricted stock units, reported at the maximum possible number of shares that may ultimately be issuable under such restricted stock units if all applicable performance-based criteria are achieved at their maximum and all applicable service-based criteria are fully satisfied (i.e., 0.3 million shares during the six months ended December 31, 2014).

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

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands, except for weighted-average grant date fair value)	2014	2013	2014	2013
Weighted-average grant date fair value per unit	$81.28	$62.85	$74.56	$53.27
Tax benefits realized by the Company in connection with vested and released restricted stock units	$1,018	$1,485	$24,319	$42,091

As of December 31, 2014, the unrecognized stock-based compensation expense balance related to restricted stock units was $93.7 million, excluding the impact of estimated forfeitures, and will be recognized over a weighted-average remaining contractual term and an estimated weighted-average amortization period of 1.4 years. The intrinsic value of outstanding restricted stock units as of December 31, 2014 was $199.9 million.

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Cash-Based Long-Term Incentive Compensation

Starting in the fiscal year ended June 30, 2013, the Company adopted a cash-based long-term incentive (“Cash LTI”) program for many of its employees as part of the Company’s employee compensation program. During the six months ended December 31, 2014, the Company approved Cash LTI awards of $65.7 million under the Company’s Cash Long-Term Incentive Plan (“Cash LTI Plan”). Cash LTI awards issued to employees under the Cash LTI Plan will vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date. Executives and non-employee Board members are not participating in this program. During the three months ended December 31, 2014 and 2013, the Company recognized $10.7 million and $7.3 million, respectively, in compensation expense under the Cash LTI Plan. During the six months ended December 31, 2014 and 2013, the Company recognized $18.5 million and $11.4 million, respectively, in compensation expense under the Cash LTI Plan. As of December 31, 2014, the unrecognized compensation balance (excluding the impact of estimated forfeitures) related to the Cash LTI Plan was $125.8 million.

Employee Stock Purchase Plan

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

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

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

	Three months ended December 31,		Six months ended December 31,	
	2014	2013	2014	2013
Stock purchase plan:				
Expected stock price volatility	23.5 %	29.1 %	23.5 %	29.1 %
Risk-free interest rate	0.1 %	0.1 %	0.1 %	0.1 %
Dividend yield	2.7 %	2.9 %	2.7 %	2.9 %
Expected life (in years)	0.5	0.5	0.5	0.5

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

(In thousands, except for weighted-average fair value per share)	Three months ended December 31,		Six months ended December 31,	
	2014	2013	2014	2013
Total cash received from employees for the issuance of shares under the ESPP	$24,186	$22,035	$24,186	$22,035
Number of shares purchased by employees through the ESPP	405	469	405	469
Tax benefits realized by the Company in connection with the disqualifying dispositions of shares purchased under the ESPP	$106	$87	$1,189	$873
Weighted-average fair value per share based on Black-Scholes model	$14.66	$11.80	$14.66	$11.80

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The ESPP shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2.0 million shares or the number of shares which KLA-Tencor estimates will be required to be issued under the ESPP during the forthcoming fiscal year. In August 2014, the Company added 2.0 million additional shares to the ESPP pursuant to the plan's share replenishment provision with respect to the fiscal year ending June 30, 2015. As of December 31, 2014, a total of 2.5 million shares were reserved and available for issuance under the ESPP.

Quarterly cash dividends

On November 6, 2014, the Company's Board of Directors declared a regular quarterly cash dividend of $0.50 per share on the outstanding shares of the Company's common stock, which was paid on December 1, 2014 to the stockholders of record as of the close of business on November 17, 2014. The total amount of regular quarterly cash dividends paid by the Company during the three months ended December 31, 2014 and 2013 was $82.3 million and $75.0 million, respectively. The total amount of regular quarterly cash dividends paid by the Company during the six months ended December 31, 2014 and 2013 was $164.7 million and $149.6 million, respectively. The amount of accrued dividends for quarterly cash dividends for unvested restricted stock units with dividend equivalent rights was immaterial as of December 31, 2014.

Special cash dividend

On November 19, 2014, the Company's Board of Directors declared a special cash dividend of $16.50 per share, which was paid on December 9, 2014 to the stockholders of record as of the close of business on December 1, 2014. Additionally, in connection with the special cash dividend, the Company's Board of Directors and the Compensation Committee of the Board of Directors approved a proportionate and equitable adjustment to outstanding equity awards (restricted stock units and stock options), as required under the 2004 Plan, subject to the vesting requirements of the underlying awards. As the adjustment was required by the 2004 Plan, the adjustment to the outstanding awards did not result in any incremental compensation expense due to modification of such awards, under the authoritative guidance. Under the authoritative guidance, the dividend when declared is recognized as a reduction of retained earnings, to the extent available, with any excess recognized as a reduction of additional paid-in-capital. The special cash dividend reduced the retained earnings by $2.1 billion as of the special cash dividend declaration date, reducing the retained earnings amount to zero and the excess amount of the special cash dividend of $646.5 million was charged against additional paid-in capital. The declaration and payment of the special cash dividend are part of the Company's leveraged recapitalization transaction under which the special cash dividend was financed through a combination of existing cash and proceeds from the debt financing disclosed in Note 7, "Debt" that was completed during the three months ended December 31, 2014. The total amount of the special cash dividend accrued by the Company during the three and six months ended December 31, 2014 was approximately $2.76 billion, substantially all of which was paid out during the three months ended December 31, 2014, except for the aggregate special cash dividend of $43.0 million that was accrued for the unvested restricted stock units noted above. The Company did not declare any special cash dividend in the three and six months ended December 31, 2013. For additional details on accrued dividends, refer to Management's Discussion and Analysis of Financial Condition and Results of Operations, "Liquidity and Capital Resources," in Part I, Item 2.

NOTE 9 – STOCK REPURCHASE PROGRAM

The Company's Board of Directors has authorized a program for the Company to repurchase shares of the Company's common stock. The intent of this program is to offset the dilution from KLA-Tencor's equity incentive plans and employee stock purchase plan, as well as to return excess cash to the Company's stockholders. Subject to market conditions, applicable legal requirements and other factors, the repurchases will be made from time to time in the open market in compliance with applicable securities laws, including the Securities Exchange Act of 1934 and the rules promulgated thereunder, such as Rule 10b-18. On July 8, 2014, the Company's Board of Directors authorized KLA-Tencor to repurchase up to 13 million additional shares of the Company's common stock. On October 23, 2014, as part of the leveraged recapitalization transaction announcement, the Board of Directors authorized an increase to the existing stock repurchase program of 3.6 million additional shares of the Company's common stock. As of December 31, 2014, an aggregate of approximately 14.8 million shares were available for repurchase under the Company's repurchase program.

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2014	2013	2014	2013
Number of shares of common stock repurchased	2,120	959	3,862	1,997
Total cost of repurchases	$148,266	$60,302	$278,949	$120,806

As of December 31, 2014, the Company had repurchased 176,123 shares for $12.6 million, which repurchases had not settled prior to December 31, 2014 and were recorded as a component of other current liabilities.

NOTE 10 – NET INCOME PER SHARE

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

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

(In thousands, except per share amounts)	Three months ended December 31,		Six months ended December 31,	
	2014	2013	2014	2013
Numerator:				
Net income	$20,268	$139,246	$92,501	$250,443
Denominator:				
Weighted-average shares-basic, excluding unvested restricted stock units	164,036	166,414	164,440	166,150
Effect of dilutive options and restricted stock units	1,281	1,792	1,510	2,328
Weighted-average shares-diluted	165,317	168,206	165,950	168,478
Basic net income per share	$0.12	$0.84	$0.56	$1.51
Diluted net income per share	$0.12	$0.83	$0.56	$1.49
Anti-dilutive securities excluded from the computation of diluted net income per share	32	—	13	—

NOTE 11 – INCOME TAXES

The following table provides details of income taxes:

	Three months ended December 31,		Six months ended December 31,	
(Dollar amounts in thousands)	2014	2013	2014	2013
Income (loss) before income taxes	$(6,268)	$176,745	$92,739	$316,609
Provision (benefit from) for income taxes	$(26,536)	$37,499	$238	$66,166
Effective tax rate	423.4 %	21.2 %	0.3 %	20.9 %

The Company's estimated annual effective tax rate for the fiscal year ending June 30, 2015 is forecasted to be approximately 19% after considering the tax benefit on the pre-tax net loss of $131.7 million due to the redemption of the 2018 Senior Notes. The Company estimates an effective tax rate of approximately 22% for the remainder of the fiscal year ending June 30, 2015.

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The difference between the actual tax benefit during the three months ended December 31, 2014 and the estimated annual tax expense is primarily due to the impact of the following items:

- Tax expense was decreased by $45.8 million during the three months ended December 31, 2014 related to a pre-tax net loss of $131.7 million due to the redemption of the 2018 Senior Notes; and
- Tax expense was decreased by $10.4 million during the three months ended December 31, 2014 related to the reinstatement of the U.S. federal research credit. On December 19, 2014, the Tax Increase Prevention Act of 2014 reinstated the research credit retroactively to January 1, 2014 through December 31, 2014.

The Company recognized a tax benefit during the three months ended December 31, 2014 compared to a tax expense during three months ended December 31, 2013 primarily due to the impact of the following items:

- Tax expense was decreased by $45.8 million during the three months ended December 31, 2014 related to a pre-tax net loss of $131.7 million due to the redemption of the 2018 Senior Notes; and
- Tax expense was decreased by $8.3 million during the three months ended December 31, 2014 related to the reinstatement of the U.S. federal research credit. On December 19, 2014, the Tax Increase Prevention Act of 2014 reinstated the research credit retroactively to January 1, 2014 through December 31, 2014.

Tax expense as a percentage of income before taxes during the six months ended December 31, 2014 was lower compared to the tax expense as a percentage of income during the six months ended December 31, 2013 primarily due to the impact of the following items:

- Tax expense was decreased by $45.8 million during the six months ended December 31, 2014 related to a pre-tax net loss of $131.7 million due to the redemption of the 2018 Senior Notes;
- Tax expense was decreased by $3.5 million during the six months ended December 31, 2014 related to the reinstatement of the U.S. federal research credit. On December 19, 2014, the Tax Increase Prevention Act of 2014 reinstated the research credit retroactively to January 1, 2014 through December 31, 2014; offset by
- Tax expense was decreased by $4.5 million during the six months ended December 31, 2013 related to a non-taxable increase in the value of the assets held within the Company's Executive Deferred Savings Plan.

In the normal course of business, the Company is subject to examination by tax authorities throughout the world. The Company is subject to U.S. federal income tax examination for all years beginning from the fiscal year ended June 30, 2011. The Company is subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2010. The Company is also subject to examinations in other major foreign jurisdictions, including Singapore, for all years beginning from the fiscal year ended June 30, 2010. It is possible that certain examinations may be concluded in the next twelve months. The Company believes it is possible that it may recognize up to $11.6 million of its existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of examinations with various tax authorities.

NOTE 12 – LITIGATION AND OTHER LEGAL MATTERS

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

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NOTE 13 – COMMITMENTS AND CONTINGENCIES

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

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2014	2013	2014	2013
Receivables sold under factoring agreements	$47,598	$10,412	$73,218	$56,294
Proceeds from sales of LCs	$—	$—	$6,920	$—

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

Facilities. KLA-Tencor leases certain of its facilities under arrangements that are accounted for as operating leases. Rent expense was $2.3 million each for the three months ended December 31, 2014 and 2013. Rent expense was $4.6 million and $4.4 million for the six months ended December 31, 2014 and 2013, respectively.

The following is a schedule of expected operating lease payments:

Fiscal year ending June 30,	Amount (In thousands)
2015 (remaining 6 months)	$4,246
2016	7,482
2017	5,321
2018	3,688
2019	1,781
2020 and thereafter	1,781
Total minimum lease payments	$24,299

Purchase Commitments. KLA-Tencor maintains commitments to purchase inventory from its suppliers as well as goods and services in the ordinary course of business. The Company’s liability under these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecasted time-horizon can vary among different suppliers. The Company’s estimate of its significant purchase commitments is approximately $312.8 million as of December 31, 2014 which are primarily due within the next 12 months. Actual expenditures will vary based upon the volume of the transactions and length of contractual service provided. In addition, the amounts paid under these arrangements may be less in the event that the arrangements are renegotiated or canceled. Certain agreements provide for potential cancellation penalties.

Cash Long-Term Incentive Plan. As of December 31, 2014, the Company had committed $137.8 million for future payment obligations under its Cash LTI Plan. The calculation of compensation expense related to the Cash LTI Plan includes estimated forfeiture rate assumptions. Cash LTI awards issued to employees under the Cash LTI Plan vest in four equal installments, with 25% of the aggregate amount of the Cash LTI award vesting on each yearly anniversary of the grant date over a four-year period. In order to receive payments under a Cash LTI award, participants must remain employed by the Company as of the applicable award vesting date.

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

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2014	2013	2014	2013
Beginning balance	$33,059	$37,314	$37,746	$42,603
Accruals for warranties issued during the period	10,212	15,988	17,191	25,296
Changes in liability related to pre-existing warranties	704	(2,424)	(766)	(5,808)
Settlements made during the period	(9,565)	(9,279)	(19,761)	(20,492)
Ending balance	$34,410	$41,599	$34,410	$41,599

The Company maintains guarantee arrangements available through various financial institutions for up to $25.7 million, of which $23.0 million had been issued as of December 31, 2014, primarily to fund guarantees to customs authorities for value-added tax ("VAT") and other operating requirements of the Company's subsidiaries in Europe and Asia.

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

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

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

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

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

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NOTE 14 – DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

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

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

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

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

In October 2014, in anticipation of the issuance of the Senior Notes, the Company entered into a series of forward contracts ("Rate Lock Agreements") to lock the benchmark rate on a portion of the Senior Notes. The objective of the Rate Lock Agreements was to hedge the risk associated with the variability in interest rates due to the changes in the benchmark rate leading up to the closing of the intended financing, on the notional amount being hedged. The Rate Lock Agreements had a notional amount of $1 billion in aggregate, with contract maturity dates in the second quarter of the fiscal year ending June 30, 2015. Each forward contract was to be closed on the earlier of the completion date of pricing of the portion of the intended debt being hedged or the expiration date. The Company designated each of the Rate Lock Agreements as a qualifying hedging instrument to be accounted for as a cash flow hedge, under which the effective portion of the gain or loss on the close out of the Rate Lock Agreements was initially recognized in accumulated other comprehensive income (loss) as a reduction of total stockholders' equity and subsequently amortized into earnings as a component of interest expense over the term of the underlying debt. The ineffective portion, if any, was recognized in earnings immediately. The Rate Lock Agreements were terminated on the date of pricing of the $1.25 billion of 4.650% Senior Notes due in 2024 and the Company recorded the fair value of a $7.5 million receivable as a gain within accumulated other comprehensive income (loss). For the three months and six months ended December 31, 2014, the Company recognized $0.1 million for the amortization of the gain recognized in accumulated other comprehensive income (loss), which amount reduced the interest expense. The Company did not record any ineffectiveness for the three months and six months ended December 31, 2014. The cash proceeds of $7.5 million from the settlement of the Rate Lock Agreements were included in the cash flows from operating activities in the condensed consolidated statements of cash flows because the designated hedged item was classified as interest expense in the cash flows from operating activities in the condensed consolidated statements of cash flows.

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In addition, in November 2014, the Company entered into a non-designated forward contract to lock the treasury rate used to determine the redemption amount of the 2018 Senior Notes. The objective of the forward contract was to hedge the risk associated with the variability of the redemption amount due to changes in interest rates through the redemption of the existing 2018 Senior Notes. The forward contract had a notional amount of $750 million. The forward contract was terminated in December 2014 and the resulting fair value of $1.2 million receivable was included in the loss on extinguishment of debt and other, net line in the condensed consolidated statements of operations, partially offsetting the loss on redemption of the debt. The cash proceeds from the forward contract were included in the cash flows from financing activities in the condensed consolidated statements of cash flows, partially offsetting the cash outflows for the redemption of the 2018 Senior Notes.

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

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

		Three months ended December 31,		Six months ended December 31,	
(In thousands)	Location in Financial Statements	2014	2013	2014	2013
Derivatives Designated as Hedging Instruments					
Gains (losses) in accumulated OCI on derivatives (effective portion)	Accumulated OCI	$11,924	$3,864	$13,957	$3,573
Gains reclassified from accumulated OCI into income (effective portion):	Revenues	$1,933	$(128)	$2,202	$2,322
	Costs of revenues	(475)	150	(516)	216
	Interest expense	126	—	126	—
	Net gains reclassified from accumulated OCI into income (effective portion)	$1,584	$22	$1,812	$2,538
Gains (losses) recognized in income on derivatives (ineffective portion and amount excluded from effectiveness testing)	Interest income and other, net	$77	$44	$120	$26
Derivatives Not Designated as Hedging Instruments					
Gains recognized in income	Interest income and other, net	$7,187	$2,722	$11,112	$5,348
	Loss on extinguishment of debt and other, net	$1,180	$—	$1,180	$—

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

(In thousands)	As of December 31, 2014	As of June 30, 2014
Cash flow hedge contracts		
Purchase	$24,672	$6,066
Sell	$50,058	$33,999
Other foreign currency hedge contracts		
Purchase	$106,993	$108,901
Sell	$139,157	$106,322

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

	Asset Derivatives			Liability Derivatives		
	Balance Sheet Location	As of December 31, 2014	As of June 30, 2014	Balance Sheet Location	As of December 31, 2014	As of June 30, 2014
(In thousands)		Fair Value			Fair Value	
Derivatives designated as hedging instruments						
Foreign exchange contracts	Other current assets	$3,817	$120	Other current liabilities	$460	$100
Total derivatives designated as hedging instruments		$3,817	$120		$460	$100
Derivatives not designated as hedging instruments						
Foreign exchange contracts	Other current assets	$7,767	$546	Other current liabilities	$1,356	$798
Total derivatives not designated as hedging instruments		$7,767	$546		$1,356	$798
Total derivatives		$11,584	$666		$1,816	$898

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

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	2014	2013	2014	2013
Beginning balance	$1,785	$(323)	$(20)	$2,484
Amount reclassified to income	(1,584)	(22)	(1,812)	(2,538)
Net change	11,924	3,864	13,957	3,573
Ending balance	$12,125	$3,519	$12,125	$3,519

Offsetting of Derivative Assets and Liabilities

KLA-Tencor presents derivatives at gross fair values in the Condensed Consolidated Balance Sheets. The Company has entered into arrangements with each of its counterparties, which reduce credit risk by permitting net settlement of transactions with the same counterparty under certain conditions. As of December 31, 2014 and June 30, 2014, information related to the offsetting arrangements was as follows (in thousands):

As of December 31, 2014				Gross Amounts of Derivatives Not Offset in the Condensed Consolidated Balance Sheets		
Description	Gross Amounts of Derivatives	Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets	Net Amount of Derivatives Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	Net Amount
Derivatives - Assets	$11,584	$—	$11,584	$(1,816)	$—	$9,768
Derivatives - Liabilities	$(1,816)	$—	$(1,816)	$1,816	$—	$—

As of June 30, 2014				Gross Amounts of Derivatives Not Offset in		

				the Condensed Consolidated Balance Sheets		
Description	Gross Amounts of Derivatives	Gross Amounts of Derivatives Offset in the Condensed Consolidated Balance Sheets	Net Amount of Derivatives Presented in the Condensed Consolidated Balance Sheets	Financial Instruments	Cash Collateral Received	Net Amount
Derivatives - Assets	$666	$—	$666	$(423)	$—	$243
Derivatives - Liabilities	$(898)	$—	$(898)	$423		