PRUDENTIAL PLC
Form 6-K
August 12, 2010

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 6-K

REPORT OF FOREIGN PRIVATE ISSUER

**Pursuant to Rule 13a-16 or 15d-16 of
the Securities Exchange Act of 1934**

For the month of August, 2010

PRUDENTIAL PUBLIC LIMITED COMPANY

(Translation of registrant's name into English)

**LAURENCE POUNTNEY HILL,
LONDON, EC4R 0HH, ENGLAND**
(Address of principal executive offices)

Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F X   Form 40-F

Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes   No X

If "Yes" is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-

Enclosures: Prudential PLC Half Yearly Report 2010 Part 6

IFRS Disclosure

PRUDENTIAL PLC HALF YEAR 2010 RESULTS

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BASIS RESULTS

CONDENSED CONSOLIDATED INCOME STATEMENT

	Half year 2010 £m	Half year 2009 £m	Full year 2009 £m
Earned premiums, net of reinsurance	**11,256**	9,518	19,976
Investment return (notes G and I)	**5,027**	3,625	26,889
Other income	**754**	574	1,234
Total revenue, net of reinsurance	**17,037**	13,717	48,099
Benefits and claims and movement in unallocated surplus of with-profits funds,			
net of reinsurance (note J)	**(13,650)**	(10,783)	(41,195)
Acquisition costs and other expenditure (notes G and H)	**(2,654)**	(2,446)	(4,572)
Finance costs: interest on core structural borrowings of shareholder-financed operations	**(129)**	(84)	(209)
Loss on sale of Taiwan agency business (note K)	**-**	(559)	(559)
Total charges, net of reinsurance	**(16,433)**	(13,872)	(46,535)
Profit (loss) before tax *(being tax attributable to shareholders' and policyholders' returns)**	**604**	(155)	1,564
Tax (charge) credit attributable to policyholders' returns	**(11)**	79	(818)
Profit (loss) before tax attributable to shareholders (note C)	**593**	(76)	746
Tax (charge) credit (note L)	**(160)**	(103)	(873)
Less: tax attributable to policyholders' returns	**11**	(79)	818
Tax (charge) credit attributable to shareholders' returns (note L)	**(149)**	(182)	(55)

Profit (loss) from continuing operations after tax	**444**	(258)	691
Discontinued operations (net of tax)**	**-**	-	(14)
Profit (loss) for the period	**444**	(258)	677
Attributable to:			
Equity holders of the Company	**442**	(254)	676
Non-controlling interests	**2**	(4)	1
Profit (loss) for the period	**444**	(258)	677

Earnings per share (in pence)

	Half year 2010	**Half year 2009**	**Full year 2009**
Basic:			
Based on profit (loss) from continuing operations attributable to the equity holders of the Company (note M)	**17.5p**	(10.2)p	27.6p
Based on loss from discontinued operations attributable to the equity holders of the Company	**-**	-	(0.6)p
	17.5p	(10.2)p	27.0p
Diluted:			
Based on profit (loss) from continuing operations attributable to the equity holders of the Company (note M)	**17.5p**	(10.2)p	27.6p
Based on loss from discontinued operations attributable to the equity holders of the Company	**-**	-	(0.6)p
	17.5p	(10.2)p	27.0p

* This measure is the formal profit (loss) before tax measure under IFRS but it is not the result attributable to shareholders.

**The full year 2009 charge which was net of £nil tax, reflected completion adjustments for a previously disposed business.

<u>INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BASIS RESULTS</u>

CONDENSED CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Half year 2010	Half year 2009	Full year 2009

	£m	£m	£m
Profit (loss) for the period	**444**	(258)	677
Other comprehensive income (loss):			
Exchange movements on foreign operations and net investment hedges:			
Exchange movements arising during the period	**315**	(292)	(206)
Related tax	**(8)**	(6)	11
	307	(298)	(195)
Available-for-sale securities:			
Unrealised valuation movements on securities of US insurance operations classified as available-for-sale:			
Unrealised holding gains arising during the period	**1,123**	662	2,249
Add back net losses included in the income statement on disposal and impairment	**21**	146	420
Total (note W)	**1,144**	808	2,669
Related change in amortisation of deferred income and acquisition costs (note S)	**(510)**	(235)	(1,069)
Related tax	**(215)**	(150)	(557)
	419	423	1,043
Other comprehensive income for the period, net of related tax	**726**	125	848
Total comprehensive income (loss) for the period	**1,170**	(133)	1,525

Attributable to:			
Equity holders of the Company	**1,168**	(129)	1,524
Non-controlling interests	**2**	(4)	1
Total comprehensive income (loss) for the period	**1,170**	(133)	1,525

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BASIS RESULTS

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Period ended 30 Jun 2010							
	Share capital	Share premium	Retained earnings	Translation reserve	Available-for-sale securities reserve	**Shareholders' equity**	**Non-controlling interests**	**Total equity**
	£m	£m	£m	£m	£m	**£m**	**£m**	**£m**

Reserves								
Total comprehensive income for the period	**-**	**-**	**442**	**307**	**419**	**1,168**	**2**	**1,170**
Dividends	**-**	**-**	**(344)**	**-**	**-**	**(344)**	**-**	**(344)**
Reserve movements in respect of share-based payments	**-**	**-**	**15**	**-**	**-**	**15**	**-**	**15**
Change in non-controlling interests arising principally from purchase and sale of property partnerships of the PAC with-profits fund and other consolidated investment funds	**-**	**-**	**-**	**-**	**-**	**-**	**3**	**3**
Share capital and share premium								
New share capital subscribed	**-**	**39**	**-**	**-**	**-**	**39**	**-**	**39**
Transfer to retained earnings in respect of shares issued in lieu of cash dividends	**-**	**(26)**	**26**	**-**	**-**	**-**	**-**	**-**
Treasury shares								
Movement in own shares in respect of share-based payment plans	**-**	**-**	**8**	**-**	**-**	**8**	**-**	**8**
Movement in Prudential plc shares purchased by unit trusts consolidated under IFRS	**-**	**-**	**4**	**-**	**-**	**4**	**-**	**4**
Net increase in equity	**-**	**13**	**151**	**307**	**419**	**890**	**5**	**895**
At beginning of period	**127**	**1,843**	**3,964**	**203**	**134**	**6,271**	**32**	**6,303**
At end of period	**127**	**1,856**	**4,115**	**510**	**553**	**7,161**	**37**	**7,198**

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

	Period ended 30 Jun 2009							
	Share capital £m	**Share premium £m**	**Retained earnings £m**	**Translation reserve £m**	**Available-for-sale securities reserve £m**	**Shareholders' equity £m**	**Non-controlling interests £m**	**Total equity £m**
Reserves								
Total comprehensive income (loss) for the period	-	-	(254)	(298)	423	(129)	(4)	(133)
Dividends	-	-	(322)	-	-	(322)	-	(322)
Reserve movements in respect of share-based payments	-	-	18	-	-	18	-	18
Change in non-controlling interests arising principally from purchase and sale of property partnerships of the PAC with-profits fund and other consolidated investment funds	-	-	-	-	-	-	(22)	(22)
Share capital and share premium								
New share capital subscribed	1	95	-	-	-	96	-	96
Transfer to retained earnings in respect of shares issued in lieu of cash dividends	-	(95)	95	-	-	-	-	-
Treasury shares								

Movement in own shares in respect of share-based payment plans	-	-	7	-	-	7	-	7
Movement in Prudential plc shares purchased by unit trusts consolidated under IFRS	-	-	(8)	-	-	(8)	-	(8)
Net increase (decrease) in equity	1	-	(464)	(298)	423	(338)	(26)	(364)
At beginning of period	125	1,840	3,604	398	(909)	5,058	55	5,113
At end of period	126	1,840	3,140	100	(486)	4,720	29	4,749

CONDENSED CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

					Year ended 31 Dec 2009			
	Share capital £m	Share premium £m	Retained earnings £m	Translation reserve £m	Available-for-sale securities reserve £m	Shareholders' equity £m	Non-controlling interests £m	Total equity £m
Reserves								
Total comprehensive income (loss) for the year	-	-	676	(195)	1,043	1,524	1	1,525
Dividends	-	-	(481)	-	-	(481)	-	(481)
Reserve movements in respect of share-based payments	-	-	29	-	-	29	-	29
Change in non-controlling interests arising principally from purchase and sale of property partnerships of the PAC with-profits fund and other consolidated investment funds	-	-	-	-	-	-	(24)	(24)

Share capital and share premium								
New share capital subscribed	2	139	-	-	-	141	-	141
Transfer to retained earnings in respect of shares issued in lieu of cash dividends	-	(136)	136	-	-	-	-	-
Treasury shares								
Movement in own shares in respect of share-based payment plans	-	-	3	-	-	3	-	3
Movement in Prudential plc shares purchased by unit trusts consolidated under IFRS	-	-	(3)	-	-	(3)	-	(3)
Net increase (decrease) in equity	2	3	360	(195)	1,043	1,213	(23)	1,190
At beginning of year	125	1,840	3,604	398	(909)	5,058	55	5,113
At end of year	127	1,843	3,964	203	134	6,271	32	6,303

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INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BASIS RESULTS

CONDENSED CONSOLIDATED STATEMENT OF FINANCIAL POSITION

	30 Jun 2010	30 Jun 2009	31 Dec 2009
	£m	£m	£m
Assets			
Intangible assets attributable to shareholders:			
Goodwill (note R)	**1,465**	1,310	1,310
Deferred acquisition costs and other intangible assets (note S)	**4,028**	4,045	4,049
	5,493	5,355	5,359
Intangible assets attributable to with-profits funds:			
In respect of acquired subsidiaries for venture fund and other investment purposes	**124**	159	124

Deferred acquisition costs and other intangible assets	**110**	111	106
	234	270	230
Total	**5,727**	5,625	5,589
Other non-investment and non-cash assets:			
Property, plant and equipment	**382**	428	367
Reinsurers' share of insurance contract liabilities	**1,369**	1,114	1,187
Deferred tax assets (note L)	**2,691**	2,149	2,708
Current tax recoverable	**575**	389	636
Accrued investment income	**2,559**	2,366	2,473
Other debtors	**1,467**	1,311	762
Total	**9,043**	7,757	8,133
Investments of long-term business and other operations:			
Investment properties	**11,360**	10,479	10,905
Investments accounted for using the equity method	**9**	6	6
Financial investments:			
Loans (note U)	**9,587**	8,613	8,754
Equity securities and portfolio holdings in unit trusts	**71,775**	56,069	69,354
Debt securities (note V)	**113,334**	89,399	101,751
Other investments	**6,768**	6,085	5,132
Deposits	**9,766**	8,806	12,820
Total	**222,599**	179,457	208,722
Properties held for sale	**3**	5	3
Cash and cash equivalents	**6,040**	6,542	5,307
Total assets (note O)	**243,412**	199,386	227,754

	30 Jun		
		30 Jun	31 Dec
	2010	2009	2009
	£m	£m	£m
Equity and liabilities			
Equity			
Shareholders' equity	**7,161**	4,720	6,271
Non-controlling interests	**37**	29	32
Total equity	**7,198**	4,749	6,303

Liabilities			
Policyholder liabilities and unallocated surplus of with-profits funds			
Contract liabilities (including amounts in respect of contracts classified as investment contracts under IFRS 4)	**198,913**	165,047	186,398
Unallocated surplus of with-profits funds	**10,066**	7,061	10,019
Total (note AA)	**208,979**	172,108	196,417
Core structural borrowings of shareholder-financed operations:			
Subordinated debt	**2,767**	2,198	2,691
Other	**715**	701	703
Total (note X)	**3,482**	2,899	3,394

Other borrowings:			
Operational borrowings attributable to shareholder-financed operations (note Y)	**3,234**	2,855	2,751
Borrowings attributable to with-profits operations (note Y)	**1,313**	1,349	1,284
Other non-insurance liabilities:			
Obligations under funding, securities lending and sale and repurchase agreements	**3,222**	4,218	3,482
Net asset value attributable to unit holders of consolidated unit trusts and similar funds	**2,667**	2,706	3,809
Current tax liabilities	**1,272**	663	1,215
Deferred tax liabilities (note L)	**4,115**	2,651	3,872
Accruals and deferred income	**555**	626	594
Other creditors	**3,246**	1,640	1,612
Provisions	**641**	614	643
Derivative liabilities	**2,033**	1,379	1,501
Other liabilities	**1,455**	929	877
Total	**19,206**	15,426	17,605
Total liabilities	**236,214**	194,637	221,451
Total equity and liabilities (note O)	**243,412**	199,386	227,754

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BASIS RESULTS

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS

Full year

	Half year 2010 £m	Half year 2009 £m	2009 £m
Cash flows from operating activities			
Profit (loss) before tax *(being tax attributable to shareholders' and policyholders' returns)* (note (i))	**604**	(155)	1,564
Loss before tax from discontinued operations	**-**	-	(14)
Total profit (loss) before tax	**604**	(155)	1,550
Changes in operating assets and liabilities (note (ii))	**516**	1,068	(2,139)
Other items (note (ii))	**167**	633	697
Net cash flows from operating activities	**1,287**	1,546	108
Cash flows from investing activities			
Net cash flows from purchases and disposals of property, plant and equipment	**(22)**	(22)	(37)
Completion adjustment for previously disposed business	**-**	-	(20)
Disposal of Taiwan agency business (notes (iii) and K)	**-**	(436)	(497)
Acquisition of UOB Life, net of cash balance (note (iv))	**(101)**	-	-
Net cash flows from investing activities	**(123)**	(458)	(554)
Cash flows from financing activities			
Structural borrowings of the Group:			
Shareholder-financed operations (notes (v) and X):			
Issue of subordinated debt, net of costs	**-**	379	822
Redemption of senior debt	**-**	(249)	(249)
Interest paid	**(131)**	(98)	(207)
With-profits operations (notes (vi) and Y):			
Interest paid	**(4)**	(9)	(9)
Equity capital (note (vii)):			
Issues of ordinary share capital	**13**	-	3
Dividends paid	**(318)**	(226)	(344)
Net cash flows from financing activities	**(440)**	(203)	16
Net increase (decrease) in cash and cash equivalents	**724**	885	(430)
Cash and cash equivalents at beginning of period	**5,307**	5,955	5,955
Effect of exchange rate changes on cash and cash equivalents	**9**	(298)	(218)
Cash and cash equivalents at end of period	**6,040**	6,542	5,307

Notes

(i) This measure is the formal profit (loss) before tax measure under IFRS but it is not the result attributable to shareholders.

(ii) The adjusting items to profit (loss) before tax include changes in operating assets and liabilities, and other items including adjustments in respect of non-cash items, together with operational interest receipts and payments, dividend receipts, and tax paid. The figure of £633 million for other items at half year 2009 (full year 2009: £697 million) includes £559 million (full year 2009: £559 million) for the loss on disposal of Taiwan agency business. The elements of the adjusting items within changes in operating assets and liabilities are as follows:

	Half year	Half year	Full year
	2010	2009	2009
	£m	£m	£m
Other non-investment and non-cash assets	**(997)**	227	(384)
Investments	**(5,278)**	(1,076)	(26,388)
Policyholder liabilities (including unallocated surplus)	**6,086**	2,265	24,932
Other liabilities (including operational borrowings)	**705**	(348)	(299)
Changes in operating assets and liabilities	**516**	1,068	(2,139)

(iii) The amount of £436 million for half year 2009 and £497 million for full year 2009 in respect of the disposal of the Taiwan agency business shown above, represents the cash and cash equivalents of £388 million held by Taiwan agency business transferred on disposal and restructuring costs paid in cash in the period (half year 2009: £3 million; full year 2009: £ 64 million). In addition, the cashflow for the disposal includes a £45 million outflow to purchase a 9.99 per cent stake in China Life.

(iv) On 6 January 2010, the Group announced the acquisition from United Overseas Bank Limited (UOB) of its 100 per cent interest in UOB Life Assurance Limited in Singapore (see note Q). The amount of £101 million net cash outflow in respect of this acquisition represents consideration which has been paid as at 30 June 2010 of £188 million, acquisition-related costs paid of £2 million, less cash and cash equivalents acquired of £89 million.

(v) Structural borrowings of shareholder-financed operations comprise core debt of the holding company and Jackson surplus notes. Core debt excludes borrowings to support short-term fixed income securities programmes, non-recourse borrowings of investment subsidiaries of shareholder-financed operations and other borrowings of shareholder-financed operations. Cash flows in respect of these borrowings are included within cash flows from operating activities.

(vi) Structural borrowings of with-profits operations relate solely to the £100 million 8.5 per cent undated subordinated guaranteed bonds which contribute to the solvency base of the Scottish Amicable Insurance Fund (SAIF), a ring-fenced sub-fund of the PAC with-profits fund. Cash flows in respect of other borrowings of with-profits funds, which principally relate to consolidated investment funds, are included within cash flows from operating activities.

(vii) Cash movements in respect of equity capital exclude scrip dividends.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) BASIS RESULTS

NOTES ON THE IFRS BASIS RESULTS

A Basis of preparation and audit status

These condensed consolidated interim financial statements for the six months ended 30 June 2010 have been prepared in accordance with IAS 34 "Interim Financial Reporting" as issued by the International Accounting Standards Board (IASB) and as adopted by the European Union (EU). The Group's policy for preparing this interim financial information is to use the accounting policies adopted by the Group in its last consolidated financial statements, as updated by any changes in accounting policies it intends to make in its next consolidated financial statements as a result of new or amended IFRSs that are applicable or available for early adoption for the next annual financial statements and other policy improvements. EU-endorsed IFRSs may differ from IFRSs issued by the IASB if, at any point in time, new or amended IFRSs have not been endorsed by the EU. At 30 June 2010, there were no unendorsed standards effective for the period ended 30 June 2010 affecting the condensed consolidated financial statements, and there were no differences between IFRSs endorsed by the EU and IFRSs issued by the IASB in terms of their application to the Group.

The IFRS basis results for the 2010 and 2009 half years are unaudited. The 2009 full year IFRS basis results have been derived from the 2009 statutory accounts. The auditors have reported on the 2009 statutory accounts which have been delivered to the Registrar of Companies. The auditors' report was (i) unqualified, (ii) did not include a reference to any matters to which the auditors drew attention by way of emphasis without qualifying their report and (iii) did not contain a statement under section 498(2) or (3) of the Companies Act 2006.

B Significant accounting policies

The accounting policies applied by the Group in determining the IFRS basis results in this announcement are the same as those previously applied in the Group's consolidated financial statements for the year ended 31 December 2009, except for the following adoption of new accounting pronouncements in 2010:

Revised IFRS 3, 'Business Combinations' and Amendments to IAS 27, 'Consolidated and Separate Financial Statements'

The Group has applied the revised IFRS 3 and amended IAS 27 from 1 January 2010. The revised IFRS 3 and amended IAS 27 are the outcomes of the second phase of the IASB's and the US Financial Accounting Standards Board's (FASB) joint business combination project. The change in accounting policy as a result of the adoption of these standards has been applied prospectively. No restatement to 2009 comparatives is required. The more significant changes from the revised IFRS 3 include:

- the immediate expensing of acquisition-related costs rather than inclusion in goodwill; and

- recognition and measurement at fair value of contingent consideration at acquisition date with subsequent changes to income.

The amendments to IAS 27 reflect changes to the accounting for non-controlling interests (known as minority interests prior to the amendments). From 1 January 2010, transactions that increase or decrease non-controlling interests without a change of control are accounted as equity transactions and therefore no goodwill is recognised.

The adoption of revised IFRS 3 and amended IAS 27 has resulted in presentational and disclosure changes in the Group's financial statements, and affected the accounting for the acquisition of United Overseas Bank (UOB) Life Assurance Limited in Singapore. The disclosure on this acquisition is provided in note Q. As a result of the adoption of the revised IFRS 3, the Group has expensed the UOB Life acquisition-related costs incurred of £2 million which would otherwise have been included within goodwill.

Other accounting pronouncements adopted in 2010

In addition, the Group has adopted the following accounting pronouncements in 2010 but their adoption has had no material impact on the results and financial position of the Group:

- Improvements to IFRSs (2009)
- Amendments to IFRS 2 - Group cash-settled share-based payment transactions
- Amendments to IAS 39, 'Financial instruments: Recognition and Measurement' - Eligible hedged items

This is not intended to be a complete list of accounting pronouncements effective in 2010 as only those that could have an impact upon the Group's financial statements have been discussed.

C Segment disclosure - income statement

	Half year	**Half year**	**Full year**
	2010	2009	2009
	£m	**£m**	**£m**
Asian operations (note (i))			
Insurance operations (note E (i)):			
Underlying results before exceptional credit	**262**	149	353

Exceptional credit (note E (i)(b))	**-**	63	63
Total Asian insurance operations	**262**	212	416
Development expenses	**(3)**	(5)	(6)
Total Asian insurance operations after development expenses	**259**	207	410
Asian asset management	**36**	21	55
Total Asian operations	**295**	228	465
<u>US operations</u>			
Jackson (US insurance operations) (notes (ii) and E (ii))	**450**	217	459
Broker-dealer and asset management	**15**	2	4
Total US operations	**465**	219	463
<u>UK operations</u>			
UK insurance operations:			
Long-term business (note E (iii))	**307**	303	606
General insurance commission (note (iii))	**23**	27	51
Total UK insurance operations	**330**	330	657
M&G	**143**	102	238
Total UK operations	**473**	432	895
Total segment profit	**1,233**	879	1,823
<u>Other income and expenditure</u>			
Investment return and other income	**5**	13	22
Interest payable on core structural borrowings	**(129)**	(84)	(209)
Corporate expenditure:			
Group Head Office	**(86)**	(74)	(146)
Asia Regional Head Office	**(27)**	(23)	(57)
Charge for share-based payments for Prudential schemes (note (iv))	**(3)**	(11)	(5)
Total	**(240)**	(179)	(395)
Solvency II implementation costs	**(22)**	-	-
Restructuring costs (note (v))	**(3)**	(12)	(23)
Operating profit based on longer-term investment returns (note (i))	**968**	688	1,405
Short-term fluctuations in investment returns on shareholder-backed business (note F)	**26**	(80)	36
Shareholders' share of actuarial and other gains and losses on defined benefit pension schemes (note (vi))	**(24)**	(63)	(74)
Costs of terminated AIA transaction (note G)	**(377)**	-	-
Loss on sale and results for Taiwan agency business (notes (i) and K)	**-**	(621)	(621)
Profit (loss) from continuing operations before tax attributable to shareholders	**593**	(76)	746

Notes

(i) Sale of Taiwan agency business: In order to facilitate comparisons of operating profit based on longer-term investment returns that reflect the Group's retained operations, the results attributable to the Taiwan business for which the sale process was completed in June 2009 are included separately within the supplementary analysis of profit for 2009.

(ii) The US insurance operating profit of £450 million includes £123 million of net equity hedging gains, net of related DAC, (half year 2009: losses of £23 million; full year 2009: losses of £159 million) representing the movement in fair value of free standing derivatives included in operating profit and the movement in the accounting value of Jackson's variable and fixed index annuity products, for which a significant proportion are not fair valued. These net gains / losses are variable in nature.

(iii) UK operations transferred its general insurance business to Churchill in 2002, with general insurance commission representing the net commission receivable net of expenses for Prudential-branded general insurance products as part of this arrangement.

(iv) The charge for share-based payments for Prudential schemes is for the SAYE and Group performance-related schemes.

(v) Restructuring costs of £3 million have been incurred in the UK (half year 2009: £7 million; full year 2009: £16 million) and £nil in central operations (half year 2009: £5 million; full year 2009: £7 million).

(vi) The shareholders' share of actuarial and other gains and losses on defined benefit pension schemes reflects the aggregate of actual less expected returns on scheme assets, experience gains and losses, the effect of changes in assumptions and altered provisions for deficit funding, where relevant.

Determining operating segments and performance measure of operating segments

The Group's operating segments determined in accordance with IFRS 8, are as follows:

Insurance operations

- Asia
- US (Jackson)
- UK

Asset management operations

- M&G
- Asian asset management
- US broker-dealer and asset management (including Curian)

Prudential Capital has been incorporated into the M&G operating segment for the purposes of segment reporting.

The performance measure of operating segments utilised by the Company is IFRS operating profit attributable to shareholders based on longer-term investment returns. This measure excludes the recurrent items of short-term fluctuations in investment returns and the shareholders' share of actuarial and other gains and losses on defined benefit pension schemes and transaction costs arising from business combinations. In addition, for 2010 this measure excluded costs associated with the terminated AIA transaction. For 2009 it excluded the non-recurrent cost of hedging the Group IGD capital surplus included within short-term fluctuations in investment returns. Furthermore, in 2009 the Company sold its Taiwan agency business. In order to facilitate comparisons on a like for like basis, the loss on sale and the results of the Taiwan agency business during the period of ownership are shown separately within the supplementary analysis of profits. Segments results that are reported to the Group Executive Committee (GEC) include items directly attributable to a segment as well as those that can be allocated on a reasonable basis. Unallocated items are mainly in relation to the Group Head Office and Asian Regional Head Office.

For the purposes of measuring operating profit, investment returns on shareholder-financed business are based on the expected longer-term rates of return. This reflects the particular features of long-term insurance business where assets and liabilities are held for the long-term and for which the accounting basis for insurance liabilities under current IFRS is not generally conducive to demonstrating trends in underlying performance for life businesses exclusive of changes in market conditions. In determining profit on this basis, the following key elements are applied to the results of the Group's shareholder-financed operations.

(a)Debt and equity securities

Longer-term investment returns comprise income and longer-term capital returns. For debt securities the longer-term capital returns comprise two elements. These are a risk margin reserve based charge for expected defaults, which is determined by reference to the credit quality of the portfolio, and amortisation of interest-related realised gains and losses to operating results based on longer-term investment returns to the date when sold bonds would have otherwise matured.

The shareholder-backed operation for which the risk margin reserve (RMR) charge is most significant is Jackson National Life. During the second half of 2009, the National Association of Insurance Commissioners (NAIC) changed its approach to the determination of regulatory ratings of residential mortgage-backed securities (RMBS), using an external third party, PIMCO, to develop regulatory ratings detail for more than 20,000 RMBS securities owned by US insurers at end of 2009. Jackson has used the ratings resulting from this model to determine the average annual RMR for half year 2010 and full year 2009 as this is considered more relevant information for the RMBS securities concerned than the previous approach of using ratings by Nationally Recognised Statistical Ratings Organisation (NRSRO). It should be noted that this has no impact on the valuation applied to those securities within the IFRS statement of financial position and there is no impact to IFRS profit before tax or shareholders' equity as a result of this change.

(b)Derivative value movements

Value movements for Jackson's equity-based derivatives and variable and fixed index annuity product embedded derivatives are included in operating profits based on longer-term investment returns. To ensure these reflect longer-term movements the fair value movement included in operating profit is based on longer-term equity volatility levels and long-term average AA corporate bond rate curves, with the movement relating to change in current rates being included in short-term fluctuations. The operating profits based on longer-term investment returns explicitly include:

- The fair value movement in free standing hedging derivatives, excluding the impact of the difference between longer-term and current period implied equity volatility levels as mentioned above;

- The movement in liabilities for those embedded derivative liabilities which are fair valued in accordance with IFRS, primarily GMWB "not for life" and fixed index annuity business, excluding the impacts of the differences between longer-term and current period equity volatility and incorporating 10-year average yield curves, in lieu of current period yield curves;

- Movements in IFRS basis guarantee liabilities for GMWB "for life", being those policies where a minimum annual withdrawal is permitted for the duration of the policyholders life subject to certain conditions, and GMDB business for which, under the US GAAP rules applied under IFRS, the reserving methodology under US GAAP principles generally gives rise to a muted impact of current period market movements; and

- Related changes to the amortisation of deferred acquisition costs for each of the above items.

The effects of the above components give rise to variable gains and losses arising from the differing measuring basis between some assets and liabilities. This is further discussed in note E (ii).

Other derivative value movements are excluded from operating results based on longer-term investment returns. These derivatives are primarily held by Jackson as part of a broadly-based hedging programme for features of Jackson's bond portfolio (for which value movements are booked in the statement of comprehensive income rather than the income statement) and product liabilities (for which US GAAP accounting does not reflect the economic features being hedged).

These key elements are of most importance in determining the operating results based on longer-term investment returns of Jackson.

There are two exceptions to the basis described above for determining operating results based on longer-term investment returns. These are for:

- Unit-linked and US variable annuity business. For such business the policyholder liabilities are directly reflective of the asset value movements. Accordingly all asset value movements are recorded in the operating results based on longer-term investment returns.

- Assets covering non participating business liabilities that are interest rate sensitive. For UK annuity business policyholder liabilities are determined by reference to current interest rates. The value movements of the assets covering liabilities are closely correlated with the related change in liabilities. Accordingly asset value movements are recorded within the operating results based on longer-term investment returns. Policyholder liabilities include a margin for credit risk. Variations between actual and best estimate expected impairments are recorded as a component of short-term fluctuations in investment returns.

(c)Liabilities to policyholders and embedded derivatives for product guarantees

Under IFRS, the degree to which the carrying values of liabilities to policyholders are sensitive to current market conditions varies between territories depending upon the nature of the 'grandfathered' measurement basis. In general, in those instances where the liabilities are particularly sensitive to routine changes in market conditions, the accounting basis is such that the impact of market movements on the assets and liabilities is broadly equivalent in the income statement, and operating profit based on longer-term investments returns is not distorted. In these circumstances, there is no need for the movement in the liability to be bifurcated between the elements that relate to longer-term market conditions and short-term effects.

However, some types of business movements in liabilities do require bifurcation to ensure that at the net level (i.e. after allocated investment return and change for policyholder benefits) the operating result reflects longer-term market returns.

Examples where such bifurcation is necessary are:

(i) Asia

· *Vietnamese participating business*

For the participating business in Vietnam the liabilities include policyholders' interest in investment appreciation and other surplus. Bonuses paid in a reporting period and accrued policyholders' interest in investment appreciation and other surpluses primarily reflect the level of realised investment gains above contract specific hurdle levels. For this business, operating profit based on longer-term investment returns includes the aggregate of longer-term returns on the relevant investments, a credit or charge equal to movements on the liability for the policyholders' interest in realised investment gains (net of any recovery of prior deficits on the participating pool), less amortisation over five years of current and prior movements on such credits or charges.

The overall purpose of these adjustments is to ensure that investment returns included in operating results equal longer-term returns but that in any one reporting period movements on liabilities to policyholders caused by investment returns are substantially matched in the presentation of the supplementary analysis of profit before tax attributable to policyholders.

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· *Non-participating business*

Bifurcation for the effect of determining the movement in the carrying value of liabilities to be included in operating results based on longer-term investment returns, and the residual element for the effect of using year end rates is included in short-term fluctuations and in the income statement.

· *Guaranteed Minimum Death Benefit (GMDB) product features*

For unhedged GMDB liabilities accounted for under IFRS using 'grandfathered' US GAAP, such as in the Japanese business, the change in carrying value is determined under FASB Accounting Standards Codification Subtopic 944-80 (formerly SOP 03-01), which partially reflects changes in market conditions. Under the Company's supplementary basis of reporting the operating profit reflects the change in liability based on longer-term market conditions with the difference between the charge to the operating result and the movement reflected in the total result included in short-term fluctuations in investment returns.

(ii) US operations - Embedded derivatives for variable annuity guarantee features

Under IFRS, the 'not for life' Guaranteed Minimum Withdrawal Benefit (GMWB) is required to be fair valued as an embedded derivative. The movement in carrying values is affected by changes in equity market levels, as well as the level of observed implied equity volatility and changes to the interest rates applied from period to period. For these embedded derivatives the interest rates applied reflect current yield curve rates. For the purposes of determining operating profit based on longer-term investment returns the charge for these features is determined using historical longer-term equity volatility levels and long-term average yield curves.

The Guaranteed Minimum Income Benefit (GMIB) liability, which is fully reinsured, subject to annual claim limits, is accounted for in accordance with FASB Accounting Standards Codification Subtopic 944-80 (formerly SOP 03-01). As the corresponding reinsurance asset is net settled, it is considered to be a derivative under IAS 39 and the asset is therefore recognised at fair value. As the GMIB benefit is economically reinsured the mark to market element of the reinsurance asset is included as a component of short-term derivative fluctuation.

(iii) UK shareholder-backed annuity business

With one exception, the operating result based on longer-term investment returns reflects the impact of all value movements on policyholder liabilities for annuity business in PRIL and the PAC non-profit sub-fund.

The exception is for the impact on credit risk provisioning of actual downgrades during the period. As this feature arises due to short-term market conditions, the effect of downgrades, if any, in a particular period, on the overall provisions for credit risk is included in the category of short-term fluctuations in investment returns.

The effects of other changes to credit risk provisioning are included in the operating result, as is the net effect of changes to the valuation rate of interest due to portfolio rebalancing to align more closely with management benchmark.

(d) Fund management and other non-insurance businesses

For these businesses, the particular features applicable for life assurance noted above do not apply. For these businesses it is inappropriate to include returns in the operating result on the basis described above. Instead, it is appropriate to generally include realised gains and losses (including impairments) in the operating result with unrealised gains and losses being included in short-term fluctuations. For this purpose impairments are calculated as the credit loss determined by comparing the projected cash flows discounted at the original effective interest rate to the carrying value. In some instances it may also be appropriate to amortise realised gains and losses on derivatives and other financial instruments to operating results over a time period that reflects the underlying economic substance of the arrangements.

Additional segmental analysis of revenue

The additional segmental analyses of revenue from external customers are as follows:

	Half year 2010				
	Asia	**US**	**UK**	**Intragroup**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**
Revenue from external customers:					
Insurance operations	**3,009**	**5,676**	**2,733**	**(6)**	**11,412**
Asset management	**120**	**295**	**322**	**(146)**	**591**
Unallocated corporate	**-**	**-**	**7**	**-**	**7**
Intragroup revenue eliminated on consolidation	**(36)**	**(32)**	**(84)**	**152**	**-**
Total revenue from external customers	**3,093**	**5,939**	**2,978**	**-**	**12,010**

	Half year 2009				
	Asia	**US**	**UK**	**Intragroup**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**
Revenue from external customers :					
Insurance operations	2,783	3,970	3,048	(8)	9,793
Asset management	64	190	162	(122)	294
Unallocated corporate	-	-	5	-	5
Intragroup revenue eliminated on consolidation	(32)	(29)	(69)	130	-
Total revenue from external customers	2,815	4,131	3,146	-	10,092

	Full year 2009				
	Asia	**US**	**UK**	**Intragroup**	**Total**
	£m	**£m**	**£m**	**£m**	**£m**
Revenue from external customers:					
Insurance operations	5,336	9,097	5,822	(11)	20,244
Asset management	213	499	513	(271)	954
Unallocated corporate	-	-	12	-	12
Intragroup revenue eliminated on consolidation	(70)	(67)	(145)	282	-
Total revenue from external customers	5,479	9,529	6,202	-	21,210

Revenue from external customers is made up of the following:

	Half year 2010	**Half year 2009**	**Full year 2009**
	£m	**£m**	**£m**
Earned premiums, net of reinsurance	**11,256**	9,518	19,976
Fee income from investment contract business and asset management (included within 'Other income')	**754**	574	1,234
Total revenue from external customers	**12,010**	10,092	21,210

In their capacity as fund managers to fellow Prudential Group subsidiaries, M&G, the US and the Asian asset management businesses earns fees for investment management and related services. These fees totalled £146 million in half year 2010 (half year 2009: £122 million; and full year 2009: £271 million) and are included in the asset management segment above. In half year 2010, the remaining £6 million (half year 2009: £8 million; full year 2009: £11 million) of intragroup revenue was recognised by UK insurance operations. These services are charged at appropriate arm's length prices, typically priced as a percentage of funds under management.

D Profit before tax - Asset management operations

The profit included in the income statement in respect of asset management operations is as follows:

	M&G	**US**	**Asia**	**Half year**	Half year	Full year

				2010	2009	2009
	£m	**£m**	**£m**	**£m**	**£m**	**£m**
Revenue (note (i))	**364**	**299**	**121**	**784**	663	1,516
Charges (note (i))	**(225)**	**(284)**	**(85)**	**(594)**	(537)	(1,163)
Profit before tax	**139**	**15**	**36**	**190**	126	353
Comprising:						
Operating profit based on longer-term investment returns (note (ii))	**143**	**15**	**36**	**194**	125	297
Short-term fluctuations in investment returns	**12**	**-**	**-**	**12**	3	70
Actuarial losses on defined benefit pension schemes	**(16)**	**-**	**-**	**(16)**	(2)	(14)
	139	**15**	**36**	**190**	126	353

Notes

(i) Included within M&G are realised and unrealised net investment gains/losses in respect of consolidated investment funds and Prudential Capital. The investment funds are managed on behalf of third parties and consolidated under IFRS in recognition of the control arrangements for the funds. The investment gains/losses in respect of the investment funds are non-recourse to M&G and the Group and are added back through charges. Consequently there is no impact on profit before tax. Excluding the grossing up in respect of the consolidated investment funds, the revenue for M&G would be £ 338 million (half year 2009: £262 million; full year 2009: £697 million) and the charges £199 million (half year 2009: £159 million; full year 2009: £403 million).

(ii) M&G operating profit based on longer-term investment returns

	Half year	Half year	Full year
	2010	2009	2009
	£m	**£m**	**£m**
Asset management fee income	**298**	195	457
Other income	**1**	7	13
Staff costs	**(122)**	(85)	(205)
Other costs	**(58)**	(42)	(100)
Underlying profit before performance-related fees	**119**	75	165
Performance-related fees	**3**	-	12
Operating profit from asset management operations	**122**	75	177
Operating profit from Prudential Capital	**21**	27	61
Total M&G operating profit based on longer-term investment returns	**143**	102	238

The difference between the fees and other income shown above in respect of asset management operations, and the revenue figure for M&G shown in the main table primarily relates to income and investment gains (losses) earned by Prudential Capital and by investment funds controlled by the asset management operations which are consolidated under IFRS.

E Key assumptions, estimates and bases used to measure insurance assets and liabilities

(i) Asian insurance operations

(a) In half year 2010, one-off changes made to reserving assumptions resulted in a release from liabilities of £19 million.

(b) In 2009, the local regulatory basis in Malaysia was replaced by the Malaysian authority's Risk-Based Capital (RBC) framework. In light of this development, the Company re-measured these liabilities by reference to the method applied under the new RBC framework which resulted in a one-off release from liabilities at 1 January 2009 of £63 million.

(ii) US insurance operations

(c) In half year 2010, half year 2009, full year 2009 and full year 2008, the operating result for Jackson was affected by net equity hedge effects in the following manner:

	Half year 2010 £m	**Half year 2009 £m**	**Full year** 2009 **£m**	Full year 2008 **£m**
Result excluding equity hedge result and related amortisation of deferred acquisition costs (note (i))	**327**	240	618	335
Equity hedge results net of related amortisation of deferred acquisition costs	**123**	(23)	(159)	71
Operating profit based on longer-term investment returns	**450**	217	459	406

Note

(i) The result excluding the equity hedge result after amortisation of deferred acquisition costs which varies both with the underlying financial performance of the Jackson business and with the difference between the actual separate account return in the period and that assumed in the prior year DAC valuation. This acceleration or deceleration in DAC as a result of market movement is discussed further in note S.

Equity hedge results

The equity hedge result relates to the management of the equity hedge risk within the Group's variable annuity, and to a much lesser extent fixed index annuity businesses. It primarily reflects the difference between the value movement included in operating profit on free-standing derivatives and the movement in the accounting value of liabilities for guarantees in Jackson's variable annuity products. For certain of these guarantees, namely Guaranteed Minimum Death Benefit (GMDB) and "for-life" Guaranteed Minimum Withdrawal Benefit (GMWB) features, the liabilities are not fair valued for accounting purposes but are reported pursuant to the US GAAP measurement basis applied for IFRS. Among other factors, these differences in approach to valuing assets and liabilities give rise to variable hedging gains or losses, which for the six month period ended 30 June 2010 totalled £123 million positive after allowing for related DAC amortisation. Over the longer term it is anticipated that such gains and losses will substantially reverse. The total cumulative impact of these equity hedge results, net of related deferred acquisition costs, for the 30 months ended 30 June 2010 is a small gain of £35 million.

Jackson hedges on an economic basis all embedded derivatives as well as related fees and claims, through a combination of options and futures after taking into account the natural offsets in the book. These equity related hedging instruments and the liabilities to which they relate have been included in operating results consistent with the fees and claims to which they will ultimately relate.

(iii) UK insurance operations - annuity business: allowance for credit risk

For IFRS reporting, the results for UK shareholder-backed annuity business are particularly sensitive to the allowances made for credit risk. The allowance is reflected in the deduction from the valuation rate of interest for discounting projected future annuity payments to policyholders that would have otherwise applied. Since mid-2007 there has been a significant increase in the actual and perceived credit risk associated with corporate bonds as reflected in the significant widening that has occurred in corporate bond spreads. Although bond spreads over swap rates have narrowed from their peak in March 2009, they are still high compared with the levels seen in the years immediately preceding the start of the dislocated markets in 2007. The allowance that should therefore be made for credit risk remains a particular area of judgement.

The additional yield received on corporate bonds relative to swaps can be broken into the following constituent parts:

- the expected level of future defaults;

- the credit risk premium that is required to compensate for the potential volatility in default levels; and

- the liquidity premium that is required to compensate for the lower liquidity of corporate bonds relative to swaps.

The credit risk allowance is a function of the asset type and the credit quality of the underlying portfolio. Government bonds are generally given a credit default allowance of zero. For corporate bonds the credit allowance varies by credit rating. An analysis of the credit ratings of debt securities is included in note V.

Given that the normal business model is for Prudential's annuity business to hold bonds to match long-term liabilities, the valuation rate that is applied to discount the future annuity payments includes a liquidity premium that reflects the residual element of current bond spreads over swap rates after providing for the credit risk.

Historically, until the second half of 2007, when corporate bond spreads widened significantly, the allowance for credit risk was calculated as the long-term expected defaults and a long-term credit risk premium. This long-term credit risk was supplemented by a short-term allowance from 31 December 2007 to allow for the concern that credit ratings applied by the rating agencies may be downgraded and defaults in the short term might be higher than the long-term assumptions.

The weighted components of the bond spread over swap rates for shareholder-backed fixed and linked annuity business for PRIL at 30 June 2010, 30 June 2009 and 31 December 2009, based on the asset mix at the relevant balance sheet date are shown below.

30 June 2010	**Pillar I regulatory basis**	**Adjustment from regulatory to IFRS basis**	**IFRS**
	(bps)	**(bps)**	(bps)
Bond spread over swap rates (note (i))	**173**	**-**	**173**
Credit risk allowance			
Long-term expected defaults (note (ii))	**17**	**-**	**17**
Long-term credit risk premium (note (iii))	**11**	**-**	**11**
Short-term allowance for credit risk (note (iv))	**39**	**(25)**	**14**
Total credit risk allowance	**67**	**(25)**	**42**
Liquidity premium	**106**	**25**	**131**

30 June 2009	**Pillar I regulatory basis**	**Adjustment from regulatory to IFRS basis**	**IFRS**
			(bps)

	(bps)	(bps)	
Bond spread over swap rates (note (i))	275	-	275
Credit risk allowance			
Long-term expected defaults (note (ii))	24	-	24
Long-term credit risk premium (note (iii))	15	-	15
Short-term allowance for credit risk (note (iv))	46	(28)	18
Total credit risk allowance	85	(28)	57
Liquidity premium	190	28	218

31 December 2009	**Pillar I** Regulatory basis	**Adjustment from regulatory to IFRS basis**	**IFRS**
	(bps)	(bps)	(bps)
Bond spread over swap rates (note (i))	175	-	175
Credit risk allowance			
Long-term expected defaults (note (ii))	19	-	19
Long-term credit risk premium (note (iii))	13	-	13
Short-term allowance for credit risk (note (iv))	39	(24)	15
Total credit risk allowance	71	(24)	47
Liquidity premium	104	24	128

Notes

(i) Bond spread over swap rates reflect market observed data.

(ii) Long-term expected defaults are derived by applying Moody's data from 1970 to 2004 uplifted by between 100 per cent (B) and 200 per cent (AAA) according to credit rating on the annuity asset portfolio. The credit rating assigned to each asset held is based on external credit rating and for this purpose the credit rating assigned to each asset held is the lowest credit rating published by Moody's, Standard and Poors and Fitch.

(iii) The long-term credit risk premium provides compensation against the risk of potential volatility in the level of defaults and is derived by applying the 95th percentile from Moody's data from 1970 to 2004 to the annuity asset portfolio.

(iv) The short-term allowance for credit risk was increased substantially in 2008 to be equal to 25 per cent of the increase in corporate bond spreads as estimated from the movements in published corporate bonds spreads (as

estimated from the movements in published corporate bond indices) since 31 December 2006. Subsequent to this date movements have reflected events in the period, namely the impact of credit migration, the decision not to release favourable default experience, new business and asset trading amongst other items. This is demonstrated by the analyses below.

The very prudent Pillar I regulatory basis reflects the overriding objective of ensuring sufficient provisions and capital to ensure payments to policyholders can be made. The approach for IFRS, on the other hand, aims to establish liabilities that are closer to 'best estimate'.

IFRS default assumptions are therefore set between the EEV and Pillar I assumptions.

Factors affecting the credit risk allowance at 30 June 2010

The main factors influencing the credit risk allowance at 30 June 2010 for PRIL were as follows:

	Pillar 1 Regulatory basis (bps)			**IFRS (bps)**		
	Long term	Short term	Total	Long term	Short term	Total
Total allowance for credit risk at 31 December 2009	**32**	**39**	**71**	**32**	**15**	**47**
Credit migration	**1**	**(1)**	**-**	**1**	**(1)**	**-**
Retention of surplus from favourable default experience	**-**	**3**	**3**	**-**	**1**	**1**
Asset trading	**(4)**	**-**	**(4)**	**(4)**	**-**	**(4)**
New business	**-**	**(1)**	**(1)**	**-**	**-**	**-**
Other	**(1)**	**(1)**	**(2)**	**(1)**	**(1)**	**(2)**
Total allowance for credit risk at 30 June 2010	**28**	**39**	**67**	**28**	**14**	**42**

The reserves for credit risk allowance at 30 June 2010 for the UK shareholder annuity fund were as follows:

	Pillar 1 Regulatory basis			**IFRS**		
	Long term	Short term	Total	Long term	Short term	Total
	£bn	**£bn**	**£bn**	**£bn**	**£bn**	**£bn**
PRIL	**0.6**	**0.9**	**1.5**	**0.6**	**0.3**	**0.9**
PAC non-profit sub-fund	**0.1**	**0.1**	**0.2**	**0.1**	**0.0**	**0.1**

Total	**0.7**	**1.0**	**1.7**	**0.7**	**0.3**	**1.0**

F Short-term fluctuations in investment returns on shareholder-backed business

	Half year 2010 £m	Half year 2009 £m	Full year 2009 £m
Insurance operations:			
Asian (note (ii))	**41**	(41)	31
US (note (iii))	**(120)**	165	27
UK (notes (i) and (iv))	**93**	(63)	108
Other operations			
- IGD hedge costs (note (v))	**-**	(216)	(235)
- Other (note (vi))	**12**	75	105
	12	(141)	(130)
Total	**26**	(80)	36

Notes

(i) *General overview of defaults*

The Group did not incur any defaults in the half year 2010 on its debt securities portfolio (half year 2009: £11 million; full year 2009: £11 million). The defaults of £11 million in the half year and full year 2009 were experienced primarily by the UK Shareholder-backed annuity business. Jackson experienced less than £1 million of default losses during 2009.

(ii) *Asian insurance operations*

The fluctuations for Asian operations in the half year 2010 were a gain of £41 million (half year 2009: charge of £41 million; full year 2009: gain of £31 million) and primarily relate to unrealised gains on the shareholder debt portfolio in the period.

(iii) *US insurance operations*

The short-term fluctuations in investment returns for US insurance operations comprise the following items:

	Half year	Half year	Full year
	2010	2009	2009
	£m	**£m**	**£m**
Short-term fluctuations relating to debt securities:			
Charges in the period (note a)			
Defaults	**-**	-	-
Losses on sales of impaired and deteriorating bonds	**(100)**	(44)	(6)
Bond write downs	**(64)**	(324)	(630)
Recoveries / reversals	**3**	2	5
	(161)	(366)	(631)
Less: Risk margin charge included in operating profit based on longer-term investment returns (note b)	**36**	41	76
	(125)	(325)	(555)
Interest related realised gains (losses):			
Arising in the period	**169**	75	125
Less: Amortisation of gains and losses arising in current and prior periods to operating profit based on longer-term investment returns	**(47)**	(34)	(59)
	122	41	66
Related change to amortisation of deferred acquisition costs	**(2)**	37	75
Total short-term fluctuation related to debt securities	**(5)**	(247)	(414)
Derivatives (other than equity related): market value movement (net of related change to amortisation of deferred acquisition costs) (note c)	**111**	339	385
Equity type investments: actual less longer-term return (net of related change to amortisation of deferred acquisition costs)	**1**	(40)	(59)
Equity-related derivatives: volatility and interest rate normalisation (net of related change to amortisation of deferred acquisition costs) (note d)	**(238)**	91	85
Other items (net of related change to amortisation of deferred acquisition costs)	**11**	22	30
Total	**(120)**	165	27

a The charges in the period relating to debt securities of Jackson comprise the following:

	Half year	Half year	Full year
	2010	2009	2009
	£m	**£m**	**£m**
Residential mortgage-backed securities:			
Prime	**7**	123	268
Alt-A	**26**	98	192
Sub-prime	**6**	18	49
Total residential mortgage-backed securities	**39**	239	509
Piedmont securities	**25**	5	30
Corporates	**-**	80	91
Losses on sales of impaired and deteriorating bonds net of recoveries	**97**	42	1
Total	**161**	366	631

Jackson experienced no bond default losses during the first half of 2010.

b The risk margin reserve (RMR) charge for longer-term credit related losses for half year 2010 is based on an average annual RMR of 25 basis points (half year 2009: 28 basis points; full year 2009: 27 basis points) on an average book value of US$43.7 billion (half year 2009: US$44.1 billion; full year 2009: US$43.9 billion) as shown below:

	Half year 2010	**Half year 2009**	**Full year 2009**
Moody's rating category or equivalent under NAIC ratings of RMBS	There were no significant changes in our critical accounting estimates and policies during the three months ended December 31, 2010. Please refer to Management s Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for our fiscal year ended June 30, 2010 for a more complete discussion of our critical accounting policies and estimates. **Valuation of Goodwill and Intangible Assets** We assess goodwill for impairment annually as well as whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Long-lived assets are tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. We completed our annual evaluation of goodwill by reporting unit during the three months ended December 31, 2010 and 2009 and concluded that there was no impairment as of December 31, 2010 and 2009.		

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Revenue Recognition for Certain Arrangements with Software Elements and/or Multiple Deliverables

In October 2009, the Financial Accounting Standards Board (FASB) amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product s essential functionality from the scope of industry-specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

provide updated guidance on how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method; and

require an entity to allocate revenue in an arrangement using estimated selling prices (ESP) of deliverables if it does not have vendor-specific objective evidence (VSOE) or third-party evidence (TPE) of selling price. Valuation terms are defined as follows:

VSOE the price at which we sell the element in a separate stand-alone transaction.

TPE evidence from us or other companies of the value of a largely interchangeable element in a transaction.

ESP our best estimate of the selling price of an element in a transaction.

We elected to early adopt this accounting guidance at the beginning of the second quarter of our fiscal year ended June 30, 2010 and applied the adoption retrospectively to the beginning of the fiscal year to apply the guidance to transactions originating or materially modified after June 30, 2009. The implementation resulted in additional qualitative disclosures that are included below but did not have a material impact on our financial position, results of operations or cash flows.

This guidance does not generally change the units of accounting for our revenue transactions. We typically recognize revenue for system sales upon acceptance by the customer that the system has been installed and is operating according to predetermined specifications. Under certain circumstances, however, we recognize revenue upon shipment, prior to acceptance by the customer. The portion of revenue associated with installation is deferred based on relative sales price and recognized upon completion of the installation. Spare parts revenue is recognized when the product has been shipped and risk of loss has passed to the customer, and collectability is reasonably assured. Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. Revenue from services performed in the absence of a contract, such as consulting and training revenue, is recognized when the related services are performed, and collectability is reasonably assured. Our arrangements generally do not include any provisions for cancellation, termination or refunds that would significantly impact recognized revenue.

We enter into revenue arrangements that may consist of multiple deliverables of our products and services where certain elements of a sales contract are not delivered and accepted in one reporting period.

In many instances, products are sold in stand-alone arrangements. Services are sold separately through renewals of annual maintenance contracts. As a result, for substantially all of the arrangements with multiple deliverables pertaining to products and services, we use VSOE or TPE to allocate the selling price to each deliverable. We determine TPE based on historical prices charged for products and services when sold on a stand-alone basis.

When we are unable to establish relative selling price using VSOE or TPE, we use ESP in our allocation of arrangement consideration. The objective of ESP is to determine the price at which we would transact a sale if the product or service were sold on a stand-alone basis. ESP could potentially be used for new or customized products.

We regularly review relative selling prices and maintain internal controls over the establishment and updates of these estimates.

Recent Accounting Pronouncements

In December 2010, the FASB amended its guidance on goodwill and other intangible assets. The amendment modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if there are qualitative factors indicating that it is more likely than not that a goodwill impairment exists. The qualitative factors are consistent with the existing guidance which requires goodwill of a reporting unit to be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. This amendment was effective for our interim period ending December 31, 2010. The amendment did not have an impact on our financial position, results of operations or cash flows.

In December 2010, the FASB amended its guidance on business combinations. Under the amended guidance, a public entity that presents comparative financial statements must disclose the revenue and earnings of the combined entity as though the business combination(s) that occurred during the current year had occurred as of the beginning of the prior annual reporting period. The amendment is effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. Early adoption is permitted. The amendment did not have an impact on our financial position, results of operations or cash flows.

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In April 2010, the FASB amended its guidance on share-based payment awards with an exercise price denominated in certain currencies. The amendment clarifies that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity s equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, an entity would not classify such an award as a liability if it otherwise qualifies as equity. This amendment becomes effective for our interim period ending September 30, 2011. We do not expect the implementation to have an impact on our financial position, results of operations or cash flows.

In January 2010, the FASB issued authoritative guidance for fair value measurements. This guidance now requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and also to describe the reasons for these transfers. This authoritative guidance also requires enhanced disclosure of activity in Level 3 fair value measurements. The guidance for Level 1 and Level 2 fair value measurements was effective for our interim reporting period ended March 31, 2010. The implementation did not have an impact on our financial position, results of operations or cash flows as it is disclosure-only in nature. The guidance for Level 3 fair value measurements disclosures becomes effective for our interim reporting period ending September 30, 2011, and we do not expect that this guidance will have an impact on our financial position, results of operations or cash flows as it is disclosure-only in nature.

EXECUTIVE SUMMARY

KLA-Tencor Corporation is a leading supplier of process control and yield management solutions for the semiconductor and related nanoelectronics industries. Our comprehensive portfolio of products, services, software and expertise helps integrated circuit (IC or chip) manufacturers manage yield throughout the entire wafer fabrication process from research and development to final volume production. In addition to the semiconductor industry, our technologies serve a number of other industries, including light emitting diode (LED), data storage, photovoltaic, and general materials research and manufacturing.

Our products and services are used by virtually every major wafer, IC, reticle and disk manufacturer in the world. Our revenues are driven largely by capital spending by our customers who operate in one or more of several key semiconductor markets, including the memory, foundry and logic markets. Our customers purchase our products because of their need to drive advances in their process and product technologies, or to ramp up production to satisfy demand from their customers for chips used in a growing number of consumer electronics, communications, data processing, and industrial products. We believe that, over the long term, our customers will continue to invest in advanced technologies and new materials to enable smaller design rules and higher density applications, as well as to reduce cost. This in turn will drive increased adoption of process control equipment and service that reduce semiconductor defectivity and improve manufacturing yields.

As a supplier to the global semiconductor and semiconductor-related industries, we are subject to business cycles, the timing, length and volatility of which can be difficult to predict. The industries we serve have historically been cyclical due to sudden changes in overall market demand and manufacturing capacity. Our ability to predict future capacity-related capital spending by our customers is extremely limited, as such spending is very closely connected to the unpredictable business cycles within their industries. While our customer base, particularly in the semiconductor industry, historically has been, and is becoming increasingly concentrated, we expect our customers capital spending on process control to increase over the long term. This increase is driven by the demand for more precise diagnostics capabilities to address new defects as a result of shrinking of device feature sizes, the transition to new materials, new device and circuit architecture, new lithography and other chip manufacturing challenges, and ongoing fab process innovation.

The demand for our products is ultimately affected by the profitability of our customers, which is driven by a number of factors including macroeconomic conditions, consumer and business demand for products that use their semiconductors, the successful development and introduction of new products and product applications, and the overall balance of manufacturing supply to customer demand in key market segments. While semiconductor content in consumer electronics, communications, data processing, and other industrial products continues to increase, the global economic weakness during the fiscal year ended June 30, 2009 adversely impacted many of our customers and consequently impacted the demand for our products.

However, during the fiscal year ended June 30, 2010, economic conditions generally began to gradually improve, especially in some of the more rapidly developing economies in Asia. Demand for many technology-intensive products started to recover, and manufacturing capacity utilization in much of the semiconductor industry improved. As a result, several of our customers, particularly in the foundry market, began to increase their investments in manufacturing capacity and R&D, resulting in growing demand for our products and services throughout the year.

We continued to experience strong demand from our customers during the three months ended December 31, 2010, which, though lower than the preceding two quarters, was near historical highs. In response to this strong demand from our customers, we have been increasing our production volumes and customer support services. Our results for the three months ended December 31, 2010 reflect the sixth consecutive quarter of revenue growth.

We cannot predict the duration and sustainability of these business conditions. We remain at risk of incurring inventory or other capacity related charges if current favorable business conditions do not continue.

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The following table sets forth some of the key quarterly unaudited financial information that we use to manage our business:

(In thousands, except net income per share)	Three months ended December 31, 2010	September 30, 2010	June 30, 2010	Three months ended March 31, 2010	December 31, 2009	September 30, 2009
Total revenues	$ 766,327	$ 682,342	$ 559,419	$ 478,299	$ 440,355	$ 342,687
Total costs and operating expenses	$ 497,461	$ 446,726	$ 398,577	$ 387,020	$ 393,260	$ 327,737
Gross margin	$ 454,929	$ 418,373	$ 331,500	$ 269,734	$ 233,069	$ 170,795
Income from operations	$ 268,866	$ 235,616	$ 160,842	$ 91,279	$ 47,095	$ 14,950
Net income	$ 185,492	$ 154,196	$ 113,085	$ 57,016	$ 21,794	$ 20,405
Net income per share:						
Basic (1)	$ 1.11	$ 0.92	$ 0.67	$ 0.33	$ 0.13	$ 0.12
Diluted (1)	$ 1.09	$ 0.91	$ 0.66	$ 0.33	$ 0.13	$ 0.12

(1) Basic and diluted earnings per share are computed independently for each of the quarters presented based on the weighted average basic and fully diluted shares outstanding for each quarter. Therefore, the sum of quarterly basic and diluted per share information may not equal annual basic and diluted earnings per share.

RESULTS OF OPERATIONS

Revenues and Gross Margin

(Dollar amounts in thousands)	Three months ended December 31, 2010	September 30, 2010	December 31, 2009	Q2 FY11 vs. Q1 FY11		Q2 FY11 vs. Q2 FY10	
Revenues:							
Product	$ 627,857	$ 550,609	$ 314,946	$ 77,248	14%	$ 312,911	99%
Service	$ 138,470	$ 131,733	$ 125,409	$ 6,737	5%	$ 13,061	10%
Total revenues	$ 766,327	$ 682,342	$ 440,355	$ 83,985	12%	$ 325,972	74%
Costs of revenues	$ 311,398	$ 263,969	$ 207,286	$ 47,429	18%	$ 104,112	50%
Stock-based compensation expense included in costs of revenues	$ 3,439	$ 4,168	$ 3,325	$ (729)	-17%	$ 114	3%
Gross margin percentage	59%	61%	53%				

(Dollar amounts in thousands)	Six months ended December 31, 2010	December 31, 2009	Q2 FY10 YTD vs. Q2 FY09 YTD	
Revenues:				
Product	$ 1,178,466	$ 544,197	$ 634,269	117%
Service	270,203	238,845	31,358	13%
Total revenues	$ 1,448,669	$ 783,042	$ 665,627	85%
Costs of revenues	$ 575,367	$ 379,178	$ 196,189	52%
Gross margin percentage	60%	52%		

Stock-based compensation expense included in costs of revenues	$	7,607	$	6,613	$	994	15%

Product revenues

Product revenues increased during the three months ended December 31, 2010 from the three months ended September 30, 2010 as many of our customers maintained high levels of capital spending for both technology and capacity related investments, and as we recognized revenues during the three months ended December 31, 2010 from system orders received in current and prior periods. This increase was primarily the result of higher revenues derived from defect inspection equipment, as compared to the three months ended September 30, 2010.

Product revenues increased during the three and six months ended December 31, 2010 from the three and six months ended December 31, 2009 as our customers increased capital spending for both technology and capacity related investments of process control equipment, in response to anticipated semiconductor electronics end market demand. These factors contributed to an increase in the revenues that we recognized across each of our major products, as well as an increase in the number of tools that we sold, primarily defect inspection and metrology equipment, as compared to the three and six months ended December 31, 2009.

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Service revenues

Service revenues are generated from maintenance service contracts, as well as billable time and material service calls made to our customers after the expiration of the warranty period. The amount of service revenues generated is generally a function of the number of post-warranty systems installed at our customers sites and the utilization of those systems. Service revenues during the three months ended December 31, 2010 increased compared to the three months ended September 30, 2010 and December 31, 2009, and increased during the six months ended December 31, 2010 compared to the six months ended December 2009, in each case as a result of high factory utilization by our customers.

Revenues by region

Revenues by region for the periods indicated were as follows:

	Three months ended					
(Dollar amounts in thousands)	December 31, 2010		September 30, 2010		December 31, 2009	
United States	$ 149,843	20%	$ 86,519	12%	$ 105,489	24%
Taiwan	233,081	30%	188,541	28%	171,947	39%
Japan	59,813	8%	93,888	14%	56,140	13%
Europe & Israel	60,491	8%	39,246	6%	26,908	6%
Korea	123,154	16%	162,091	24%	19,437	4%
Rest of Asia	139,945	18%	112,057	16%	60,434	14%
Total	$ 766,327	100%	$ 682,342	100%	$ 440,355	100%

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

Gross margin

Our gross margin fluctuates with revenue levels and product mix, and is affected by variations in costs related to manufacturing and servicing our products. Our customers maintained strong demand for new high value products, and we continued to benefit from significant volume efficiencies in manufacturing operations worldwide, ongoing effective cost management, and a lower overall manufacturing cost structure as a result of our globalization initiatives, all while generating higher revenue than during the prior quarter. While we continue to maintain a high gross margin percentage in comparison to historic levels, our gross margin decreased slightly during the three months ended December 31, 2010 compared to the three months ended September 30, 2010, primarily due to changes in product mix.

Our gross margin percentage significantly increased for the three and six months ended December 31, 2010 compared to the three and six months ended December 31, 2009 principally due to higher demand for our products, a more favorable product mix, significant volume efficiencies in manufacturing operations worldwide, continued effective cost management and a lower overall manufacturing cost structure as a result of our globalization initiatives during the three and six months ended December 31, 2010.

Engineering, Research and Development (R&D)

	Three months ended						
(Dollar amounts in thousands)	December 31, 2010	September 30, 2010	December 31, 2009	Q2 FY11 vs. Q1 FY11		Q2 FY11 vs. Q2 FY10	
R&D expenses	$ 94,897	$ 94,720	$ 83,301	$ 177	0%	$ 11,596	14%

Stock-based compensation expense included in R&D expenses	$ 5,814	$ 7,618	$ 6,667	$ (1,804)	-24%	$ (853)	-13%
R&D expenses as a percentage of total revenues	12%	14%	19%				

(Dollar amounts in thousands)	Six months ended December 31, 2010	December 31, 2009	Q2 FY11 YTD vs. Q2 FY10 YTD	
R&D expenses	$ 189,617	$ 161,510	$ 28,107	17%
Stock-based compensation expense included in R&D expenses	$ 13,432	$ 13,270	$ 162	1%
R&D expenses as a percentage of total revenues	13%	21%		

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R&D expenses during the three months ended December 31, 2010 remained flat compared to the three months ended September 30, 2010 as an increase of 1.1 million in engineering material costs and consulting services was offset by a decrease of 1.0 million in employee-related expenses primarily due to lower stock-based compensation expense.

The increase in R&D expenses during the three months ended December 31, 2010 as compared to the three months ended December 31, 2009 was primarily due to an increase of $6.4 million in engineering material costs, an increase of $2.5 million in consulting services and an increase of $4.3 million in employee-related expenses, partially offset by an increase of $1.5 million in external funding from government grants.

R&D expenses during the six months ended December 31, 2010 increased as compared to the six months ended December 31, 2009 primarily due to an increase of $12.1 million in engineering material costs, an increase of $14.4 million in employee-related expenses from additional headcount and an increase of $5.1 million in consulting services, partially offset by an increase of $2.9 million in external funding from government grants.

R&D expenses include the benefit of $3.3 million, $2.8 million and $1.8 million of external funding received during the three months ended December 31, 2010, September 30, 2010 and December 31, 2009, respectively, for certain strategic development programs from government grants.

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

Selling, General and Administrative (SG&A)

(Dollar amounts in thousands)	Three months ended December 31, 2010	Three months ended September 30, 2010	Three months ended December 31, 2009	Q2 FY11 vs. Q1 FY11		Q2 FY11 vs. Q2 FY10	
SG&A expenses	$ 91,166	$ 88,037	$ 102,673	$ 3,129	4%	$ (11,507)	-11%
Stock-based compensation expense included in SG&A expenses	$ 10,178	$ 12,427	$ 10,863	$ (2,249)	-18%	$ (685)	-6%
SG&A expenses as a percentage of total revenues	12%	13%	23%				

(Dollar amounts in thousands)	Six months ended December 31, 2010	Six months ended December 31, 2009	Q2 FY11 YTD vs. Q2 FY10 YTD	
SG&A expenses	$ 179,203	$ 180,309	$ (1,106)	-1%
Stock-based compensation expense included in SG&A expenses	$ 22,605	$ 21,171	$ 1,434	7%
SG&A expenses as a percentage of total revenues	12%	23%		

The increase in SG&A expenses during the three months ended December 31, 2010 as compared to the three months ended September 30, 2010 was primarily due to an increase of $1.1 million in legal expenses for shareholder litigation relating to our historical stock option practices and an increase of $2.2 million in employee-related compensation partially offset by a net gain of $1.4 million from the sale of real estate assets recorded during the three months ended December 31, 2010.

The decrease in SG&A expenses during the three months ended December 31, 2010 as compared to the three months ended December 31, 2009 was primarily due to $11.4 million of impairment charges recorded in the three months ended December 31, 2009 versus none recorded in the three months ended December 31, 2010, a decrease of $6.0 million in litigation expenses for shareholder litigation relating to our historical stock option practices and a net gain of $1.4 million from the sale of real estate assets recorded during the three months ended December 31, 2010, partially offset by an increase of $8.1 million in employee-related expenses and an increase of $1.1 million in consulting services.

The decrease in SG&A expenses during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009 is primarily due to decrease of $11.2 million in litigation expenses, a decrease of $11.4 million in impairment charges and a net gain of $1.4 million from the sale of real estate assets, partially offset by an increase of $23.7 million in employee-related expenses.

Impairment of Goodwill

During the three months ended December 31, 2009 and 2010, we performed our annual evaluation of goodwill by reporting unit, and concluded that there was no impairment as of December 31, 2009 and 2010. Our assessment indicated that the fair value of our reporting units was substantially in excess of their estimated carrying values, and therefore goodwill in the reporting units was not impaired as of December 31, 2009 and 2010.

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Restructuring Charges

We have undertaken a number of cost reduction activities, including workforce reductions, in an effort to lower our quarterly operating expense run rate. The program in the United States is accounted for in accordance with the authoritative guidance related to compensation for nonretirement post-employment benefits, whereas the programs in the international locations are accounted for in accordance with the authoritative guidance for contingencies. During the three months ended December 31, 2010, we recorded a $1.1 million net restructuring charge, of which $0.2 million was recorded to costs of revenues, $0.1 million was recorded to engineering, research and development expense and $0.8 million was recorded to selling, general and administrative expense. This charge represents the estimated minimum liability associated with expected termination benefits to be provided to employees after employment.

The following table shows the activity primarily related to severance and benefits expense for the three and six months ended December 31, 2010 and 2009:

	Three months ended December 31,		Six months ended December 31,	
(In thousands)	**2010**	**2009**	**2010**	**2009**
Beginning balance	$ 589	$ 4,304	$ 1,221	$ 8,086
Restructuring costs	1,065	3,262	1,430	3,845
Adjustments	(8)	(149)	(30)	(685)
Cash payments	(771)	(2,839)	(1,746)	(6,668)
Ending balance	$ 875	$ 4,578	$ 875	$ 4,578

Substantially all of the remaining accrued restructuring balance as of December 31, 2010 related to our workforce reductions is expected to be paid out by June 30, 2011.

Interest Income and Other, Net and Interest Expense

	Three months ended		
(Dollar amounts in thousands)	**December 31, 2010**	**September 30, 2010**	**December 31, 2009**
Interest income and other, net	$ (4,182)	$ 1,225	$ 4,463
Interest expense	$ 13,493	$ 13,529	$ 13,542
Interest income and other, net as a percentage of total revenues	1%	0%	1%
Interest expense as a percentage of total revenues	2%	2%	3%

	Six months ended	
(Dollar amounts in thousands)	**December 31, 2010**	**December 31, 2009**
Interest income and other, net	$ (2,957)	$ 25,762
Interest expense	$ 27,022	$ 26,999
Interest income and other, net as a percentage of total revenues	0%	3%
Interest expense as a percentage of total revenues	2%	3%

Interest income and other, net is comprised primarily of interest income earned on our investment and cash portfolio, realized gains or losses on sales of marketable securities, gains or losses from revaluation of certain foreign currency denominated assets and liabilities as well as foreign currency contracts, and impairments associated with equity investments in privately-held companies. The decrease in interest income and other, net during the three months ended December 31, 2010 compared to the three months ended September 30, 2010 and December 31, 2009 was primarily due to an impairment charge of $6.8 million recorded during the three months ended December 31, 2010 for equity investments in privately-held companies. The decrease in interest income and other, net during the six months ended December 31, 2010 compared to the six months ended December 31, 2009 was primarily attributable to reduced interest earnings due to the lower market interest rate environment and higher impairment charge related to equity investments in privately-held companies during the six months ended December 31, 2010, offset by the benefit recorded in the six months ended September 30, 2009 upon expiration of a statute of limitations relating to an uncertainty in our position with respect to a foreign transaction-based tax. No such benefit was recorded during the six months ended December 31, 2010.

Interest expense is primarily derived from the issuance of $750 million aggregate principal amount of senior notes in the fourth quarter of the fiscal year ended June 30, 2008. Interest expense remained flat in the three months ended December 31, 2010 compared to the three months ended September 30, 2010 and December 31, 2009.

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Provision for Income Taxes

The following table provides details of income taxes:

(Dollar amounts In thousands)	Three months ended December 31, 2010	Three months ended December 31, 2009	Six months ended December 31, 2010	Six months ended December 31, 2009
Income before income taxes	$ 251,191	$ 38,016	$ 474,503	$ 60,808
Provision for taxes	65,699	16,222	134,815	18,609
Effective tax rate	26.2%	42.7%	28.4%	30.6%

Our estimated annual effective tax rate for the year is approximately 29%.

The difference between the actual effective tax rate of 26.2% during the quarter and the estimated annual effective tax rate of 29% is primarily due to the tax impact of the following items during the three months ended December 31, 2010:

Tax expense was decreased by $3.7 million due to windfalls from employee stock activity. A windfall arises when the tax deduction is more than book compensation. Windfalls are generally recorded as increases to capital in excess of par value. A shortfall arises when the tax deduction is less than book compensation. Shortfalls are recorded as decreases to capital in excess of par value to the extent that cumulative windfalls exceed cumulative shortfalls. Shortfalls in excess of cumulative windfalls are recorded as provision for income taxes. When there are shortfalls recorded as provision for income taxes during an earlier quarter, windfalls arising in subsequent quarters within the same fiscal year are recorded as a reduction to income taxes to the extent of the shortfalls recorded.

Tax expense was decreased by $3.1 million related to a non-taxable increase in the assets held within our Executive Deferred Savings Plan.

Tax expense was decreased by $3.9 million related to the reinstatement of the U.S. Federal Research and Development Credit (the Federal R&D Credit), under The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, which was signed into law on December 17, 2010.

Tax expense was higher as a percentage of income during the three months ended December 31, 2009 compared to the three months ended December 31, 2010 primarily due to an increase in tax expense of $8.7 million resulting from shortfalls related to employee stock activity during the three months ended December 31, 2009. The shortfall expense during the three months ended December 31, 2009 had a significant impact on our effective tax rate due to the lower level of income generated during the three months ended December 31, 2009.

Tax expense was higher as a percentage of income during the six months ended December 31, 2009 compared to the six months ended December 31, 2010 due to a decrease in tax expense of $3.9 million resulting from the reinstatement of the Federal R&D Credit during the six months ended December 31, 2010 and an increase in tax expense of $8.7 million resulting from shortfalls related to employee stock activity during the six months ended December 31, 2009.

Our future effective income tax rate depends on various factors, such as tax legislation, the geographic composition of our pre-tax income, the amount of our pre-tax income as business activity fluctuates, non-deductible expenses incurred in connection with acquisitions, research and development credits as a percentage of aggregate pre-tax income, non-taxable or non-deductible increases or decreases in the assets held within our Executive Deferred Savings Plan, the tax effects of employee stock activity and the effectiveness of our tax planning strategies.

In the normal course of business, we are subject to examination by taxing authorities throughout the world. We are under United States federal income tax examination for the fiscal years ended June 30, 2007 through June 30, 2009, which represents all years for which tax returns have been filed and the statute of limitations has not expired. We are subject to state income tax examinations for all years beginning from the fiscal year ended June 30, 2006. We are also subject to examinations in major foreign jurisdictions, including Japan, Israel and Singapore, for all years beginning from the fiscal year ended June 30, 2006 and is currently under tax examinations in various other foreign tax jurisdictions. It is possible that certain examinations may be concluded in the next twelve months. We believe it is possible that we may recognize up to $3.6 million of our existing unrecognized tax benefits within the next twelve months as a result of the lapse of statutes of limitations and the resolution of agreements with various foreign tax authorities.

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LIQUIDITY AND CAPITAL RESOURCES

(Dollar amounts in thousands)	December 31, 2010	June 30, 2010
Cash and cash equivalents	$ 596,104	$ 529,918
Marketable securities	1,040,296	1,004,126
Total cash, cash equivalents and marketable securities	$ 1,636,400	$ 1,534,044
Percentage of total assets	39%	39%

	Six months ended	
(In thousands)	December 31, 2010	December 31, 2009
Cash flow:		
Net cash provided by operating activities	$ 289,453	$ 236,850
Net cash used in investing activities	(43,388)	(196,729)
Net cash used in financing activities	(191,295)	(40,034)
Effect of exchange rate changes on cash and cash equivalents	11,416	6,390
Net increase in cash and cash equivalents	$ 66,186	$ 6,477

At December 31, 2010, our cash, cash equivalents and marketable securities totaled $1.6 billion, an increase of $102 million from June 30, 2010. We generated $289 million and $237 million in cash from operations during the six months ended December 31, 2010 and 2009, respectively. We used $43 million and $197 million in cash from investing activities during the six months ended December 31, 2010 and 2009, respectively. We used $191 million and $40 million in cash for financing activities during the six months ended December 31, 2010 and 2009, respectively.

We have historically financed our operations through cash generated from operations. Net cash provided by operating activities during the six months ended December 31, 2010 increased compared to the six months ended December 31, 2009 from $237 million to $289 million primarily as a result of the following key factors:

An increase in cash collections by approximately $681 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, due to higher sales volume, offset by

An increase in vendor payments by approximately $316 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, to support a higher level of business activities,

An increase in payroll expenses by approximately $123 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, mainly due to the bonus payment for fiscal year 2010, and

An increase in tax payments by approximately $175 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, due to higher profitability.

Investing activities during the six months ended December 31, 2010 used net cash of $43 million, as compared to using net cash of $197 million during the six months ended December 31, 2009, and this change was primarily the result of the following factors:

- An increase in the cash proceeds from the sale of assets of approximately $13 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009, primarily from the sale of the San Jose, California campus and

- A decrease in the use of cash for purchases of available-for-sale and trading securities, net of sales and maturities, of approximately $149 million during the six months ended December 31, 2010 as compared to the six months ended December 31, 2009.

Net cash used in financing activities during the six months ended December 31, 2010 increased compared to the six months ended December 31, 2009 from $40 million to $191 million primarily as a result of our recently announced dividend increase and higher common stock repurchases. We repurchased $117 million of our common stock during the six months ended December 30, 2010, as compared to no stock repurchases during the six months ended December 31, 2009.

During the three months ended December 31, 2010, our Board of Directors declared a dividend of $0.25 per share of our outstanding common stock, which was paid on December 1, 2010 to our stockholders on record as of November 16, 2010. During the same period in fiscal year 2010, our Board of Directors declared and paid a quarterly cash dividend of $0.15 per share. The total amount of dividends paid during the three months ended December 31, 2010 and 2009 was $41.8 million and $25.7 million, respectively. The total amount of dividends paid during the six months ended December 31, 2010 and 2009 was $83.6 million and $51.3 million, respectively.

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The following is a schedule summarizing our significant obligations to make future payments under contractual obligations as of December 31, 2010:

				Fiscal year ending June 30,				
(In thousands)	Total	2011 (2)	2012	2013	2014	2015	Thereafter	Other
Long-term debt obligations(1)	$ 750,000	$	$	$	$	$	$ 750,000	
Interest expense associated with long-term debt obligations	379,498	25,875	51,750	51,750	51,750	51,750	146,623	
Purchase commitments	289,170	260,982	25,770	1,630	491	253	44	
Non-current income tax payable(3)	69,388							69,388
Operating leases	24,385	4,445	6,636	4,398	2,912	1,721	4,273	
Pension obligations	23,373	868	1,572	1,960	1,927	2,541	14,505	
Total contractual cash obligations	$ 1,535,814	$ 292,170	$ 85,728	$ 59,738	$ 57,080	$ 56,265	$ 915,445	$ 69,388

(1) In April 2008, we issued $750 million aggregate principal amount of senior notes due in 2018.
(2) Remaining 6 months.
(3) Represents the non-current income tax payable obligation. We are unable to make a reasonably reliable estimate of the timing of payments in individual years beyond 12 months due to uncertainties in the timing of tax audit outcomes.

We have agreements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, from time to time we will discount, without recourse, letters of credit (LCs) received from customers in payment of goods.

The following table shows total receivables sold under factoring agreements and proceeds from sales of LCs and related discounting fees paid for the three and six months ended December 31, 2010 and 2009:

	Three months ended		Six months ended	
(In thousands)	December 31, 2010	December 31, 2009	December 31, 2010	December 31, 2009
Receivables sold under factoring agreements	$ 96,586	$ 39,818	$ 156,611	$ 70,019
Proceeds from sales of LCs	$ 33,327	$	$ 84,263	$ 10,630
Discounting fees paid on sales of LCs (1)	$ 50	$	$ 155	$ 123

(1) Discounting fees include bank fees and interest expense and were recorded in interest income and other, net.

We maintain guarantee arrangements available through various financial institutions for up to $20.3 million, of which $18.2 million had been issued as of December 31, 2010 primarily to fund guarantees to customs authorities for VAT and other operating requirements of our subsidiaries in Europe and Asia.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply for key components. Our 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. Our open inventory purchase commitments were $289.2 million as of December 31, 2010, and 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.

We provide standard warranty coverage on our systems for 40 hours per week for twelve months, providing labor and parts necessary to repair the systems during the warranty period. We account for the estimated warranty cost as a charge to costs of revenues when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. The actual product performance and/or field expense profiles may differ, and in those cases we adjust our warranty accruals accordingly. The difference between the estimated and actual warranty costs tends to be larger for new product introductions as there is limited historical product performance to estimate warranty expense; more mature products with longer product performance histories tend to be more stable in our warranty charge estimates. Non-standard warranty coverage generally includes services incremental to the standard 40-hour per week coverage for twelve months. See Note 13, Commitments and Contingencies, to the Condensed Consolidated Financial Statements for a detailed description.

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Working capital increased to $2.3 billion as of December 31, 2010, compared to $2.1 billion as of June 30, 2010. As of December 31, 2010, our principal sources of liquidity consisted of $1.6 billion of cash, cash equivalents, and marketable securities. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, we believe that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for at least the next twelve months.

During the fiscal years ended June 30, 2008, 2009 and 2010, our investment portfolio included auction rate securities, which are investments with contractual maturities generally between 20 to 30 years. They are usually found in the form of municipal bonds, preferred stock, a pool of student loans, or collateralized debt obligations whose interest rates are reset. The reset typically occurs every seven to forty-nine days, through an auction process. At the end of each reset period, investors can sell or continue to hold the securities at par. The auction rate securities that we held were backed by student loans and were collateralized, insured and guaranteed by the United States Federal Department of Education. In addition, all auction rate securities that we held were rated by the major independent rating agencies as either AAA or Aaa. In February 2008, auctions failed for approximately $48.2 million in par value of municipal auction rate securities that we held because sell orders exceeded buy orders. These failures were not believed to be a credit issue, but rather caused by a lack of liquidity. The funds associated with these failed auctions might not have been accessible until the issuer called the security, a successful auction occurred, a buyer was found outside of the auction process, or the security matured.

By letter dated August 8, 2008, we received notification from UBS AG (UBS), in connection with a settlement entered into between UBS and certain regulatory agencies, offering to repurchase all of our auction rate security holdings at par value. We formally accepted the settlement offer and entered into a repurchase agreement (Agreement) with UBS on November 11, 2008 (Acceptance Date). By accepting the Agreement, we (1) received the right (Put Option) to sell our auction rate securities at par value to UBS between June 30, 2010 and June 30, 2012 and (2) gave UBS the right to purchase the auction rate securities from us any time after the Acceptance Date as long as we receive the par value. As of June 30, 2010, all of our auction rate securities had been sold and subsequently settled in July 2010.

In April 2008, we issued $750 million aggregate principal amount of 6.90% senior, unsecured long-term debt due in 2018 with an effective interest rate of 7.00%. The discount on the debt amounted to $5.4 million and is being amortized over the life of the debt using the straight-line method as opposed to the interest method due to immateriality. Interest is payable semi-annually on November 1 and May 1. The debt indenture includes covenants that limit our ability to grant liens on our facilities and to enter into sale and leaseback transactions, subject to significant allowances under which certain sale and leaseback transactions are not restricted. We were in compliance with all of our covenants as at December 31, 2010.

Our credit ratings and outlooks as of January 14, 2011 are summarized below.

Rating Agency	Rating	Outlook
Fitch	BBB	Stable
Moody s	Baa1	Stable
Standard & Poor s	BBB	Stable

Factors that can affect our credit ratings include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, and changes in our business strategy.

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Off-Balance Sheet Arrangements

Under our foreign currency risk management strategy, we utilize derivative instruments to protect our interests from unanticipated fluctuations in earnings and cash flows caused by volatility in currency exchange rates. This financial exposure is monitored and managed as an integral part of our overall risk management program which focuses on the unpredictability of financial markets and seeks to reduce the potentially adverse effects that the volatility of these markets may have on our operating results. We continue our policy of hedging our current and forecasted foreign currency exposures with hedging instruments having tenors of up to 18 months. The outstanding hedge contracts, with maximum maturity of 13 months, were as follows:

(In thousands)	As of December 31, 2010	As of June 30, 2010
Cash flow hedge contracts		
Purchase	$ 12,620	$ 15,835
Sell	(50,741)	(32,853)
Other foreign currency hedge contracts		
Purchase	83,156	82,535
Sell	(89,031)	(104,414)
Net	$ (43,996)	$ (38,897)

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments, such as foreign currency hedges. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position as of December 31, 2010. Actual results may differ materially.

As of December 31, 2010, we had an investment portfolio of fixed income securities of $1.0 billion, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of December 31, 2010, the fair value of the portfolio would have declined by $1.1 million.

As of December 31, 2010, we had net forward contracts to purchase $44.0 million in foreign currency in order to hedge currency exposures (see Note 15, Derivative Instruments and Hedging Activities, to the Condensed Consolidated Financial Statements for a detailed description). If we had entered into these contracts on December 31, 2010, the U.S. dollar equivalent would have been $46.3 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by $17.0 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on net income or cash flows.

In April 2008, we issued $750 million aggregate principal amount of 6.90% senior unsecured notes due in 2018. The fair market value of long-term fixed interest rate debt is subject to interest rate risk. Generally, the fair market value of fixed interest rate debt will increase as interest rates fall and decrease as interest rates rise. At December 31, 2010, the book value and the fair value of our fixed rate debt were $746.0 million and $829.1 million, respectively.

See Note 4, Marketable Securities, to the Condensed Consolidated Financial Statements in Part I, Item 1; Management s Discussion and Analysis of Financial Condition and Results of Operations, *Liquidity and Capital Resources,* in Part I, Item 2; and Risk Factors in Part II, Item 1A of this Quarterly Report on Form

10-Q for a description of recent market events that may affect the value of the investments in our portfolio that we held at December 31, 2010.

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ITEM 4. CONTROLS AND PROCEDURES
Evaluation of Disclosure Controls and Procedures and Related CEO and CFO Certifications

Evaluation of Disclosure Controls and Procedures

The Company conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in the Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) (Disclosure Controls) as of the end of the period covered by this Quarterly Report on Form 10-Q (this Report) required by Exchange Act Rules 13a-15(b) or 15d-15b. The controls evaluation was conducted under the supervision and with the participation of the Company s management, including the Company s Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on this evaluation, the CEO and CFO have concluded that as of the end of the period covered by this Report the Company s disclosure controls and procedures were effective at a reasonable assurance level.

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

Definition of Disclosure Controls

Disclosure Controls are controls and procedures designed to reasonably assure that information required to be disclosed in the Company s reports filed under the Exchange Act, such as this Report, is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure Controls are also designed to reasonably assure that such information is accumulated and communicated to the Company s management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. The Company s Disclosure Controls include components of its internal control over financial reporting, which consists of control processes designed to provide reasonable assurance regarding the reliability of its financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles in the United States. To the extent that components of the Company s internal control over financial reporting are included within its Disclosure Controls, they are included in the scope of the Company s annual controls evaluation.

Limitations on the Effectiveness of Controls

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

There have been no changes in our internal control over financial reporting during the three months ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The information set forth above under Note 12, Litigation and Other Legal Matters, to the Condensed Consolidated Financial Statements in Item 1 of Part 1 is incorporated herein by reference.

ITEM 1A. RISK FACTORS

A description of factors that could materially affect our business, financial condition or operating results is provided below.

Risks Associated with Our Industry and Market Conditions

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

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The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. The cyclical nature of the primary industry in which we operate is largely a function of our customers capital spending patterns and need for expanded manufacturing capacity, which in turn are affected by factors such as capacity utilization, consumer demand for products, inventory levels and our customers access to capital. This cyclicality affects our ability to accurately predict future revenue and, in some cases, future expense levels. In the current environment, our ability to accurately predict our future operating results is particularly limited.

During down cycles in our industry, the financial results of our customers may be negatively impacted, which could result not only in a decrease in, or cancellation or delay of, orders (which are generally subject to cancellation or delay by the customer with limited or no penalty) but also a weakening of their financial condition that could impair their ability to pay for our products or our ability to recognize revenue from certain customers. When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During periods of declining revenues, as was experienced during fiscal year 2009, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. If we fail to respond, or if our attempts to respond fail to accomplish our intended results, then our business could be seriously harmed. Furthermore, any workforce reductions and cost reduction actions that we adopt in response to down cycles may result in additional restructuring charges, disruptions in our operations and loss of key personnel. In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles. Each of these factors could adversely impact our operating results and financial condition.

In addition, the semiconductor equipment industry and other industries that we serve are constantly developing and changing over time. These changes currently, or in the future may, include the increasing cost of building and operating fabrication facilities and the impact of such increases on our customers investment decisions; the variability of future growth rates in the semiconductor and related industries; the ever-increasing cost and complexity involved in the adoption by our customers of technology advances and the potential impact that may have on their rate of adoption; pricing trends in the end-markets for consumer electronics and other products, which places a growing emphasis on our customers cost of ownership; overall changes in capital spending patterns by our customers; and demand by semiconductor manufacturers for shorter cycle times for developing, manufacturing and installing capital equipment. Further, many semiconductor manufacturers have recently experienced decreased profitability, causing them to enter into collaboration or sharing arrangements for capacity, cost or risk with other manufacturers, outsource manufacturing activities, focus only on specific markets or applications, or purchase less manufacturing equipment. Any of the changes described in this paragraph may, particularly during periods of challenging macroeconomic conditions, negatively affect our customers rate of investment in capital equipment, which could result in downward pressure on our prices, customer orders, revenues and gross margins. If we do not successfully manage the risks resulting from any of these or other potential changes in our industries, our business, financial condition and operating results could be adversely impacted.

We are exposed to risks associated with a weakening in the condition of the financial markets and the global economy.

The severe tightening of the credit markets, turmoil in the financial markets and weakening of the global economy that were experienced during the fiscal year ended June 30, 2009 contributed to slowdowns in the industries in which we operate, which slowdowns could recur or worsen if economic conditions were to deteriorate again.

The markets for semiconductors, and therefore our business, are ultimately driven by the global demand for electronic devices by consumers and businesses. Economic uncertainty frequently leads to reduced consumer and business spending, which caused our customers to decrease, cancel or delay their equipment and service orders from us in the economic slowdown during fiscal year 2009. In addition, the tightening of credit markets and concerns regarding the availability of credit that accompanied that slowdown made it more difficult for our customers to raise capital, whether debt or equity, to finance their purchases of capital equipment, including the products we sell. Reduced demand, combined with delays in our customers ability to obtain financing (or the unavailability of such financing), has at times in the past several years adversely affected our product and service sales and revenues and therefore has harmed our business and operating results, and our operating results and financial condition may again be adversely impacted if economic conditions decline from their current levels.

In addition, a decline in the condition of the global financial markets could adversely impact the market values or liquidity of our investments. Our investment portfolio includes corporate and government securities, money market funds and other types of debt and equity investments. Although we believe our portfolio continues to be comprised of sound investments due to the quality and (where applicable) credit ratings and government guarantees of the underlying investments, a decline in the capital and financial markets would adversely impact the market values of our investments and their liquidity. If the market value of such investments were to decline, or if we were to have to sell some of our investments under illiquid market conditions, we may be required to recognize an impairment charge on such investments or a loss on such sales, either of which could have an adverse effect on our financial condition and operating results.

If we are unable to timely and appropriately adapt to changes resulting from difficult macroeconomic conditions, our business, financial condition or results of operations may be materially and adversely affected.

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

Our industry includes large manufacturers with substantial resources to support customers worldwide. Some of our competitors are diversified companies with greater financial resources and more extensive research, engineering, manufacturing, marketing, and customer service and support capabilities than we possess. We face competition from companies whose strategy is to provide a broad array of products and services, some of which compete with the products and services that we offer. These competitors may bundle their products in a manner that may discourage customers from purchasing our products, including pricing such competitive tools significantly below our product offerings. In addition, we face competition from smaller emerging semiconductor equipment companies whose strategy is to provide a portion of the products and services that we offer, using innovative technology to sell products into specialized markets. The strength of our competitive positions in many of our existing markets is largely due to our leading technology, which is the result of continuing significant investments in product research and development. However, we may enter new markets, whether through acquisitions or new internal product development, in which competition is based primarily on product pricing, not technological superiority. Further, some new growth markets that emerge may not require leading technologies. Loss of competitive position in any of the markets we serve, or an inability to sell our products on favorable commercial terms in new markets we may enter, could negatively affect our prices, customer orders, revenues, gross margins and market share, any of which would negatively affect our operating results and financial condition.

We are exposed to risks associated with a highly concentrated customer base.

Our customer base, particularly in the semiconductor industry, historically has been, and is becoming increasingly, highly concentrated. In this environment, orders from a relatively limited number of manufacturers have accounted for, and are expected to continue to account for, a substantial portion of our sales. In addition, the mix and type of customers, and sales to any single customer, may vary significantly from quarter to quarter and from year to year. If customers do not place orders, or they delay or cancel orders, we may not be able to replace the business. Furthermore, because our products are configured to customer specifications, any changes, delays or cancellations of orders may result in significant, non-recoverable costs. As a result of the consolidation within our customer base, the customers that survive that consolidation represent a greater portion of our sales. Those surviving customers may have more aggressive policies regarding engaging alternative, second-source suppliers for the products we serve and, in addition, may seek, and on occasion receive, pricing, payment, intellectual property-related, or other commercial terms that are less favorable to us. Any of these changes could negatively impact our prices, customer orders, revenues and gross margins. Also, certain customers have undergone significant ownership changes, experienced management changes or have outsourced manufacturing activities, any of which may result in additional complexities in managing customer relationships and transactions. As a result of the challenging economic environment during fiscal year 2009, we were (and in some cases continue to be) exposed to additional risks related to the continued financial viability of certain of our customers. To the extent our customers experience liquidity issues, we may be required to incur additional bad debt expense with respect to receivables owed to us by those customers. In addition, customers with liquidity issues may be forced to discontinue operations or may be acquired by one of our customers, and in either case such event would have the effect of further consolidating our customer base. Any of these factors could have a material adverse effect on our business, financial condition and operating results.

Risks Related to Our Business

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

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

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

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

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers to supply these materials. We generally do not have guaranteed supply arrangements with our suppliers. Because of the variability and uniqueness of customers orders, we do not maintain an extensive inventory of materials for manufacturing. We seek to minimize the risk of production and service interruptions and/or shortages of key parts by selecting and qualifying alternative suppliers for key parts, monitoring the financial stability of key suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, key parts may be available only from a single supplier or a limited group of suppliers. Also, key parts we obtain from some of our suppliers incorporate the suppliers proprietary intellectual property; in those cases we are increasingly reliant on third parties for high-performance, high-technology components, which reduces the amount of control we have over the availability and protection of the technology and intellectual property that is used in our products. In addition, if certain of our key suppliers experience liquidity issues and are forced to discontinue operations, which is a heightened risk during economic downturns, that would affect their ability to deliver parts and could result in delays for our products. Our operating results and business may be adversely impacted if we are unable to obtain parts to meet our production requirements and product specifications, or if we are only able to do so on unfavorable terms.

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

We have significant manufacturing operations in the United States, Singapore, Israel, Belgium and Germany. In addition, our business is international in nature, with our sales, service and administrative personnel and our customers located in numerous countries throughout the world. Operations at our manufacturing facilities and our assembly subcontractors, as well as our other operations and those of our customers, are subject to disruption for a variety of reasons, including work stoppages, acts of war, terrorism, health epidemics, fire, earthquake, volcanic eruptions, energy shortages, flooding or other natural disasters. Such disruption could cause delays in, among other things, shipments of products to our customers, our ability to perform services requested by our customers, or the installation and acceptance of our products at customer sites. We cannot ensure that alternate means of conducting our operations (whether through alternate production capacity or service providers or otherwise) would be available if a major disruption were to occur or that, if such alternate means were available, they could be obtained on favorable terms.

As part of our cost-cutting actions, we have consolidated several operating facilities. Our California operations are now primarily centralized in our Milpitas facility. The consolidation of our California operations into a single campus could further concentrate the risks related to any of the disruptive events described in the preceding paragraph, such as acts of war or terrorism, earthquakes, fires or other natural disasters, if any such event were to impact our Milpitas facility.

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

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

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

Our success is dependent in part on our technology and other proprietary rights. We own various United States and international patents and have additional pending patent applications relating to some of our products and technologies. The process of seeking patent protection is lengthy and expensive, and we cannot be certain that pending or future applications will actually result in issued patents or that issued patents will be of sufficient scope or strength to provide meaningful protection or commercial advantage to us. Other companies and individuals, including our larger competitors, may develop technologies and obtain patents relating to our business that are similar or superior to our technology or may design around the patents we own, adversely affecting our business. In addition, we at times engage in collaborative technology development efforts with our customers and suppliers, and these collaborations may constitute a key component of certain of our ongoing technology and product research and development projects. The termination of any such collaboration, or delays caused by disputes or other unanticipated challenges that may arise in connection with any such collaboration, could significantly impair our research and development efforts, which could have a material adverse impact on our business and operations.

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

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

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

As is typical in the semiconductor equipment industry, from time to time we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which they believe cover certain of our products, processes, technologies or information. In addition, we occasionally receive notification from customers who believe that we owe them indemnification or other obligations related to intellectual property claims made against such customers by third parties. Litigation tends to be expensive and requires significant management time and attention and could have a negative effect on our results of operations or business if we lose or have to settle a case on significantly adverse terms. Our customary practice is to evaluate such infringement assertions and to consider whether to seek licenses where appropriate. However, we cannot ensure that licenses can be obtained or, if obtained, will be on acceptable terms or that costly litigation or other administrative proceedings will not occur. The inability to obtain necessary licenses or other rights on reasonable terms, or the instigation of litigation or other administrative proceedings, could seriously harm our operating results and financial condition.

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

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

If we fail to operate our business in accordance with our business plan, our operating results, business and stock price may be significantly and adversely impacted.

We attempt to operate our business in accordance with a business plan that is established annually, revised frequently (generally quarterly), and reviewed by management even more frequently (at least monthly). Our business plan is developed based on a number of factors, many of which require estimates and assumptions, such as our expectations of the economic environment, future business levels, our customers willingness and ability to place orders, lead-times, and future revenue and cash flow. Our budgeted operating expenses, for example, are based in part on our future revenue expectations. However, our ability to achieve our anticipated revenue levels is a function of numerous factors, including the volatile and cyclical nature of our industry, customer order cancellations, macroeconomic changes, operational matters regarding particular agreements, our ability to manage customer deliveries and resources for the installation and acceptance of our products (for products where customer acceptance is required before we can recognize revenue from such sales), our ability to manage delays or accelerations by customers in taking deliveries and the acceptance of our products (for products where customer acceptance is required before we can recognize revenue from such sales), our ability to operate our business and sales processes effectively, and a number of the other risk factors set forth in this Item 1A.

Because our expenses are in most cases relatively fixed in the short term, any revenue shortfall below expectations could have an immediate and significant adverse effect on our operating results. Similarly, if we fail to manage our expenses effectively or otherwise fail to maintain rigorous cost controls, we could experience greater than anticipated expenses during an operating period, which would also negatively affect our results of operations. If we fail to operate our business consistent with our business plan, our operating results in any period may be significantly and adversely impacted. Such an outcome could cause customers, suppliers or investors to view us as less stable, or could cause us to fail to meet financial analysts revenue or earnings estimates, any of which could have a material adverse impact on our business, financial condition or stock price.

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Acquisitions are an important element of our strategy but, because of the uncertainties involved, we may not find suitable acquisition candidates and we may not be able to successfully integrate and manage acquired businesses. We are also exposed to risks in connection with strategic alliances into which we may enter.

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

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

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

At times, we may also enter into strategic alliances with customers, suppliers or other business partners with respect to development of technology and intellectual property. These alliances typically require significant investments of capital and exchange of proprietary, highly sensitive information. The success of these alliances depends on various factors over which we may have limited or no control and requires ongoing and effective cooperation with our strategic partners. Mergers and acquisitions and strategic alliances are inherently subject to significant risks, and the inability to effectively manage these risks could materially and adversely affect our business, financial condition and operating results.

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

Federal securities laws, rules and regulations, as well as NASDAQ rules and regulations, require companies to maintain extensive corporate governance measures, impose comprehensive reporting and disclosure requirements, set strict independence and financial expertise standards for audit and other committee members and impose civil and criminal penalties for companies and their chief executive officers, chief financial officers and directors for securities law violations. These laws, rules and regulations have increased, and in the future are expected to continue to increase, the scope, complexity and cost of our corporate governance, reporting and disclosure practices, which could harm our results of operations and divert management s attention from business operations.

We are predominantly uninsured for losses and interruptions caused by terrorist acts and acts of war. If international political instability continues or increases, our business and results of operations could be harmed.

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

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

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

A change in accounting standards or practices or a change in existing taxation rules or practices (or changes in interpretations or applications of such standards, practices or rules) can have a significant effect on our reported results and may even affect reporting of transactions completed before the change is effective.

New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation rules have occurred and may occur in the future. Changes to (or revised interpretations or applications of) existing tax or accounting rules or the questioning of current or past practices may adversely affect our reported financial results or the way we conduct our business.

For example, the adoption of the authoritative guidance for stock-based compensation*,* which required us to measure all employee stock-based compensation awards using a fair value method beginning in fiscal year 2006 and record such expense in our consolidated financial statements, has had a material impact on our consolidated financial statements, as reported under accounting principles generally accepted in the United States of America.

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

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

We are exposed to various risks related to the legal, regulatory and tax environments in which we perform our operations and conduct our business.

We are subject to various risks related to compliance with new, existing, different, inconsistent or even conflicting laws, rules and regulations enacted by legislative bodies and/or regulatory agencies in the countries in which we operate and with which we must comply, including environmental, safety, antitrust and export control regulations. For example, we are or may become subject to existing or future environmental and safety regulations (including those related to climate change) in connection with our global business operations, including regulations related to the development, manufacture and use of our products, recycling and disposal of materials used in our products or in producing our products, the operation of our facilities, and the use of our real property. Our failure or inability to comply with existing or future laws, rules or regulations, or changes to existing laws, rules or regulations, including changes that result in inconsistent or conflicting laws, rules or regulations, in the countries in which we operate could result in violations of contractual or regulatory obligations that may adversely affect our operating results, financial condition and our ability to conduct our business.

In addition, we may from time to time be involved in legal proceedings or claims regarding employment, contracts, product performance, product liability, antitrust, environmental regulations, securities, unfair competition and other matters (in addition to proceedings and claims related to intellectual property matters, which are separately discussed elsewhere in this Item 1A). These legal proceedings and claims, regardless of their merit, may be time-consuming and expensive to prosecute or defend, divert management s attention and resources, and/or inhibit our ability to sell our products. There can be no assurance regarding the outcome of current or future legal proceedings or claims, which could adversely affect our operating results, financial condition and our ability to operate our business.

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We are also exposed to additional risks related to our receipt of external funding for certain strategic development programs from various governments and government agencies, both domestically and internationally. Governments and government agencies typically have the right to terminate funding programs at any time in their sole discretion, so there is no assurance that these sources of external funding will continue to be available to us in the future. In addition, under the terms of these government grants, the applicable granting agency typically has the right to audit the costs that we incur, directly and indirectly, in connection with such programs. Any such audit could result in modifications to, or even termination of, the applicable government funding program. For example, if an audit were to identify any costs as being improperly allocated to the applicable program, those costs would not be reimbursed, and any such costs that had already been reimbursed would have to be refunded. We do not know the outcome of any future audits. Any adverse finding resulting from any such audit could lead to penalties (financial or otherwise), termination of funding programs, suspension of payments, fines and suspension or prohibition from receiving future government funding from the applicable government or government agency, any of which could adversely impact our operating results, financial condition and our ability to operate our business.

Furthermore, we are subject to tax audits in various jurisdictions, and such jurisdictions may assess additional income or other taxes against us. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material adverse effect on our operating results or cash flows in the period or periods for which that determination is made.

A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We are exposed to numerous risks as a result of the international nature of our business and operations.

A majority of our annual revenues are derived from outside the United States, and we maintain significant operations outside the United States. We expect that these conditions will continue in the foreseeable future. Managing global operations and sites located throughout the world presents challenges associated with, among other things, cultural diversity and organizational alignment. Moreover, each region in the global semiconductor equipment market exhibits unique characteristics that can cause capital equipment investment patterns to vary significantly from period to period. Periodic local or international economic downturns, trade balance issues, tariffs or other trade barriers (including those applied to our products or to parts and supplies that we purchase), political instability, legal or regulatory changes or terrorism in regions where we have operations or where we do business, along with fluctuations in interest and currency exchange rates, could negatively affect our business and results of operations. Although we attempt to manage near-term currency risks through the use of hedging instruments, there can be no assurance that such efforts will be adequate.

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

We have some exposure to fluctuations in foreign currency exchange rates, primarily the Euro and the Japanese Yen. We have international subsidiaries that operate and sell our products globally. In addition, an increasing proportion of our manufacturing activities are conducted outside of the United States, and many of the costs associated with such activities are denominated in foreign currencies. We routinely hedge our exposures to certain foreign currencies with various financial institutions in an effort to minimize the impact of certain currency exchange rate fluctuations, but these hedges may be inadequate to protect us from currency exchange rate fluctuations. To the extent that these hedges are inadequate, or if there are significant currency exchange rate fluctuations in currencies for which we do not have hedges in place, our reported financial results or the way we conduct our business could be adversely affected. Furthermore, if a financial counter-party to our hedges experiences financial difficulties or is otherwise unable to honor the terms of the foreign currency hedge, we may experience material financial losses.

We are exposed to risks related to our financial arrangements with respect to receivables factoring and banking arrangements.

We enter into factoring arrangements with financial institutions to sell certain of our trade receivables and promissory notes from customers without recourse. In addition, we maintain bank accounts with several domestic and foreign financial institutions, any of which may prove not to be financially viable. If we were to stop entering into these factoring arrangements, our operating results, financial condition and cash flows could be adversely impacted by delays or failures in collecting trade receivables. However, by entering into these arrangements, and by engaging these financial institutions for banking services, we are exposed to additional risks. If any of these financial institutions experiences financial difficulties or is otherwise unable to honor the terms of our factoring or deposit arrangements, we may experience material financial losses due to the failure of such arrangements or a lack of access to our funds, any of which could have an adverse impact upon our operating results, financial condition and cash flows.

In addition, pursuant to the terms of certain of our agreements regarding sales of our trade receivables, we may be required to repurchase the trade receivables from the financial institutions party to such agreements in the event of a dispute between us and the applicable customer regarding the customer s obligation to pay the underlying trade receivable. Such a mandatory repurchase could have an adverse impact on our cash flows for the period in which the repurchase takes place.

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There are risks associated with our outstanding indebtedness.

As of December 31, 2010, we had $750 million aggregate principal amount of outstanding indebtedness represented by our senior notes that will mature in 2018, and we may incur additional indebtedness in the future. Our ability to pay interest and repay the principal for our indebtedness is dependent upon our ability to manage our business operations and the other risk factors discussed in this section. There can be no assurance that we will be able to manage any of these risks successfully.

In addition, changes by any rating agency to our outlook or credit rating could negatively affect the value and liquidity of both our debt and equity securities. Factors that can affect our credit rating include changes in our operating performance, the economic environment, conditions in the semiconductor and semiconductor equipment industries, our financial position, and changes in our business strategy.

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

There can be no assurance that we will continue to declare cash dividends at all or in any particular amounts.

Our Board of Directors first instituted a quarterly dividend during the fiscal year ended June 30, 2005. Since that time, we have announced two increases in the amount of our quarterly dividend level. We intend to continue to pay quarterly dividends subject to capital availability and periodic determinations by our Board of Directors that cash dividends are in the best interest of our stockholders and are in compliance with all laws and agreements applicable to the declaration and payment of cash dividends by us. Future dividends may be affected by, among other factors: our views on potential future capital requirements for investments in acquisitions and the funding of our research and development; legal risks; stock repurchase programs; changes in federal and state income tax laws or corporate laws; and changes to our business model. Our dividend payments may change from time to time, and we cannot provide assurance that we will continue to declare dividends at all or in any particular amounts. A reduction in our dividend payments could have a negative effect on our stock price.

We are exposed to fluctuations in the market values of our portfolio investments and in interest rates; impairment of our investments could harm our earnings. In addition, we and our stockholders are exposed to risks related to the volatility of the market for our common stock.

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

In addition, the market price for our common stock is volatile and has fluctuated significantly during recent years. The trading price of our common stock could continue to be highly volatile and fluctuate widely in response to various factors, including without limitation conditions in the semiconductor industry and other industries in which we operate, fluctuations in the global economy or capital markets, our operating results or other performance metrics, or adverse consequences experienced by us as a result of any of the risks described elsewhere in this Item 1A. Volatility in the market price of our common stock could cause an investor in our common stock to experience a loss on the value of their investment in us and could also adversely impact our ability to raise capital through the sale of our common stock or to use our common stock as consideration to acquire other companies.

We have recorded significant restructuring, inventory write-off and asset impairment charges in the past and may do so again in the future, which could have a material negative impact on our business.

During the fiscal year ended June 30, 2009, we recorded material restructuring charges of $38.7 million related to our global workforce reduction, large excess inventory write-offs of $85.6 million, and material impairment charges of $446.7 million related to our goodwill and purchased intangible assets. If we were to encounter challenging economic conditions once again, we may implement additional cost reduction actions, which would require us to take additional, potentially material, restructuring charges related to, among other things, employee terminations or exit costs. We may also be required to write off additional inventory if our product build plans or usage of service inventory decline, and such additional write-offs could constitute material charges.

As noted above, we recorded a material charge during the fiscal year ended June 30, 2009 related to the impairment of our goodwill and purchased intangible assets. Goodwill represents the excess of costs over the net fair value of net assets acquired in a business combination. Goodwill is not amortized, but is instead tested for impairment at least annually in accordance with authoritative guidance for goodwill. Purchased intangible assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment in accordance with authoritative guidance for long-lived assets. The valuation of goodwill and intangible assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. A substantial decline in our stock price, or any other adverse change in market conditions, particularly if such change has the effect of changing one of the critical assumptions or estimates we used to calculate the amount of such impairment charge, could result in a change to the estimation of fair value that could result in an additional impairment charge.

Any such additional material charges, whether related to restructuring or goodwill or purchased intangible asset impairment, may have a material negative impact on our operating results and related financial statements.

We are exposed to risks related to our commercial terms and conditions, including our indemnification of third parties, as well as the performance of our products.

Although our standard commercial documentation sets forth the terms and conditions that we intend to apply to commercial transactions with our business partners, counterparties to such transactions may not explicitly agree to our terms and conditions. In situations where we engage in business with a third party without an explicit master agreement regarding the applicable terms and conditions, or where the commercial documentation applicable to the transaction is subject to varying interpretations, we may have disputes with those third parties regarding the applicable terms and conditions of our business relationship with them. Such disputes could lead to a deterioration of our commercial relationship with those parties, costly and time-consuming litigation, or additional concessions or obligations being offered by us to resolve such disputes, or could impact our revenue or cost recognition. Any of these outcomes could materially and adversely affect our business, financial condition and results of operations.

In addition, in our commercial agreements, from time to time in the normal course of business we indemnify third parties with whom we enter into contractual relationships, including customers and lessors, with respect to certain matters. We have agreed, under certain conditions, to hold these third parties harmless against specified losses, such as those arising from a breach of representations or covenants, other third party claims that our products when used for their intended purposes infringe the intellectual property rights of such other third parties, or other claims made against certain parties. We may be compelled to enter into or accrue for probable settlements of alleged indemnification obligations or subject to potential liability arising from our customers involvements in legal disputes. In addition, notwithstanding the provisions related to limitations on our liability that we seek to include in our business agreements, the counter-parties to such agreements may dispute our interpretation or application of such provisions, and a court of law may not interpret or apply such provisions in our favor, any of which could result in an obligation for us to pay material damages to third parties and engage in costly legal proceedings. It is difficult to determine the maximum potential amount of liability under any indemnification obligations, whether or not asserted, due to our limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in any particular claim. Our business, financial condition and results of operations in a reported fiscal period could be materially adversely affected if we expend significant amounts in defending or settling any purported claims, regardless of their merit or outcomes.

We are also exposed to potential costs associated with unexpected product performance issues. Our products and production processes are extremely complex and thus could contain unexpected product defects, especially when products are first introduced. Unexpected product performance issues could result in significant costs being incurred by us, including increased service or warranty costs, providing product replacements for (or modifications to) defective products, litigation related to defective products, product recalls, or product write-offs or disposal costs. These costs could be substantial and could have an adverse impact upon our business, financial condition and operating results. In addition, our reputation with our customers could be damaged as a result of such product defects, which could reduce demand for our products and negatively impact our business.

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

efficiency of our business operations.

Our global operations are linked by information systems, including telecommunications, the internet, our corporate intranet, network communications, email and various computer hardware and software applications. Despite our implementation of network security measures, our tools and servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems and tools located at customer sites, or could be subject to system failures or malfunctions for other reasons. System failures or malfunctioning, such as difficulties with our customer relationship management (CRM) system, could disrupt our operations and our ability to timely and accurately process and report key components of our financial results. In addition, any disruptions or difficulties that may occur in connection with our enterprise resource planning (ERP) system or other systems (whether in connection with the regular operation of such systems or as a result of the integration of our acquired businesses into such systems) could adversely affect our ability to complete important business processes, such as the evaluation of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act of 2002. Any such event could have an adverse effect on our business, operating results and financial condition.

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We are subject to the risks of additional government actions in the event we were to breach the terms of any settlement arrangement into which we have entered.

In connection with the settlement of certain government actions and other legal proceedings related to our historical stock option practices, we have explicitly agreed as a condition to such settlements that we will comply with certain laws, such as the books and records provisions of the federal securities laws. If we were to violate any such law, we might not only be subject to the significant penalties applicable to such violation, but our past settlements may also be impacted by such violation, which could give rise to additional government actions or other legal proceedings. Any such additional actions or proceedings may require us to expend significant management time and incur significant accounting, legal and other expenses, and may divert attention and resources from the operation of our business. These expenditures and diversions, as well as an adverse resolution of any such action or proceeding, could have a material adverse effect on our business, financial condition and results of operations.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
Equity Repurchase Plans

The following is a summary of stock repurchases for the three months ended December 31, 2010: [(1)]

Period	Total Number of Shares Purchased (2)	Average Price Paid per Share	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs (3)
October 1, 2010 to October 31, 2010	535,481	$ 35.31	2,698,770
November 1, 2010 to November 30, 2010	517,898	$ 36.80	2,180,872
December 1, 2010 to December 31, 2010	505,500	$ 39.50	1,675,372
Total	1,558,879	$ 37.17	

(1) In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase up to 17.8 million shares of its common stock in the open market. This plan was put into place to reduce the dilution from our employee benefit and incentive plans, such as our stock option and employee stock purchase plans, and to return excess cash to our stockholders. The Board of Directors has authorized the Company to repurchase additional shares of its common stock under the repurchase program in February 2005 (up to 10.0 million shares), February 2007 (up to 10.0 million shares), August 2007 (up to 10.0 million shares) and June 2008 (up to 15.0 million shares), in each case in addition to the originally authorized 17.8 million shares described in the first sentence of this footnote.

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

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES
None.

ITEM 4. (REMOVED AND RESERVED)

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

10.46	2010 Executive Severance Plan *
31.1	Certification of Chief Executive Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer Under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934.
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C Section 1350.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Document
101.PRE	XBRL Taxonomy Definition Presentation Document

* Denotes a management contract, plan or arrangement

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SIGNATURES

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

	KLA-Tencor Corporation (Registrant)
January 27, 2011 (Date)	/s/ RICHARD P. WALLACE Richard P. Wallace President and Chief Executive Officer (Principal Executive Officer)
January 27, 2011 (Date)	/s/ MARK P. DENTINGER Mark P. Dentinger Executive Vice President and Chief Financial Officer (Principal Financial Officer)
January 27, 2011 (Date)	/s/ VIRENDRA A. KIRLOSKAR Virendra A. Kirloskar Senior Vice President and Chief Accounting Officer (Principal Accounting Officer)

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KLA-TENCOR CORPORATION

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference Form	File Number	Exhibit Number	Filing Date
10.46	2010 Executive Severance Plan*				
31.1	Certification of Chief Executive Officer under Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934				
31.2	Certification of Chief Financial Officer under Rule 13a-14(a) /15d-14(a) of the Securities Exchange Act of 1934				
32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350				
101.INS	XBRL Instance Document				
101.SCH	XBRL Taxonomy Extension Schema Document				
101.CAL	XBRL Taxonomy Extension Calculation Document				
101.DEF	XBRL Taxonomy Extension Definition Document				
101.LAB	XBRL Taxonomy Extension Label Document				
101.PRE	XBRL Taxonomy Extension Presentation Document				

* Denotes a management contract, plan or arrangement