

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

(MARK ONE)

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

FOR THE FISCAL YEAR ENDED JUNE 30, 1998

OR

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

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NO. 0-9992

KLA-TENCOR CORPORATION  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

04-2564110  
(I.R.S. EMPLOYER IDENTIFICATION NO.)

160 RIO ROBLES SAN JOSE, CALIFORNIA  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICES)

95134  
(ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (408) 875-4200  
SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS NAME OF EACH EXCHANGE ON WHICH REGISTERED  
NONE NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:  
COMMON STOCK, \$0.001 PAR VALUE  
COMMON STOCK PURCHASE RIGHTS  
(TITLE OF CLASS)

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

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

The aggregate market value of the voting stock held by non-affiliates of the  
registrant based upon the closing price of the registrant's stock, as of  
September 18, 1998, was \$1,313,690,577. Shares of common stock held by each  
officer and director and by each person or group who owns 5% or more of the  
outstanding common stock have been excluded in that such persons or groups may  
be deemed to be affiliates. This determination of affiliate status is not

necessarily a conclusive determination for other purposes.

The registrant had 87,321,556 shares of Common Stock outstanding as of September 18, 1998.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Annual Report to Stockholders for the fiscal year ended June 30, 1998 ("1998 Annual Report to Stockholders") are incorporated by reference into Parts I, II and IV of this Report. Portions of the Proxy Statement for the Annual Meeting of Stockholders ("Proxy Statement") to be held on November 17, 1998, and to be filed pursuant to Regulation 14A within 120 days after registrant's fiscal year ended June 30, 1998, are incorporated by reference into Part III of this Report.

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PART I

ITEM 1. DESCRIPTION OF BUSINESS

THE COMPANY

General. Effective April 30, 1997, Tencor Instruments ("Tencor") merged into a wholly-owned subsidiary of KLA Instruments Corporation ("KLA"). Following the Merger, KLA changed its name to KLA-Tencor Corporation (the "Company"). The Merger brought together two companies with largely complementary product lines which provide customers with yield management solutions and process monitoring products throughout the semiconductor manufacturing process. The Company was incorporated in Delaware in July 1975. Its headquarters are located at 160 Rio Robles, San Jose, California, 95134, telephone (408) 875-4200.

As the complexity of the sub-micron semiconductor manufacturing process increases, the need for more, and more effective, process monitors also increases. Quickly attaining and then maintaining high yields is one of the most important determinants of profitability in the semiconductor industry. The importance of high yields from the manufacturing process has grown dramatically as wafer sizes increase and process geometries decrease. Total yield management solutions have taken on a significance which has not been experienced in the past. The Company is in a unique position to be the single source for comprehensive yield management solutions with a portfolio of applications-focused technologies and dedicated yield consulting expertise.

The Company is the leader in the design, manufacture, marketing and service of yield management and process monitoring systems for the semiconductor industry. The Company uses its technical expertise and understanding of customer needs to supply unique yield management solutions and one of the broadest lines of wafer inspection, thin film measurement, metrology and reticle inspection systems available in the semiconductor industry. The Company's systems are used to analyze product and process quality at critical steps in the manufacturing process for integrated circuits and to provide feedback to its customers so that fabrication problems can be identified, addressed and contained. This understanding of defect sources and how to contain them enables semiconductor manufacturers to increase yields. Semiconductor fabrication facilities are increasingly expensive to build and equip. Yield management and process monitoring systems, which typically represent a small percentage of the total investment required to build and equip a fabrication facility, enable integrated circuit manufacturers to leverage these expensive facilities and improve their returns on investment.

The Company's principal market is the semiconductor industry, marketing and selling products worldwide to all of the major semiconductor manufacturers. The Company's revenues are derived primarily from product sales, principally through its direct sales force, and to a lesser extent, through distributors.

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Yield Management Solutions Group

Maximizing yields, or the number of good die per wafer, is a key goal of modern semiconductor manufacturing. Higher yields increase the revenue a manufacturer can obtain for each semiconductor wafer processed. As geometry

linewidths decrease, yields become more sensitive to the size and density of defects. Semiconductor manufacturers use yield management and process monitoring systems to improve yields by identifying defects, by analyzing them to determine process problems, and, after corrective action has been taken, by monitoring subsequent results to ensure that the problem has been contained. Monitoring and analysis often take place at various points in the fabrication process as wafers move through a production cycle consisting of hundreds of separate process steps.

The following are some of the methods used to manage yield, all of which require the capture and analysis of data gathered through many measurements:

- Engineering analysis is performed off the manufacturing line to identify and analyze defect sources. Engineering analysis equipment operates with very high sensitivity to enable comprehensive analysis of wafers. Because they operate off-line, engineering analysis systems do not require high operational speeds.
- In-line monitoring is used to review the status of circuits during production steps. Information generated is used to determine whether the fabrication process steps are within required tolerances and to make any necessary process adjustments in real-time before wafer lots move to subsequent process stations. Because the information is needed quickly to be of greatest value, in-line monitoring requires both high throughput and high sensitivity.
- Pass/fail tests are used at several steps in the manufacturing process to evaluate products. For example, a pass/fail test is used to determine whether reticles used in photolithography are defect-free; electrical pass/fail testing is performed at the end of the manufacturing process to determine whether products meet performance specifications.

The most significant opportunities for yield improvement generally occur when production is started at new factories and when new products are first built. Equipment that helps a manufacturer quickly increase new product yields enables the manufacturer to offer these new products in volume at a time when they are likely to generate the greatest profits.

#### Wafer Inspection Group

The Company created the market for automated defect inspection of semiconductor wafers over 13 years ago. The wafer inspection group product offerings include unpatterned wafer inspection and patterned wafer inspection tools which are used to find, count and characterize particles and pattern defects on wafers both in engineering applications and in-line at various

stages during the semiconductor and wafer manufacturing processes. Semiconductor manufacturers use wafer inspection systems to monitor their manufacturing processes and to refine those processes to increase the yield of acceptable integrated circuits. Accordingly, semiconductor manufacturers base their purchase of wafer inspection systems on a variety of criteria, including sensitivity, throughput, total cost of ownership, ease of use, degree of automation, system repeatability and correlation and its ability to be integrated into overall yield management systems.

In 1992, the Company introduced the 21XX inspection systems providing the sensitivity required for microprocessors and other logic devices as well as both the logic and repeating array portions of memory devices. Subsequent upgrades with each new model provided greater sensitivity and greater maximum speed compared to its predecessor. The 2135 was introduced in 1996 with twice the throughput and higher sensitivity compared to its predecessor. In 1997, the Company introduced the 2138, a new patterned wafer inspection system with advanced capability for demanding inspection applications. It is based on the 21XX inspection platform and combines an ultra- broadband illumination source and significantly improved bright field optics with Segmented Auto Thresholding. This combination significantly increases defect sensitivity and capture, while

reducing or eliminating false defect counts in semiconductor processes. In 1998, the 2230 was introduced offering combined darkfield illumination with high-speed image processing for production line monitoring of yield limiting defects.

The Company's Surfscan(R) family of laser-scanning products are widely used for wafer qualification, process monitoring and equipment monitoring. They provide the high sensitivity, fast throughput and low cost of ownership required in a production environment and are used in virtually all semiconductor manufacturing processes. Surfscans are key components of the defect reduction strategies of many leading semiconductor manufacturers. The systems use a standardized file format that allow defect location data to be easily transferred to off-line review stations for defect classification. The Surfscan AIT is the cost/performance leader for in-line monitoring of deposited films. The Surfscan AIT, the 2138 and the 2230 are part of the Company's Intelligent Line Monitoring solution, which includes the full line of patterned wafer inspection systems, as well as the IMPACT/Online ADC, CRS/Offline ADC and Quest defect data analysis systems. This integrated yield management approach provides semiconductor device manufacturers with a comprehensive tool set which enables the acceleration of time-to-yield enhancements and yield goals. The SP1, introduced in 1997, was the Company's first system to address the unique unpatterned inspection requirements of 300mm wafers, combining a stationary illumination beam, uniform axi-symmetric collection optics and an optional bright field channel with a rotating wafer scheme to allow detection of surface defects and contaminants at speeds of 100 wafers per hour on 300mm wafers, and 150 wafers per hour on 200mm wafers. It performs rapid, highly sensitive inspection of unpatterned 300mm wafers, providing capabilities critical to wafer and equipment manufacturers who are developing products for emerging 0.25 micron process technologies and below.

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The Company offers analysis systems comprised of database management hardware and software to translate raw inspection data into patterns which reveal process problems. The Company's productivity and analysis software systems collect, store and analyze data collected by test equipment manufactured by both the Company and others to provide semiconductor manufacturers with an integrated yield management solution. The software systems identify defect sources, show defect trends and help semiconductor manufacturers develop long-term yield improvement strategies.

E-Beam Technology, CD and Overlay Group

As feature sizes of semiconductor circuits continue to decrease for leading edge semiconductor products, the Company believes that conventional optical technologies ultimately will begin to reach physical limits imposed by the wavelength of light and fail to provide the necessary inspection resolution. Working closely with those customers with the most advanced inspection requirements, the Company has developed the SEMSpec, the industry's only fully automatic defect electron beam inspection system. The development of these systems was funded in part by customer-sponsored research and development programs. The Company expects the market for these inspection systems to emerge slowly.

The Company's E-Beam metrology business has an established position in the Critical Dimension Scanning Electron Microscope (CD-SEM) inspection market, a market which the Company believes is larger than the optical overlay market, and one which it believes will grow as semiconductor manufacturers continue to produce more complex semiconductor devices. The Company's first generation E-Beam metrology system features high throughput and automated setup. The new 8100XP series is used for precision measurement of high aspect ratio structures in highly automated process control applications.

Lithography for sub-micron semiconductor fabrication requires increasingly stringent overlay and critical dimension tolerances. In particular, decreasing linewidths, larger die sizes, and additional layers have made overlay mis-registration errors a crucial cause of yield loss. To address these challenges, the Company offers the 5000 series metrology systems: the 5100 for overlay, and the 5105 for both overlay and critical dimension measurement. In 1996, the Company introduced the 5200 overlay system, which has performance and usability enhancements compared to the 5100.

The Company, utilizing its expertise in digital image processing, has developed sophisticated measurement algorithms for the 5000 series that are more tolerant of process variations. Using coherence probe microscopy, the system scans the image-forming coherence region through the wafer plane, only gathering information from in-focus surfaces. As a result, measurements are more tolerant of process and substrate reflectivity variations than those from ordinary optical systems. The precision measurements from the 5000 series identify the magnitude and direction of overlay mis-registration errors arising from the stepping process and

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from optical distortion inherent in the stepper lens. Based upon these measurements, users can fine-tune the stepper program to compensate for these errors, and improve process yield.

#### Precision Measurement Group

Reticle Inspection. RAPID, the Company's original business unit, created the market for automated inspection of reticles and photomasks for the semiconductor manufacturing industry over 20 years ago and continues to have a predominant share of this market. During photolithography, a stepper projects a circuit pattern from a reticle onto a wafer. Error-free reticles are the first step in ensuring high yields in the manufacturing process because defects in reticles can translate into millions of ruined die.

The Company's 3XX product family incorporates a reference database generator and data preparation system which give full die-to-database functionality to the inspection, permitting inspection against the ideal reticle pattern as specified by the user's CAD program. The Company has continued to develop enhancements to the 3XX inspection system to improve performance, serviceability and reliability. In 1997, the Company introduced two new reticle and photomask inspection enhancements, the Advanced Performance Algorithm (APA) and the STARlight High Resolution option. These enhancements enable highly accurate and reliable inspection of next-generation 0.25 micron reticles, including reticles with complex optical proximity correction geometries. In 1998, the 353UV automated reticle inspection system was introduced which allows for ultraviolet-based inspection providing the sensitivity levels necessary on complex reticles designed for deep UV lithography applications.

Film Measurement. The Company's film measurement division produces both film thickness and resistivity measurement tools. The film thickness products are used to measure a variety of optical properties of thin films, while the resistivity products measure the resistivity of the various layers used to make integrated circuits. These products are used to control a wide range of wafer fabrication steps, where within-wafer and wafer-to-wafer uniformity of the process is of paramount importance to semiconductor manufacturers to achieve high yields at the lowest possible cost.

The Company has been a leader in the thin film market since entering it over 12 years ago. In 1995, the Company introduced the UV-1250SE, which brought a powerful new technology, spectroscopic ellipsometry, to production. Continuing innovations resulted in the UV-1280SE with one of the most robust measurement capabilities in the industry. The use of thin film systems throughout the manufacturing facility creates significant challenges in measurement flexibility (especially on new film materials and multi-layer films), recipe management and factory floor computer automation. The Company's UV product line, which has an installed base of over 500 systems has addressed these requirements by delivering powerful measurement engines in reliable, easy to use system designs. The systems also incorporate software which enables extensive use of host computer operation to control the equipment, analyze the data and

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feedback to the process equipment, all steps which are critical for effective process control and maintaining high yields.

Surface Metrology. Stylus profilers are used to measure the surface topography of films and etched surfaces and are used in basic research and development as well as production and quality control areas. In addition, the Company produces stress measurement systems which detect reliability related problems such as film cracking, voiding and lifting. The Company recently introduced a new high-resolution profiler (HRP) product which significantly increased the potential applications for surface profilers because it is the first metrology system to offer the combined monitoring capability traditionally achieved by two different instruments, an in-line profiler for measuring wide spatial problems such as dishing and erosion and the off-line atomic force microscope for the nanoscale problem of plug recess.

#### CUSTOMERS

The Company sells its systems to all of the world's major semiconductor manufacturers. In fiscal 1998, 1997 and 1996, no single customer accounted for more than 10% of the Company's revenues.

#### INTERNATIONAL REVENUES

The Company has wholly-owned foreign subsidiaries or foreign branches of domestic subsidiaries in Japan, Korea, Taiwan, Europe, Israel, Singapore and Malaysia for marketing, sales and service of products. In addition, the Company has manufacturing operations in Israel for its metrology products. International sales accounted for approximately 56%, 65% and 66% of the Company's revenues in fiscal 1998, 1997 and 1996, respectively. For information regarding the Company's revenues from foreign operations for the Company's last three fiscal years, see Note 8 of Notes to Consolidated Financial Statements incorporated herein by reference to Exhibit 13.1 hereto.

The Company believes that foreign sales will continue to be a significant percentage of revenues. The future performance of the Company will be dependent upon, in part, its ability to continue to compete successfully in Asia, one of the largest markets for the sale of yield management services in process monitoring equipment. The Company's ability to compete in this area in the future is dependent upon the continuation of favorable trading relationships between the region (especially Japan and Korea) and the United States and the continuing ability of the Company to maintain satisfactory relationships with leading semiconductor companies in the region. International sales and operations may be adversely affected by imposition of governmental controls, restrictions on export technology, political instability, trade restrictions, changes in tariffs and the difficulties associated with staffing and managing international operations. In addition, international sales may be adversely affected by the economic conditions in each country. The revenues from the Company's international business may be affected by fluctuations in currency exchange rates. Although the Company attempts to manage near term

currency risks through "hedging," there can be no assurance that such efforts will be adequate. These factors could have a material adverse effect on the Company's future business and financial results.

#### SALES, SERVICE AND MARKETING

The Company believes that the size and location of its field sales, service and applications engineering organization represents a competitive advantage in its served markets. In the United States, Europe, Asia Pacific and Japan the Company has a direct sales force although in the past it has used a mix of direct sales and distributor/sales representative arrangements. The Company maintains an export compliance program that fully meets the requirements of the U.S. Department of Commerce and the Department of State. The Company does not consider its business to be seasonal in nature, but it is cyclical with respect to the capital equipment procurement practices of major semiconductor manufacturers and is impacted by the investment patterns of such manufacturers in different global markets.

The Company's sales, service and applications facilities throughout the world employ over 1,700 sales, service and applications engineers. The Company maintains sales and service offices throughout the United States and in Japan,

Korea, Taiwan, Singapore, Europe and Israel.

#### RESEARCH AND DEVELOPMENT

The market for yield management and process monitoring systems is characterized by rapid technological development and product innovation. The Company believes that continued and timely development of new products and enhancements to existing products are necessary to maintain its competitive position. Accordingly, the Company devotes a significant portion of its personnel and financial resources to research and development programs and seeks to maintain close relationships with customers to remain responsive to their needs. In order to meet continuing developments in the semiconductor industry the Company is committed to significant engineering efforts for product improvement and new product development. New product introductions may contribute to fluctuations in operating results, since customers may defer ordering products from existing product lines. If new products have reliability or quality problems, reduced orders, higher manufacturing costs, delays in acceptance of and payment for new products and additional service and warranty expense may result. On occasion, the Company has experienced reliability and quality problems in connection with certain product introductions, resulting in some of these consequences. There can be no assurance that the Company will successfully develop and manufacture new hardware and software products or that new hardware and software products introduced by the Company will be accepted in the marketplace. If the Company does not successfully introduce new products, its results of operations will be adversely affected. For information regarding the Company's research and development expense during the last three fiscal years, see Management's Discussion and Analysis of Results of Operations and Financial Condition incorporated herein by reference to Exhibit 13.1 hereto.

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#### MANUFACTURING

The Company's principal manufacturing activities take place in San Jose and Milpitas, California and Migdal Ha'Emek, Israel, and consist primarily of manufacturing, assembling and testing components and subassemblies which are acquired from third party vendors and then integrated into the Company's finished products. The Company employs over 1,900 manufacturing and engineering personnel and also cross-trains personnel in order to respond to changes in product mix.

Many of the components and subassemblies are standard products, although certain items are made to Company specifications. Certain of the components and subassemblies included in the Company's systems are obtained from a single source or a limited group of suppliers. Those parts subject to single or limited source supply are routinely monitored by management and the Company endeavors to ensure that adequate supplies are available to maintain manufacturing schedules, should supply for any part be interrupted. Although the Company seeks to reduce its dependence on sole and limited source suppliers, in some cases the partial or complete loss of certain of these sources could disrupt scheduled deliveries to customers and have a material adverse effect on the Company's results of operations and damage customer relationships.

#### COMPETITION

The worldwide market for yield management and process control systems is highly competitive. In each of the markets it serves, the Company faces competition from established and potential competitors, some of which may have greater financial, engineering, manufacturing and marketing resources than the Company. The Company believes that to remain competitive it will require significant financial resources in order to offer a broad range of products, to maintain customer service and support centers worldwide, and to invest in product and process research and development. The semiconductor equipment industry is becoming increasingly dominated by large manufacturers such as Applied Materials, Inc., Hitachi Electronics Engineering Co., Ltd. and Tokyo Electron Limited, who have the resources to support customers on a worldwide basis. Some of these competitors have substantially greater financial resources and more extensive engineering, manufacturing, marketing and customer service and support capabilities than the Company. The Company expects its competitors to continue to improve the design and performance of their current products and processes and to introduce new products and processes with improved price and

performance characteristics. No assurance can be given that the Company will be able to continue to compete successfully against its competitors.

Significant competitive factors in the market for yield management and process control systems include system performance, ease of use, reliability, installed base and technical service and support. The Company believes that, while price and delivery are important competitive factors, the customers' overriding requirement is for systems which easily and effectively incorporate automated, highly accurate inspection capabilities into their existing manufacturing processes, thereby enhancing productivity. The Company's yield management and process

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control systems for the semiconductor industry are generally higher priced than those of its present competitors and are intended to compete based upon performance and technical capabilities. These systems also compete with less expensive, more labor-intensive manual inspection devices.

In addition, in configuring their fabrication plants, semiconductor manufacturers increasingly tend to select specific items of manufacturing equipment for all of the fabrication facilities used to produce each generation of integrated circuits. As a result of this process, the Company's failure to have one or more of its products selected by a semiconductor manufacturer for use in its facilities for a particular generation of integrated circuits may effectively eliminate sales of that product for all of that manufacturer's fabrication plants used for that generation of integrated circuits which could have a significant and long-term adverse effect on the Company's results of operations. Although the Company has been relatively successful to date in these selection decisions, not all of the Company's products have been selected by each of its customers for fabrication facilities for each generation of integrated circuits. Further, there can be no assurance that the Company's products will be selected in the future, or that the Company will continue to be as successful in connection with selection processes as it has been to date.

#### PATENTS AND OTHER PROPRIETARY RIGHTS

The Company protects its proprietary technology through a variety of intellectual property laws including patent, copyright and trade secrets law; however, the Company believes that, due to the rapid pace of innovation within the yield management and process control systems industry, its protection of patent and other intellectual property rights is less important than factors such as its technological expertise, continuing development of new systems, market penetration and installed base and the ability to provide comprehensive support and service to customers. There can be no assurance that the Company will be able to protect its technology or that competitors will not be able to develop similar technology independently.

The Company currently holds 117 U.S. patents and has applied for 78 additional patents in the United States. In addition, the Company has 28 foreign patents and applied for 85 additional foreign patents. From time to time the Company acquires license rights under U.S. and foreign patents and other proprietary rights of third parties. No assurance can be given that patents will be issued on any of the Company's applications, that license assignments will be made as anticipated or that the Company's patents, licenses or other proprietary rights will be sufficiently broad to protect its technology. In addition, no assurance can be given that any patents issued to or licensed by the Company will not be challenged, invalidated or circumvented or that the rights granted thereunder will provide a competitive advantage to the Company.

#### BACKLOG

At June 30, 1998, the Company's backlog for systems totaled \$424 million, compared to \$573 million at June 30, 1997. In general, systems ship within six months to a year after receipt

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of a customer's purchase order. The Company expects to fill the present backlog of orders during fiscal 1999. All orders are subject to cancellation or delay by the customer with limited or no penalty. The Company's backlog is not necessarily indicative of actual sales for any succeeding period.

## EMPLOYEES

As of June 30, 1998, the Company employed a total of approximately 4,500 persons. None of the Company's employees are represented by a labor union. The Company has experienced no work stoppages and believes that its employee relations are good.

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

## ITEM 2. PROPERTIES

Certain information concerning the Company's properties at June 30, 1998 is set forth below:

LOCATION -----	Type ----	Principal use -----	Footage -----	Ownership -----
San Jose, CA	Office, plant and warehouse	Corporate Headquarters, Research and Engineering, Marketing, Manufacturing, Sales and Service and Sales Administration	519,382	Leased
Milpitas, CA	Office, plant and warehouse	Research and Engineering, Marketing, Manufacturing, Sales and Service and Sales Administration	233,699 572,670	Owned Lease
Scotts Valley, CA	Office, plant	Research and Development	9,945	Leased
Austin, TX	Office	Sales and Service, Training	37,074	Leased
Richardson, TX	Office	Sales and Service, Training	28,474	Leased
Basingstoke and Wokingham, England	Office, plant	Sales and Service, Warehouse	16,475	Leased
Grenoble, Bretonneux and Evry, France	Office	Sales and Service	14,798	Leased
Dresden and Puchheim Germany	Office	Sales and Service	14,975	Leased
Naruse, Japan	office	Sales and Service	29,107	Leased
Yokohama, Japan	office	Sales and Service	56,967	Leased
Seoul, Korea	office	Sales and Service	17,558	Leased
Hsinchu, Taiwan	office	Sales and Service	14,892	Leased
Migdal Ha'Emek and Herzliya, Israel	office	Research and Engineering, Marketing, Manufacturing and Sales and Service and Sales Administration	56,057	Leased

The Company leases several other facilities under operating leases that expire at various times through June 30, 2012 with renewal options at the fair market value for additional periods up to five years. See Note 7 to Notes to Consolidated Financial Statements in Exhibit 13.1 hereto.

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ITEM 3. LEGAL PROCEEDINGS

None.

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

None.

## PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON STOCK AND RELATED  
STOCKHOLDER MATTERS

The information required by this Item is incorporated herein by reference to Exhibit 13.1 hereto.

ITEM 6. SELECTED FINANCIAL DATA

The information required by this Item is incorporated herein by reference to Exhibit 13.1 hereto.

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

Management's Discussion and Analysis of Results of Operations and Financial Condition is incorporated herein by reference to Exhibit 13.1 hereto.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this item is incorporated herein by reference to Exhibit 13.1 hereto.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The consolidated financial statements are incorporated herein by reference to Exhibit 13.1 hereto.

ITEM 9. DISAGREEMENTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

Not Applicable.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Set forth below are the names of the present directors and executive officers of the

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Company, their ages and positions held with the Company. Additional information required by Item 405 of Regulation S-K of the Securities Act of 1933, as amended, is incorporated herein by reference to the Company's Proxy Statement.

NAME - - - - -	AGE ---	POSITION -----
Jon D. Tompkins	58	Chairman of the Board
Kenneth Levy	55	Chief Executive Officer and Director
Kenneth L. Schroeder	52	President and Chief Operating Officer and Director
Robert J. Boehlke	57	Executive Vice President and Chief Financial Officer
Frederick A. Ball	36	Vice President Finance and Accounting
Lisa C. Berry	40	Vice President and General Counsel
Gary E. Dickerson	41	Executive Vice President, Yield Management Solutions
Edward C. Grady	51	Executive Vice President, Precision Measurement Group
Samuel A. Harrell	58	Senior Vice President, Strategic Business Development
Neil Richardson	43	Executive Vice President, E-Beam Technology, CD and Overlay Group
Magnus O. W. Ryde	42	Vice President, Worldwide Sales Operations
Arthur P. Schnitzer	55	Executive Vice President, Human Resources
Graham J. Siddall	51	Executive Vice President Wafer Inspection Group
James W. Bagley	59	Director
Edward W. Barnholt	55	Director
Leo J. Chamberlain	68	Director
Richard J. Elkus, Jr.	63	Director
Dean O. Morton	66	Director
Yoshio Nishi	58	Director
Samuel Rubinovitz	68	Director

Dag Tellefsen	56	Director
Lida Urbaneck	55	Director

Kenneth Levy is a founder of the Company and since July 1, 1998 has been Chief Executive Officer and a Director. From 1975 until April 30, 1997 he was Chairman of the Board and Chief Executive Officer. From April 30, 1997 until June 30, 1998 he was Chairman of the Board. He currently serves on the boards of directors of Ultratech Stepper, Inc. and Integrated Process Equipment Corporation.

Jon D. Tompkins has been Chairman of the Board since July 1, 1998. From April 30, 1997 until July 1, 1998 he was Chief Executive Officer and a Director of the Company. From 1991 until

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April 30, 1997 he was President and Chief Executive Officer of Tencor Instruments, a manufacturer of wafer inspection, film measurement and metrology systems for the semiconductor industry ("Tencor") prior to its merger with the Company in April 1997 (the "Merger"). He was a director of Tencor from 1991 until April 1997 and was appointed chairman of the board of directors of Tencor in November 1993. He currently serves on the boards of directors of Varian Corporation and ESI Incorporated as well as chairman of the board of SEMI/SEMATECH, a private research and development consortium of U.S. semiconductor equipment and materials companies.

Kenneth L. Schroeder has been President, Chief Operating Officer and Director of the Company since November 1991. He currently serves on the board of directors of GaSonics International.

Robert J. Boehlke has been Vice President and Chief Financial Officer of the Company since July 1990. In April 1997 he was promoted to Executive Vice President. He currently serves on the board of directors of LTX Corporation and Fluorware.

Frederick A. Ball became Vice President Finance and Accounting of the Company on April 30, 1997 as a result of the Merger. He joined Tencor as corporate controller in March 1995 and was promoted to corporate vice president and appointed corporate secretary in January of 1996. Prior to Tencor, Mr. Ball was with Price Waterhouse LLP for ten years.

Lisa C. Berry joined the Company in September 1996 as Vice President and General Counsel. Ms. Berry joined the Company from LSI Logic Corporation, a manufacturer of application specific integrated circuits, where she held the positions of associate general counsel from October 1994 until September 1996 and assistant general counsel from August 1991 until October 1994.

Gary E. Dickerson joined the Company in January 1986 and has held a series of positions. In July 1990 he was promoted to Director of Marketing and Vice President of Marketing in July 1992. In July 1993, he was promoted to Vice President and Director of the Wafer Inspection Group. In January 1996, he was promoted to Group Vice President. In 1997, Mr. Dickerson became Executive Vice President of the newly formed Yield Management Solutions Group.

Edward C. Grady joined the Company in December 1994 as Vice President of Advanced Programs. He took the position of Vice President of Marketing in July 1995 until March 1996. In March 1996 until August 1998 he was Vice President and General Management of the RAPID Division. In August 1998 he was promoted to Executive Vice President of the Precision Measurement Group.

Dr. Samuel A. Harrell joined the Company in September 1995 as Senior Vice President of Strategic Business Development. Dr. Harrell is responsible for strategic corporate development. Dr. Harrell served from October 1992 to December 1995 as the senior vice president and chief

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strategy officer of SEMATECH. From August 1987 to September 1992 he served as president of SEMI/SEMATECH.

Dr. Neil Richardson joined the Company in June 1993 as Vice President and General Manager of the Metrology Division. He became Executive Vice President of the Metrology Group (of the combined operations of the Company and Tencor as a result of the Merger) in 1997. He served as vice president and general manager of the Diagnostic Systems Group of Schlumberger Technologies from September 1985 to November 1991, and was the corporate technology adviser for Schlumberger Ltd., a manufacturer of electronic test equipment, from November 1991 to May 1993.

Magnus O.W. Ryde joined the Company in June 1980 and has held a series of positions. In 1991, Mr. Ryde became Vice President of Operations for the Company's ATS division. He was promoted to Vice President and General Manager of the Customer Support division in July 1992. In July 1995, he became Vice President for the United States and European Sales Organizations. In July 1997 he was promoted to Vice President of Worldwide Field Operations.

Arthur P. Schnitzer joined the Company in July 1978 and has held a series of positions. In 1989 he was promoted to Vice President and General Manager of the Wisard division. In July 1993, he became Group Vice President responsible for RAPID, SEMSPEC, PRISM and manufacturing for WISARD and RAPID. Since June 1997 he has been Executive Vice President, Human Resources.

Dr. Graham J. Siddall was appointed Executive Vice President of the Wafer Group (of the combined operations of the Company and Tencor as a result of the Merger) in April 1997. In December 1995, he was appointed executive vice president and chief operating officer of Tencor. Previously Dr. Siddall served as senior vice president for the Tencor Instruments Wafer Inspection Division from November 1994 to December 1995. He joined Tencor as a vice president in 1988.

James W. Bagley has been a Director of the Company since April 30, 1997. He was a director of Tencor from June 1993 until April 30, 1997. He has been chief executive officer and a director of Lam Research Corporation, a manufacturer of semiconductor processing equipment, since August 1997. From May 1996 until August 1997 he was chairman of the board and chief executive officer of OnTrak Systems, Inc. until its merger with Lam Research Corporation in August 1997. From December 1987 until December 1993, Mr. Bagley was president and chief operating officer for Applied Materials, Inc., a manufacturer of wafer fabrication systems to the semiconductor industry. From January 1994 until October 1995 he was vice chairman and chief operating officer of Applied Materials, Inc., and vice chairman from November 1995 until May 1996. Mr. Bagley currently serves on the boards of directors of Teradyne, Inc., Kulicke & Soffa Industries, Inc., Micron Technology, Inc., and SEMI/SEMATECH.

Edward W. Barnholt has been a Director of the Company since 1995. Mr. Barnholt joined Hewlett-Packard Company, a manufacturer of electronic and computer equipment in December

1966. From 1988 to 1990 he was general manager of the Electronics Instruments Group of Hewlett-Packard Company. In July 1988, he was elected vice president and in November 1993 he was elected senior vice president of Hewlett-Packard Company. Mr. Barnholt is currently executive vice president and general manager of the Test and Measurement Organization of Hewlett Packard Company.

Leo J. Chamberlain has been a Director of the Company since 1982. He is a private investor.

Richard J. Elkus, Jr. has been a Director of the Company since April 30, 1997. He was executive vice president and vice chairman of the board of directors of Tencor from February 1994 until April 30, 1997. Previously, he was with Prometrix Corporation from September 1983 until February 1994 where he held the positions of chairman and chief executive officer until its merger with Tencor in February 1994. He currently serves on the boards of directors of Voyan Technology and Lam Research Corporation.

Dean O. Morton has been a Director of the Company since April 30, 1997. From June 1993 until April 30, 1997 he was a director of Tencor. In October 1992 Mr. Morton retired as executive vice president, chief operating officer and a director of Hewlett-Packard Company, where he held various positions from 1960 until his retirement. Mr. Morton currently serves as chairman of the board of Centigram Communications Corporation and as a director of ALZA Corporation, The Clorox Company, BEA Systems Inc. and Raychem Corporation. Mr. Morton is also a trustee of the Metropolitan Series Fund and State Street Research Funds Group and Portfolios Inc.

Yoshio Nishi has been a Director of the Company since 1989. Since May 1995 he has been director of research and development and senior vice president of the Semiconductor Group of Texas Instruments Incorporated, a manufacturer of integrated circuits and electronic equipment. From January 1986 to April 1995 he was director of the Silicon Process Laboratory for Hewlett-Packard Laboratories, a semiconductor technology research facility affiliated with Hewlett-Packard Company.

Samuel Rubinovitz has been a Director of the Company since 1990. He previously served as a Director of the Company from October 1979 to January 1989. From April 1989 to January 1994 he was executive vice president of EG&G, Inc., a diversified manufacturer of scientific instruments and electronic, optical and mechanical equipment. He currently serves on the boards of directors of Richardson Electronics, Inc., LTX Corporation and Kronos, Inc.

Dag Tellefsen has been a Director of the Company since 1978. He is the general partner of the Investment Manager of Glenwood Ventures I and II, venture capital funds. He currently serves on the boards of directors of Iwerks Entertainment Corporation, Aptix, Metorex International and Aeneid.

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Lida Urbanek has been a Director of the Company since April 30, 1997. She is a private investor. She was a director of Tencor from August 1991 until April 30, 1997.

ITEM 11. EXECUTIVE COMPENSATION

The information required by this Item is incorporated by reference to "EXECUTIVE COMPENSATION" in the Company's Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The information required by this Item is incorporated by reference to "SECURITY OWNERSHIP -- Principal Stockholders and Security Ownership of Management" in the Company's Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information regarding "Certain Relationships and Related Transactions" as it appears in the Proxy Statement is incorporated herein by reference.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENTS, SCHEDULES, AND REPORT ON FORM 8-K

(a) FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES.

1. Financial Statements.

Consolidated Balance Sheets - As of June 30, 1998 and 1997  
Consolidated Statements of Operations - For the Three Years Ended June 30, 1998  
Consolidated Statement of Stockholders' Equity - For the Three Years Ended June 30, 1998  
Consolidated Statements of Cash Flows - For the Three Years Ended June 30, 1998  
Notes to Consolidated Financial Statements Report of Independent Accountants

2. Financial Statement Schedules.

All schedules are omitted because they are either not applicable or the required information is shown in the consolidated financial statements or notes thereto.

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3. Exhibits.

EXHIBIT NO. -----	DESCRIPTION -----
3.1	Certificate of Incorporation as amended(1)
3.2	Bylaws, as amended(1)
4.1	Amended and Restated Rights Agreement dated as of August 25, 1996, between the Company and First National Bank of Boston, as Rights Agent. The Rights Agreement includes as Exhibit A, the form of Right Certificate and as Exhibit B, the summary of terms of Rights.(2)
10.1	Form of Retention and Non-Competition Agreement(3)
10.2	Form of KLA-Tencor Corporation Corporate Officers Retention Plan(3)
10.3	Form of Indemnification Agreement(4)
10.4	1990 Outside Directors Stock Option Plan(5)
10.5	Second Amended and Restated 1981 Employee Stock Purchase Plan(6)
10.6	Restated 1982 Stock Option Plan(7)
10.7	Tencor Instruments Second Amended and Restated 1984 Stock Option Plan(8)
10.8	Tencor Instruments Amended and Restated 1993 Equity Incentive Plan(8)
10.9	Tencor Instruments 1993 Nonemployee Directors Stock Option Plan(8)
10.10	1983 Employee Incentive Stock Option Plan of Prometrix Corporation(8)
10.11	1993 Employee Incentive Stock Option Plan of Prometrix Corporation(8)
10.12	1997 Employee Stock Purchase Plan(9)
10.13	Excess Profit Stock Plan(10)
13.1	1998 Annual Report to Stockholders (deemed to be filed except to the extent that the information is specifically incorporated by reference)
21.1	List of Subsidiaries of KLA-Tencor Corporation
23.1	Consent of Independent Accountants
27.1	Financial Data Schedule

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Notes

- (1) Filed as an exhibit to the Registrant's Form 10-Q for the quarter ended March 31, 1997.
- (2) Filed as exhibit 1 to the Registrant's Report on Form 8-A/A, Amendment No. 2, to the Registration Statement on Form 8-A filed September 24, 1996, SEC File No. 0-9992.
- (3) Filed as an exhibit to the Registrant's Registration Statement on Form S-4 filed March 11, 1997, SEC File No. 333-23075.
- (4) Filed as an exhibit to the Registrant's Annual Report on Form 10-K for the year ended June 30, 1997.
- (5) Filed as exhibit 4.6 to the Registrant's Annual Report on Form 10-K for the year ended June 30, 1991.
- (6) Filed as exhibit 10.1 to the Registrant's Registration Statement on Form S-8 filed January 30, 1998, SEC File No. 333-45271.

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- (7) Filed as exhibit 10.74 to the Registrant's Registration Statement on Form S-8 filed March 7, 1997, SEC File No. 333-22941.
- (8) Filed as exhibits 10.1, 10.2, 10.3, 10.6 and 10.7, respectively, to the Registrant's Registration Statement on Form S-8 filed May 8, 1997, SEC File No. 333-26681.
- (9) Filed as exhibit 10.2 to the Registrant's Registration Statement on Form S-8 filed January 30, 1998, SEC File No. 333-45271.
- (10) Filed as exhibit 10.15 to the Registrant's Registration Statement on Form S-8 filed August 7, 1998, SEC File No. 333-60887.

(b)REPORT ON FORM 8-K.

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 on September 28, 1998.

KLA-Tencor Corporation  
By: /s / Kenneth Levy  
-----  
Kenneth Levy, Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Signature	Title	Date
-----	-----	----
/s/ Kenneth Levy	Chief Executive Officer and Director	

----- Kenneth Levy	(Principal Executive Officer)	September 28, 1998
/s/ Jon D. Tompkins ----- Jon D. Tompkins	Chairman of the Board and Director	September 28, 1998
/s/ Kenneth L. Schroeder ----- Kenneth L. Schroeder	President, Chief Operating Officer and Director	September 28, 1998
/s/ Robert J. Boehlke ----- Robert J. Boehlke	Executive Vice President and Chief Financial Officer (Principal Accounting Officer)	September 28, 1998
/s/ James W. Bagley ----- James W. Bagley	Director	September 28, 1998
/s/ Edward W. Barnholt ----- Edward W. Barnholt	Director	September 28, 1998
/s/ Leo J. Chamberlain ----- Leo J. Chamberlain	Director	September 28, 1998
/s/ Richard J. Elkus, Jr. ----- Richard J. Elkus, Jr.	Director	September 28, 1998
/s/ Dean O. Morton ----- Dean O. Morton	Director	September 28, 1998
/s/ Yoshio Nishi ----- Yoshio Nishi	Director	September 28, 1998
/s/ Samuel Rubinovitz ----- Samuel Rubinovitz	Director	September 28, 1998
/s/ Dag Tellefsen ----- Dag Tellefsen	Director	September 28, 1998
/s/ Lida Urbanek ----- Lida Urbanek	Director	September 28, 1998

EXHIBIT INDEX

EXHIBIT NUMBER -----	DESCRIPTION -----
13.1	1998 Annual Report to Stockholders (deemed to be filed except to the extent that the information is specifically incorporated by reference)
21.1	List of Subsidiaries of KLA-Tencor Corporation
23.1	Consent of Independent Accountants
27.1	Financial Data Schedule





## FINANCIAL HIGHLIGHTS

In thousands, except per share data

Year ended June 30,	1994	1995	1996	1997	1998
OPERATIONS:					
Revenues	\$ 376,454	\$ 695,950	\$1,094,492	\$1,031,824	\$1,166,325
Income from operations	\$ 55,784	\$ 156,609	\$ 296,266	\$ 145,832	\$ 164,631
Net income	\$ 40,443	\$ 104,811	\$ 196,634	\$ 105,396	\$ 134,096
Basic income per share	\$ 0.61	\$ 1.40	\$ 2.42	\$ 1.29	\$ 1.58
Diluted income per share	\$ 0.59	\$ 1.34	\$ 2.34	\$ 1.24	\$ 1.52
Net income excluding other charges(1)	\$ 40,443	\$ 120,965	\$ 196,634	\$ 151,272	\$ 155,574
Diluted income per share excluding other charges(1)	\$ 0.59	\$ 1.54	\$ 2.34	\$ 1.78	\$ 1.76
YEAR END STATUS:					
Cash, cash equivalents and marketable securities	\$ 174,305	\$ 385,040	\$ 468,475	\$ 687,249	\$ 723,481
Working capital	\$ 277,791	\$ 452,350	\$ 591,397	\$ 531,313	\$ 605,688
Total assets	\$ 430,453	\$ 850,406	\$1,157,919	\$1,343,307	\$1,548,397
Stockholders equity	\$ 307,334	\$ 652,222	\$ 870,999	\$1,014,613	\$1,197,714

(1) Excludes non-recurring acquisition, merger and restructuring charges of \$16 million, \$61 million and \$22 million in 1995, 1997 and 1998, respectively.

## KLA - TENCOR 1998

MANAGEMENT'S DISCUSSION & ANALYSIS of  
FINANCIAL CONDITION & RESULTS of OPERATIONS

RESULTS OF OPERATIONS. Fiscal 1998 was the third consecutive year the Company achieved revenues in excess of \$1 billion. The year began with continued recovery of the orders and shipments of process control and yield management equipment over the previous year as many semiconductor manufacturers expanded and upgraded existing facilities. However, in the last half of fiscal 1998, revenue growth and operations were impacted sharply by a downturn in the semiconductor industry driven by overcapacity and pricing pressures in the DRAM market as well as weakness in Japan and Asia Pacific economies. These conditions were evidenced by a shift in the Company's percent of revenues from Asia Pacific to the United States and Western Europe. The first half of fiscal 1998 showed marked improvements in sales in the Yield Management Solutions Group and growth in the Company's market share of the Metrology business. While these trends have continued throughout the year, results declined, primarily in the Wafer Inspection Group, since new fab construction was delayed or stopped as semiconductor manufacturers reassessed their capital spending and expansion plans in light of the deteriorating market conditions.

Despite the market fluctuations, the financial position of the Company has remained strong. In response to the decline in revenue growth and new order levels, broad measures have been implemented to reduce costs and control spending. However, the Company has continued its new product development by investment in leading edge technologies and by strategic acquisitions. These investments have and are expected to continue to position the Company's extensive productline to address the critical initiatives that are key to its customers, including the acceleration of technology to sub-quarter micron and 300 millimeter wafers. During this most recent downturn in the business cycle, yield management and yield enhancement are more critical than ever before as semiconductor companies strive to maintain effective low cost manufacturing environments with reduced capital budgets.

REVENUES AND GROSS MARGINS. Revenues increased \$135 million, or 13%, in 1998 versus 1997 primarily due to increased volumes of the Company's data analysis systems sales including Automatic Defect Classification, review systems and increased market penetration by the CD SEM model 8100. In addition, increases

were realized in Field Service revenue. These increases offset declines in the Wafer Inspection Group's revenues during the last half of fiscal 1998. Overall revenue declines in the second half of fiscal 1998 were driven by reduced spending capital, particularly in the Asia Pacific region. Revenues in 1997 when compared to 1996 declined approximately 6% due to excess capacity and lower prices in the DRAM market which slowed semiconductor equipment purchases.

Gross margin decreased to 52.4% in 1998 from 54.3% in 1997 and 57.1% in 1996. The decrease during the last two years was primarily due to increased infrastructure costs of the Company's Customer Service Group and higher warranty and installation costs related to new product introductions.

RESEARCH AND DEVELOPMENT. Net research and development (R&D) expenses were \$182 million, \$134 million and \$116 million, or 15.6%, 13.0% and 10.6% of revenues in 1998, 1997 and 1996, respectively. The increase in dollars in 1998 compared to 1997, and in 1997 compared to 1996, is primarily attributable to increases in headcount and project material costs associated with the Company's ongoing efforts to develop products which address new market segments and enhancements to existing products including next generation 300mm products and inspection enhancements for sub-quarter micron technology.

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SELLING, GENERAL AND ADMINISTRATIVE. Selling, general and administrative (SG&A) expenses were \$242 million, \$219 million and \$213 million, or 20.8%, 21.3% and 19.4% of revenues, in 1998, 1997 and 1996, respectively. The increase in dollars in 1998 compared to 1997 can be attributed primarily to strengthening of the worldwide sales and applications infrastructure organization. The increase in dollars in 1997 compared to 1996 can be attributed primarily to increases in expenses resulting from the significant efforts involved with enhancements to the Company's information systems infrastructure.

NON-RECURRING ACQUISITION, RESTRUCTURING AND OTHER CHARGES. During fiscal 1998, the Company acquired complementary businesses and technologies including Nanopro GmbH, Groff Associates (dba VARS) and DeviceWare Inc. which were recorded under the purchase method of accounting. These companies were acquired for an aggregate amount of approximately \$21 million consisting primarily of in-process technology. Additionally, the Company acquired Amray, Inc. (Amray), which was recorded under the pooling-of-interests method of accounting. The Company incurred approximately \$2 million in professional fees related to this acquisition which have been included in "non-recurring acquisition, restructuring and other charges". Amray's historical operations, net assets, and cash flows were not material to the Company's consolidated financial results prior to the acquisition. Excluding the non-recurring charges, the Company's results of operations were not materially affected by these acquisitions.

During fiscal 1997, the Company recorded charges totaling \$61 million for merger, restructuring and other non-recurring events. Of this amount approximately \$46 million was the result of the merger between KLA Instruments and Tencor Instruments on April 30, 1997, \$6 million was a result of the write-off of a Tencor bad debt and \$9 million was additional restructuring charges primarily related to lease exit costs incurred by Tencor Instruments prior to the merger. The remaining balance of approximately \$5 million will be used in the first half of fiscal 1999.

INTEREST INCOME AND OTHER, NET. Interest income and other, net is comprised primarily of income recognized upon settlement of certain foreign currency contracts and interest income earned on the Company's investment and cash portfolio. The increase over the last two years has been attributable to income recognized upon settlement of certain foreign currency contracts and interest resulting from higher average investment balances.

PROVISION FOR INCOME TAXES. The provision for income taxes on the Company's pretax income was 35%, 39.4% and 37.3% in fiscal 1998, 1997 and 1996, respectively. The Company's effective tax rate decreased to 32% in 1998 excluding the effect of non-recurring acquisition costs from 34.9% in 1997 prior to restructuring and merger costs. This decline results primarily from realization of tax attributes related to a prior acquisition, relatively fewer non-deductible merger and acquisition related costs and a relative reduction in state and foreign taxes.

LIQUIDITY AND CAPITAL RESOURCES. Working capital grew to \$606 million in 1998 compared to \$531 million in 1997. Major components of working capital and liquidity continue to be the Company's \$308 million in cash, cash equivalents and short-term investments. In addition, the Company maintains \$415 million in marketable securities classified as long-term as of June 30, 1998. Cash flow from operations was approximately \$50 million in 1998, compared to operating cash flow of approximately \$236 million in 1997. The change in cash flow from operations in 1998 compared to 1997 is primarily due to increases in inventory and accounts receivable.

Capital expenditures for each of the fiscal years 1998, 1997 and 1996 approximated \$60 million and consisted primarily of computers and manufacturing equipment. The Company believes that the existing cash balances and short-term investments, along with cash generated from operations, will be sufficient to meet the Company's working capital requirements through fiscal year 1999.

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YEAR 2000 COMPLIANCE. Many currently installed computer systems and software products are coded to accept only two digit entries in the date code field. These date code fields will need to accept four digit entries to distinguish 21st century dates from 20th century dates. As a result, many companies' software and computer systems may need to be upgraded or replaced in order to comply with such "Year 2000" requirements. The Company believes that the majority of its products and systems are Year 2000 ready or will be brought to a state of readiness prior to the year 2000. However, complete testing is not feasible and hidden problems may remain. In addition, the Company utilizes third-party equipment and software that may not be Year 2000 compliant although these too are under evaluation and planning for Year 2000 readiness. Failure of the companies products or third-party equipment or software to operate properly with regard to the Year 2000 and thereafter could require the Company to incur unanticipated expenses to remedy any problems, which could have a material adverse effect on the Company's business and operating results. Furthermore, the purchasing patterns of customers or potential customers may be affected by Year 2000 issues as companies expend significant resources to correct their current systems for Year 2000 compliance. These expenditures may result in reduced funds available to purchase products and services such as those offered by the Company, which could have a material adverse effect on the Company's business and operating results.

OTHER FACTORS AFFECTING COMPANY RESULTS. The Company's operating results have fluctuated in the past and may fluctuate in the future. During the last half of fiscal 1998 operating results have been adversely affected as the Company experienced declines in revenues and margins and due to reduced capital equipment spending by the semiconductor industry. This decline is primarily due to the build up of excess semiconductor manufacturing capacity, coupled with the Asian financial crisis. The Company's operating results are dependent on many factors, including the economic conditions in the semiconductor and related industries, both in the US and abroad, the size and timing of the receipt of orders from customers, customer cancellations or delays of shipments, the Company's ability to develop, introduce, and market new and enhanced products on a timely basis, among others. The Company has experienced reductions in orders, cancellations and delays in shipments which may continue to adversely affect sales and margins in future periods. The Company expects unfavorable effects on orders, sales and margins to persist at least through the remainder of the calendar year and possibly beyond. The Company's expense levels are based, in part, on expectations of future revenues. If revenue levels in a particular period do not meet expectations operating results may be adversely affected.

The Company's business depends and will continue to depend in the future upon the capital equipment expenditures of semiconductor manufacturers, which in turn depend on the current and anticipated market demand for integrated circuits and products utilizing integrated circuits. The current industry downturn has had an adverse effect on the semiconductor industry's level of capital expenditures. The Company believes that it is relatively well positioned for this downturn because of its array of products, its focus on yield improvement and process development rather than pure capacity, its sales of metrology products to non-semiconductor industries and its strong balance sheet. Nevertheless, there can be no assurance that the Company will be able to withstand the effects of an industry downturn in the short term or over an extended period if the downturn is prolonged.

Rapid technological changes in semiconductor manufacturing processes subject the semiconductor manufacturing equipment industry to increased pressure to maintain technological parity with deep submicron process technology. While focused on controlling expenses to address the downturn in the semiconductor industry, the Company continues to believe that its future success will depend in part upon its ability to develop, manufacture and successfully introduce new products with improved capabilities including those for 300mm wafers and devices with critical dimensions at .25-micron and below and to continue to enhance existing products. Due to the risks inherent in transitioning to new products, the Company will be required to forecast demand for new products while managing the transition from older products. There can be no assurance that the Company will successfully and timely develop and manufacture new hardware and

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software products or that new hardware and software products introduced by the Company will be accepted in the marketplace. If new products have reliability or quality problems then reduced orders, higher manufacturing costs, delays in collecting accounts receivable and additional service and warranty expense may result. Additionally, there can be no assurance that future technologies, processes or product developments will not render the Company's current product offerings obsolete. However, if the Company does not continue to successfully introduce new products, its results of operations will be adversely affected. The Company expects to continue to make significant investments in research and development and to sustain its current spending levels for customer support in fiscal year 1999 to meet current customer requirements and effectively position the Company for growth when the business cycle turns favorable.

The semiconductor equipment industry is highly competitive. The Company has experienced and expects to continue to face substantial global competition. The Company believes that to remain competitive it will require significant financial resources in order to offer a broad range of products, to maintain customer service and support centers worldwide, and to invest in product and process research and development. The Company believes that the semiconductor equipment industry is becoming increasingly dominated by large manufacturers, who have the resources to support customers on a worldwide basis. A few of these competitors have substantially greater financial resources and more extensive engineering, manufacturing, marketing and customer service and support capabilities than the Company. In addition, there are smaller emerging semiconductor equipment companies which provide innovative technology. No assurance can be given that the Company will be able to compete successfully worldwide.

The Company expects that international revenues will continue to represent a significant percentage of its net revenues. International revenues and operations may be adversely affected by imposition of governmental controls, restrictions on export technology, political instability, trade restrictions, changes in tariffs and the difficulties associated with staffing and managing international operations. In addition, international sales may be adversely affected by economic conditions in each country. The future performance of the Company will be dependent, in part, upon its ability to continue to compete successfully in the Asia Pacific, one of the largest areas for the sale of yield management and process monitoring equipment. Countries in the Asia Pacific region, including Japan, Korea and Taiwan, have experienced weaknesses in their currency, banking and equity markets in recent periods. These weaknesses may continue to adversely affect demand for the Company's products, the U.S. dollar value of the Company's foreign currency denominated sales, the availability and supply of resources, and the Company's consolidated results of operations. Although the Company attempts to manage near term currency risks through "hedging," there can be no assurance that such efforts will be adequate. These factors may have a material adverse effect on the Company's future business and financial results.

EFFECTS OF RECENT ACCOUNTING PRONOUNCEMENTS. In June 1997, the Financial Accounting Standards Board issued Statement No. 130, "Reporting Comprehensive Income". This Statement establishes standards for reporting and display of comprehensive income and its components (revenues, expenses, gains, and losses) in a full set of general-purpose financial statements. Such items may include foreign currency translation adjustments, unrealized gains/losses from investing and hedging activities, and other transactions. Such items include foreign

currency translation adjustments and unrealized gains/losses from investing and hedging activities for the Company. This Statement is required to be adopted in the first quarter of the Company's fiscal year ending June 30, 1999.

In June 1997, the Financial Accounting Standards Board issued Statement No. 131, "Disclosures about Segments of an Enterprise and Related Information". This Statement establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments and related disclosures about products and services, geographic areas, and major customers in interim financial reports issued to shareholders. This Statement is required to be adopted in the Company's fiscal year ending June 30, 1999. The effect of SFAS No. 131 will not be material to the Company's financial statement disclosure.

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In June 1998, the Financial Accounting Standards Board issued Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133). It establishes accounting and reporting standards for derivative instruments including standalone instruments, such as forward currency exchange contracts and interest note swaps or embedded derivatives, such as conversion options contained in convertible debt investments are requires that these instruments be marked-to-market on an ongoing basis. The Company is required to adopt SFAS 133 in the first quarter of its fiscal year ending June 30, 2000. The effect of SFAS No. 133 will not be material to the Company's financial statements.

MARKET RISK DISCLOSURE. At the end of fiscal 1998, the Company had an investment portfolio of fixed income securities, excluding those classified as cash and cash equivalents, of \$458 million (see Note 4 of Notes to Consolidated Financial Statements). These securities, like 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 June 30, 1998, the fair value of the portfolio would decline by approximately \$5.5 million.

Other than statements of historical fact, statements made in this Annual Report include forward looking statements, such as statements with respect to the Company's future financial performance, operating results, plans and objectives. Actual results may differ materially from those currently anticipated depending on a variety of risk factors some of which are set forth in "Other Factors Affecting Company Results" above.

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KLA - TENCOR 1998

CONSOLIDATED BALANCE SHEETS

June 30, (in thousands, except per share data)	1997	1998
	-----	-----
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 279,225	\$ 215,970
Short-term investments	69,606	92,343
Accounts receivable, net	269,291	304,140
Inventories	174,634	234,565
Deferred income taxes	54,799	90,729
Other current assets	12,452	18,624
	-----	-----
Total current assets	860,007	956,371
	-----	-----

Land, property and equipment, net	117,595	140,937
Marketable securities	338,418	415,168
Other assets	27,287	35,921
	-----	-----
Total assets	\$ 1,343,307	\$ 1,548,397
	-----	-----

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Notes payable	\$ 25,113	\$ 21,482
Accounts Payable	41,155	46,353
Other current liabilities	262,426	282,848
	-----	-----
Total current liabilities	328,694	350,683

Commitments and contingencies (Note 7)

Stockholders' equity:		
Common stock, \$0.001 par value, 250,000 authorized, 83,759 and 87,444 shares issued and outstanding	84	87
Capital in excess of par value	458,224	497,496
Retained earnings	542,706	683,836
Net unrealized gain on investments	17,591	26,108
Cumulative translation adjustment	(3,992)	(9,813)
	-----	-----
Total stockholders' equity	1,014,613	1,197,714
	-----	-----
Total liabilities and stockholders' equity	\$ 1,343,307	\$ 1,548,397
	=====	=====

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS of INCOME

Year ended June 30, (in thousands, except per share data)	1996	1997	1998
	-----	-----	-----
Revenues	\$ 1,094,492	\$ 1,031,824	\$ 1,166,325
	-----	-----	-----
Costs and operating expenses:			
Cost of goods sold	469,681	471,910	554,917
Engineering, research and development	115,920	134,105	181,903
Selling, general and administrative	212,625	219,425	242,400
Non-recurring acquisition, restructuring and other charges	--	60,552	22,474
	-----	-----	-----
Total costs and operating expenses	798,226	885,992	1,001,694
	-----	-----	-----
Income from operations	296,266	145,832	164,631
Interest income and other, net	17,834	28,147	41,680
	-----	-----	-----
Income before income taxes	314,100	173,979	206,311
Provision for income taxes	117,466	68,583	72,215
	-----	-----	-----
Net income	\$ 196,634	\$ 105,396	\$ 134,096
	-----	-----	-----

Earnings per share:				
Basic	\$	2.42	\$ 1.29	\$ 1.58
Diluted	\$	2.34	\$ 1.24	\$ 1.52
Weighted average number of shares:				
Basic		81,148	81,943	85,097
Diluted		84,195	85,203	88,522

See accompanying notes to consolidated financial statements.

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KLA - TENCOR 1998

CONSOLIDATED STATEMENTS of STOCKHOLDERS' EQUITY

(in thousands)	Common Stock and Capital in Excess of Par Value		Retained Earnings	Net Unrealized Gain	Cumulative Translation Adjustment	Totals
	Shares	Amount				
Balances at June 30, 1995	80,392	\$ 406,810	\$ 240,676	\$ 1,241	\$ 3,495	\$ 652,222
Net issuance under employee stock plans	1,604	15,298	--	--	--	15,298
Repurchase of common stock	(250)	(5,456)	--	--	--	(5,456)
Tax benefits of stock option transactions	--	9,778	--	--	--	9,778
Cumulative translation adjustment	--	--	--	--	(5,439)	(5,439)
Unrealized gain on investments, net	--	--	--	7,962	--	7,962
Net income	--	--	196,634	--	--	196,634
Balances at June 30, 1996	81,746	426,430	437,310	9,203	(1,944)	870,999
Net issuance under employee stock plans	2,013	22,235	--	--	--	22,235
Tax benefits of stock option transactions	--	9,643	--	--	--	9,643
Cumulative translation adjustment	--	--	--	--	(2,048)	(2,048)
Unrealized gain on investments, net	--	--	--	8,388	--	8,388
Net income	--	--	105,396	--	--	105,396
Balances at June 30, 1997	83,759	458,308	542,706	17,591	(3,992)	1,014,613
Net issuance under employee stock plans	2,263	34,537	--	--	--	34,537
Repurchase of common stock	(378)	(16,038)	--	--	--	(16,038)
Tax benefits of stock option transactions	--	20,529	--	--	--	20,529
Cumulative translation adjustment	--	--	--	--	(5,821)	(5,821)
Unrealized gain on investments, net	--	--	--	8,517	--	8,517
Issuance of common stock in connection with acquisition	1,800	247	7,034	--	--	7,281
Net income	--	--	134,096	--	--	134,096
Balances at June 30, 1998	87,444	\$ 497,583	\$ 683,836	\$ 26,108	\$ (9,813)	\$ 1,197,714

See accompanying notes to consolidated financial statements.

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KLA - TENCOR 1998

CONSOLIDATED STATEMENTS of CASHFLOW

Year ended June 30, (in thousands)	1996	1997	1998
Cash flows from operating activities:			
Net income	\$ 196,634	\$ 105,396	\$ 134,096
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	24,967	52,340	38,917
Write-off of acquired in-process technology and other non-recurring acquisition charges	--	--	20,546
Deferred income taxes	(19,704)	(17,267)	(46,225)



Changes in assets and liabilities:			
Accounts receivable	(96,586)	34,859	(57,542)
Inventories	(86,538)	21,307	(62,271)
Other assets	3,815	(11,817)	(16,951)
Accounts payable	15,921	(3,580)	3,821
Other current liabilities	72,760	55,094	35,866
	-----	-----	-----
Net cash provided by operating activities	111,269	236,332	50,257
	-----	-----	-----
Cash flows from investing activities:			
Payments for in-process technology and other non-recurring acquisition charges	--	--	(18,771)
Purchase of property and equipment	(64,589)	(56,793)	(64,389)
Purchases of available for sale securities	(509,262)	(997,283)	(915,185)
Proceeds from available for sale securities	484,060	870,391	825,643
	-----	-----	-----
Net cash used in investing activities	(89,791)	(183,685)	(172,702)
	-----	-----	-----
Cash flows from financing activities:			
Issuance of common stock, net	25,076	31,878	58,440
Stock repurchases	(5,456)	--	(16,038)
Payments under debt obligations	(39,277)	(42,490)	(36,632)
Borrowings under debt obligations	45,177	35,738	33,996
	-----	-----	-----
Net cash provided by financing activities	25,520	25,126	39,766
	-----	-----	-----
Effect of exchange rate changes on cash and cash equivalents	2,586	(252)	19,424
	-----	-----	-----
Net increase (decrease) in cash and cash equivalents	49,584	77,521	(63,255)
Cash and cash equivalents at beginning of period	152,120	201,704	279,225
	-----	-----	-----
Cash and cash equivalents at end of period	\$ 201,704	\$ 279,225	\$ 215,970
	=====	=====	=====
Supplemental cash flow disclosures:			
Income taxes paid	\$ 108,196	\$ 68,430	\$ 85,394
Interest paid	\$ 2,103	\$ 1,551	\$ 2,303

See accompanying notes to consolidated financial statements.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### DESCRIPTION OF THE OPERATIONS AND PRINCIPLES OF CONSOLIDATION

KLA-Tencor Corporation ("the Company") is a global provider of yield management solutions for semiconductor manufacturing and related industries. The Company has subsidiaries in the United States, Western Europe, Japan and Asia Pacific. The consolidated financial statements include the financial statements of KLA-Tencor and its wholly owned subsidiaries. All significant intercompany transactions and accounts have been eliminated.

#### CASH EQUIVALENTS AND INVESTMENTS

Cash equivalents consist of highly liquid investments that are valued at amortized cost, which approximates market value, and have original maturity dates of three months or less from the date of acquisition. Investments include equity and debt securities with maturities greater than three months from the date of acquisition. The Company has classified all securities as available-for-sale, as the sale of such securities may be required prior to maturity to implement management strategies. Investments classified as available-for-sale are reported at fair value with unrealized gains or losses excluded from earnings and reported as a separate component of shareholders' equity, net of applicable taxes, until realized.

#### INVENTORIES

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

#### PROPERTY AND EQUIPMENT

Property and equipment are recorded at cost. Depreciation of property and equipment is based on the straight-line method over the estimated useful lives of the assets, which are 30 years for buildings, ten years for building improvements, five to seven years for furniture and fixtures, and three to five years for machinery and equipment. The life of the lease or the useful life, whichever is shorter, is used for the amortization of leasehold improvements.

## CONCENTRATION OF CREDIT RISK

Financial instruments which potentially subject the Company to credit risk consist principally of investments, accounts receivable and financial instruments used in hedging activities.

Investments are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. Generally, these securities maintain a highly liquid market and may be redeemed upon demand and, therefore, bear minimal risk. The Company, by policy, limits the amount of credit exposure to any one financial institution or commercial issuer. The Company has not experienced any material losses on its investments.

A majority of the Company's trade receivables are derived from sales to large multinational semiconductor manufacturers. Concentration of credit risk with respect to trade receivables are considered to be limited due to its customer base and the diversity of its geographic sales areas. The Company performs ongoing credit evaluations of its customers' financial condition. The Company maintains a provision for potential credit losses based upon expected collectibility of all accounts receivable. The write-off of uncollectable amounts has been insignificant except for the write-off of Tencor bad debt of approximately \$6 million in fiscal 1997.

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The Company is exposed to credit loss in the event of nonperformance by counterparties on the foreign exchange contracts used in hedging activities. The Company does not anticipate nonperformance by these counterparties.

## FOREIGN CURRENCY

The functional currencies of the Company's significant foreign subsidiaries are the local currencies. Accordingly, all assets and liabilities of the foreign operations are translated to U.S. dollars at current exchange rates, and revenues and expenses are translated to U.S. dollars using weighted average exchange rates in effect during the period. The gains and losses from foreign currency translation of these subsidiaries' financial statements are recorded directly into a separate component of shareholders' equity under the caption "cumulative translation adjustment." Foreign currency transaction gains and losses have not been significant.

The Company's foreign subsidiaries operate and sell the Company's products in various global markets. As a result the Company is exposed to changes in interest rates and foreign currency exchange rates. The Company utilizes foreign currency forward exchange contracts to hedge against future movements in foreign exchange rates that affect certain foreign currency denominated sales and purchase transactions. The Company attempts to match the forward contracts with the underlying items being hedged in terms of currency, amount, and maturity. The Company does not use derivative financial instruments for speculative or trading purposes. Because the impact of movements in currency exchange rates on forward contracts offsets the related impact on the exposures hedged, these financial instruments do not subject the Company to speculative risk that would otherwise result from changes in currency exchange rates. Realized gains and losses on forward exchange contracts are included in other income, net, which offset foreign exchange gains or losses from revaluation of foreign currency-denominated receivable and payable balances. The cash flows related to gains and losses on these contracts are classified in the same category as the hedged transactions in the Consolidated Statements of Cash Flows.

At June 30, 1998, the Company had forward exchange contracts maturing throughout fiscal 1999 and early fiscal 2000 to sell and purchase approximately \$219 million and \$6 million, respectively, in foreign currency, primarily Japanese yen. At June 30, 1997, the Company had forward contracts maturing throughout fiscal 1998 and early 1999 to sell and purchase approximately \$225 million and \$10 million, respectively, in foreign currency, primarily Japanese yen. Of these forward exchange contracts, approximately \$111 million and \$5 million of contracts hedge foreign currency assets and liabilities, respectively, carried on the balance sheet as of June 30, 1998, and consequently the financial statements reflect the fair market value of the contracts and their underlying transactions. Approximately \$108 million and \$1 million of the contracts hedge

firm commitments for future sales and purchases, respectively, denominated in foreign currency. The fair market value of these contracts on June 30, 1998, based upon prevailing market rates on that date, was approximately \$104 million and \$1 million, respectively. As of June 30, 1998, and based on prevailing market rates on that date, the unrealized loss on each set of contracts was approximately \$4 million.

#### FAIR VALUE OF FINANCIAL INSTRUMENTS

The Company has evaluated the estimated fair value of financial instruments using available market information and valuation methodologies. The amounts reported as investments and bank borrowings reasonably estimate their fair value. The fair value of the Company's cash, cash equivalents, accounts receivable, accounts payable and other current liabilities approximates the carrying amount due to the relatively short maturity of these items.

#### REVENUE RECOGNITION

The Company recognizes revenue when the product has been shipped and collection of the resulting receivable is probable. A provision for the estimated costs of fulfilling warranty and installation

obligations is recorded at the time the related revenue is recognized. Service and maintenance contract revenues are deferred and recognized ratably over the period of the related contract.

#### NET INCOME PER SHARE

In December 1997 the Company adopted Statement of Financial Accounting Standards No. 128, "Earnings per Share" (EPS). Under the provisions of this statement, basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by using the weighted average number of common shares outstanding during the period and gives effect to all dilutive potential common shares outstanding during the period. The reconciling difference between the computation of basic and diluted earnings per share for all periods presented, is the inclusion of the dilutive effect of stock options issued to employees under employee stock option plans.

Options to purchase approximately 1,078,708, 674,028, and 1,357,376 shares were outstanding at June 30, 1998, 1997, and 1996 respectively, but not included in the computation of diluted EPS because the exercise price was greater than the average market price of common shares in each respective year. The exercise price ranges of these options were \$48.06 to \$69.88, \$33.81 to \$48.31, and \$33.81 to \$46.56 at June 30, 1998, 1997 and 1996 respectively.

#### MANAGEMENT ESTIMATES

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### STOCK-BASED COMPENSATION PLANS

The Company accounts for its employee stock option plans and employee stock purchase plan in accordance with provisions of the Accounting Principles Board's Opinion No. 25 (APB 25), "Accounting for Stock Issued to Employees." The Company provides additional proforma disclosure required by Financial Accounting Standard (SFAS) No. 123, "Accounting for Stock-Based Compensation" (see Note 6).

#### RECLASSIFICATIONS

Certain amounts in fiscal years prior to 1998 have been reclassified to conform to the 1998 financial statement presentation.

#### RECENT ACCOUNTING PRONOUNCEMENTS

In June 1997, the Financial Accounting Standards Board issued Statement No. 130, "Reporting Comprehensive Income." This Statement establishes standards for reporting and display of comprehensive income and its components (revenues, expenses, gains, and losses) in a full set of general-purpose financial statements. Such items may include foreign currency translation adjustments, unrealized gains/losses from investing and hedging activities, and other transactions. This Statement requires that all items that are required to be recognized under accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. This Statement is required to be adopted in the Company's fiscal year ending June 30, 1999. The effect of SFAS No. 130 will not be material to the Company's financial statement disclosure.

In June 1997, the Financial Accounting Standards Board issued Statement No. 131, "Disclosures about Segments of an Enterprise and Related Information." This Statement establishes standards for the way that public business enterprises report information about operating segments in annual financial statements and requires that those enterprises report selected information about operating segments in interim financial reports issued to stockholders. It also establishes standards for related

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disclosures about products and services, geographic areas, and major customers. This Statement is required to be adopted in the Company's fiscal year ending June 30, 1999. The effect of SFAS No. 131 will not be material to the Company's financial statement disclosure.

In June 1998, the Financial Accounting Standards Board issued Statement No. 133, "Accounting for Derivative Instruments and Hedging Activities" (SFAS 133). It establishes accounting and reporting standards for derivative instruments including standalone instruments, such as forward currency exchange contracts and interest rate swaps or embedded derivatives, such as conversion options contained in convertible debt investments and requires that these instruments be marked-to-market on an ongoing basis. Along with the derivatives, the underlying hedged items are also to be marked-to-market on an ongoing basis. These market value adjustments are to be included either in the income statement or stockholders' equity, depending on the nature of the transaction. The Company currently only participates in hedge transactions of assets, liabilities and firm commitments and does not anticipate that the adoption of this Statement will have a material impact on the financial statements as the gains and losses on the hedge transactions offset the losses and gains on the underlying items being hedged. The Company is required to adopt SFAS 133 in the first quarter of its fiscal year ending June 30, 2000.

NOTE 2 - BALANCE SHEET COMPONENTS

June 30, (in thousands)	1997	1998
	-----	-----
Inventories:		
Customer service parts	\$ 31,387	\$ 31,671
Raw materials	36,829	49,630
Work-in-process	71,998	79,238
Demonstration equipment	20,580	47,234
Finished goods	13,840	26,792
	-----	-----
	\$ 174,634	\$ 234,565
	=====	=====
Property and equipment:		
Land	\$ 10,502	\$ 10,687
Buildings and improvements	11,053	11,169
Machinery and equipment	129,869	158,317
Office furniture and fixtures	17,849	22,280
Leasehold improvements	38,805	54,440

	-----	-----
	208,078	256,893
Less: accumulated depreciation and amortization	(90,483)	(115,956)
	-----	-----
	\$ 117,595	\$ 140,937
	=====	=====
Other current liabilities:		
Warranty, installation and retrofit	\$ 50,569	\$ 60,008
Compensation and benefits	76,955	101,975
Income taxes payable	62,784	57,660
Other accrued expenses	72,118	63,205
	-----	-----
	\$ 262,426	\$ 282,848
	=====	=====

NOTE 3 - NON-RECURRING ACQUISITION, RESTRUCTURING AND OTHER CHARGES

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During fiscal 1998, the Company acquired all of the outstanding stock of Nanopro GmbH, VARS Inc. and Device Ware for an aggregate amount of approximately \$21 million in cash. These companies specialize in various aspects of advanced wafer inspection tools and related software. These acquisitions were accounted for using the purchase method of accounting. The purchase price was allocated to the acquired assets and liabilities which primarily consisted of in-process technology. Excluding the aggregate \$21 million write-offs of acquired in-process technology, the aggregate impact of these acquisitions were not material to the Company's consolidated statements of operations in the current fiscal year.

In April 1998, the Company completed its acquisition of Amray, Inc. (Amray), a privately owned provider of scanning electron microscope systems, using the pooling of interests method of accounting. The Company acquired all of the outstanding capital stock of Amray in exchange shares of its common stock. In addition, the Company incurred \$2 million in professional fees and restructuring charges related to this acquisition. Amray's historical operations, net assets, and cash flows are not material to the Company's consolidated financial results and, therefore, were not reflected in the Company's consolidated financial results prior to the acquisition.

During fiscal 1997, the Company recorded charges totaling \$61 million for merger, restructuring and other non-recurring events. Of this amount approximately \$46 million was the result of the merger between KLA Instruments and Tencor Instruments on April 30, 1997, \$6 million was a result of the write-off of a Tencor bad debt and additional restructuring charges of \$9 million primarily related to lease exit costs incurred by Tencor Instruments prior to the merger. During fiscal 1998, approximately \$17 million of the accrued balance was used and \$5 million of the accrued balance remains and is expected to be utilized ratably during the first half of fiscal 1999.

NOTE 4 - INVESTMENTS

The amortized cost and estimated fair value of securities available for sale as of June 30, 1997 and 1998, are as follows (in thousands):

	Gross Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	-----	-----	-----	-----
June 30, 1997				
U.S. Treasuries	\$ 70,777	\$ 236	\$ 373	\$ 70,640
Municipal bonds	273,391	1,010	494	273,907

Corporate debt securities	26,120	63	228	25,955
Other	245,178	28,111	26	273,263
	-----	-----	-----	-----
	\$ 615,466	\$ 29,420	\$ 1,121	\$ 643,765
Less: cash equivalents	235,622	135	16	235,741
short-term investments	42,159	28,517	1,070	69,606
	-----	-----	-----	-----
Long-term investments	\$ 337,685	\$ 768	\$ 35	\$ 338,418
	=====	=====	=====	=====

June 30, 1998

U.S. Treasuries	\$ 22,849	\$ 102	\$ 21	\$ 22,930
Mortgage backed securities	39,951	567	76	40,442
Municipal bonds	414,760	3,649	140	418,269
Corporate debt securities	63,439	155	53	63,541
Corporate equity securities	10,895	38,292	--	49,187
Other	84,727	139	233	84,633
	-----	-----	-----	-----

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	Gross Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
	-----	-----	-----	-----
Other	84,727	139	233	84,633
	-----	-----	-----	-----
	\$ 636,621	\$ 42,904	\$ 523	\$ 679,002
Less: cash equivalents	171,466	43	18	171,491
short-term investments	73,260	19,406	323	92,343
	-----	-----	-----	-----
Long-term investments	\$ 391,895	\$ 23,455	\$ 182	\$ 415,168
	=====	=====	=====	=====

The contractual maturities of securities classified as available for sale as of June 30, 1998, regardless of the consolidated balance sheet classification, are as follows (in thousands):

	Estimated Fair Value
	-----
Due within one year	\$ 180,966
Due after one year through five years	229,034
Due after five years	219,815
	-----
	\$ 629,815
	=====

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The realized gains and losses for the year ended June 30, 1998 and 1997, were not material to the Company's financial position or results of operations.

NOTE 5 - INCOME TAXES

Year ended June 30, (in thousands)	1996	1997	1998
	-----	-----	-----
The components of income before income taxes are as follows:			
Domestic income before income taxes	\$ 290,199	\$ 152,778	\$ 172,964
Foreign income before income taxes	23,901	21,201	33,347
	-----	-----	-----
	\$ 314,100	\$ 173,979	\$ 206,311
	=====	=====	=====

The provision (benefit) for income taxes are comprised of the following:

Current:			
Federal	\$ 109,420	\$ 66,439	\$ 94,402
State	18,193	10,603	13,598
Foreign	9,557	8,808	10,440
	-----	-----	-----
	137,170	85,850	118,440
Deferred:			
Federal	(19,162)	(15,238)	(42,149)
State	(1,787)	(1,766)	(4,376)
Foreign	1,245	(263)	300
	-----	-----	-----
	(19,704)	(17,267)	(46,225)
	-----	-----	-----
Provision for income taxes	\$ 117,466	\$ 68,583	\$ 72,215
	=====	=====	=====

Actual current tax liabilities are lower than reflected above for fiscal years 1996, 1997 and 1998 by \$10, \$10 and \$20 million, respectively, due to the stock option deduction benefits recorded as credits to capital in excess of par value.

The significant components of deferred income tax assets (liabilities) are as follows:

Deferred tax assets:

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Federal and state loss and credit carryforwards	\$ 2,820	\$ 1,633
State tax	597	26,606
Nondeductible reserves and other	73,767	98,218
	-----	-----
	77,184	126,457
	-----	-----
Deferred tax liabilities:		
Depreciation	(4,105)	(4,625)
Unremitted earnings of foreign subsidiaries not permanently reinvested	(11,239)	(11,501)
Unrealized (gain) loss on investments	(11,036)	(15,330)
Other	(2,713)	(6,951)
	-----	-----
	(29,093)	(38,407)
	-----	-----
Deferred tax assets valuation allowance	(4,576)	(1,633)
	-----	-----
Total net deferred tax assets	\$ 43,515	\$ 86,417
	=====	=====

The reconciliation of the United States federal statutory income tax rate to the Company's effective income tax rate is as follows:

Federal statutory rate	35.0%	35.0%	35.0%
State income taxes, net of federal benefit	3.5	3.3	2.9
Effect of foreign operations taxed at various rates	0.4	0.7	0.0
Benefit from foreign sales corporation	(2.9)	(3.3)	(2.8)
Realized deferred tax assets previously reserved	(0.4)	--	(1.4)
Merger costs	--	4.5	3.0
Other	1.7	(0.8)	(1.7)
	----	----	----
	37.3%	39.4%	35.0%
	=====	=====	=====

Undistributed earnings of certain of the Company's foreign subsidiaries, for which no U.S. federal income taxes have been provided, aggregated approximately \$13 million at June 30,1998. The amount of the unrecognized deferred tax expense related to the investments in foreign subsidiaries is estimated at approximately \$5 million at June 30,1998.

The IRS is currently auditing the Company's federal income tax returns for fiscal 1995 to 1996. Management believes sufficient taxes have been provided in prior years and that the ultimate outcome of the IRS audits will not have a material adverse impact on the Company's financial position or results of operations.

#### NOTE 6 - STOCKHOLDERS' EQUITY AND EMPLOYEE BENEFITS

In March 1989, the Company implemented a plan to protect stockholders' rights in the event of a proposed takeover of the Company. The Plan provides that if any person or group acquires 15% or more of the Company's Common Stock, each Right not owned by such person or group will entitle its holder to purchase, at the then-current exercise price, the Company's Common Stock at a value of twice that exercise price. The rights are redeemable by the Company and expire in April 2006.

STOCK OPTION AND INCENTIVE PLANS. The Company has various stock option and management incentive plans for selected employees, officers, directors, and consultants. The plans provide for awards in the form of stock options, stock appreciation rights, stock purchase rights, and performance shares. As of June 30, 1998, only stock options have been awarded under the plans.

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In calendar 1996, the Company granted employees the right to re-price certain stock options issued to employees during the period August 1994 through August 1996. The re-pricing was done in the form of an exchange, whereby eligible optionees could cancel their current options in exchange for new options with exercise prices at the fair market value on the date of grant.

The activity under the option plans, combined, was as follows:

	Available For Grant -----	Options Outstanding -----	Weighted- Average Exercise Price -----
Balances at June 30, 1995	2,738,614	7,737,430	11.82
Additional shares reserved	3,700,000	--	--
Options granted	(3,283,370)	3,283,370	30.62
Options canceled/expired	1,240,116	(1,253,098)	32.03
Options exercised	--	(906,797)	5.40



Balances at June 30, 1996	4,395,360	8,860,905	16.70
Additional shares reserved	1,600,000	--	--
Options granted	(4,479,879)	4,479,879	30.15
Options canceled/expired	610,357	(1,992,129)	31.22
Options exercised	--	(1,087,689)	8.20
Balances at June 30, 1997	2,125,838	10,260,966	\$ 20.65
Additional shares reserved	2,501,603	--	--
Options granted	(3,629,888)	3,629,888	46.44
Options canceled/expired	751,710	(915,914)	30.56
Options exercised	--	(1,380,175)	10.33
Balances at June 30, 1998	1,749,263	11,594,765	29.11

The options outstanding at June 30, 1998, have been segregated into ranges for additional disclosure as follows:

Range of Exercise Prices	Options Outstanding			Options Vested and Exercisable	
	Number Outstanding at 06/30/98	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Vested and Exercisable at 06/30/98	Weighted-Average Exercise Price
\$ 1.48 - \$18.13	2,648,431	5.58	\$ 10.33	2,520,700	\$ 10.09
\$18.14 - \$21.88	3,441,548	7.26	19.99	1,546,289	19.32
\$21.89 - \$40.81	1,494,828	8.63	35.32	286,795	31.55
\$40.82 - \$40.94	1,749,010	9.33	40.94	500	40.88
\$40.95 - \$54.75	1,369,056	8.83	46.10	386,214	44.46
\$54.76 - \$69.89	891,892	9.09	60.58	371,414	60.56
\$ 1.48 - \$69.89	11,594,765	7.69	\$ 29.11	5,111,912	\$ 20.35

The weighted average fair value of options granted in 1998, 1997 and 1996 is \$26.36, \$14.61 and \$14.56, respectively. Options exercisable were 5,111,912, 4,592,963, and 4,425,065 as of June 30, 1998, 1997 and 1996, respectively.

EMPLOYEE STOCK PURCHASE PLAN. The Company's employee stock purchase plan provides that eligible employees may contribute up to 10% of their base earnings toward the semi-annual purchase of the Company's Common Stock. The employee's purchase price is derived from a formula based on the fair market value of the Common Stock. No compensation expense is recorded in connection with the plan. In 1998, 1997 and 1996, 882,869, 925,311 and 697,203 shares, respectively, had been purchased by employees. At June 30, 1998, 819,306 shares were reserved and available for

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issuance under this plan. The weighted average fair value of shares issued in 1998, 1997 and 1996 is \$11.20, \$7.67, and \$8.07, respectively.

PRO FORMA NET INCOME AND EARNINGS PER SHARE. Pro forma information regarding net income and net income per share is required by SFAS 123, and has been determined as if the Company had accounted for its employee stock purchase plan and employee stock options granted subsequent to June 30, 1995, under the fair value method of SFAS 123. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model for the single option approach with the following weighted-average assumptions:

1996	1997	1998
----	----	----

Stock option plan:			
Expected stock price volatility	50.0%	50.0%	55.0%
Risk free interest rate	6.4%	6.2%	5.8%
Expected life of options (years)	5.4	5.4	5.6
Stock purchase plan:			
Expected stock price volatility	50.0%	50.0%	55.0%
Risk free interest rate	5.7%	5.6%	5.4%
Expected life of options (years)	1-2	1-2	1-2

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options and employee stock purchase plan have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of such Company options.

For purposes of pro forma disclosures required by SFAS 123, the estimated fair value of the options is amortized to expense over the options' vesting periods. The Company's pro forma information follows for the years ended June 30, 1996, 1997, 1998 follows (in thousands except for earnings per share information):

	1996 -----	1997 -----	1998 -----
Net income:			
Historical	\$ 196,634	\$ 105,396	\$ 134,096
Proforma	\$ 189,331	\$ 89,608	\$ 106,882
Historical earnings per share:			
Basic	\$ 2.42	\$ 1.29	\$ 1.58
Diluted	\$ 2.34	\$ 1.24	\$ 1.52
Proforma earnings per share:			
Basic	\$ 2.33	\$ 1.09	\$ 1.26
Diluted	\$ 2.27	\$ 1.07	\$ 1.24

The pro forma effect on net income and earnings per share for fiscal 1998 and fiscal 1997 is not representative of the pro forma effect net income in future years because it does not take into consideration pro forma compensation expense related to grants made prior to fiscal 1996.

OTHER EMPLOYEE BENEFIT PLANS. The Company has a profit sharing program for eligible employees which distributes, on a quarterly basis, a percentage of pretax profits. In addition, the Company has an employee savings plan that qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. During 1998, the Company matched dollar-for-dollar up to \$1,000 of an eligible employee's contribution. The total charge to operations under the profit sharing and 401(k) programs aggregated approximately \$22 million, \$24 million and \$32 million in 1998, 1997 and 1996, respectively.

The Company has a non-qualified deferred compensation plan whereby certain key executives may defer a portion of their salary and bonus. Participants direct the investment of their account balances among mutual funds selected by the participants. Distributions from the plan commence following a participant's retirement or termination of employment. At June 30, 1998, the Company had a deferred compensation liability under the plan of \$26 million.

NOTE 7 - COMMITMENTS AND CONTINGENCIES

The Company has an agreement with a bank to sell, with recourse, certain of its trade receivables. The total amount of the facility is the yen equivalent of approximately \$80 million based upon exchange rates as of June 30, 1998. The Company has accounted for the sale of certain of these receivables as an off balance sheet financing arrangement. During fiscal 1998, approximately \$166 million of receivables were sold under this arrangement. As of June 30, 1998, \$52 million remains uncollected. The Company does not believe it is materially at risk for any losses as a result of this agreement.

The Company has entered into a master operating lease for land, office and manufacturing facilities constructed for its use in Milpitas and San Jose, California. Monthly rent payments under these leases vary based upon the London Interbank Offering Rate (LIBOR). At the end of the lease the Company, at its option, can acquire the properties at their original cost or arrange for the properties to be acquired. If the Company does not purchase the properties at the end of the lease, the Company will be contingently liable to the lessor for residual value guarantees aggregating \$132 million. In addition, under the terms of the lease, the Company must maintain compliance with certain financial covenants. As of June 30, 1998, the Company was in compliance with all of its covenants. Management believes that the contingent liability relating to the residual value guarantees does not currently have a material adverse effect on the Company's financial position or results of operations.

The Company leases several other facilities under operating leases that expire at various times through fiscal 2012, with renewal options at the fair market value for additional periods up to five years. The Company also leases equipment and other facilities under operating leases.

Total rent expense under all operating leases was \$18 million, \$15 million and \$10 million for the years ended June 30, 1998, 1997 and 1996, respectively.

Future minimum lease commitments under these operating leases at June 30, 1998 (which include estimated lease payments for the Company's Milpitas and San Jose, California, facilities using a LIBOR of approximately 6.0% and total construction costs of \$132 million), are \$19 million, \$16 million, \$14 million, \$13 million, \$6 million, and \$11 million in fiscal 1999 through 2003 and thereafter, respectively.

NOTE 8 - INDUSTRY AND GEOGRAPHIC INFORMATION

No single customer accounted for more than 10% of net revenues in 1998, 1997 and 1996. International sales accounted for 56%, 65% and 66% of the Company's revenues in 1998, 1997 and 1996, respectively.

The following is a summary of the Company's geographic operations:

Year ended June 30, (in thousands)	1996	1997	1998
	-----	-----	-----
Sales to unaffiliated customers:			
United States	\$ 375,639	\$ 364,162	\$ 513,065
Western Europe	143,816	137,314	147,070
Japan	352,080	257,382	291,175
Asia Pacific	222,957	272,966	215,015
	-----	-----	-----
Total sales to unaffiliated customers	1,094,492	1,031,824	1,166,325
Intercompany sales among geographic areas:			
United States	90,561	5,548	43,993
Western Europe	54,059	85,075	10,843
Japan	81,494	124,998	229,102
Asia Pacific	18,627	6,337	10,706
Consolidation eliminations	(244,741)	(221,958)	(294,644)
	-----	-----	-----
Revenues	\$ 1,094,492	\$ 1,031,824	\$ 1,166,325
	=====	=====	=====
Operating results:			
United States	\$ 75,597	\$ 40,802	\$ 90,655
Western Europe	54,436	39,344	25,079
Japan	124,100	68,835	51,187

Asia Pacific	67,085	62,685	38,648
	321,218	211,666	205,569
General corporate expenses	(24,952)	(65,834)	(40,938)
	-----	-----	-----
Income from operations	\$ 296,266	\$ 145,832	\$ 164,631
	=====	=====	=====
Identifiable assets:			
United States	\$ 423,560	\$ 822,067	\$ 657,147
Western Europe	51,045	49,417	97,336
Japan	124,839	100,311	126,764
Asia Pacific	81,724	22,680	38,180
General corporate assets	476,751	348,832	628,970
	-----	-----	-----
Total assets	\$ 1,157,919	\$ 1,343,307	\$ 1,548,397
	=====	=====	=====

Intercompany sales among the Company's geographic areas are recorded on the basis of intercompany prices established by the Company.

At June 30, 1998, 1997 and 1996, total foreign liabilities (excluding intercompany balances) were \$71 million, \$85 million and \$76 million, respectively. For fiscal years 1998, 1997 and 1996, foreign capital expenditures and depreciation expense were \$14 million, \$4 million and \$7 million and \$5 million, \$2 million and \$1 million, respectively.

NOTE 9 - QUARTERLY CONSOLIDATED RESULTS OF OPERATIONS (UNAUDITED)

In thousands, except per share amounts	September 30	December 31	March 31	June 30
	-----	-----	-----	-----
1998:				
Revenues	\$312,420	\$326,361	\$274,164	\$253,380
Gross profit	171,656	176,126	139,940	123,686
Income from operations	64,341	67,224	30,708 (1)	2,358 (2)

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In thousands, except per share amounts	September 30	December 31	March 31	June 30
	-----	-----	-----	-----
Net Income	49,722	52,058	28,971 (1)	3,345 (2)
Net Income per share:				
Basic	\$ 0.59	\$ 0.61	\$ 0.34 (1)	\$ 0.04 (2)
Diluted	\$ 0.56	\$ 0.59	\$ 0.33 (1)	\$ 0.04 (2)
1997:				
Revenues	\$261,140	\$242,155	\$252,346	\$276,183
Gross profit	145,776	127,281	135,241	151,616
Income from operations	46,165 (3)	47,750	49,000	2,917 (4)
Net Income	33,580 (3)	34,219	36,995	602 (4)
Net Income per share:				
Basic	\$ 0.41 (3)	\$ 0.42	\$ 0.45	\$ 0.01 (4)
Diluted	\$ 0.40 (3)	\$ 0.40	0.43	\$ 0.01 (4)

(1) Includes non-recurring acquisition and restructuring charges of \$3 million. Net income, basic and diluted net income per share would have been \$31 million, \$0.37 and \$0.35, respectively, excluding these costs.

(2) Includes non-recurring acquisition and restructuring charges of \$19 million. Net income, basic and diluted net income per share would have been \$23 million, \$0.26 and \$0.26, respectively, excluding these costs.

- (3) Includes restructuring costs of \$9 million. Net income, basic and diluted net income per share would have been \$39 million, \$0.47 and \$0.46, respectively, excluding these costs.
- (4) Includes merger, restructuring and other costs of \$52 million. Net income, basic and diluted net income per share would have been \$42 million, \$0.50 and \$0.48, respectively, excluding these costs.

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QUARTERLY COMMON STOCK MARKET PRICE:

1998 Quarter ended -----	September 30 -----	December 31 -----	March 31 -----	June 30 -----
High	76 7/8	74	48	43 1/4
Low	48 1/4	33 1/2	33 3/8	24 1/4

1997 Quarter ended -----	September 30 -----	December 31 -----	March 31 -----	June 30 -----
High	24 3/4	40	49 3/4	53 1/8
Low	14 3/4	17 5/8	25 1/2	35 1/2

The preceding table sets forth the high and low prices of the Company's Common Stock as traded on the Nasdaq National Market System during the last two years. As of September 1, 1998, there were approximately 2,103 shareholders of record of the Company's Common Stock. The price for the Company's Common Stock as of the close of business on September 1, 1998 was \$25.38 per share. The Company has never paid cash dividends to its stockholders. The Company does not plan to pay cash dividends in the foreseeable future.

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REPORT OF INDEPENDENT ACCOUNTANTS

To the Board of Directors and Stockholders of KLA-Tencor Corporation

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of stockholders' equity and of cash flows present fairly, in all material respects, the financial position of KLA-Tencor Corporation and its subsidiaries at June 30, 1998 and 1997, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 1998, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

PRICEWATERHOUSECOOPERS LLP

San Jose, California  
July 28, 1998

## KLA-TENCOR SUBSIDIARIES

NAME - - - - -	State or Other Jurisdiction of Incorporation -----
DOMESTIC SUBSIDIARIES	
International Sales & Business, Inc.	California
KLA-Tencor Building Corporation	California
KLA-Tencor Disc Corporation	California
KLA-Tencor International Corporation	California
KLA-Tencor Klinnik Corporation	California
KLA-Tencor Management Corporation	California
KLA-Tencor (Thailand Branch) Corporation	California
VLSI Standards, Inc.	California
Amray, Inc.	Delaware
Groff Associates, Inc.	California
DeviceWare, Inc.	California
INTERNATIONAL SUBSIDIARIES	
KLA-Tencor (Cayman) Limited I	Cayman Islands
KLA-Tencor (Cayman) Limited II	Cayman Islands
KLA-Tencor (Cayman) Limited III	Cayman Islands
KLA-Tencor (Israel) Corporation	Israel
KLA-Tencor Holding Corporation 1987 Limited	Israel
KLA-Tencor Corporation 1992 Limited	Israel
KLA-Tencor Italy S.R.L.	Italy
KLA-Tencor Japan, Ltd.	Japan
KLA-Tencor Foreign Sales Corporation	U.S. Virgin Islands
KLA-Tencor GmbH	Germany
KLA-Tencor France SARL	France
KLA-Tencor Korea, Inc.	Korea
KLA-Tencor Limited	United Kingdom
KLA-Tencor (Malaysia) Sdn Bhd	Malaysia
KLA-Tencor (Singapore) PTE, Ltd.	Singapore
Tencor Instruments (Service)	
Limited	United Kingdom
VLSI Standards, KK	Japan

## Consent of Independent Accountants

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (No. 33-15784, No. 2-71584, No. 2-75314, No. 33-26002, No. 33-42973, No. 33-42982, No. 33-42975, No. 33-55362, No. 33-88662, No. 333-03003, No. 333-22939, No. 333-22941, No. 333-26681, No. 333-32537, No. 333-45271, No. 333-60887, and No. 333-60883) and in the Prospectus constituting part of the Registration Statement on Form S-3 (No. 333-52393) of KLA-Tencor Corporation of our report dated July 28, 1998 appearing on page 34 of the Annual Report to Stockholders, which is incorporated in this Annual Report on Form 10-K.

PricewaterhouseCoopers LLP  
San Jose, California  
September 28, 1998



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