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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**FORM 10-Q**

(Mark One)

- Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the quarterly period ended: December 31, 2003

or

- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-9992

**KLA-Tencor Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**

**04-2564110**

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

160 Rio Robles  
San Jose, California  
95134  
(Address of principal executive offices)  
(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

As of January 30, 2004 there were 196,305,696 shares of the Registrant's Common Stock, \$0.001 par value, outstanding.

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**KLA-TENCOR CORPORATION**  
**Condensed Consolidated Balance Sheets**  
(Uaudited)

(in thousands)	<b>December 31, 2003</b>	<b>June 30, 2003</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 660,814	\$ 606,903
Marketable securities	401,080	350,061
Accounts receivable, net	245,841	223,535
Inventories	288,355	258,799
Other current assets	369,185	367,085
Total current assets	1,965,275	1,806,383
Land, property and equipment, net	374,692	382,729
Marketable securities	567,136	530,919
Other assets	165,330	146,566
Total assets	<u>\$ 3,072,433</u>	<u>\$ 2,866,597</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 51,722	\$ 33,893
Deferred profit	155,973	177,486
Unearned revenue	44,572	48,203
Other current liabilities	421,359	391,474
Total current liabilities	673,626	651,056
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Common stock and capital in excess of par value	917,951	814,968
Retained earnings	1,478,238	1,396,886
Accumulated other comprehensive income	2,618	3,687
Total stockholders' equity	2,398,807	2,215,541
Total liabilities and stockholders' equity	<u>\$ 3,072,433</u>	<u>\$ 2,866,597</u>

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

**KLA-TENCOR CORPORATION**  
**Condensed Consolidated Statements of Operations**  
(Uaudited)

(in thousands except per share data)	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
<b>Revenues:</b>				
Product	\$ 264,824	\$ 268,075	\$ 514,969	\$ 580,583
Service	73,714	66,843	141,539	129,855
<b>Total revenues</b>	<b>338,538</b>	<b>334,918</b>	<b>656,508</b>	<b>710,438</b>
<b>Costs and operating expenses:</b>				
Costs of goods sold	156,369	171,138	311,910	357,482
Research and development	68,930	71,935	134,382	142,788
Selling, general and administrative	62,177	65,089	122,186	135,530
Non-recurring acquisition, restructuring and other, net	—	—	—	(9,402)
<b>Total costs and operating expenses</b>	<b>287,476</b>	<b>308,162</b>	<b>568,478</b>	<b>626,398</b>
<b>Income from operations</b>	<b>51,062</b>	<b>26,756</b>	<b>88,030</b>	<b>84,040</b>
Interest income and other, net	7,332	11,702	15,733	21,872
<b>Income before income taxes</b>	<b>58,394</b>	<b>38,458</b>	<b>103,763</b>	<b>105,912</b>
Provision for income taxes	13,879	9,230	22,411	25,419
<b>Net income</b>	<b>\$ 44,515</b>	<b>\$ 29,228</b>	<b>\$ 81,352</b>	<b>\$ 80,493</b>
<b>Basic earning per share:</b>				
Net income	\$ 0.23	\$ 0.15	\$ 0.42	\$ 0.43
<b>Diluted earnings per share:</b>				
Net income	\$ 0.22	\$ 0.15	\$ 0.40	\$ 0.42
<b>Weighted average number of shares:</b>				
Basic	194,872	189,018	193,751	189,229
<b>Diluted</b>	<b>202,450</b>	<b>193,519</b>	<b>201,323</b>	<b>193,904</b>

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

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

	Six Months Ended December 31,	
(in thousands)	2003	2002
Cash flows from operating activities:		
Net income	\$ 81,352	\$ 80,493
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	41,394	35,434
Non-recurring restructuring and other, net	—	(9,402)
Net gain on sale of marketable securities	(7,513)	(8,677)
Changes in assets and liabilities:		
Accounts receivable, net	(22,308)	19,446
Inventories	(29,557)	33,057
Other assets	(15,396)	(11,139)
Accounts payable	17,835	(30,039)
Deferred profit	(21,513)	(16,001)
Other current liabilities	18,947	4,737
Net cash provided by operating activities	63,241	97,709
Cash flows from investing activities:		
Purchases of land, property and equipment, net	(23,193)	(126,155)
Purchases of marketable securities	(935,921)	(799,620)
Proceeds from sale of marketable securities	756,146	892,439
Proceeds from maturity of marketable securities	82,292	49,468
Net cash (used in) provided by investing activities	(120,676)	16,132
Cash flows from financing activities:		
Issuance of common stock	111,565	33,826
Common stock repurchases	(8,481)	(48,359)
Net cash provided by (used in) financing activities	103,084	(14,533)
Effect of exchange rate changes on cash and cash equivalents	8,262	1,267
Net increase in cash and cash equivalents	53,911	100,775
Cash and cash equivalents at beginning of period	606,903	429,820
Cash and cash equivalents at end of period	\$ 660,814	\$ 530,595
Supplemental cash flow disclosures:		
Income taxes (refunded) paid, net	\$ 15,378	\$ (2,924)
Interest paid	\$ 231	\$ 142

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

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

**NOTE 1 – BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of presentation** The condensed consolidated financial statements have been prepared by KLA-Tencor Corporation (“KLA-Tencor” or the “Company”) pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the unaudited interim financial statements reflect all adjustments (consisting only of normal, recurring adjustments) necessary for a fair presentation of the financial position, results of operations and cash flows for the periods indicated. These financial statements and notes, however, should be read in conjunction with the Item 8, “Financial Statements and Supplementary Data” included in the Company’s Annual Report on Form 10-K for the fiscal year ended June 30, 2003, filed with the SEC on September 16, 2003, as amended by the Company’s Annual Report on Form 10-K/A filed on September 29, 2003.

The results of operations for the three and six month periods ended December 31, 2003 are not necessarily indicative of the results that may be expected for any other interim period or for the full fiscal year ending June 30, 2004.

**Fair Value of Financial Instruments** KLA-Tencor has evaluated the estimated fair value of financial instruments using available market information and valuation methodologies as provided by the custodian. The use of different market assumptions and/or estimation methodologies could have a significant effect on the estimated fair value amounts. The fair value of KLA-Tencor’s cash, cash equivalents, accounts receivable, accounts payable and other current liabilities approximate their carrying amounts due to the relatively short maturity of these items.

**Cash Equivalents and Marketable Securities** All highly liquid debt instruments with original maturities of ninety days or less are considered to be cash equivalents. Investments with remaining maturities greater than three months and that mature within one year from the balance sheet date are considered to be short-term marketable securities. Non-current marketable securities include debt securities with maturities exceeding one year from the balance sheet date. Short-term and non-current marketable securities are generally classified as available-for-sale and are reported at fair value, with unrealized gains and losses, net of tax, presented as a separate component of accumulated other comprehensive income. KLA-Tencor has classified some equity securities that have readily determinable fair values in a similar manner. The fair value of marketable securities is based on quoted market prices. All realized gains and losses and unrealized losses and declines in fair value that are other than temporary are recorded in earnings in the period of occurrence. The specific identification method is used to determine the realized gains and losses on investments. Certain equity securities were classified as trading securities. These trading securities were reported at fair value determined based on quoted market prices at the reporting date for those instruments, with unrealized gains or losses included in earnings for the applicable period. The net amounts of such gains and losses for the three months and six months ended December 31, 2003 were not material. As of December 31, 2003, all of the trading securities had been sold.

**Non Marketable Equity Securities and Other Investments** KLA-Tencor acquires certain equity investments for the promotion of business and strategic objectives, and to the extent these investments continue to have strategic value, the Company typically does not attempt to reduce or eliminate the inherent market risks. Non-marketable equity securities and other investments are accounted for at historical cost or, if KLA-Tencor has significant influence over the investee, using the equity method of accounting. KLA-Tencor's proportionate share of income or losses from investments is accounted for under the equity method and any gain or loss is recorded in interest income and other, net. Non-marketable equity securities, equity-method investments, and other investments are included in "Other assets" on the balance sheet. Non-marketable equity securities are subject to a periodic impairment review; however, there are no open-market valuations, and the impairment analysis requires significant judgment. This analysis includes assessment of the investee's financial condition, the business outlook for its products and technology, its projected results and cash flow, the likelihood of obtaining subsequent rounds of financing and the impact of any relevant contractual equity preferences held by KLA-Tencor or others. If an investee obtains additional funding at a valuation lower than KLA-Tencor's carrying amount, it is presumed that the investment is other than temporarily impaired, unless specific facts and circumstances indicate otherwise, for example if KLA-Tencor holds contractual rights that include a preference over the rights of other investors. Impairment of non-marketable equity securities is recorded in interest income and other, net.

**Intangible Assets** Purchased technology, patents, trademarks and goodwill are presented at cost, net of accumulated amortization. Effective July 1, 2002, KLA-Tencor replaced ratable amortization of goodwill with periodic testing of goodwill for impairment in accordance with the provision of Statement of Financial Accounting Standard No. 142, "Goodwill and Intangible Assets." Intangible assets other than goodwill are amortized over their estimated useful lives using the straight-line method.

**Impairment of Long-Lived Assets** KLA-Tencor evaluates the carrying value of its long-lived assets whenever events or changes in circumstances indicate that the carrying value of the asset may be impaired in accordance with the provisions of Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." An impairment loss is recognized when estimated future cash flows expected to result from the use of the asset including disposition, is less than the carrying value of the asset.

**Capitalized software** KLA-Tencor capitalizes certain internal and external costs incurred to acquire and create internal use software in accordance with AICPA Statement of Position 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Capitalized software is included in property plant and equipment and is depreciated over three to five years when development is complete.

**Concentration of Credit Risk** Financial instruments that potentially subject KLA-Tencor to significant concentrations of credit risk consist principally of cash equivalents, short-term and non-current marketable securities, trade accounts receivable and derivative financial instruments used in hedging activities. KLA-Tencor invests in a variety of financial instruments, such as, but not limited to, certificates of deposit, corporate and municipal bonds, U.S. Treasury and agency securities, equity securities and, by policy, limits the amount of credit exposure with any one financial institution or commercial issuer. KLA-Tencor has not experienced any material credit losses on its investments.

A majority of KLA-Tencor's trade receivables are derived from sales to large multinational semiconductor manufacturers located throughout the world. Concentration of credit risk with respect to trade receivables is considered to be limited due to its customer base and the diversity of its geographic sales areas. KLA-Tencor performs ongoing credit evaluations of its customers' financial condition and generally requires no collateral to secure accounts receivable. KLA-Tencor maintains a provision for potential credit losses based upon expected collectibility of all accounts receivable. In addition, KLA-Tencor may utilize letters of credit or non-recourse factoring to mitigate credit risk when considered appropriate.

KLA-Tencor is exposed to credit loss in the event of nonperformance by counterparties on the foreign exchange contracts used in hedging activities. These counterparties are large international financial institutions and to date, no such counterparty has failed to meet its financial obligations to the Company. KLA-Tencor does not anticipate nonperformance by these counterparties.

**Warranty** KLA-Tencor provides standard warranty coverage on its systems for twelve months, providing labor and parts necessary to repair the systems during the warranty period. KLA-Tencor accounts for the estimated warranty cost as a charge to cost of sales when revenue is recognized. The estimated warranty cost is based on historical product performance and field expenses. Utilizing actual service records, KLA-Tencor calculates the average service hours and parts expense per system and apply the actual labor and overhead rates to determine the estimated warranty charge. KLA-Tencor reevaluates these estimated charges every quarter. The actual product performance and/or field expense profiles may differ, and in those cases KLA-Tencor adjusts warranty accruals accordingly.

**Revenue Recognition** KLA-Tencor derives revenue from four sources – system sales, service contracts, spare part sales and software license fees. System sales include hardware and software that is incidental to the product. Prior to the implementation of Staff Accounting Bulletin No, 101 ("SAB 101"), system revenue was generally recognized upon shipment. Effective July 1, 2000, KLA-Tencor changed its method of accounting for system sales to generally recognize revenue upon a positive affirmation by the customer that the system has been installed and is operating according to predetermined specifications. In certain limited cases, KLA-Tencor may deviate from the need for a written acceptance by the customer, as follows:

- When system sales to independent distributors have no installation, contain no acceptance agreement, and 100% payment is due upon shipment, revenue is recognized on shipment;
- When the system requires no integration and installation is inconsequential, revenue is recognized on shipment. In these cases the Company may be required to perform the installation but considers installation not essential to the functionality of the equipment, and there are no additional tests required to be performed on-site. In addition, third party distributors and customers regularly complete the installation of these tools;
- When the customer fab has already accepted the same tool, with the same specifications on the same process, for the same application, and it can be objectively demonstrated that it meets all of the required acceptance criteria upon shipment, a portion of revenue can be recognized at the time of shipment. Revenue recognized upon shipment is exclusive of the amount allocable to the installation element. Revenue attributable to the installation element is the higher of the payment amount due upon acceptance or the fair value of installation;

- When the system is performing in production and meets all published and contractually agreed specifications, but the customer withholds signature on the Company's acceptance document due to warranty or other issues unrelated to product performance;
- When the system is damaged during transit, revenue is recognized upon receipt of cash payment from the customer.

Total revenue recognized under conditions where KLA-Tencor deviates from the need for a written acceptance by the customer were approximately 3.0% and 2.9% of total revenue for the three and six months ended December 31, 2003, respectively compared to 3.5% and 3.0% of total revenue for the three and six months ended December 31, 2002, respectively. Shipping charges billed to customers are included in system revenue and the related shipping costs are included in cost of sales.

In accordance with SAB 101, KLA-Tencor also allows for multiple element revenue arrangement in cases where certain elements of a sales contract are not delivered and accepted at the same time. In such cases, KLA-Tencor defers the fair value of the unaccepted element until that element is delivered to and accepted by the customer. To be considered a separate element, the product or service in question must represent a separate earnings process, and is not essential to the functionality of the delivered and accepted portion of the same sales contract. If the unaccepted element is essential to the functionality of the delivered and accepted portion, the whole amount of the sales contract is deferred until all elements are accepted.

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

Service and maintenance contract revenue is recognized ratably over the term of the maintenance contract. If maintenance is included in an arrangement, which includes a software license agreement, amounts related to maintenance are allocated based on vendor specific objective evidence. Non-standard warranty includes services incremental to the standard 40-hour per week coverage for twelve months. Non-standard warranty is deferred as unearned revenue and is recognized ratably as revenue when the applicable warranty term period commences. Consulting and training revenue is recognized when the related services are performed.

Revenue from software license fees is typically recognized upon shipment if collection of the resulting receivable is probable, the fee is fixed or determinable, and vendor-specific objective evidence exists to allocate a portion of the total fee to any undelivered elements of the arrangement. Such undelivered elements in these arrangements typically consist of services and/or upgrades. If vendor-specific objective evidence does not exist for the undelivered elements of the arrangement, all revenue is deferred until such evidence does exist, or until all elements are delivered, whichever is earlier. In instances where an arrangement to deliver software requires significant modification or customization, license fees are recognized under the percentage of completion method of contract accounting. Allowances are established for potential product returns and credit losses.

The deferred profit balance as of December 31, 2003 and June 30, 2003 was \$156 million and \$177 million, respectively, and equals the amount of system revenue that was invoiced and due on shipment but deferred under SAB 101 less applicable product and warranty costs. KLA-Tencor also defers the fair value of non-standard warranty bundled with equipment sales as unearned revenue. The unearned revenue balance at December 31, 2003 and June 30, 2003 was \$45 million and \$48 million, respectively.

**Strategic Development Agreements** Gross engineering, research and development expenses were partially offset by external funding received under certain strategic development programs funded by KLA-Tencor's customers and government agencies. KLA-Tencor received external funding of \$3 million and \$7 million for the three months and six months ended December 31, 2003, respectively, compared to \$4 million and \$10 million for the three and six months ended December 31, 2002, respectively. As previously disclosed, on October 23, 2003, KLA-Tencor received notice from the National Institute of Standards and Technology ("NIST") disallowing approximately \$5 million of funding received under an Advanced Technology Cooperative Agreement. This notice has since been rescinded and the findings of the audit are being reviewed by NIST again.

**Earnings Per Share** Basic earnings per share ("EPS") is calculated 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 calculated by using the weighted average number of common shares and equivalents (representing the dilutive effect of stock options) 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.

During the three months and six months ended December 31, 2003, options to purchase approximately 213,440 shares and 245,462 shares, respectively, at per share prices ranging from \$56.31 to \$68.00, were not included in the computation of diluted EPS because the exercise price was greater than the average market price of common shares as the effect would be anti-dilutive. During the three months and six months ended December 31, 2002, options to purchase approximately 6,358,394 shares and 5,869,964 shares, respectively, at per share prices ranging from \$37.05 to \$68.00, were not included in the computation of diluted EPS because the exercise price was greater than the average market price of common shares as the effect would be anti-dilutive.

**Accounting for Stock-Based Compensation Plans** KLA-Tencor accounts for its employee stock option and employee stock purchase plans under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations. No stock-based employee compensation is reflected in net income, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of grant. In December 2002, FASB issued Statement of Financial Accounting Standards No. 148 (SFAS 148), "Accounting for Stock-Based Compensation Transition and Disclosure." This Statement amends SFAS 123, to provide alternative methods of transition for an entity that voluntarily changes to the fair value based method of accounting for stock-based employee compensation. It also amends the disclosure provisions of that Statement to require prominent disclosure about the effects on reported net income of an entity's accounting policy decisions with respect to stock-based employee compensation. Finally, this Statement amends APB Opinion No. 28, Interim Financial Reporting, to require disclosure about those effects in interim financial information. Since KLA-Tencor continues to account for stock-based compensation according to APB 25, its adoption of SFAS 148 required the Company to provide prominent disclosures about the effects of SFAS 123 on reported income and required the Company to disclose these affects in the financial statements as well.

Pro forma information regarding net income and net income per share is required by SFAS 123, and has been determined as if KLA-Tencor 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 valuation model and the single option approach with the following weighted-average assumptions:

*Three and six months ended December 31,*

	2003	2002
<b>Stock option plan:</b>		
Expected stock price volatility	65%-67%	71%
Risk free interest rate	2.8%-3.25%	2.8%
Expected life of options (in years)	5.4	5.4
<b>Stock purchase plan:</b>		
Expected stock price volatility	47%-51%	68%-69%
Risk free interest rate	1.2%-1.8%	2.2%-2.8%
Expected life of options (in years)	1-2	1-2

SFAS No. 123 requires the use of option pricing models that were not developed for use in valuing employee stock options. The Black-Scholes option-pricing model was developed for use in estimating the fair value of short-lived exchange traded options that have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. Because the Company's employee stock options 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 the opinion of management, the existing models do not necessarily provide a reliable single measure of the fair value of employee stock 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 using straight-line method. KLA-Tencor's pro forma information is as follows:

<i>(in thousands)</i>	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
Net income	\$ 44,515	\$ 29,228	\$ 81,352	\$ 80,493
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(24,284)	(23,399)	(46,851)	(48,375)
<b>Pro forma Net Income</b>	<b>\$ 20,231</b>	<b>\$ 5,829</b>	<b>\$ 34,501</b>	<b>\$ 32,118</b>
<b>Earnings per basic share:</b>				
As reported	\$ 0.23	\$ 0.15	\$ 0.42	\$ 0.43
<b>Pro forma</b>	<b>\$ 0.10</b>	<b>\$ 0.03</b>	<b>\$ 0.18</b>	<b>\$ 0.17</b>
<b>Earnings per diluted share:</b>				
As reported	\$ 0.22	\$ 0.15	\$ 0.40	\$ 0.42
<b>Pro-forma</b>	<b>\$ 0.10</b>	<b>\$ 0.03</b>	<b>\$ 0.17</b>	<b>\$ 0.17</b>

**Reclassifications** Certain prior year balances have been reclassified to conform to the current financial statement presentation. These reclassifications had no impact on previously reported results of operations or stockholder's equity.

**Recent Accounting Pronouncements** In November 2002, the EITF reached a consensus on Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." This issue addresses determination of whether an arrangement involving more than one deliverable contains more than one unit of accounting and how arrangement consideration should be measured and allocated to the separate units of accounting. EITF Issue No. 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard had no material impact on the Company's consolidated financial statements.

In August 2003, the EITF reached a consensus on Issue No. 03-5, "Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables". This issue focuses solely on whether non-software deliverables included in arrangements that contain more-than-incidental software should be accounted for in accordance with SOP 97-2. The Task Force confirmed that in an arrangement that contains software that is more-than-incidental to the products or services as a whole, only the software and software-related elements are included within the scope of SOP 97-2. Software-related elements include software-related products and services such as those listed in paragraph 9 of SOP 97-2, as well as other deliverables for which the software is essential to their functionality. EITF Issue No. 03-5 is effective for revenue arrangements entered into in fiscal periods beginning after August 13, 2003. The adoption of this standard had no material impact on its consolidated financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. Since January 31, 2003, the Company has not invested in any entities it believes are variable interest entities. For those arrangements entered into prior to February 1, 2003, the Company is required to adopt the provisions of FIN 46 (as revised December 2003) at the end of the third quarter of fiscal 2004. KLA-Tencor expects the adoption of FIN 46 will result in the consolidation of a development stage semiconductor capital equipment company, in which KLA Tencor has a 45% interest. The adoption of FIN 46 is not expected to have a material impact on its consolidated financial statements.

In April 2003, the FASB issued Statement No. 149 ("SFAS No. 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments by requiring that contracts with comparable characteristics be accounted for similarly. In particular, this statement clarifies the circumstances under which a contract with an initial net investment meets the characteristics of a derivative, clarifies when a derivative contains a financing component, amends the definition of an underlying to conform it to the language used in FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," and amends certain other existing pronouncements. The provisions of SFAS No. 149, which were not already applied under an Implementation Issue, are effective for contracts entered into or modified after June 30, 2003. The adoption of this standard did not have a material impact on the Company's consolidated balance sheet or statement of operations.

In May 2003, the FASB issued Statement No. 150 ("SFAS No. 150"), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for classification and measurement of certain financial instruments with characteristics of both liabilities and equity. It requires financial instruments within its scope be classified as a liability (or an asset in some circumstances). Many of those financial instruments were previously classified as equity. SFAS 150 is applicable to financial instruments entered into or modified after May 31, 2003 and is effective for the Company in the period ending March 31, 2004. The adoption of this standard will not have a material impact on the Company's consolidated balance sheet or statement of operations.

## NOTE 2 – BALANCE SHEET COMPONENTS

### Inventories

Inventories are stated at the lower of standard cost (which approximates the first-in, first-out basis) or market. The components of inventories are as follows:

(in thousands)	December 31, 2003	June 30, 2003
<b>Inventories</b>		
Customer service parts	\$ 97,739	\$ 107,709
Raw materials	38,614	30,558
Work-in-process	72,725	57,819
Demonstration equipment	60,807	40,732
Finished goods	18,470	21,981
<b>Total</b>	<b>\$ 288,355</b>	<b>\$ 258,799</b>

### Marketable Securities

The estimated fair value of securities available-for-sale as of December 31, 2003 and June 30, 2003 are follows:

(in thousands)	December 31, 2003	June 30, 2003
U.S. Treasuries	\$ 85,024	\$ 5,139
Mortgage-backed securities	42,841	22,263
Municipal bonds	1,206,925	1,105,852
Corporate debt securities	27,710	15,177
Corporate equity securities	2,792	22,967
Money market bank deposits and other	151,582	218,717
Less: Cash equivalents	1,516,874	1,390,115
Short-term marketable securities	548,658	509,135
Long-term marketable securities	<b>\$ 567,136</b>	<b>\$ 530,919</b>

### NOTE 3 – STOCK REPURCHASE PROGRAM

The Company has adopted a plan to repurchase shares of its Common Stock in the open market for the purpose of partially offsetting dilution created by employee stock options and stock purchase plans. During the six months ended December 31, 2003 and 2002, the Company repurchased 151,000 and 1,466,000 shares of its Common Stock at a cost of approximately \$8 million and \$48 million, respectively.

#### NOTE 4 – COMPREHENSIVE INCOME

The components of comprehensive income, net of tax, are as follows:

(in thousands)	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
Net income	\$ 44,515	\$ 29,228	\$ 81,352	\$ 80,493
Other comprehensive income (loss):				
Currency translation adjustments	6,566	3,966	11,647	1,600
Gain (loss) on cash flow hedging instruments, net	(2,549)	(1,356)	(7,241)	1,469
Unrealized gains (losses) on investments, net of taxes (benefits) of (\$2,003) and (\$3,456) for the three and six months ended December 31, 2003 and (\$2,097) and \$343 for the three and six month months ended December 31, 2002	(3,173)	(3,321)	(5,475)	544
Other comprehensive gain (loss)	844	(711)	(1,069)	3,613
Total comprehensive income	\$ 45,359	\$ 28,517	\$ 80,283	\$ 84,106

#### NOTE 5 – NONRECURRING ACQUISITION, RESTRUCTURING AND OTHER COSTS

##### *Restructuring and Other Costs*

During the three months ended September 30, 2002, KLA-Tencor restructured certain of its operations to realign costs with planned business levels in light of the industry downturn. Restructuring costs were classified into two main categories: facilities and other charges of \$4.6 million and severance and benefits of \$1.1 million. As part of the facilities consolidation, KLA-Tencor exited several of its leased buildings and has included the remaining net book value of the related leasehold improvements as well as the future lease payments, net of anticipated sublease revenue, in the charge. Severance and benefit charges were related to the involuntary termination of approximately 70 personnel from manufacturing, engineering, sales, marketing, and administration in the United States, Japan and Europe. The restructuring actions taken in fiscal 2003 are proceeding as planned, with the termination of employees having been completed and the facilities related lease payments scheduled to be completed by the end of fiscal 2004. The following table shows the details of the facilities, severance and other restructuring costs accrual as of the six months ended December 31, 2003:

(in thousands)	Balance at June 30, 2003	Non-recurring charges	Utilized	Balance at December 31, 2003
	\$ 3,193	\$ —	\$ (1,670)	\$ 1,523
Facilities and other	\$ 47	\$ —	\$ (47)	\$ —
Severance and benefits				
Total	\$ 3,240	\$ —	\$ (1,717)	\$ 1,523

## **NOTE 6 – COMMITMENTS AND CONTINGENCIES**

### **Facilities**

KLA-Tencor leases certain of its facilities under operating leases, which qualify for operating lease accounting treatment under SFAS 13, "Accounting for Leases," and, as such, these facilities are not included on its Condensed Consolidated Balance Sheet.

The following is a schedule of operating leases payments as of December 31, 2003 (in thousands):

Fiscal year ending June 30,	Amount
2004	\$ 4,716
2005	8,399
2006	5,127
2007	2,636
2008	1,610
Thereafter	4,107
 Total minimum lease payments	 \$ 26,595

### **Factoring**

KLA-Tencor has agreements with three banking institutions to sell certain of its trade receivables and promissory notes from Japanese customers without recourse. During the three months and six months ended December 31, 2003, approximately \$27 million and \$45 million of receivables were sold under these arrangements, respectively. As of December 31, 2003, approximately \$34 million was outstanding. The total amount available under the facility is the Japanese yen equivalent of \$140 million based upon exchange rates as of December 31, 2003. KLA-Tencor does not believe it is at risk for any material losses as a result of this agreement. In addition from time to time KLA-Tencor will discount without recourse Letters of Credit ("LCs") received from customers in payment of goods. During the three and six months ended December 31, 2003, several LCs were sold with proceeds totaling \$14 million and \$26 million, respectively. Discounting fees of \$0.1 million and \$0.2 million for the three and six months ended December 31, 2003, respectively, were recorded in interest and other income net as interest expense.

### **Purchase Commitments**

KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply chain for key components. KLA-Tencor's liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. As such, it is difficult to accurately report KLA-Tencor's true open purchase commitments at any particular point in time. However, the Company estimates its open inventory purchase commitment as of December 31, 2003 to be no more than an aggregate of \$105 million.

### **Derivative Instruments**

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts to hedge against certain future movements

in foreign exchange rates that affect certain foreign currency denominated sales and purchase transactions. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes. At December 31, 2003, KLA-Tencor had foreign exchange forward contracts maturing throughout fiscal 2004 to sell and purchase \$268 million and \$157 million, respectively, in foreign currency, primarily Japanese yen and Euros.

#### **Guarantees**

The following table provides the changes in the product warranty accrual for the six months ended December 31, 2003:

<i>(in thousands)</i>	<i>Amount of Liability Debit/Credit</i>
Balance at June 30, 2003	\$ (33,226)
Accruals for warranties issued during the current period	(17,757)
Adjustments of prior period accrual estimates	4,568
Settlements on warranty claims made during the period	16,192
 Balance at December 31, 2003	 \$ (30,223)

In connection with certain business combinations and purchased technology transactions, KLA-Tencor was subject to certain contingent consideration arrangements at December 31, 2003. These arrangements are based upon sales volume or the occurrence of other events subsequent to the acquisition and lapse in fiscal years 2004 to 2005. The payment of the contingency would result in an increase to goodwill or operating expenses. Amounts paid under these arrangements have not been and are not expected to have a material effect on KLA-Tencor's financial condition or results of operations and could range, in aggregate, from \$1.1 million to \$2.5 million.

Subject to certain limitations, KLA-Tencor indemnifies its current and former officers and directors for certain events or occurrences. Although the maximum potential amount of future payments KLA-Tencor could be required to make under these agreements is theoretically unlimited, based on prior experience, we believe the fair value of this liability is de minimis and no liability has been recorded.

#### **Legal Matters**

KLA-Tencor is named from time to time as a party to lawsuits in the normal course of its business. Litigation, in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. The Company believes that we have defenses in each of the matters and are vigorously contesting each of these matters.

#### *ADE Corporation*

On October 11, 2000, ADE Corporation ("ADE"), a competitor, filed a patent infringement lawsuit against KLA-Tencor in the U.S. District Court in Delaware. ADE claimed damages and sought an injunction under U.S. Patent No. 6,118,525 ("'525 patent"). KLA-Tencor filed a counterclaim in the same court alleging that ADE has infringed four of KLA-Tencor's patents. KLA-Tencor is seeking damages and a permanent injunction against ADE. In addition, KLA-Tencor is seeking a declaration from the District Court that the '525 patent is invalid. On October 22, 2001, KLA-Tencor filed a separate action for declaratory judgment against ADE in the Northern District of California requesting a

declaration that U.S. Patent No. 6,292,259 ("259 patent") is invalid and not infringed. That action was consolidated with the prior action in the Delaware proceeding and ADE amended its complaint in that proceeding to allege that KLA-Tencor is infringing the '259 patent. On August 8, 2002, the magistrate presiding over the action issued a recommendation that the court enter summary judgment in KLA-Tencor's favor on the issue of non-infringement under ADE's '525 patent. On the same day, the magistrate issued recommendations that the court enter summary judgment in favor of ADE on the issue of non-infringement of two of KLA-Tencor's patents. The district court judge subsequently substantially adopted the recommendations of the magistrate regarding claims construction. The district court judge has ruled in KLA-Tencor's favor and granted summary judgment of non-infringement regarding both the '525 and '259 patents. KLA-Tencor has voluntarily withdrawn one of its patents from this suit, and KLA-Tencor continued to pursue its claim that ADE infringes its US Patent No. 6,215,551. KLA-Tencor's case against ADE's alleged infringement of its patent went to trial on January 27, 2004 and on February 4, 2004, the court entered judgement in favor of ADE, ruling that the '551 patent is invalid. KLA-Tencor is evaluating post-trial options, including possible motions and appeals.

Tokyo Seimitsu Co. Ltd.

On June 27, 2001, KLA-Tencor filed a lawsuit against Tokyo Seimitsu Co. Ltd. and TSK America Inc. ("TSK"), a competitor, in the U.S. District Court in the Northern District of California alleging that TSK infringes on one of the Company's patents. The suit seeks damages and an injunction under U.S. Patent No. 4,805,123 ("'123 patent"). TSK filed a counterclaim in the same court seeking a declaration that the '123 patent is invalid, unenforceable and not infringed, and also alleged violations of the antitrust and unfair competition laws. On October 23, 2003 the parties settled the litigation. Pursuant to the settlement, both KLA-Tencor and Tokyo Seimitsu/Accretech dismissed their claims and terminated their litigation against each other. The terms of the settlement are confidential.

#### **NOTE 7 – GOODWILL AND OTHER INTANGIBLE ASSETS**

Effective July 1, 2001, KLA-Tencor adopted Statement of Financial Accounting Standards No. 141, "Business Combinations," and No. 142, "Goodwill and Other Intangible Assets." Under these accounting standards, KLA-Tencor ceased amortization of goodwill recorded for business combinations consummated prior to July 1, 2001, and reclassified amounts attributed to workforce in acquisitions made prior to July 1, 2001 that did not meet the criteria for separate recognition as other intangible assets under SFAS 141 to goodwill. The net carrying value of goodwill recorded through acquisitions was \$17.3 million as of December 31, 2003. In accordance with SFAS 142, KLA-Tencor during the three months ended December 31 2003, evaluated the goodwill for impairment and concluded there was no impairment of goodwill.

The net carrying value of other intangible assets as of December 31, 2003 was \$3.3 million; the components of which are as follows (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Amount
Existing technology	\$ 1,252	\$ 668	\$ 584
Patents	4,761	2,294	2,467
Trademark	625	355	270
<b>Subtotal</b>	<b>\$ 6,638</b>	<b>\$ 3,317</b>	<b>\$ 3,321</b>

Other intangible assets are amortized on a straight-line basis over their estimated useful lives. For the three months and six months ended December 31, 2003, amortization expense for other intangible assets was \$0.4 million and \$0.7 million, respectively compared to \$0.6 million and \$1.2 million for the three and six months ended December 31, 2002. KLA-Tencor will continue to review the carrying value of the other intangible assets in relation to the fair value of the discounted cash flows. Based on intangibles assets recorded at December 31, 2003, and assuming no subsequent impairment of the underlying assets, the annual estimated amortization expense is expected to be as follows (in thousands):

Fiscal year ending June 30:	Amount
2004	\$ 1,438
2005	1,434
2006	689
2007 and thereafter	484

#### NOTE 8 -- GEOGRAPHIC INFORMATION

KLA-Tencor has significant operations outside the United States, which include a manufacturing facility in Israel and sales, marketing and service offices in Western Europe, Japan, and the Asia Pacific region. For geographical revenue reporting, revenues are attributed to the geographic regions in which the customer is located. Long-lived assets consist of net property and equipment, goodwill, capitalized software and other intangibles, and other long-term assets, excluding long-term deferred tax assets and are attributed to the geographic region in which they are located. The following is a summary of operations by entities located within the indicated geographic regions for three months and six months ended December 31, 2003 and 2002, except where indicated.

(in thousands)	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
<b>Revenue:</b>				
United States	\$ 77,211	\$ 91,959	\$ 139,125	\$ 182,057
Europe & Israel	63,980	40,545	122,804	112,731
Japan	94,871	65,848	162,028	157,878
Taiwan	48,906	85,537	80,639	150,690
Korea	17,755	23,373	80,979	46,266
Asia Pacific	35,815	27,656	70,933	60,816
<b>Total</b>	<b>\$ 338,538</b>	<b>\$ 334,918</b>	<b>\$ 656,508</b>	<b>\$ 710,438</b>

(in thousands)	December 31, 2003		June 30, 2003	
	2003	2002	2003	2002
<b>Long-lived assets:</b>				
United States	\$ 478,561	\$ 468,171		
Europe & Israel	6,433	6,416		
Japan	4,855	4,757		
Taiwan	2,331	2,528		
Asia Pacific	4,112	4,383		
<b>Total</b>	<b>\$ 496,292</b>	<b>\$ 486,255</b>		

The following is a summary of revenues by major products for three and six months ended December 31, 2003 and 2002 (as a percentage of total revenue).

	Three months ended December 31,		Six months ended December 31,	
	2003	2002	2003	2002
<b>Revenue:</b>				
Defect Inspection	61%	56%	61%	61%
Metrology	15%	16%	15%	16%
Service	22%	20%	21%	18%
Software and other	2%	8%	3%	5%
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

In the three months ended December 31, 2003, one customer, Intel Corporation, accounted for 11% of revenue. For the six months ended December 31, 2003, two customers, Samsung and Intel Corporation, accounted for 12% and 10% of revenue, respectively. For the three months and six months ended December 31, 2002, no single customer accounted for more than 10% of revenue. As of the three months ended December 31, 2003 and 2002 no single customer accounted for more than 10% of net accounts receivable.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****FORWARD-LOOKING STATEMENTS**

*This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. All statements included in or incorporated by reference in this Quarterly Report on Form 10-Q, other than statements of historical fact, are forward-looking statements. These statements are generally accompanied by words such as "may," "will," "could," "would," "should," "expect," "plan," "anticipate," "rely," "believe," "estimate," "predict," "intend," "potential," "continue," "forecast" or the negative of such terms, or other comparable terminology. Forward-looking statements also include the assumptions underlying or relating to any of the foregoing statements. Such forward-looking statements include, among others, those statements regarding forecasts of the future results of our operations; orders for our products; sales of semiconductors; growth in the semiconductor capital equipment business; the allocation of capital spending by our customers; growth in the semiconductor capital equipment industry; technological trends in the semiconductor industry; our future product offerings and product features, as well as market acceptance of new products; timing of shipment of backlog; recognition of deferred revenue; the growth in spending for process controls; the future of our service revenues; the future of our gross margins; the future of our selling, general and administrative expenses; anticipated revenue from various domestic and international regions; international sales and operations; maintenance of our competitive advantage; success of our product offerings; creation of programs for research and development; attraction and retention of employees; management of risks involved in acquisitions of third parties, or the technology or assets thereof; benefits received from any acquisitions and development of acquired technologies; the outcome of any litigation to which we are a party; results of our investment in leading edge technologies; our future income tax rate; the effects of hedging transactions; outcome of any ongoing, tax, governmental, other audits; sufficiency of our existing cash balance, investments and cash generated from operations to meet our operating and working capital requirements; and the adoption of new accounting pronouncements.*

*Our actual results may differ significantly from those projected in the forward-looking statements in this report. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in this section and those set forth in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" and Item 1, "Business" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2003, filed with the Securities and Exchange Commission ("SEC") on September 16, 2003, as amended by the Company's Annual Report on Form 10-K/A filed on September 29, 2003. You should carefully review these risks and also review the risks described in other documents we file from time to time with the SEC. You are cautioned not to place undue reliance on these forward-looking statements. We expressly disclaim any obligation to update or alter our forward-looking statements, whether, as a result of new information, future events or otherwise.*

**CRITICAL ACCOUNTING POLICIES**

The preparation of our Condensed Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We based these estimates and assumptions on historical experience and evaluate them on an on-going basis to help ensure they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the audit committee of our board of directors on a quarterly basis, and the audit committee has reviewed the Company's critical accounting estimates as described in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2003. For the six months ended December 31, 2003, there were no changes to these critical accounting policies.

## RESULTS OF OPERATIONS

KLA-Tencor Corporation is the world's leading supplier of process control and yield management solutions for the semiconductor and related microelectronics industries. Our comprehensive portfolio of products, software, analysis, services and expertise is designed to help integrated circuit manufacturers manage yield throughout the entire wafer fabrication process – from research and development to final mass production yield analysis.

In calendar year 2001, the demand for semiconductors dropped by approximately 32% and remained flat to slightly higher in calendar year 2002. According to industry analysts, semiconductor sales are projected to grow approximately 20% for calendar year 2004, which industry analysts believe will translate into approximately 35% growth for the semiconductor capital equipment business. New system and service orders, which are new orders net of cancellations, grew sequentially by approximately \$168 million or 49% in the three months ended December 31, 2003, compared to the previous quarter as a result of utilization of our customers' fabs for leading edge products began to exceed their capacity and the need of our customers to expand these 200-millimeter fabs to meet short-term capacity requirements.

Over the long-term we expect process control to continue to represent a higher percentage of our customers' capital spending. We believe this increase in process control spending will be driven by the demand for more precise diagnostics capabilities to address multiple new defects as a result of further shrinking of device feature sizes, the transition to copper and other new materials and the accelerated transition to new 300-millimeter fabs. We anticipate these factors will drive increased demand for our products and services as the semiconductor industry recovers.

New system and service orders by region were as follows (in millions):

	Fiscal Quarter 2004			Fiscal Quarter 2003								
	Second		First	Fourth		Third	Second	First				
	\$	129	\$	71	\$	104	\$	98	\$	92	\$	80
United States												
Europe		75		21		39		40		58		30
Japan		128		80		101		64		67		57
Taiwan		89		96		28		44		17		46
Asia Pacific		87		72		65		70		52		29
Total orders		\$ 508		\$ 340		\$ 337		\$ 316		\$ 286		\$ 242

KLA-Tencor's backlog for unshipped system orders as of December 31, 2003, was approximately \$678 million, a majority of which we expect to ship over the next six to nine months. In addition, we have \$370 million of SAB 101 deferred revenue that is related to products that have been delivered but are awaiting written acceptance from the customer.

#### **Revenues and Gross Margin**

Product revenue decreased \$3 million, to \$265 million for the three months ended December 31, 2003, from \$268 million for the three months ended December 31, 2002. Product revenue declined \$66 million, or 11%, to \$515 million for the six months ended December 31, 2003 from \$581 million for the six months ended December 31, 2002. Product revenue declines were primarily the result of reduced capital spending as a result of the semiconductor industry downturn. International revenue increased to 77% of revenue, in the three months ended December 31, 2003 from 73% in the same period of the prior fiscal year, due to higher revenue in Japan, Europe and China partially offset by lower revenue in Taiwan and Korea. International revenue increased to 79% of revenue for the six months ended December 31, 2003 from 74% in the same period of the prior fiscal year, due to relatively higher revenue in Korea, Japan and Europe partially offset by lower revenue in Taiwan. In the three months ended December 31, 2003, one customer, Intel Corporation, accounted for 11% of revenue. For the six months ended December 31, 2003, two customers, Samsung and Intel Corporation, accounted for 12% and 10% of revenue, respectively. For the three months and six months ended December 31, 2002, no single customer accounted for more than 10% of revenue.

Service revenue is generated from maintenance service contracts, as well as time and material billable service calls made to our customers after the expiration of the warranty period. Service revenue was \$74 million and \$67 million for the three months ended December 31, 2003 and 2002, respectively. Service revenue was \$142 million and \$130 million for the six months ended December 31, 2003 and 2002, respectively. Service revenue increased as our installed base of equipment at our customers' sites continued to grow. The amount of service revenue generated is generally proportional to the number of post-warranty systems installed at our customers' sites and the degree of utilization of those systems.

As the semiconductor industry recovers we expect product shipments to continue to increase, which will result in an increase in product revenue. We expect service revenue as a percentage of total revenue to decline with the increase in product revenue.

Gross margin as a percentage of revenue was 54% and 53% for the three and six months ended December 31, 2003, compared to 49% and 50% for the same periods in the prior fiscal year, respectively. Gross margins increased year over year, despite lower sales volume, due to implementation of certain programs for streamlining of manufacturing, installation and servicing costs. As the conditions in the semiconductor industry continue to strengthen, we expect gross margins to improve with the increase in sales volume, introduction of new models, streamlining manufacturing costs through the use of common platforms, leveraging manufacturing procurement through consolidation of vendors and further expanding on outsourcing initiatives.

#### **Engineering, Research and Development**

Net engineering, research and development ("R&D") expenses were \$69 million and \$134 million for the three and six months ended December 31, 2003, compared to \$72 million and \$143 million for the same periods in the prior fiscal year. As a percentage of revenue, R&D expenses were 20% and 21% for the three and six months ended December 31, 2003, compared to 22% and 20% for the same periods in the prior fiscal year. The absolute dollars for R&D investment decreased primarily due to reductions in temporary labor and discretionary spending as well as realization of savings from cost reduction measures implemented over the last several quarters of the prior fiscal year in response to the industry slow down. We expect our net engineering, research and development expenses to increase as we accelerate our investments in critical programs focusing on new technologies and enhancements to existing products.

Gross engineering, research and development expenses were partially offset by external funding received under certain strategic development programs conducted with several of our customers and government grants. We received external funding of \$3 million and \$7 million for the three and six months ended December 31, 2003, respectively compared to \$4 million and \$10 million for the three and six months ended December 31, 2002, respectively. As previously disclosed, on October 23, 2003, we received notice from the National Institute of Standards and Technology ("NIST") disallowing approximately \$5 million of funding received under an Advanced Technology Cooperative Agreement. This notice has since been rescinded and the findings of the audit are being reviewed by NIST again; regardless of the ultimate resolution of the audit, the impact will not be material to our consolidated financial statements.

Our future operating results will depend significantly on our ability to produce products and provide services that have a competitive advantage in our marketplace. To do this, we believe that we must continue to make substantial investments in our research and development efforts. We remain committed to product development in new and emerging technologies as we address the further shrinking of device feature sizes, the transition to copper and other new materials, and the transition to new 300-millimeter fabs. Our investments in new technology and existing product enhancements are intended to enable our customers to achieve a higher return on their capital investments and higher productivity through cost-effective, leading edge technology solutions.

#### **Selling, General and Administrative**

Selling, general and administrative expenses were \$62 million and \$122 million for the three and six months ended December 31, 2003, compared to \$65 million and \$136 million for the same periods in the prior fiscal year. As a percentage of revenue, selling, general and administrative expenses were 18% and 19% for the three and six months ended December 31, 2003, respectively, compared to 19% for the same periods in the prior fiscal year. The absolute dollars for selling, general and administrative expenses decreased primarily due to reductions in temporary labor and discretionary spending as well as other realization of savings from cost reduction measures implemented over the last several quarters in the prior fiscal year in response to the industry slowdown. We expect our selling, general and administrative expenses to increase as we build up our organization to meet increased customer demands.

#### **Restructuring and Other Costs**

During the three months ended September 30, 2002, we restructured certain of our operations to realign costs with planned business levels in light of the industry downturn. Restructuring costs were classified into two main categories: facilities and other charges of \$4.6 million and severance and benefits of \$1.1 million. As part of the facilities consolidation, we exited several of our leased buildings and have included the remaining net book value of the related leasehold improvements as well as the future lease payments, net of anticipated sublease revenue, in the charge. Severance and benefit charges were related to the involuntary termination of approximately 70 personnel from manufacturing, engineering, sales, marketing, and administration in the United States, Japan and Europe. The restructuring actions taken in fiscal 2003 are proceeding as planned, with the termination of employees having been completed and the facilities related lease payments scheduled to be completed by the end of fiscal 2004. The following table shows the details of the facilities, severance and other restructuring costs accrual as of the six months ended December 31, 2003:

(in thousands)	Balance at June 30, 2003	Non-recurring charges	Utilized	Balance at December 31, 2003
Facilities and other	\$ 3,193	\$ —	\$ (1,670)	\$ 1,523
Severance and benefits	47	—	(47)	—
<b>Total</b>	<b>\$ 3,240</b>	<b>\$ —</b>	<b>\$ (1,717)</b>	<b>\$ 1,523</b>

#### Interest Income and Other, Net

Interest income and other, net, was \$7 million and \$16 million for the three and six months ended December 31, 2003, compared to \$12 million and \$22 million in the same periods in the prior fiscal year. Interest income and other, net is comprised primarily of gains realized on sales of marketable securities, interest income earned on the investment and cash portfolio, as well as income recognized upon settlement of certain foreign currency contracts and unrealized gains and losses from marking to market investments classified as trading securities. The decrease in interest income and other, net for the three months and six months ended December 31, 2003 as compared to the three months and six months ended December 31, 2002 was primarily due to decreased interest income resulting from declining interest rates and a decrease in gains realized on sales of marketable securities.

#### Provision for Income Taxes

Our effective tax rate for the three months and six months ended December 31, 2003 was approximately 24% and 22%, respectively. The six month effective tax rate of 22% includes a one time non-recurring benefit of \$1.5 million or 1.5%, related to the resolution of a prior year federal tax audit matter in the first fiscal quarter of 2004. This benefit was partially offset by an upward revision of our projected on-going effective tax rate for fiscal year 2004 from 22% to 23% during the current quarter. The effective tax rates of 22% for the six months ended December 31, 2003 and the revised on going rate of 23% for fiscal year 2004 are lower than the effective tax rate of 24% realized in the same periods of the prior fiscal year as a result of more foreign tax benefits and the one time non-recurring benefit compared relatively to these same items as a percentage of pre-tax income of the same periods during the prior fiscal year. Congress is considering legislation to repeal the existing export incentive provided by the United States Internal Revenue Code and replace it with a tax incentive tied to U.S. based manufacturing. If the legislation is enacted it may increase our effective tax rate in future periods.

#### Stock Option and Incentive Plans

KLA-Tencor's stock option program is a broad-based, long-term retention program that is intended to attract and retain qualified management and technical employees ("knowledge employees"), and align stockholder and employee interests. Under KLA-Tencor's stock option plans, options generally have a vesting period of five years, are exercisable for a period not to exceed ten years from the date of issuance and are granted at prices not less than the fair market value of KLA-Tencor's common stock at the grant date. This program consists of three plans: one under which non-employee directors may be granted options to purchase shares of our stock, another in which officers, key employees, consultants and all other employees may be granted options to purchase shares of our stock and a third in which consultants and all employees other than directors and officers may be granted options to purchase shares of our stock. Substantially all of our employees that meet established performance goals and that qualify as knowledge employees participate in one of our stock option plans. Options granted to officers and employees from fiscal year 2001 through December 31, 2003 are summarized as follows (in thousands):

	Six months ended December 31 2003	Fiscal year ended June 30,		
	2003	2002	2001	
Weighted average number of shares outstanding	194,872	189,817	187,677	185,860
Total options granted during the period	3,633	4,922	9,760	10,274
Less options forfeited	(574)	(2,416)	(1,786)	(2,418)
Net options granted	3,059	2,506	7,974	7,856
Net grants during the period as a percentage of weighted average shares outstanding	1.6%	1.3%	4.2%	4.2%
Grants to top five officers during the period as a percentage of weighted average shares outstanding	0.2%	0.2%	0.3%	0.2%
Grants to top five officers during the period as a percentage of total options granted	8.1%	6.0%	6.0%	4.0%

During the six months ended December 31 2003, the Company granted options to purchase approximately 3.6 million shares of stock to employees. After deducting options forfeited, the net grant of options was 3.1 million shares. The net options granted after forfeiture represented 1.6% of the weighted average outstanding shares of approximately 194.9 million as of December 31, 2003.

Options granted to the top five officers, who represent the chief executive officer and each of the four other most highly compensated executive officers whose salary plus bonus exceeded \$100,000 for the fiscal year ended June 30, 2003, as a percentage of the total options granted to all employees, vary from quarter to quarter and year to year. In the six months ended December 31, 2003, there were 294,000 options granted to the top five officers.

The following table summarizes stock options exercised by the top five officers during the six months ended December 31, 2003:

	Shares Acquired on Exercise	Value Realized	Total Number of Securities Underlying Unexercised Options at December 31, 2003		Total Value of Unexercised, In-the-Money Options at December 31, 2003 (1)	
			Vested	Unvested	Exercisable	Unexercisable
Kenneth L. Schroeder Chief Executive Officer	224,100	\$ 9,724,129	688,441	490,059	\$ 23,456,998	\$ 11,540,206
Gary E. Dickerson President & Chief Operating Officer	40,000	\$ 1,591,734	284,973	223,392	\$ 7,051,791	\$ 4,380,010
John H. Kispert Executive Vice President and Chief Financial Officer	95,000	\$ 2,019,069	27,259	125,941	\$ 727,623	\$ 2,451,957
Dennis J. Fortino Executive Vice President	35,792	\$ 854,765	116,727	121,398	\$ 2,445,052	\$ 2,294,446
Richard P. Wallace Executive Vice President	60,000	\$ 1,369,178	18,145	115,483	\$ 248,246	\$ 2,149,333

(1) Total Value of vested options based on fair market value of the Company's Common Stock of \$58.54 per share as of December 31, 2003.

The following table summarizes KLA-Tencor's stock option plans as of December 31, 2003:

	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under stock option plan
Stock option plan approved by stockholders	19,806,346	\$ 31.09	16,657,975
Stock option plan not approved by stockholders <sup>(1)</sup>	9,330,003	37.75	2,953,986
<b>Total</b>	<b>29,136,349</b>	<b>\$ 33.17</b>	<b>19,611,961</b>

(1) Officers and directors are not eligible to receive options granted under this plan.

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

	Available For Grant	Options Outstanding	Weighted- Average Price
Balances at June 30, 2001	8,508,074	26,289,586	\$ 26.18
Additional shares reserved	5,610,752	—	—
Options granted	(9,760,303)	9,760,303	31.83
Options canceled/expired	1,786,295	(1,786,295)	32.55
Options exercised	—	(4,173,887)	19.36
 Balances at June 30, 2002	 6,144,818	 30,089,707	 \$ 28.60
Additional shares reserved	13,280,928	—	—
Options granted	(4,922,001)	4,922,001	35.26
Options canceled/expired	2,415,973	(2,415,973)	35.16
Options exercised	—	(2,861,777)	20.94
 Balances at June 30, 2003	 16,919,718	 29,733,958	 \$ 29.94
Additional shares reserved	5,750,290	—	—
Options granted <sup>(1)</sup>	(3,632,527)	3,632,527	52.95
Options canceled/expired	574,480	(574,480)	37.25
Options exercised	—	(3,655,656)	25.93
 Balances at December 31, 2003	 19,611,961	 29,136,349	 \$ 32.27

<sup>(1)</sup> In addition, in January 2004, KLA-Tencor granted approximately 1.1 million stock options (1.0 million to non-executives and 0.1 million to executive employees) related primarily to the fiscal year 2003 annual performance cycle review of KLA-Tencor.

#### LIQUIDITY AND CAPITAL RESOURCES

Cash, cash equivalents and short-term investments balances during the three months ended December 31, 2003 increased to \$1.06 billion from \$957 million at June 30, 2003. In addition marketable securities classified as long-term at December 31, 2003 increased to \$567 million from \$531 million at June 30, 2003. KLA-Tencor has historically financed its operations through cash generated from operations. Net cash provided by operating activities for the six months ended December 31, 2003 was \$63 million, compared to \$98 million of net cash from operating activities for the same period of the prior fiscal year. The decrease in cash provided by operating activities in six months ended December 31, 2003 compared to the same period in the prior fiscal year was primarily due to increases in inventory and accounts receivable balances partially offset by higher accounts payable balances. Inventories balances increased due to a ramping up of manufacturing of products. Accounts receivable balances increased due an increase in shipments during the last month of the quarter. Accounts payable balances increased due to timing of payments and build up of inventory.

Net cash used in investing activities for the six months ended December 31, 2003 was \$121 million, compared to \$16 million provided by investing activities for the same period of the prior fiscal year, primarily as a result of increased net purchases of short and long-term marketable securities partially offset by lower capital expenditures. Net cash provided by financing activities for the six months ended December 31, 2003 was \$103 million as compared to net cash used in financing activities of \$15 million for the same period of the prior fiscal year. This change was primarily due to an increase in stock option exercises of \$78 million and a decrease in stock repurchases of \$40 million.

The following is a schedule summarizing our significant operating lease commitments as of December 31, 2003 (in millions):

	Payments Due by Fiscal Year						
	Total	2004	2005	2006	2007	2008	Thereafter
Operating leases	\$ 26.6	\$ 4.7	\$ 8.4	\$ 5.1	\$ 2.6	\$ 1.6	\$ 4.2

We have agreements with three banking institutions to sell certain of our trade receivables and promissory notes from Japanese customers without recourse. During the three months and six months ended approximately December 31, 2003, approximately \$27 million and \$45 million of receivables were sold under these arrangements, respectively. As of December 31, 2003, approximately \$34 million was outstanding. The total amount available under the facility is the Japanese yen equivalent of \$140 million based upon exchange rates as of December 31, 2003. We do not believe we are at risk for any material losses as a result of this agreement. In addition, from time to time we will discount without recourse Letters of Credit ("LCs") received from customers in payment of goods. During the three and six months ended December 31, 2003 several LCs were sold with proceeds totaling \$14 million and \$26 million, respectively. Discounting fees of \$0.1 million \$0.2 million for the three and six months ended December 31, 2003, respectively, were equivalent to interest expense and were recorded in interest and other income net.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply chain for key components. Our liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. As such, it is difficult to accurately report our true open purchase commitments at any particular point in time. However, we estimate our open inventory purchase commitment as of December 31, 2003 to be no more than an aggregate of \$105 million.

Working capital increased to \$1.29 billion as of December 31, 2003, compared to \$1.16 billion at June 30, 2003. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, our management believes that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for the next twelve months.

#### **FACTORS AFFECTING RESULTS, INCLUDING RISKS AND UNCERTAINTIES**

##### *Fluctuations in Operating Results and Stock Price*

Our operating results have varied widely in the past, and our future operating results will continue to be subject to quarterly variations based upon numerous factors, including those listed in this section and throughout this quarterly report on Form 10-Q. In addition, future operating results may not follow any past trends. We believe the factors that could make our results fluctuate and difficult to predict include:

- the cyclical nature of the semiconductor industry;
- global economic uncertainty;
- changing international economic conditions;

- competitive pressure;
- our ability to develop and implement new technologies and introduce new products;
- our ability to manage our manufacturing requirements;
- our ability to protect our intellectual property;
- our ability to attract, retain, and replace key employees;
- worldwide political instability; and
- earthquake and other uninsured risks.

Operating results also could be affected by sudden changes in customer requirements, currency exchange rate fluctuations and other economic conditions affecting customer demand and the cost of operations in one or more of the global markets in which we do business. As a result of these or other factors, we could fail to achieve our expectations as to future revenue, gross profit and income from operations. Our failure to meet the performance expectations set and published by external sources could result in a sudden and significant drop in the price of our stock and could negatively affect the value of any investment in our stock.

#### *Semiconductor Equipment Industry Volatility*

The semiconductor equipment industry is highly cyclical. The purchasing decisions of our customers are highly dependent on the economies of both the local markets in which they are located and the semiconductor industry worldwide. The timing, length and severity of the up-and-down cycles in the semiconductor equipment industry are difficult to predict. This cyclical nature of the industry in which we operate affects our ability to accurately predict future revenue and, thus, future expense levels. When cyclical fluctuations result in lower than expected revenue levels, operating results may be adversely affected and cost reduction measures may be necessary in order for us to remain competitive and financially sound. During a down cycle, we must be in a position to adjust our cost and expense structure to prevailing market conditions and to continue to motivate and retain our key employees. In addition, during periods of rapid growth, we must be able to increase manufacturing capacity and personnel to meet customer demand. We can provide no assurance that these objectives can be met in a timely manner in response to industry cycles. If we fail to respond to industry cycles, our business could be seriously harmed.

We are currently emerging from an industry down cycle. We are not able to predict if or for how long the upturn will last. During a down cycle, the semiconductor industry typically experiences excess production capacity that causes semiconductor manufacturers to decrease capital spending. We generally do not have long-term volume production contracts with our customers, and we do not control the timing or volume of orders placed by our customers. Whether and to what extent our customers place orders for any specific products, as well as the mix and quantities of products included in those orders, are factors beyond our control. Insufficient orders, especially in our down cycles, will result in under-utilization of our manufacturing facilities and infrastructure and will negatively affect our operating results and financial condition.

#### *Global Economic Uncertainty*

Our business is ultimately driven by the global demand for electronic devices by consumers and businesses. While demand for electronic devices has increased over time, it remains subject to global economic uncertainty. A protracted global economic slowdown could adversely affect our business and results of operation.

#### *International Trade and Economic Conditions*

We serve an increasingly global market. A majority of our annual revenue is derived from outside the United States, and we expect that international revenue will continue to represent a substantial percentage of our revenue. Our international revenue and operations are affected by economic conditions specific to each country and region. Because of our significant dependence on international revenue, a decline in the economies of any of the countries or regions in which we do business could negatively affect our operating results.

Managing global operations and sites located throughout the world presents challenges associated with, among other things, cultural diversity and organizational alignment. Moreover, each region in the global semiconductor equipment market exhibits unique characteristics that can cause capital equipment investment patterns to vary significantly from period to period. Periodic local or international economic downturns, trade balance issues, political instability in regions where we have operations, such as Israel, and fluctuations in interest and currency exchange rates could negatively affect our business and results of operations. Although we attempt to manage near-term currency risks through the use of hedging instruments, there can be no assurance that such efforts will be adequate. In addition, our ability to address normal business transaction issues in Asia may still be at risk due to the potential reoccurrence of a Severe Acute Respiratory Syndrome outbreak and outbreaks of other infectious diseases in Asia, which may result in management's decision to limit travel to Asia in accordance with the World Health Organization's recommendations.

#### *Competition*

Our industry includes large manufacturers with substantial resources to support customers worldwide. Our future performance depends, in part, upon our ability to continue to compete successfully worldwide. Some of our competitors are diversified companies with greater financial resources and more extensive research, engineering, manufacturing, marketing and customer service and support capabilities than we can provide. We face competition from companies whose strategy is to provide a broad array of products and services, some of which compete with the products and service that we offer. These competitors may bundle their products in a manner that may discourage customers from purchasing our products. In addition, we face competition from smaller emerging semiconductor equipment companies whose strategy is to provide a portion of the products and services, which we offer, using innovative technology to sell products into specialized markets. Loss of competitive position could negatively affect our prices, customer orders, revenue, gross margin, and market share, any of which would negatively affect our operating results and financial condition. Our failure to compete successfully with these other companies would seriously harm our business.

#### *Technological Change and Customer Requirements*

Success in the semiconductor equipment industry depends, in part, on continual improvement of existing technologies and rapid innovation of new solutions. For example, the semiconductor industry continues to shrink the size of semiconductor devices, transition to copper and other new materials, and transition to new 300-millimeter fabs. While we expect these trends will increase our customers' reliance on our diagnostic products, we cannot ensure that they will directly improve our business. These and other evolving customer needs require us to respond with continued development programs and to cut back or discontinue older programs, which may no longer have industry-wide support. Technical innovations are inherently complex and require long development cycles and appropriate professional staffing. Our competitive advantage and future business success depend on our ability to accurately predict evolving industry standards, to develop and introduce new products which successfully address changing customer needs, to win market acceptance of these new products and to manufacture these new products in a timely and cost-effective manner. If we do not develop and introduce new products and technologies in a timely manner in response to changing market conditions or customer requirements, our business could be seriously harmed.

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

#### *Key Suppliers*

We use a wide range of materials in the production of our products, including custom electronic and mechanical components, and we use numerous suppliers to supply these materials. We generally do not have guaranteed supply arrangements with our suppliers. Because of the variability and uniqueness of customers' orders, we do not maintain an extensive inventory of materials for manufacturing. We seek to minimize the risk of production and service interruptions and/or shortages of key parts by selecting and qualifying alternative suppliers for key parts, monitoring the financial stability of key suppliers and maintaining appropriate inventories of key parts. Although we make reasonable efforts to ensure that parts are available from multiple suppliers, key parts may be available only from a single supplier or a limited group of suppliers. Our business would be harmed if we do not receive sufficient parts to meet our production requirements in a timely and cost-effective manner.

#### *Manufacturing Disruption*

Most of our manufacturing facilities are located in the United States, with a small operation located in Israel. Operations at our manufacturing facilities and our assembly subcontractors are subject to disruption for a variety of reasons, including work stoppages, acts of war, terrorism, fire, earthquake, energy shortages, flooding or other natural disasters. Such disruption could cause delays in shipments of products to our customers. We cannot ensure that alternate production capacity would be available if a major disruption were to occur or that, if it were available, it could be obtained on favorable terms. Such disruption could result in cancellation of orders or loss of customers and could seriously harm our business. We currently are in the initial stages of design and implementation of a new integrated financial and supply chain management system. Disruptions or delays in making changes to our integrated financial and supply chain management system could adversely impact our operations and our ability to forecast sales demand, ship products, manage our product inventory and record and report financial and management information on a timely and accurate basis.

#### *Intellectual Property Obsolescence and Infringement*

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

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

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

As is typical in the semiconductor equipment industry, from time to time we have received communications from other parties asserting the existence of patent rights, copyrights, trademark rights or other intellectual property rights which they believe cover certain of our products, processes, technologies or information. Our customary practice is to evaluate such assertions and to consider whether to seek licenses where appropriate. However, we cannot ensure that licenses can be obtained or, if obtained, will be on acceptable terms or that costly litigation or other administrative proceedings will not occur. The inability to obtain necessary licenses or other rights on reasonable terms, or instigation of litigation or other administrative proceedings could seriously harm our operating results and financial condition.

#### *Key Employees*

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

#### *Acquisitions*

In addition to our efforts to develop new technologies from internal sources, we also seek to acquire new technologies from external sources. As part of this effort, we may make acquisitions of, or significant investments in, businesses with complementary products, services and/or technologies. Acquisitions involve numerous risks, including management issues and costs in connection with the integration of the operations and personnel, technologies and products of the acquired companies, the possible write-downs of impaired assets, and the potential loss of key employees of the acquired companies. The inability to manage these risks effectively could seriously harm our business.

#### *Litigation*

From time to time we are involved in litigation of various types, including litigation alleging infringement of intellectual property rights and other claims. Litigation tends to be expensive and requires significant management time and attention and could have a negative effect on our results of operations or business if we lose or have to settle a case on significantly adverse terms.

#### *Terrorism and Political Instability*

The threat of terrorism targeted at the regions of the world in which we do business, including the United States, increases the uncertainty in our markets and may delay any recovery in the general economy. Any delay in the recovery of the economy and the semiconductor industry could adversely affect our business. Increased international political instability, as demonstrated by the September 2001 terrorist attacks, disruption in air transportation and further enhanced security measures as a result of the terrorist attacks, and the continuing instability in the Middle East, may hinder our ability to do business and may increase our costs of operations. Such continuing instability could cause us to incur increased costs in transportation, make such transportation unreliable, increase our insurance costs, and cause international currency markets to fluctuate. This same instability could have the same effects on our suppliers and their ability to timely deliver their products. If this international political instability continues or increases, our business and results of operations could be harmed.

#### *Earthquake and other uninsured risks*

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

#### **Effects of Recent Accounting Pronouncements**

In November 2002, EITF reached a consensus on Issue No. 00-21, "Accounting for Revenue Arrangements with Multiple Deliverables." This issue addresses determination of whether an arrangement involving more than one deliverable contains more than one unit of accounting and how arrangement consideration should be measured and allocated to the separate units of accounting. EITF Issue No. 00-21 is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The adoption of this standard did not have a material impact on our consolidated financial statements.

In August 2003, the EITF reached a consensus on Issue No. 03-5, "Applicability of AICPA Statement of Position 97-2, Software Revenue Recognition, to Non-Software Deliverables". This issue focuses solely on whether non-software deliverables included in arrangements that contain more-than-incidental software should be accounted for in accordance with SOP 97-2. The Task Force confirmed that in an arrangement that contains software that is more-than-incidental to the products or services as a whole, only the software and software-related elements are included within the scope of SOP 97-2. Software-related elements include software-related products and services such as those listed in paragraph 9 of SOP 97-2, as well as other deliverables for which the software is essential to their functionality. EITF Issue No. 03-5 is effective for revenue arrangements entered into in fiscal periods beginning after August 13, 2003. The adoption of this standard did not have a material impact on our consolidated financial statements.

In January 2003, the FASB issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," an Interpretation of ARB No. 51. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. Since January 31, 2003, we have not invested in any entities we believe are variable interest entities. For those arrangements we entered into prior to February 1, 2003, we are required to adopt the provisions of FIN 46 (as revised December 2003) at the end of the third quarter of fiscal 2004. We expect the adoption of FIN 46 will result in the consolidation of a development stage semiconductor capital equipment company, in which we have a 45% interest. The adoption of FIN 46 is not expected to have a material impact to our consolidated financial statements.

In April 2003, the FASB issued Statement No. 149 ("SFAS No. 149"), "Amendment of Statement 133 on Derivative Instruments and Hedging Activities." SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments by requiring that contracts with comparable characteristics be accounted for similarly. In particular, this statement clarifies the circumstances under which a contract with an initial net investment meets the characteristics of a derivative, clarifies when a derivative contains a financing component, amends the definition of an underlying to conform it to the language used in FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others," and amends certain other existing pronouncements. The provisions of SFAS No. 149, which were not already applied under an Implementation Issue, are effective for contracts entered into or modified after June 30, 2003. We believe that the adoption of this standard did not have a material impact on our consolidated balance sheet or statement of operations.

In May 2003, the FASB issued Statement No. 150 ("SFAS No. 150"), "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 establishes standards for classification and measurement of certain financial instruments with characteristics of both liabilities and equity. It requires financial instruments within its scope to be classified as a liability (or an asset in some circumstances). Many of those financial instruments were previously classified as equity.

SFAS 150 is applicable to financial instruments entered into or modified after May 31, 2003 and is effective for the Company in the period ending March 31, 2004. We believe that the adoption of this standard will not have a material impact on our consolidated balance sheet or statement of operations.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position at December 31, 2003. Actual results may differ materially.

At the end of December 31, 2003, we had an investment portfolio of fixed income securities of \$965 million, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of December 31, 2003, the fair value of the portfolio would have declined by \$3 million.

As of December 31, 2003, we had net forward contracts to sell \$111 million in foreign currency in order to hedge currency exposures (see Note 6 of the Notes to the Consolidated Financial Statements under "Derivative Instruments.") If we had entered into these contracts on December 31, 2003, the U.S. dollar equivalent would be \$117 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by \$33 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on income or cash flows.

### **Item 4. CONTROLS AND PROCEDURES**

#### **Evaluation of disclosure controls and procedures**

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

#### **Changes in internal controls over financial reporting**

There was no change in our internal controls over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

KLA-Tencor is named from time to time as a party to lawsuits in the normal course of its business. Litigation, in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. We believe that we have defenses in each of the matters and are vigorously contesting each of these matters.

A discussion regarding certain pending legal proceedings is included in Part I, Item 3, "Legal Proceedings," included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2003. Since the fiscal year ended June 30, 2003, certain developments have occurred with respect to the legal proceedings described in our Annual Report as follows:

#### **Legal Matters**

##### ADE Corporation

On October 11, 2000, ADE Corporation ("ADE"), a competitor, filed a patent infringement lawsuit against us in the U.S. District Court in Delaware. ADE claimed damages and sought an injunction under U.S. Patent No. 6,118,525 ("'525 patent"). We filed a counterclaim in the same court alleging that ADE has infringed four of our patents. We are seeking damages and a permanent injunction against ADE. In addition, we are seeking a declaration from the District Court that the '525 patent is invalid. On October 22, 2001, we filed a separate action for declaratory judgment against ADE in the Northern District of California requesting a declaration that U.S. Patent No. 6,292,259 ("'259 patent") is invalid and not infringed. That action was consolidated with the prior action in the Delaware proceeding and ADE amended its complaint in that proceeding to allege that we are infringing the '259 patent. On August 8, 2002, the magistrate presiding over the action issued a recommendation that the court enter summary judgment in our favor on the issue of non-infringement under ADE's '525 patent. On the same day, the magistrate issued recommendations that the court enter summary judgment in favor of ADE on the issue of non-infringement of two of our patents. The district court judge subsequently substantially adopted the recommendations of the magistrate regarding claims construction. The district court judge has ruled in our favor and granted summary judgment of non-infringement regarding both the '525 and '259 patents. We have voluntarily withdrawn one of our patents from this suit, and we continued to pursue our claim that ADE infringes our US Patent No. 6,215,551. Our case against ADE for their alleged infringement of our patent is set to go to trial on January 26, 2004 and on February 4, 2004, the court entered judgement in favor of ADE, ruling that the '551 patent is invalid. KLA-Tencor is evaluating post-trial options, including possible motions and appeals.

##### Tokyo Seimitsu Co. Ltd.

On June 27, 2001, we filed lawsuit against Tokyo Seimitsu Co. Ltd. and TSK America Inc. ("TSK"), a competitor, in the U.S. District Court in the Northern District of California alleging that TSK infringed on one of our patents. The suit seeks damages and an injunction under U.S. Patent No. 4,805,123 ("'123 patent"). TSK filed a counterclaim in the same court seeking a declaration that the '123 patent is invalid, unenforceable and not infringed, and also alleged violations of the antitrust and unfair competition laws. On October 23, 2003 the parties settled the litigation. Pursuant to the

settlement, we and Tokyo Seimitsu/Accretech dismissed our claims and terminated our litigation against each other. The terms of the settlement are confidential.

Although we cannot predict the outcome of these claims, we do not believe that any of these legal matters will have a material adverse effect on KLA-Tencor. Were an unfavorable ruling to occur in one or more of the pending claims, there exists the possibility of a material impact on our operating results for the period in which the ruling occurred and in future periods.

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

The Annual Meeting of Stockholders of KLA-Tencor Corporation was held on November 5, 2003 at the Company's offices in Milpitas, California. Of the 193,915,876 shares of Common Stock outstanding as of September 15, 2003 (the record date), 170,812,344 shares (88.09%) were present or represented by proxy at the meeting.

1. The table below presents the results of the election to the Company's board of directors.

	Votes for	Votes Withheld
H. Raymond Bingham	164,748,560	6,063,784
Robert T. Bond	163,664,291	7,148,053
Richard J. Elkus, Jr.	163,602,298	7,210,046
Michael E. Marks	167,666,997	3,145,347

The terms of Kenneth Levy, Jon D. Tompkins, Lida Urbanek, Edward W. Barnholt, Stephen P. Kaufman and Kenneth L. Schroeder as directors of the Company, continued after the meeting.

2. The stockholders ratified the appointment of PricewaterhouseCoopers LLP as the Company's independent accountants for the fiscal year ended June 30, 2004. This proposal received 160,947,503 votes for, 9,070,419 votes against and 794,422 abstentions.

#### **ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

(a) Exhibits

31.1 Certification of Chief Executive Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934.

31.2 Certification of Chief Financial Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934

32.1 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.

(b) Form 8-K

On October, 22, 2003, KLA-Tencor furnished a report on Form 8-K relating to its financial information for the quarter ended September 30, 2003, as presented in a press release of October 22, 2003.

## **SIGNATURES**

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

**KLA-TENCOR CORPORATION**  
(Registrant)

February 6, 2004

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(Date)

/s/ KENNETH L. SCHROEDER

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February 6, 2004

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(Date)

**Kenneth L. Schroeder**  
Chief Executive Officer  
(Principal Executive Officer)

/s/ JOHN H. KISPERT

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**John H. Kispert**  
Executive Vice President  
and Chief Financial Officer  
(Principal Accounting Officer)

EXHIBIT INDEX

Exhibit Number	Exhibit Name
31.1	Certification of Chief Executive Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934.
31.2	Certification of Chief Financial Officer under Rule 13a-14(a) of the Securities Exchange Act of 1934
32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350.

**Certification of Chief Executive Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, Kenneth L. Schroeder, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of KLA-Tencor Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) omitted
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 6, 2004

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/s/ KENNETH L. SCHROEDER

(Date)

Kenneth L. Schroeder  
Chief Executive Officer  
(Principal Executive Officer)

**Certification of Chief Financial Officer  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, John H. Kispert, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of KLA-Tencor Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) omitted
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

February 6, 2004

/s/ JOHN H. KISPERT

(Date)

John H. Kispert  
Executive Vice President  
and Chief Financial Officer  
(Principal Accounting Officer)

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Kenneth L. Schroeder, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the quarterly report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended December 31, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such quarterly report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

February 6, 2004

By: /s/ KENNETH L. SCHROEDER

Dated

Name: **Kenneth L. Schroeder**  
Title: **Chief Executive Officer**

**CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, John H. Kispert, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the quarterly report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended December 31, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such quarterly report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

February 6, 2004

By: /s/ JOHN H. KISPERT

Dated

Name: **John H. Kispert**  
Title: **Chief Financial Officer**