KLA TENCOR CORP
Form 10-K/A
September 29, 2003

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K/A
Amendment No. 1

(Mark One)

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

For the Fiscal Year Ended June 30, 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 No. 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 Number)**
160 Rio Robles, San Jose, California	**95134**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant's Telephone Number, Including Area Code: (408) 875-6000
Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
None	None

Securities Registered Pursuant to Section 12(g) of the Act:
Common Stock, $0.001 Par Value
Common Stock Purchase Rights
(Title of Class)

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

Yes [X] No [ ]

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

[X]

The aggregate market value of the voting stock held by non-affiliates of the registrant based upon the closing price of the registrant's stock, as of September 10, 2003, was $10,755,202,546. Shares of common stock held by each officer and director and by each person or group who owns 5% or more of the outstanding common stock have been excluded in that such persons or groups may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

Yes [X]   No [ ]

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

Yes [X]   No [ ]

The registrant had 193,903,231 shares of common stock outstanding as of September 10, 2003.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2003 Annual Meeting of Stockholders ("Proxy Statement") to be held on November 5, 2003, which was filed with the Securities and Exchange Commission pursuant to Regulation 14A on September 23, 2003, are incorporated by reference into Part III of this report. See Explanatory Note.

EXPLANATORY NOTE

This Annual Report on Form 10-K/A ("Form 10-K/A") is being filed as Amendment No. 1 to the registrant's Annual Report on Form 10-K for the fiscal year ended June 30, 2003 ("Form 10-K"). This Form 10-K/A is being filed with the Securities and Exchange Commission for the purpose of correcting the following clerical errors:

(i) On page 52 of the Form 10-K in Part I, Item 8 Financial Statements and Supplementary Data in our Consolidated Statements of Cash Flows, we listed the amount under the year ended June 30, 2002 column for the line item heading "Net borrowings (payments) under short term debt obligations" as being "--" or zero; however, the correct amount for this number is "(448)" or negative four hundred forty-eight thousand dollars.

(ii) On page 61 of the Form 10-K in Part I, Item 8 Financial Statements and Supplementary Data in Note 1 to the consolidated financial statements, we listed the amount under the year ended June 30, 2001 column for the line item heading "Pro forma net income" as being "27,013" or twenty seven million thirteen thousand dollars; however the correct amount for this number is "(27,013)" or negative twenty seven million thirteen thousand dollars.

(iii) On page 86 of the Form 10-K we numbered the section titled "Controls and Procedures" as Item 14 under Part IV of the Form 10-K, this section should instead be renumbered as Item 9A Controls and Procedures under Part II of the Form 10-K.

Both Item 8 Financial Statements and Supplementary Data and Item 14 Controls and Procedures are hereby amended and restated in their entirety as follows. This Form 10-K/A does not otherwise change or update the disclosures set forth in the Form 10-K as originally filed and does not otherwise reflect events occurring after the original filing of the Form 10-K.

PART I

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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KLA-Tencor Corporation
Consolidated Balance Sheets

June 30, *(in thousands, except per share data)*	**2003**	**2002**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 606,903	$ 429,820
Marketable securities	350,061	243,526
Accounts receivable, net	223,535	277,006
Inventories	258,799	323,016
Deferred income taxes	324,098	315,049
Other current assets	42,987	30,871
Total current assets	1,806,383	1,619,288
Land, property and equipment, net	382,729	300,560
Marketable securities	530,919	660,237
Other assets	146,566	137,633
Total assets	$2,866,597	$2,717,718
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 33,893	$ 52,988
Deferred system profit	177,486	193,852
Unearned revenue	48,203	54,886
Other current liabilities	391,474	385,764
Total current liabilities	651,056	687,490
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Preferred stock, $0.001 par value, 1,000 shares authorized, none outstanding	--	--
Common stock, $0.001 par value, 500,000 shares authorized, 191,733 and 189,752 shares issued and outstanding	192	190
Capital in excess of par value	814,776	765,756
Retained earnings	1,396,886	1,259,695

Accumulated other comprehensive income	3,687	4,587
Total stockholders' equity	2,215,541	2,030,228
Total liabilities and stockholders' equity	$2,866,597	$2,717,718

See accompanying notes to consolidated financial statements.

KLA-Tencor Corporation
Consolidated Statements of Operations

Year ended June 30, (in thousands, except per share data)	**2003**	**2002**	**2001**
Revenues:			
Product	$1,060,142	$1,428,107	$1,907,364
Service	262,907	209,175	196,393
Total revenues	1,323,049	1,637,282	2,103,757
Cost and operating expenses:			
Cost of goods sold	671,505	814,393	937,152
Engineering, research and development	268,291	287,408	355,772
Selling, general and administrative	253,933	290,588	354,368
Non-recurring acquisition, restructuring and other	(9,402)	--	(2,003)
Total cost and operating expenses	1,184,327	1,392,389	1,645,289
Income from operations	138,722	244,893	458,468
Interest income and other, net	41,796	42,563	54,116
Income before income taxes and cumulative effect of change in accounting principle	180,518	287,456	512,584
Provision for income taxes	43,327	71,290	139,526
Income before cumulative effect of change in accounting principle	137,191	216,166	373,058
Cumulative effect of change in accounting principle, net of tax	--	--	(306,375)
Net income	$ 137,191	$ 216,166	$ 66,683
Net income per share:			
Basic			
Income before cumulative effect of change in accounting principle	$ 0.72	$ 1.15	$ 2.01

Cumulative effect of change in accounting principle, net of tax	--	--	(1.65)
Basic net income per share	$ 0.72	$ 1.15	$ 0.36
Diluted			
Income before cumulative effect of change in accounting principle	$ 0.70	$ 1.10	$ 1.93
Cumulative effect of change in accounting principle, net of tax	--	--	(1.59)
Diluted net income per share	$ 0.70	$ 1.10	$ 0.34
Weighted average number of shares:			
Basic	189,817	187,667	185,860
Diluted	194,785	196,594	193,435

See accompanying notes to consolidated financial statements.

KLA-Tencor Corporation

Consolidated Statements of Stockholders Equity

	Common Stock and Capital in Excess of Par Value				
(in thousands)	**Shares**	**Amount**	**Retained Earnings**	**Accumulated Other Comprehensive Income**	**Total**
Balances at June 30, 2000	187,465	$ 718,165	$ 976,846	$ 13,665	$ 1,708,676
Components of comprehensive income:					
Net income	--	--	66,683	--	66,683
Change in unrealized gain on investment	--	--	--	(2,485)	(2,485)
Currency translation adjustments	--	--	--	(12,008)	(12,008)
Deferred gains on cash flow hedging instruments	--	--	--	3,432	3,432
Total comprehensive income					55,622
Net issuance under employee stock plans	4,894	93,756	--	--	93,756
Repurchase of common stock	(4,580)	(153,632)	--	--	(153,632)
Tax benefits of stock option transactions	--	56,044	--	--	56,044
Balances at June 30, 2001	187,779	714,333	1,043,529	2,604	1,760,466
Components of comprehensive income:					
Net income	--	--	216,166	--	216,166
Change in unrealized gain on investments	--	--	--	(1,048)	(1,048)
Currency translation adjustments	--	--	--	7,455	7,455

Deferred losses on cash flow hedging instruments	--	--	--	(4,424)	(4,424)
Total comprehensive income					218,149
Net issuance under employee stock plans	5,314	115,136	--	--	115,136
Repurchase of common stock	(3,341)	(123,220)	--	--	(123,220)
Tax benefits of stock option transactions	--	59,697	--	--	59,697
Balances at June 30, 2002	189,752	765,946	1,259,695	4,587	2,030,228
Components of comprehensive income:					
Net income	--	--	137,191	--	137,191
Change in unrealized gain on investments	--	--	--	(7,281)	(7,281)
Currency translation adjustments	--	--	--	5,136	5,136
Deferred gains on cash flow hedging instruments	--	--	--	1,245	1,245
Total comprehensive income					136,291
Net issuance under employee stock plans	3,953	92,499	--	--	92,499
Repurchase of common stock	(1,972)	(65,912)	--	--	(65,912)
Tax benefits of stock option transactions	--	22,435	--	--	22,435
Balances at June 30, 2003	191,733	$ 814,968	$1,396,886	$ 3,687	$ 2,215,541

See accompanying notes to consolidated financial statements.

KLA Tencor Corporation
Consolidated Statements of Cash Flows

Year ended June 30, *(in thousands)*	**2003**	**2002**	**2001**
Cash flows from operating activities:			
Net income	$ 137,191	$ 216,166	$ 66,683
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of accounting change, net of tax benefit	--	--	306,375
Depreciation and amortization	71,448	69,590	55,649
Non-recurring (income) restructuring charges	(11,912)	--	(4,297)
In-process research and development	--	--	698
Net (gain) loss on sale of investments and property plant & equipment	(24,082)	(7,573)	(7,703)
Deferred income taxes	(10,629)	36,037	(56,939)
Tax benefit from employee stock options	22,435	59,697	56,044
Changes in assets and liabilities, net of assets acquired and liabilities assumed in business combinations:			
Accounts receivable	53,468	125,005	83,761
Inventories	64,215	71,430	(101,750)

Other assets	(17,183)	(4,974)	(14,522)
Accounts payable	(19,093)	(7,754)	5,723
Deferred profit	(16,366)	(228,202)	(31,835)
Other current liabilities	(3,235)	(59,238)	50,031
Net cash provided by operating activities	246,257	270,184	407,918
Cash flows from investing activities:			
Acquisitions, net of cash received	--	(4,035)	(20,818)
Purchase of property, plant and equipment	(133,766)	(68,658)	(162,195)
Proceeds from sale of property, plant and equipment	3,197	--	--
Purchase of available-for-sale securities	(1,288,151)	(2,127,460)	(913,096)
Proceeds from sale of available-for-sale securities	1,240,437	1,619,111	731,395
Proceeds from maturity of available-for-sale securities	79,769	218,706	69,606
Net cash used in investing activities	(98,514)	(362,336)	(295,108)
Cash flows from financing activities:			
Issuance of common stock	92,499	115,136	93,756
Stock repurchases	(65,912)	(123,220)	(153,632)
Net borrowings (payments) under short term debt obligations	--	(448)	1,670
Net cash provided by (used in) financing activities	26,587	(8,532)	(58,206)
Effect of exchange rate changes on cash and cash equivalents	2,753	830	(3,142)
Net increase (decrease) in cash and cash equivalents	177,083	(99,854)	51,462
Cash and cash equivalents at the beginning of period	429,820	529,674	478,212
Cash and cash equivalents at end of period	$ 606,903	$ 429,820	$ 529,674
Supplemental cash flow disclosures:			
Income taxes paid (refunded)	$ 7,053	$ (19,875)	$ 133,710
Interest paid	$ 352	$ 779	$ 916
Supplemental non-cash investing activities:			
Software and technology exchanged for common stock of public company	$ 15,152	$ --	$ 14,309

See accompanying notes to consolidated financial statements.

KLA-TENCOR CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Description of Operations and Principles of Consolidation KLA-Tencor Corporation (KLA-Tencor) is a global provider of process control and yield management solutions for the semiconductor manufacturing and related microelectronics industries. Headquartered in San Jose, California, KLA-Tencor has subsidiaries both in the United States and in key markets throughout the world.

The Consolidated Financial Statements include the accounts of KLA-Tencor and its wholly-owned subsidiaries. Partially owned, non-controlled, equity affiliates are accounted for under the equity method. All significant intercompany balances and transactions have been eliminated.

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

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 remaining 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 have been classified as trading securities. These trading securities are 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 amount of such gains and losses for the twelve months June 30, 2003 were not material. As of June 30, 2003, the fair value of the trading securities was $10 million.

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.

Inventories Inventories are stated at the lower of cost (on a first-in, first-out basis) or market. Demonstration units are stated at their manufacturing cost and reserves are recorded to state the demonstration units at their net realizable value. KLA-Tencor reviews the adequacy of its inventory reserves on a quarterly basis. Its methodology involves matching its on-hand and on-order inventory with its demand forecast. For parts that are in excess of its forecasted demand, KLA-Tencor takes appropriate reserves to reflect risk of obsolescence. If actual demand declined below its forecast, KLA-Tencor may need to take additional inventory reserves.

Property and Equipment Property and equipment are recorded at cost. Depreciation of property and equipment is based on the straight-line method over the estimated useful lives of the assets, which are thirty to thirty-five years for buildings, ten to fifteen years for leasehold improvements, five to seven years for furniture and fixtures, and three to five years for machinery and equipment. Leasehold improvements are amortized by the straight-line method over the shorter of the life of the related asset or the term of the underlying lease. Construction in process does not depreciate until the assets are placed in service.

Intangible Assets Purchased technology, patents, trademarks, favorable leases and goodwill are presented at cost, net of accumulated amortization. Effective July 1, 2001, KLA-Tencor replaced ratable amortization of goodwill with periodic testing of goodwill for impairment in accordance with the provisions 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.

Software Development Costs Development costs incurred in the research and development of new software products are expensed as incurred until technological feasibility of the product has been established. Software development costs incurred after technological feasibility has been established are capitalized up to the time the product is available for general release to customers. At June 30, 2003 and 2002, there were no amounts capitalized as KLA-Tencor s current development process is essentially completely concurrent with the establishment of technological feasibility.

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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.

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 us. KLA-Tencor does not anticipate nonperformance by these counterparties.

Foreign Currency The functional currencies of KLA-Tencor s significant foreign subsidiaries are generally the local currencies. Accordingly, all assets and liabilities of the foreign operations are translated to U.S. dollars at current period end exchange rates, and revenues and expenses are translated to U.S. dollars using average exchange rates in effect during the period. The gains and losses from foreign currency translation of these subsidiaries financial statements are recorded directly into a separate component of stockholders equity under the caption Accumulated other comprehensive income.

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KLA-Tencor s subsidiaries in Israel use the U.S. dollar as their functional currency. Accordingly, assets and liabilities of these subsidiaries are translated using exchange rates in effect at the end of the period, except for non-monetary assets, such as inventories and property, plant and equipment that are translated using historical exchange rates. Revenues and costs are translated using average exchange rates for the period, except for costs related to those balance sheet items that are translated using historical exchange rates. The resulting translation gains and losses are included in the Consolidated Statements of Operations as incurred.

Derivative Financial Instruments KLA-Tencor uses financial instruments, such as forward exchange contracts, to hedge a portion of, but not all, existing and anticipated foreign currency denominated transactions expected to occur within 12 months. The purpose of KLA-Tencor s foreign currency program is to manage the effect of exchange rate fluctuations on certain foreign currency denominated revenues, costs and eventual cash flows. The effect of exchange rate changes on forward exchange contracts is expected to offset the effect of exchange rate changes on the underlying hedged items. KLA-Tencor believes these financial instruments do not subject it to speculative risk that would otherwise result from changes in currency exchange rates. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes.

All of KLA-Tencor s derivative financial instruments are recorded at fair value based upon quoted market prices for comparable instruments. For derivative instruments designated and qualifying as cash flow hedges of anticipated foreign currency denominated transactions, the effective portion of the gain or loss on these hedges is reported as a component of accumulated other comprehensive income in stockholders equity, and is reclassified into earnings when the hedged transaction affects earnings. If the transaction being hedged fails to occur, or if a portion of any derivative is ineffective, the gain or loss on the associated financial instrument is recorded immediately in earnings. For derivative instruments used to hedge existing foreign currency denominated assets or liabilities, the gain or loss on these hedges is recorded immediately in earnings to offset the changes in the fair value of the assets or liabilities being hedged.

At June 30, 2003, KLA-Tencor had foreign exchange forward contracts maturing throughout fiscal 2004 to sell $215 million and purchase $159 million, in foreign currency, primarily Japanese yen. At June 30, 2002, KLA-Tencor had foreign exchange forward contracts maturing throughout fiscal 2003 to sell $155 million and purchase $40 million, in foreign currency, primarily Japanese yen. All foreign exchange forward contracts are carried on the consolidated balance sheets at fair market value. See Note 8 for further information related to derivatives and hedging activities.

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 applies the actual labor and overhead rates to determine the estimated warranty charge. KLA-Tencor updates 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 (see Note 8 Commitments and Contingencies).

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Revenue Recognition In December 1999, the SEC issued Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements. The SEC Staff addressed several issues in SAB 101, including the timing of revenue recognition for sales that involve contractual customer acceptance provisions and installation of the product if these events occur after shipment and transfer of title. KLA-Tencor implemented the provisions of SAB 101 in the fourth fiscal quarter of 2001, retroactive to July 1, 2000. Prior to adoption of SAB 101, KLA-Tencor s general policy was to recognize revenue on shipment.

KLA-Tencor derives revenue from four sources system sales, spare part sales, service contracts and software license fees. System sales include hardware and software that is incidental to the product. Prior to the implementation of 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:

o 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;

o When the system requires no integration and installation is inconsequential, revenue is recognized on shipment. In these cases KLA-Tencor is required to perform the installation but KLA-Tencor 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;

o 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;

o When the system is performing in production and meets all published and contractually agreed specifications, but the customer withholds signature on our acceptance document due to warranty or other issues unrelated to product performance;

o 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 3.1% of total revenue for fiscal year 2003 and 2.5% of total revenue for fiscal years 2002 and 2001. Shipping charges billed to customers are included in system revenue and the related shipping costs are included in cost of sales.

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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 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. To date, revenue from license fees have been less than 10% of total revenue.

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As a result of implementing SAB 101, KLA-Tencor changed its method of accounting for revenue recognition. This change resulted in cumulative deferred revenue of $660.9 million as of July 1, 2000, which was recorded as a non-cash charge of $306.4 million (after reduction for product and warranty costs of $207 million and income taxes of $147.5 million). The deferred profit balance as of June 30, 2003 and 2002 was $177 million and 194 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 as of June 30, 2003 and 2002 was $48 million and $55 million, respectively.

Advertising Expenses KLA-Tencor expenses advertising costs as incurred. Advertising expenses for fiscal 2003, 2002 and 2001 were approximately $4 million, $3 million and $6 million respectively.

Strategic Development Agreements Net engineering, research and development expenses were partially offset by $18 million, $14 million and $8 million in external funding received under certain strategic development programs conducted with several of KLA-Tencor s customers and government grants in fiscal 2003, 2002 and 2001, respectively.

Income Taxes KLA-Tencor accounts for income taxes under an asset and liability approach. Deferred tax liabilities are recognized for future taxable amounts and deferred tax assets are recognized for future deductions.

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 outstanding during the period and gives effect to all dilutive potential common shares outstanding during the period. The reconciling difference between the computation of basic and diluted earnings per share for all periods presented is the inclusion of the dilutive effect of stock options issued to employees under employee stock option plans.

Options to purchase 5,270,681, 282,746 and 4,459,862 shares of KLA-Tencor s common stock were outstanding at June 30, 2003, 2002 and 2001 respectively, but not included in the computation of diluted EPS because the exercise price was greater than the average market price of common shares in each respective year. The exercise price ranges of these options were $39.35 to $68.00, $52.75 to $68.00 and $44.69 to $68.00 at June 30, 2003, 2002 and 2001, respectively.

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 APB 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 No. 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.

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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:

June 30,	2003	2002	2001
Stock option plan:			
Expected stock price volatility	70.0%	80.0%	80.0%
Risk free interest rate	2.8%	4.4%	5.5%
Expected life of options (in years)	5.4	5.4	5.4
Stock purchase plan:			
Expected stock price volatility	75.0%	80.0%	80.0%
Risk free interest rate	2.2%	2.2%	4.3%
Expected life of options (in years)	1-2	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:

Year ended June 30, (in thousands, except per share data)	**2003**	**2002**	**2001**
Income before cumulative effect of change in accounting principle	137,191	216,166	373,058
Cumulative effect of change in accounting principle, net of tax	--	--	(306,375)
Net income, as reported	$ 137,191	$ 216,166	$ 66,683
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(90,880)	(123,802)	(93,696)
Pro forma net income	$ 46,311	$ 92,364	$ (27,013)
Earnings per share:			
Income before cumulative effect of change in accounting principle			
Basic	$ 0.72	$ 1.15	$ 2.01
Diluted	$ 0.70	$ 1.10	$ 1.93
Net income as reported			
Basic	$ 0.72	$ 1.15	$ 0.36
Diluted	$ 0.70	$ 1.10	$ 0.34
Pro forma income before cumlative effect of change in accounting principle			
Basic	$ 0.24	$ 0.49	$ 1.50
Diluted	$ 0.24	$ 0.47	$ 1.44
Pro forma net income			
Basic	$ 0.24	$ 0.49	$ (0.15)
Diluted	$ 0.24	$ 0.47	$ (0.15)

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 stockholders equity.

Recent Accounting Pronouncements In July 2002, KLA-Tencor adopted Statement No. 143 (SFAS 143), Accounting for Obligations Associated with the Retirement of Long-Lived Assets. SFAS 143 establishes accounting standards for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. It also provides guidance for legal obligations associated with the retirement of tangible long-lived assets. Adoption of SFAS 143 did not have a material impact on the Company s consolidated financial statements

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 will be effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003 or the Company may elect to report the change in accounting as a cumulative-effect adjustment. The Company believes that the adoption of this standard will have 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. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after June 15, 2003. The Company believes that although the adoption of this standard will result in consolidation of certain entities, it will have no material impact on the 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 Company believes that the adoption of this standard will 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 be classified as a liability (or an asset in some circumstances). Many of those financial instruments were previously classified as equity. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003. For financial instruments created before and still existing as of the issuance of this statement, a cumulative effect of change in accounting principle shall be reported upon implementation in the first interim period beginning after June 15, 2003. The Company believes that the adoption of this standard will not have a material impact on our consolidated balance sheet or statement of operations.

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NOTE 2 FINANCIAL STATEMENT COMPONENTS

Balance Sheets

June 30, *(in thousands)*	**2003**	**2002**
Accounts receivable, net		
Accounts receivable, gross	$236,152	$290,397
Allowance for doubtful accounts	(12,617)	(13,391)
	$223,535	$277,006
Inventories:		
Customer service parts	$107,709	$123,074
Raw materials	30,558	76,238
Work-in-process	57,819	54,143

Demonstration equipment	40,732	48,564
Finished goods	21,981	20,997
	$258,799	$323,016

June 30, *(in thousands)*	2003	2002
Property and equipment:		
Land	$ 78,364	$ 28,103
Buildings and improvements	127,970	48,683
Machinery and equipment	222,267	218,977
Office furniture and fixtures	39,486	36,951
Leasehold improvements	132,908	116,787
Construction in process	43,437	74,843
	644,432	524,344
Less: accumulated depreciation and amortization	(261,703)	(223,784)
	$ 382,729	$ 300,560

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June 30, *(in thousands)*	2003	2002
Other assets:		
Goodwill & other intangibles	$ 20,278	$ 23,401
Other long-term-investments	75,463	67,071
Deferred tax assets-long-term	43,032	36,469
Other	7,794	10,692
	$146,566	$137,633

June 30, *(in thousands)*	2003	2002
Other current liabilities:		
Warranty, installation and retrofit	$ 36,827	$ 54,441
Compensation and benefits	168,499	175,282
Income taxes payable	111,778	84,024
Restructuring accrual	3,240	405
Other accrued expenses	71,130	71,612
	$391,474	$385,764

June 30, *(in thousands)*	2003	2002
Accumulated other comprehensive income:		
Currency translation adjustments	$(2,563)	$ (7,699)

Gains (losses) on cash flow hedging instruments	253	(992)
Unrealized gains on investments, net of taxes of $3,786 in 2003 and $8,383 in 2002	5,997	13,278
	$ 3,687	$ 4,587

Statements of Operations

Year ended June 30, (in thousands)	**2003**	**2002**	**2001**
Interest income and other, net			
Interest income	$24,466	$32,680	$39,652
Interest expense	(386)	(594)	(1,057)
Foreign exchange gain (loss)	(3,058)	3,897	8,478
Realized gains (losses) on sale of investments	21,780	7,573	7,703
Other	(1,006)	(993)	(660)
	$41,796	$42,563	$54,116

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

The following is summary of non-recurring acquisition, restructuring and other charges for the three fiscal years ended June 30, 2003.

(in thousands)	**2003**	**2002**	**2001**
Acquired in-process research and development expense	$ --	$ --	$ 700
Facilities	4,623	--	4,713
Severance	1,127	--	1,595
Non-recurring income from iSupport sale	(15,152)	--	(10,029)
Others	--	--	1,018
	$ (9,402)	$ --	$ (2,003)

Restructuring and Other Charges

In fiscal 2003, 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. In addition, during the first fiscal quarter of 2003, KLA-Tencor received $15.2 million as a second and final installment on the sale of software and intellectual property associated with its *iSupport* on-line customer support technology, which was netted against the above non-recurring charges, resulting in a reported net gain of $9.4 million. In addition to the restructuring action, KLA-Tencor also recorded severance charges totaling $10.9 million in operating expenses, throughout fiscal 2003, relating to a series of employee involuntary terminations.

In fiscal 2002, there were no restructuring charges. KLA-Tencor recorded severance charges of $8.5 million in operating expenses relating to a series of employee involuntary terminations throughout fiscal 2002. In fiscal 2001, in response to the downturn in the semiconductor industry, KLA-Tencor implemented a restructuring plan to reduce spending. Charges related to its restructuring plan included: facilities of $4.7 million, severance and benefits of $1.6 million, and other costs of $1.0 million. Facilities related charges were associated with two leased office buildings that were vacated and 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. During fiscal 2001, KLA-Tencor reduced its workforce by approximately 5%, primarily in the manufacturing areas and recorded severance charges related to these terminations. The restructuring actions taken in fiscal 2001 were substantially completed at the end of fiscal 2002. In addition, during the fourth fiscal quarter of 2001, KLA-Tencor sold software and intellectual property associated with its *iSupport* on-line customer support technology and recorded $10.0 million pretax, non-recurring income, which was netted with the other non-recurring charges.

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The following table shows the details of the facilities, severance and other restructuring costs accrual for the fiscal year ended June 30, 2003:

(in thousands)	Balance at June 30, 2002	Amounts Expensed	Amounts Utilized	Balance at June 30, 2003
Facilities and other	$ 405	$ 4,623	$ (1,835)	$ 3,193
Severance and benefits	--	1,127	(1,080)	47
Total	$ 405	$ 5,750	$ (2,915)	$ 3,240

Acquisitions

During fiscal years 2002 and 2001, KLA-Tencor completed certain purchase acquisitions. The Consolidated Financial Statements include the operating results of each business from the date of acquisition. Pro forma results of operations have not been presented because the effects of these acquisitions were not material on either an individual or aggregate basis. For a period of up to twelve months from the acquisition date, KLA-Tencor may change its original purchase price allocation for pre-acquisition uncertainties. After twelve months, KLA-Tencor records the fair value of such reasonably estimable contingencies.

The amounts allocated to in-process research and development (in-process R&D) were determined through established valuation techniques in the high-technology equipment industry and were expensed upon acquisition because technology feasibility had not been established and no future alternative uses existed. Amounts allocated to purchased intangible assets are amortized on a straight-line basis over periods not exceeding five years.

A summary of purchase transactions is outlined as follows (in thousands):

Acquisition year	**Acquired Company/Assets**	**Consideration Including Assumed Liabilities**	**Acquisition Cost**	**Goodwill and Purchased Intangible Assets**	**In-Process R&D Expenses**
Fiscal 2002	QC Optics(1)	$ 4,000	$ -	$4,000	$ -
Fiscal 2001	Phase Metrics(2)	$18,000	$1,300	$5,400	$700

(1) With the acquisition of QC Optics, we received certain intellectual property in laser-based inspection systems for the semiconductor, flat panel and computer hard disk manufacturing industries.

(2) KLA-Tencor acquired certain assets and technology of Phase Metrics, the leading supplier of inspection/certification productsin the data storage industry.

The difference between the purchase price and the goodwill, intangibles and in-process R&D represents amount allocated to the net tangible assets acquired. No deferred stock-based compensation was recorded for any of the acquisitions.

NOTE 4 MARKETABLE SECURITIES

The amortized costs and estimated fair value of securities available-for-sale as of June 30, 2003 and 2002 are as follows:

June 30, 2003 *(in thousands)*	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Treasuries	$ 5,113	$ 26	$ --	$ 5,139
Mortgage-backed securities	21,982	283	(2)	22,263
Municipal bonds	1,100,074	6,473	(695)	1,105,852
Corporate debt securities	15,078	99	--	15,177
Corporate equity securities	19,368	3,662	(63)	22,967
Money market bank deposits and other	218,717	--	--	218,717
	1,380,332	10,543	(760)	1,390,115
Less: Cash equivalents	509,193	12	(70)	509,135
Short-term marketable securities	345,386	4,733	(58)	350,061
Long-term marketable securities	$ 525,753	$ 5,798	$ (632)	$ 530,919

June 30, 2002 *(in thousands)*	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
U.S. Treasuries	$ 56,996	$ 406	$ (18)	$ 57,384
Mortgage-backed securities	46,862	406	(8)	47,260
Municipal bonds	860,326	6,813	(55)	867,084
Corporate debt securities	40,548	214	(5)	40,757
Corporate equity securities	6,784	15,307	(1,399)	20,692
Money market bank deposits and other	190,234	--	--	190,234
	1,201,750	23,146	(1,485)	1,223,411
Less: Cash equivalents	319,505	143	--	319,648
Short-term marketable securities	228,859	16,079	1,412	243,526
Long-term marketable securities	$ 653,386	$ 6,924	$ (73)	$ 660,237

The contractual maturities of debt securities classified as available-for-sale as of June 30, 2003, regardless of the consolidated balance sheet classification, are as follows:

June 30, 2003 *(in thousands)*	**Cost**	**Estimated Fair Value**

Due within one year	$ 795,103	$ 838,682
Due after one year through three years	460,708	460,708
Due after three years	67,758	67,758
	$1,323,569	$1,367,148

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Net realized gains and losses for the year ended June 30, 2003 were approximately $22 million. Net realized gains and losses for the years ended June 30, 2002 and 2001 were not material to KLA-Tencor s financial position or results of operations.

NOTE 5 - INCOME TAXES

The components of income before income taxes are as follows:

Year ended June 30, (in thousands)	**2003**	**2002**	**2001**
Domestic income before income taxes	$ 151,229	$ 256,926	$ 437,329
Foreign income before income taxes	29,289	30,530	75,255
Total net income before taxes	$180,518	$ 287,456	$512,584

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

Year ended June 30, (in thousands)	**2003**	**2002**	**2001**
Current:			
Federal	$ 33,665	$ (1,252)	$ 162,491
State	3,157	19,374	15,129
Foreign	17,207	17,131	17,578
	54,029	35,253	195,198
Deferred:			
Federal	(2,726)	60,076	(51,782)
State	(4,602)	(20,576)	(4,549)
Foreign	(3,374)	(3,463)	659
	(10,702)	36,037	(55,672)
Provision for income taxes	$ 43,327	$ 71,290	$ 139,526

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Actual current tax liabilities are lower than reflected above for fiscal years 2003, 2002 and 2001 by $22 million, $60 million and $56 million, respectively, due to the stock option deduction benefits recorded as credits to capital in excess of par value.

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

June 30, *(in thousands)*	**2003**	**2002**

Deferred tax assets:		
Federal and state loss and credit carryforwards	$129,217	$ 70,794
Employee benefits accrual	43,446	42,137
Non-deductible reserves and other	140,862	166,365
Deferred profit	77,337	106,959
	390,862	386,255
Deferred tax liabilities:		
Depreciation	3,109	(718)
Unremitted earnings of foreign subsidiaries not permanently reinvested	(12,148)	(11,850)
Unrealized gain on investments	(3,786)	(8,383)
Other	(13,772)	(16,338)
	(26,597)	(37,289)
Total net deferred tax assets	$364,265	$348,966

The reconciliation of the United States federal statutory income tax rate to KLA-Tencor s effective income tax rate is as follows:

Year ended June 30,	**2003**	**2002**
Federal statutory rate	35.0 %	35.0 %
State income taxes, net of federal benefit	(0.5)	(0.3)
Effect of foreign operations taxed at various rates	1.9	0.3
Export sales benefit	(5.2)	(5.3)
Research and development tax credit	(3.3)	(2.8)
Tax exempt interest	(3.8)	(2.9)
Other	(0.1)	0.8
Provision for Income Taxes	24.0 %	24.8 %

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United States federal income taxes have not been provided for the undistributed earnings of two of KLA-Tencor s foreign subsidiaries. These undistributed earnings aggregated $31 million at June 30, 2003, and it is the Company s intention that such undistributed earnings be permanently reinvested. The Company has tax credits at June 30, 2003 totaling $129 million, of which $4 million will begin to expire in 2008 and $38 million will begin to expire in 2021. The Company enjoys tax holidays in Israel where it manufactures certain of its products. These tax holidays are scheduled to expire at varying times within the next ten years. During the last three fiscal years, the effect of these tax holidays has not had a material impact on the Company s net income and net income per share.

NOTE 6 - STOCKHOLDERS EQUITY

Stockholders Rights Plan In March 1989, KLA-Tencor implemented a plan to protect stockholders rights in the event of a proposed takeover of KLA-Tencor. Each stockholder under the plan is entitled to one right per common stock owned. The Plan was amended in April 1996. The Plan provides that if any person or group acquires 15% or more of KLA-Tencor s common stock, each right not owned by such person or group will entitle its holder to purchase, at the then-current exercise price, KLA-Tencor s common stock at a value of twice that exercise price. As amended to date, under the Plan, the rights are redeemable at KLA-Tencor s option for $0.01 per right and expire in April 2006.

Stock Repurchase Program In July 1997, the Board of Directors authorized KLA-Tencor to systematically repurchase shares of its common stock in the open market. This plan was entered into to reduce the dilution from KLA-Tencor s employee benefit and incentive plans such as the stock option and employee stock purchase plans. Since the inception of the repurchase program in 1997 through June 30, 2003 the Board of Directors had authorized KLA-Tencor to repurchase a total of 17.8 million shares, including 5 million shares authorized in October 2002. In fiscal years 2003, 2002 and 2001, KLA-Tencor repurchased 1,972,000, 3,341,000 and 4,580,000 shares at an average price of $33.42, $36.89 and $33.54 per share, respectively. Since the inception of the repurchase program in 1997 through June 30, 2002, KLA-Tencor has repurchased a total of 13,321,000 shares at an average price of $32.70 per share, with an additional 4.5 million available for repurchase under the plan . All such shares remain as treasury shares.

Employee Stock Purchase Plan KLA-Tencor s employee stock purchase plan provides that eligible employees may contribute up to 10% of their eligible earnings toward the semi-annual purchase of KLA-Tencor s common stock. The employee s purchase price is derived from a formula based on the fair market value of the common stock at the time of enrollment into the Offering period versus the fair market value on the date of purchase. Offering periods are generally two years in length. As the plan is non-compensatory under APB 25, no compensation expense is recorded in connection with the plan. In fiscal years 2003, 2002 and 2001 employees purchased 1,071,571, 1,155,213 and 1,275,837 of shares issued at a weighted average fair value of $30.26, $29.72 and $28.59 respectively. The plan shares are replenished annually on the first day of each fiscal year by virtue of an evergreen provision. The provision allows for share replenishment equal to the lesser of 2,000,000 shares or the number of shares which the Company estimates will be required to issue under the plan during the forthcoming fiscal year. At June 30, 2003, a total of 930,769 shares were reserved and available for issuance under this plan.

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 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 2000 through June 30, 2003 are summarized as follows (in thousands):

	2003	2002	2001	2000
Weighted average shares outstanding	189,817	187,667	185,860	182,177
Total options granted during the period	4,922	9,760	10,274	8,166
Less options forfeited	(2,416)	(1,786)	(2,418)	(1,484)
Net options granted	2,506	7,974	7,856	6,682
Net grants during the period as % of weighted average shares outstanding	1.3%	4.2%	4.2%	3.6%
Grants to top 5 officers during the period as a % of weighted average shares outstanding	0.2%	0.3%	0.2%	0.2%
Grants to top 5 officers during the period as a % of total options granted	6.0%	6.0%	4.0%	5.0%

During fiscal 2003, the Company granted options to purchase approximately 4.9 million shares of stock to employees. After deducting options forfeited the net grant of options was 2.5 million shares. The net options granted after forfeiture represented 1.3% of weighted average outstanding shares of approximately 189.8 million as of June 30, 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 year to year. In 2003, there were 270,000 options granted to the top five officers. In fiscal 2002, options granted to the top five officers were a higher percentage of the total grants than in the other years shown because the Board of Directors approved additional grants to the CEO in recognition of his future potential to lead the corporation. The additional grants to the CEO totaled 227,400 options with vesting on said grants extended for up to an eight-year period.

All stock option grants to officers are approved by the Compensation Committee of the Board of Directors. All members of the Compensation Committee are independent directors, as defined in the applicable rules for issuers traded on the NASDAQ Stock Market.

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The following table summarizes KLA-Tencor's stock option plans as of June 30, 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	20,930,487	$ 27.70	12,925,303(1)
Stock option plan not approved by stockholders(2)	8,803,471	35.53	3,994,415
Total	29,733,958	$ 29.94	16,919,718

(1) In July 2003, an additional 5,750,290 securities were reserved for issuance in accordance with the stock option plan's evergreen feature.
(2) Officers and directors are not eligible to receive options granted under this plan.

In order to retain the incentive value for many new employees who had stock option grants with exercise prices that were far out of the money, in December 2000, 569 employees of KLA-Tencor were offered the opportunity to participate in a surrender program. This program applied to less than 9 percent of total employees and less than 5 percent of total options outstanding. The program allowed participating employees to exchange their stock options with exercise prices over $55.00 per share and all subsequently issued options for a promise to issue new options no sooner than six months and two days after the cancellation of the forfeited options. Employees who elected to participate in the exchange program were required to exchange all options issued during the period six months prior to December 2000 as well forgo any grant of new options during the six months subsequent to December 2000. The new options were granted on July 10, 2001 at the NASDAQ market closing price of $46.67. The terms of the new option replicated the surrendered option. Only 49 percent of eligible employees elected to participate in this program. A total of 278 employees surrendered an aggregate of 722,814 options with exercise prices ranging from $26.25 to $68.00 per share or an average exercise price of $45.46 per share.

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

	Available For Grant	Options Outstanding	Weighted-Average Price

Balances at June 30, 2000	5,146,702	22,355,712	$ 20.23
Additional shares reserved	11,216,391	--	--
Options granted	(10,273,504)	10,273,504	37.09
Options canceled/expired	2,418,485	(2,418,485)	36.15
Options exercised	--	(3,921,145)	14.71
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

(1) In addition in August 2003, KLA-Tencor granted 1.4 million stock options (1.3 million to non -executive employees and 0.1 million to executive employees) as part of the fiscal year 2002 annual performance cycle review of KLA-Tencor.

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The options outstanding at June 30, 2003 have been segregated into ranges for additional disclosure as follows:

	Options Outstanding			**Options Vested and Exercisable**	
Range of Exercise Prices	**Number of Shares Outstanding at June 30, 2003**	**Weighted-Average Remaining Contract Life (in years)**	**Weighted-Average Exercise Price at June 30, 2003**	**Number Vested and Exercisable**	**Weighted-Average Exercise Price at June 30, 2003**
$ 2.41-$ 9.31	683,639	1.48	$ 8.98	683,639	$ 8.98
$ 9.53-$10.63	3,748,549	5.11	$ 10.60	3,748,357	$ 10.60
$10.81-$29.26	3,610,498	5.94	$ 21.30	2,730,540	$ 19.64
$29.31-$29.31	6,908,808	8.26	$ 29.31	2,096,228	$ 29.31
$29.96-$33.75	5,454,853	6.95	$ 33.11	3,781,673	$ 33.44
$34.67-$37.05	4,337,306	9.46	$ 35.51	119,883	$ 36.52
$39.35-$46.67	4,068,342	7.34	$ 44.83	2,840,311	$ 44.99
$47.23-$68.00	921,963	7.82	$ 51.86	525,954	$ 52.35
$ 2.41-$68.00	29,733,958	7.22	$ 29.94	16,526,585	$ 27.05

The weighted average fair value of options granted in fiscal years 2003, 2002 and 2001 was $21.93, $21.87 and $25.93 respectively. Options exercisable were 16,526,585, 13,436,155 and 9,807,250 as of June 30, 2003, 2002 and 2001, respectively.

NOTE 7 EMPLOYEE BENEFIT PLANS

KLA-Tencor has a profit sharing program for eligible employees, which distributes on a quarterly basis, a percentage of pretax profits. In addition, KLA-Tencor has an employee savings plan that qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Starting fiscal year 2000, KLA-Tencor has matched up to a maximum of $1,000 or 50% of the first $2,000 of an eligible employee s contribution, with $500 of the amount funded from the profit sharing program. The total charge to operations under the profit sharing and 401(k) programs aggregated $10 million, $3 million and $57 million in fiscal years 2003, 2002 and 2001, respectively. KLA-Tencor has no defined benefit plans in the United States. In addition to the profit sharing plan and the U.S. employee saving plan, several of KLA-Tencor s foreign subsidiaries have retirement plans for their full time employees, several of which are defined benefit plans.

Net periodic pension cost for defined benefit pension plans is determined in accordance with FAS 87, *Employers Accounting for Pensions*, and is made up of several components that reflect different aspects of the Company s pension-related financial arrangements and the cost of benefits earned by participating employees. These components are determined using certain actuarial assumptions. Summary data relating to the Company s foreign defined benefit pension plans, including key weighted average assumptions used is provided in the following tables:

June 30, *(in thousands)*	**2003**	**2002**
Change in projected benefit obligation		
Projected benefit obligation at beginning of fiscal year	$ 8,632	$ 6,166
Service cost, including plan participant contributions	2,041	1,609
Interest cost	321	245
Actuarial (gain) loss	674	378
Benefit payments	(96)	(72)
Foreign currency changes	(42)	306
Projected benefit obligation at the end of the fiscal year	$ 11,530	$ 8,632
Change in fair value of plan assets and funded status		
Fair value of plan assets at beginning of fiscal year	$ 1,218	$ 673
Actual return on plan assets	22	27
Employer contributions	522	481
Benefit and expense payments	(20)	--
Foreign currency changes	(58)	36
Fair value of plan assets at end of fiscal year	1,684	1,217
Projected benefit obligation at the end of the fiscal year	11,530	8,632
Projected benefit obligation in excess of fair value of plan assets	(9,846)	(7,415)
Unamortized net obligation (asset)	984	1,234
Intangible asset	(206)	--
Unrecognized net actuarial loss	1,834	1,142
(Accrued) prepaid benefit cost at end of fiscal year	$ (7,234)	$ (5,039)

June 30,	**2003**	**2002**
Weighted -average assumptions		
Discount rate	3.5 % - 3.75 %	$ 3.5% - 4.5 %

Expected return on assets	3.75 %	4.5 %
Rate of compensation increases	0% - 3.0 %	3.0 %

The components of KLA-Tencor's net periodic cost relating to its foreign subsidiaries defined pension plans are as follow:

June 30, (in thousands)	**2003**	**2002**	**2001**
Components of net periodic pension cost			
Service cost, net of plan participant contributions	$ 2,041	$ 1,609	$ 1,337
Interest cost	321	245	203
Return on plan assets	(64)	(55)	(17)
Amortization of net transitional obligation	237	227	247
Amortization of net gain (loss)	17	14	22
Net periodic pension cost	$ 2,552	$ 2,040	$ 1,792

KLA-Tencor has a non-qualified deferred compensation plan whereby certain executives may defer a portion of their salary and bonus. Participants are credited with returns based on their allocation of their account balances among mutual funds. The Company controls the investment of these funds and the participants remain general creditors of the Company. Distributions from the plan commence the quarter following a participant s retirement or termination of employment. At June 30, 2003, KLA-Tencor had a deferred compensation liability under the plan of $78 million included as a component of other current liabilities on the consolidated balance sheet.

NOTE 8 - COMMITMENTS AND CONTINGENCIES

Factoring KLA-Tencor has agreements with two Japanese banking institutions to sell certain of its trade receivables and promissory notes without recourse. During fiscal 2003 and 2002, approximately $99 million and $98 million of receivables were sold under these arrangements, respectively. As of June 30, 2003 and 2002, approximately $27 million and $48 million were outstanding, respectively. The total amount available under the facility is the Japanese yen equivalent of $92 million based upon exchange rates as of June 30, 2003. KLA-Tencor does not believe it is materially at risk for any losses as a result of these agreements.

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. Rent expense was approximately $16.2 million, $20.3 million and $21.8 million for the years ended June 30, 2003, 2002 and 2001, respectively.

The following is a schedule of operating leases payments (in thousands):

Fiscal year ended June 30,	**Amount**
2004	$ 7,303
2005	4,911
2006	2,838
2007	1,554
2008	1,213
Thereafter	3,969

Total minimum lease payments	$21,788

The lease agreement for certain Milpitas and San Jose, California facilities had a term of five years ending in November 2002, with an option to extend up to two more years. Under the terms of the lease, KLA-Tencor, at its option, could acquire the properties at their original cost or arrange for the properties to be acquired. In November 2002, the Company purchased these facilities at the end of the lease term. The purchase transaction increased land and property by approximately $120 million and decreased cash by the same amount.

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 amongst different suppliers. The Company s open inventory purchase commitments were less than $42 million as of June 30, 2003.

Guarantees During the quarter ended December 31, 2002 KLA-Tencor adopted Financial Accounting Standards Board Interpretation No. 45 (FIN 45), Guarantor s Requirements for Guarantees, including Indirect Indebtedness of Others. FIN 45 requires disclosures concerning KLA-Tencor s obligations under certain guarantees.

The following table provides the changes in the product warranty accrual, as required by FIN 45 for the fiscal year ended June 30, 2003:

(in thousands)	**Amount of Liability Debit/(Credit)**
Balance at June 30, 2002	$ (49,047)
Accruals for warranties issued during the period	(48,539)
Changes in liability related to pre-existing warranties	17,765
Settlements made during the period	46,595
Balance at June 30, 2003	$ (33,226)

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In connection with certain business combinations and purchased technology transactions, KLA-Tencor was subject to certain contingent consideration arrangements at June 30, 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 $2.2 million to $3.6 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 our 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. KLA-Tencor believes that it has defenses in each of the cases set forth below and is 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 our 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 ADE s patent is invalid and not infringed by KLA-Tencor. 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 has now been consolidated with the prior action in the Delaware proceeding, and ADE has 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 favor of KLA-Tencor 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.

Tokyo Seimitsu Co. Ltd.

On June 27, 2001, KLA-Tencor sued 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. The district court judge has entered a ruling that calls into question the validity of the patent in suit. KLA-Tencor is examining remedies in connection with that determination.

NOTE 9 DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

Under its foreign-currency risk management strategy, KLA-Tencor utilizes derivative instruments to protect its interests from unanticipated fluctuations in earnings and cash flows caused by volatility in currency exchange rates. This financial exposure is monitored and managed by KLA-Tencor as an integral part of its overall risk management program which focuses on the unpredictability of financial markets and seeks to reduce the potentially adverse effects that the volatility of these markets may have on its operating results. KLA-Tencor continues its policy of hedging its current and anticipated foreign currency exposures with hedging instruments having tenors of up to twelve months.

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On July 1, 2001, KLA-Tencor adopted SFAS 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133). SFAS 133 requires that all derivatives be recorded on the balance sheet at fair value. Changes in the fair value of derivatives which do not qualify, or are not effective as hedges must be recognized currently in earnings. Upon adoption KLA-Tencor recognized the fair value of foreign currency forward contracts, previously held off balance sheet, and reflected their fair value on the balance sheet. These were principally offset by recording on the balance sheet the change in value of the hedged item, generally forecasted shipments. KLA-Tencor did not separately report a cumulative transition adjustment to earnings upon adoption of the standard as the impact was immaterial. All derivatives were reflected at fair value on the balance sheet at that date.

Cashflow Hedges

KLA-Tencor s international sales are primarily denominated in U.S. dollars. For foreign currency denominated sales, however, the volatility of the foreign currency markets represents risk to KLA-Tencor s margins. KLA-Tencor defines its exposure as the risk of changes in the functional-currency-equivalent cash flows (generally U.S. dollar) attributable to changes in the related foreign currency exchange rates. Upon forecasting the exposure, KLA-Tencor hedges with forward sales contracts whose critical terms are designed to match those of the underlying exposure. These hedges are evaluated for effectiveness at least quarterly using regression analysis. Ineffectiveness is measured by comparing the change in value of the forward contracts to the change in value of the underlying transaction, with the effective portion of the hedge accumulated in Other Comprehensive Income (OCI). Any measured ineffectiveness is included immediately in Interest income and other, net in the Consolidated Statements of Operations. Deferred hedge gains and losses and OCI associated with hedges of foreign currency sales are reclassified to revenue upon recognition in income of the underlying hedged exposure. All amounts reported in OCI at June 30, 2003 are anticipated to be reclassified to revenue within twelve months. At June 30, 2003, KLA-Tencor had cash flow hedge contracts, maturing throughout fiscal year 2004 to sell $66 million and purchase $7 million, in foreign currency, primarily in Japanese yen. The following table summarizes hedging activity in the OCI account during the years ended June 30, (in thousands):

	2003	2002
Beginning Balance	$ (992)	$ 3,432

Effective portion of cash flow hedging instruments	3,069	(2,045)
Reclassified to revenue upon revenue recognition	(1,824)	(2,379)
Ending Balance	$ 253	$ (992)

Other Foreign Currency Hedges

KLA-Tencor hedges its monetary non-functional assets and liabilities, and those of its subsidiaries. SFAS 52 requires that such monetary assets and liabilities be remeasured periodically for changes in the rate of exchange against the entities functional currency. Changes in value of these assets and liabilities are recorded in Interest income and other, net in the Consolidated Statements of Operations. The volatility of the non-functional currencies together with the requirement to remeasure non-functional assets and liabilities may result in some volatility to KLA-Tencor s Consolidated Statements of Operations if left unhedged. In order to mitigate these effects, KLA-Tencor enters into remeasurement hedges which are forward contracts used to offset the foreign currency positions represented by non-functional monetary assets and liabilities. Remeasurement hedges are not SFAS 133 designated hedges, thus changes in value of the remeasurement hedges are recorded currently in earnings. Changes in the values of underlying monetary non-functional assets and liabilities are also recorded currently in earnings and should offset the change in value of the hedges. At June 30, 2003, KLA-Tencor had other foreign currency hedge contracts maturing throughout fiscal 2004 to sell $149 million and purchase $152 million, in foreign currency, primarily in Japanese yen.

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NOTE 10 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 is $16.2 million as of June 30, 2003. In accordance with SFAS 142, KLA-Tencor in fiscal 2003 evaluated the goodwill for impairment and concluded there was no impairment of goodwill.

The following table reflects the components of other intangible assets as of June 30, 2003 (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Amount
Existing technology	$ 6,062	$ 5,352	$ 710
Patents	4,761	1,759	3,002
Trademark	625	292	333
Favorable leases and other	270	270	--
Subtotal	$ 11,718	$ 7,673	$ 4,045

Other intangible assets are amortized on a straight-line basis over their estimated useful lives. During the fiscal year ended June 30, 2003, as a result of the discontinuation of a product, management evaluated certain intangible assets for impairment. Using a fair-value approach based on discounted future cash flows, management determined that these assets were impaired. For the fiscal year ended June 30, 2003 amortization expense for other intangible assets was $4.2 million, including an impairment charge of $2.0 million. For the years ended June 30, 2002 and 2001, amortization expense for other intangible assets was $2.1 million and $1.0 million, respectively. 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 June 30, 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 ended June 30,	Amount

2004	$1,438
2005	1,434
2006	689
2007 and thereafter	484
Subtotal	$4,045

NOTE 11 SEGMENT REPORTING AND GEOGRAPHIC INFORMATION

In fiscal 1999, KLA-Tencor adopted SFAS 131, Disclosures about Segments of an Enterprise and Related Information. SFAS 131 establishes standards for reporting information about operating segments in annual financial statements and requires that certain selected information about operating segments be reported in interim financial reports. It also establishes standards for related disclosures about products and services, and geographic areas. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. KLA-Tencor s chief operating decision makers are the Chief Executive Officer and the President/Chief Operating Officer.

KLA-Tencor is engaged primarily in designing, manufacturing, and marketing yield management and process monitoring systems for the semiconductor industry. All operating units have been aggregated due to their inter-dependencies, commonality of long-term economic characteristics, products and services, the production processes, class of customer and distribution processes. Since KLA-Tencor operates in one segment, all financial segment information required by SFAS 131 can be found in the Consolidated Financial Statements.

KLA-Tencor's significant operations outside the United States include a manufacturing facility in Israel and sales, marketing and service offices in Western Europe, Japan, and the Asia Pacific region. For geographical reporting, revenues are attributed to the geographic location 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 location in which they are located. The following is a summary of operations by entities located within the indicated geographic areas for fiscal years 2003, 2002 and 2001.

Year ended June 30, (in thousands)	**2003**	**2002**	**2001**
Revenues:			
United States	$ 407,225	$ 539,952	$ 714,517
Europe & Israel	193,264	238,897	257,560
Japan	276,321	350,668	401,764
Taiwan	253,218	268,492	402,440
Asia Pacific	193,021	239,273	327,476
Total	$1,323,049	$1,637,282	$2,103,757

Year ended June 30, (in thousands)	**2003**	**2002**	**2001**

Long-lived assets:			
United States	$468,171	$375,600	$344,444
Europe & Israel	6,416	8,079	9,257
Japan	4,757	8,878	8,874
Taiwan	2,528	5,435	2,596
Asia Pacific	4,383	3,732	5,551
Total	$486,255	$401,724	$370,722

The following is a summary of revenues by major products for fiscal years 2003, 2002 and 2001 (as a percentage of total revenue).

	2003	2002	2001
Defect Inspection	59%	66%	65%
Metrology	15%	15%	21%
Service	20%	13%	9%
Software and other	6%	6%	5%
	100%	100%	100%

For the fiscal period ended June 30, 2003, one customer accounted for 11% of revenues and two customers accounted for 13% and 11% of accounts receivable. No single customer accounted for 10% or more of net revenues or accounts receivable for the fiscal periods ended June 30, 2002 and 2001.

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NOTE 12 - QUARTERLY CONSOLIDATED RESULTS OF OPERATIONS (UNAUDITED)

The following table presents certain unaudited consolidated quarterly financial information for the eight quarters ended June 30, 2003. In management s opinion, this information has been prepared on the same basis as the audited Consolidated Financial Statements appearing elsewhere in this Form 10-K and includes all adjustments (consisting only of normal recurring adjustments) necessary to present fairly the unaudited quarterly results of operations set forth herein.

(In thousands, except per share data)	September 30	December 31	March 31	June 30
Fiscal 2003:				
Revenues	$375,520	$ 334,918	$ 304,298	$308,313
Gross profit	189,176	163,780	147,567	151,021
Income from operations	57,284	26,756	25,600	29,082
Net income	51,265	29,228	27,339	29,359
Net income per share:				
Basic	$ 0.27	$ 0.15	$ 0.14	$ 0.15
Diluted	$ 0.26	$ 0.15	$ 0.14	$ 0.15
Fiscal 2002				
Revenues	$502,832	$ 404,148	$ 357,108	$373,194
Gross profit	258,464	202,337	175,006	187,082
Income from operations	104,293	56,280	37,097	47,223
Net income	86,465	49,048	34,149	46,504
Net income per share:				
Basic	$ 0.46	$ 0.26	$ 0.18	$ 0.25
Diluted	$ 0.44	$ 0.25	$ 0.17	$ 0.23

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Report of Independent Auditors

To the Board of Directors and Shareholders of KLA-Tencor Corporation:

In our opinion, the consolidated financial statements listed in the index appearing under Item 8 present fairly, in all material respects, the financial position of KLA-Tencor Corporation and its subsidiaries at June 30, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2003 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP
San Jose, California
July 22, 2003

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Item 14. Controls and Procedures is hereby renumbered as Item 9A under Part II of the Form 10-K and amended and restated to read in its entirety as follows:

PART II

ITEM 9A. 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 Annual Report on Form 10-K. 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 fourth fiscal quarter of fiscal 2003 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

Exhibits	Item 15 is amended to add the following exhibits
Exhibit No.	**Description**
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.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on September 29, 2003.

KLA-Tencor Corporation

/s/ JOHN H. KISPERT

By: John H. Kispert
Executive Vice President
and Chief Financial Officer

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EXHIBITS

As required under Item 15, "Exhibits, Financial Statement Schedules and Reports on Form 8-K," the exhibits filed as part of this report are provided in this separate section. The exhibits included in this section are as follows:

Exhibits	
Exhibit No.	**Description**
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.
