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

FORM 10-Q

(Mark One)

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

For the quarterly period ended: March 31, 2004

or

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

For the transition period from________ to

Commission File Number 0-9992

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

Delaware	04-2564110
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

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

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

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

Yes ☒ No ☐

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

Yes ☒ No ☐

As of April 29, 2004 there were 196,576,584 shares of the Registrant's Common Stock, $0.001 par value, outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS (Unaudited)

KLA-TENCOR CORPORATION
Condensed Consolidated Balance Sheets
(Unaudited)

(in thousands)	March 31, 2004	June 30, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 776,248	$ 606,903
Marketable securities	392,884	350,061
Accounts receivable, net	362,295	223,535
Inventories	310,328	258,799
Other current assets	380,067	367,085
Total current assets	2,221,822	1,806,383
Land, property and equipment, net	374,251	382,729
Marketable securities	551,706	530,919
Other assets	173,527	146,566
Total assets	$ 3,321,306	$ 2,866,597
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 67,471	$ 33,893
Deferred profit	216,143	177,486
Unearned revenue	51,741	48,203
Other current liabilities	497,818	391,474
Total current liabilities	833,173	651,056
Commitments and contingencies (Note 7)		
Stockholders' equity:		
Common stock and capital in excess of par value	936,968	814,968
Retained earnings	1,544,420	1,396,886
Accumulated other comprehensive income	6,745	3,687
Total stockholders' equity	2,488,133	2,215,541
Total liabilities and stockholders' equity	$ 3,321,306	$ 2,866,597

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

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

(in thousands except per share amounts)	Three months ended March 31, 2004	Three months ended March 31, 2003	Nine months ended March 31, 2004	Nine months ended March 31, 2003
Revenues:				
Product	$ 312,645	$ 238,921	$ 827,614	$ 819,504
Service	77,127	65,377	218,666	195,232
Total revenues	389,772	304,298	1,046,280	1,014,736
Costs and operating expenses:				
Costs of goods sold	170,605	156,731	482,515	514,213
Research and development	69,149	61,419	203,531	204,207
Selling, general and administrative	62,265	60,548	184,451	196,078
Non-recurring acquisition, restructuring and other, net	—	—	—	(9,402)
Total costs and operating expenses	302,019	278,698	870,497	905,096
Income from operations	87,753	25,600	175,783	109,640
Interest income and other, net	4,909	10,372	20,642	32,244
Income before income taxes	92,662	35,972	196,425	141,884
Provision for income taxes	26,480	8,633	48,891	34,052
Net income	$ 66,182	$ 27,339	$ 147,534	$ 107,832
Basic earnings per share:				
Net income	$ 0.34	$ 0.14	$ 0.76	$ 0.57
Diluted earnings per share:				
Net income	$ 0.33	$ 0.14	$ 0.73	$ 0.56
Weighted average number of shares:				
Basic	196,159	190,064	194,519	189,511
Diluted	203,150	194,393	201,952	194,121

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

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

(in thousands)	Nine Months Ended March 31, 2004	Nine Months Ended March 31, 2003
Cash flows from operating activities:		
Net income	$ 147,534	$ 107,832
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	61,668	55,181
Non-recurring restructuring and other, net	—	(9,402)
Net gain on sale of marketable securities	(9,130)	(16,227)
Changes in operating assets and liabilities:		
Accounts receivable, net	(138,762)	45,194
Inventories	(51,530)	54,493
Other assets	(29,198)	(17,352)
Accounts payable	33,584	(22,842)
Deferred profit	38,657	(14,145)
Other current liabilities	100,232	4,409
Net cash provided by operating activities	153,055	187,141
Cash flows from investing activities:		
Purchases of land, property and equipment, net	(37,898)	(125,922)
Purchases of marketable securities	(1,361,905)	(1,069,388)
Proceeds from sale of marketable securities	1,168,412	1,093,619
Proceeds from maturity of marketable securities	116,291	63,789
Net cash used in investing activities	(115,100)	(37,902)
Cash flows from financing activities:		
Issuance of common stock	141,259	50,954
Common stock repurchases	(19,158)	(62,749)
Net cash provided by (used in) financing activities	122,101	(11,795)
Effect of exchange rate changes on cash and cash equivalents	9,289	752
Net increase in cash and cash equivalents	169,345	138,196
Cash and cash equivalents at beginning of period	606,903	429,820
Cash and cash equivalents at end of period	$ 776,248	$ 568,016
Supplemental cash flow disclosures:		
Income taxes (refunded) paid, net	$ 22,836	$ 1,424
Interest paid	$ 425	$ 218

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

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

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

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

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

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

Cash Equivalents and Marketable Securities All highly liquid debt instruments with original or remaining maturities of less than three months at the date of purchase are considered to be cash equivalents. Investments not classified as cash equivalents, with remaining maturities of less than one year from the balance sheet date are considered to be short-term marketable securities. Non-current marketable securities include debt securities with maturities exceeding one year from the balance sheet date. Short-term and non-current marketable securities are generally classified as available-for-sale and are reported at fair value, with unrealized gains and losses, net of tax, presented as a separate component of accumulated other comprehensive income. KLA-Tencor has classified some equity securities that have readily determinable fair values in a similar manner. The fair value of marketable securities is based on quoted market prices. All realized gains and losses and unrealized losses and declines in fair value that are other than temporary are recorded in earnings in the period of occurrence. The specific identification method is used to determine the realized gains and losses on investments. Certain equity securities were classified as trading securities. These trading securities were reported at fair value determined based on quoted market prices at the reporting date for those instruments, with unrealized gains or losses included in earnings for the applicable period. The net amounts of such gains and losses for the three months and nine months ended March 31, 2004 were not material. As of December 31, 2003, all of the trading securities had been sold.

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

Consolidation of Variable Interest Entities In December 2003, the Financial Accounting Standards Board ("FASB") revised FASB Interpretation No. 46 "Consolidation of Variable Interest Entities – an interpretation of ARB No. 51" (FIN 46(R)). FIN 46(R) requires that if an entity is the primary beneficiary of a variable interest entity, the assets, liabilities, and results of operations of the variable interest entity should be included in the consolidated financial statements of the entity. KLA-Tencor adopted FIN 46(R) effective March 31, 2004. For additional information regarding variable interest entities and the impact of the adoption of FIN 46(R), see Note 7.

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

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

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

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

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

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

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

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

- When system sales to independent distributors have no installation, contain no acceptance agreement, and 100% payment is due upon shipment, revenue is recognized on shipment;
- When the system requires no integration and installation is inconsequential, revenue is recognized on shipment. In these cases the Company may be required to perform the installation but considers installation not essential to the functionality of the equipment, and there are no additional tests required to be performed on-site. In addition, third party distributors and customers regularly complete the installation of these tools;

- When the customer fab has already accepted the same tool, with the same specifications on the same process, for the same application, and it can be objectively demonstrated that it meets all of the required acceptance criteria upon shipment, a portion of revenue can be recognized at the time of shipment. Revenue recognized upon shipment is exclusive of the amount allocable to the installation element. Revenue attributable to the installation element is the higher of the payment amount due upon acceptance or the fair value of installation;
- When the system is performing in production and meets all published and contractually agreed specifications, but the customer withholds signature on the Company's acceptance document due to warranty or other issues unrelated to product performance;
- When the system is damaged during transit, revenue is recognized upon receipt of cash payment from the customer.

Total revenue recognized under conditions where KLA-Tencor deviates from the need for a written acceptance by the customer were approximately 5.2% and 3.8% of total revenue for the three and nine months ended March 31, 2004, respectively compared to 3.0% of total revenue for each of the three and nine months periods ended March 31, 2003, respectively. The increase in revenue exceptions results from multiple shipments of same tools that have already met the required acceptance criteria, to customers who are looking to expand capacity. Shipping charges billed to customers are included in system revenue and the related shipping costs are included in cost of goods sold.

In accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition" (SAB 104), which supercedes SAB 101, KLA-Tencor also allows for multiple element revenue arrangements in cases where certain elements of a sales contract are not delivered and accepted at the same time. In such cases, KLA-Tencor defers the fair value of the unaccepted element until that element is delivered to and accepted by the customer. To be considered a separate element, the product or service in question must represent a separate earnings process, and is not essential to the functionality of the delivered and accepted portion of the same sales contract. If the unaccepted element is essential to the functionality of the delivered and accepted portion, the whole amount of the sales contract is deferred until all elements are accepted.

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

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

Revenue from software license fees is typically recognized upon shipment if collection of the resulting receivable is probable, the fee is fixed or determinable, and vendor-specific objective evidence exists to allocate a portion of the total fee to any undelivered elements of the arrangement. Such undelivered elements in these arrangements typically consist of services and/or upgrades. If vendor-specific objective evidence does not exist for the undelivered elements of the arrangement, all revenue is deferred until such evidence does exist, or until all elements are delivered, whichever is earlier.

In instances where an arrangement to deliver software requires significant modification or customization, license fees are recognized under the percentage of completion method of contract accounting. Allowances are established for potential product returns and credit losses.

The deferred profit balance at March 31, 2004 and June 30, 2003 was $216 million and $177 million, respectively, and equals the amount of system revenue that was invoiced and due on shipment but deferred under SAB 101 less applicable product and warranty costs. KLA-Tencor also defers the fair value of non-standard warranty bundled with equipment sales as unearned revenue. The unearned revenue balance at March 31, 2004 and June 30, 2003 was $52 million and $48 million, respectively.

Strategic Development Agreements Gross engineering, research and development expenses were partially offset by external funding received under certain strategic development programs funded by KLA-Tencor's customers and government agencies. KLA-Tencor received external funding of $2 million and $9 million for the three months and nine months ended March 31, 2004, respectively, compared to $3 million and $13 million for the three and nine months ended March 31, 2003, respectively. As previously disclosed, on October 23, 2003, KLA-Tencor received notice from the National Institute of Standards and Technology ("NIST") disallowing approximately $5 million of funding received under an Advanced Technology Cooperative Agreement. This notice has since been rescinded and the findings of the audit are currently under review.

Earnings Per Share Basic earnings per share ("EPS") is calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is calculated by using the weighted average number of common shares and equivalents (representing the dilutive effect of stock options) outstanding during the period. The reconciling difference between the computation of basic and diluted earnings per share for all periods presented is the inclusion of the dilutive effect of stock options issued to employees under employee stock option plans.

During the three months and nine months ended March 31, 2004, options to purchase approximately 1,111,582 shares and 534,076 shares, respectively, at per share prices ranging from $56.31 to $68.00, were not included in the computation of diluted EPS because the exercise price was greater than the average market price of common shares as the effect would be anti-dilutive. During the three months and nine months ended March 31, 2003, options to purchase approximately 6,746,728 shares and 6,181,089 shares, respectively, at per share prices ranging from $35.88 to $68.00, were not included in the computation of diluted EPS because the exercise price was greater than the average market price of common shares as the effect would be anti-dilutive.

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

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

Three and nine months ended March 31,	**2004**	**2003**
Stock option plan:		
Expected stock price volatility	64%-67%	70%-71%
Risk free interest rate	2.8%-3.9%	2.4% -3.6%
Expected life of options (in years)	5.4	5.4
Stock purchase plan:		
Expected stock price volatility	46%-51%	61%-69%
Risk free interest rate	1.2%-1.8%	1.1%-1.9%
Expected life of options (in years)	1-2	1-2

SFAS 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:

	Three months ended March 31,		Nine months ended March 31,	
(in thousands)	2004	2003	2004	2003
Net income	$ 66,182	$ 27,339	$ 147,534	$ 107,832
Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(21,718)	(20,740)	(68,569)	(69,115)
Pro forma Net Income	$ 44,464	$ 6,599	$ 78,965	$ 38,717
Basic earnings per share:				
As reported	$ 0.34	$ 0.14	$ 0.76	$ 0.57
Pro forma	$ 0.23	$ 0.03	$ 0.41	$ 0.20
Diluted earnings per share:				
As reported	$ 0.33	$ 0.14	$ 0.73	$ 0.56
Pro-forma	$ 0.22	$ 0.03	$ 0.39	$ 0.20

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

In December 2003, the SEC issued SAB 104, which supercedes SAB 101. While the wording of SAB 104 has changed to reflect the issuance of Emerging Issues Task Force Issue No. 00-21 "Accounting for Revenue Arrangements with Multiple Deliverables"(EITF 00-21), the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The adoption of SAB 104 did not have a material effect on the financial condition or results of operations of KLA-Tencor.

In December 2003, SFAS No. 132 (revised 2003), “Employers’ Disclosures about Pensions and Other Postretirement Benefits,” (SFAS 132) was issued and amends further the annual disclosure requirements and requires new quarterly disclosures for pensions and other postretirement benefits. The revised Statement addresses disclosures only. It does not address liability measurement or expense recognition, which is determined in accordance with SFAS 87, “Employers’ Accounting for Pensions” (SFAS 87). KLA-Tencor has provided the quarterly disclosures pursuant to SFAS 132 in Note 6.

NOTE 2 – BALANCE SHEET COMPONENTS

Inventories

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

(in thousands)	March 31, 2004	June 30, 2003
Inventories		
Customer service parts	$ 102,868	$ 107,709
Raw materials	46,330	30,558
Work-in-process	76,981	57,819
Demonstration equipment	52,325	40,732
Finished goods	31,824	21,981
Total	$ 310,328	$ 258,799

Marketable Securities

The estimated fair value of securities available-for-sale as of March 31, 2004 and June 30, 2003 are as follows:

(in thousands)	March 31, 2004	June 30, 2003
U.S. Treasuries	$ 16,206	$ 5,139
Mortgage-backed securities	15,264	22,263
Municipal bonds	1,354,416	1,105,852
Corporate debt securities	—	15,177
Corporate equity securities	1,514	22,967
Money market bank deposits and other	228,898	218,717
	$ 1,616,298	$ 1,390,115
Less: Cash equivalents	671,708	509,135
Short-term marketable securities	392,884	350,061
Long-term marketable securities	$ 551,706	$ 530,919

Other Current Liabilities

(in thousands)	March 31, 2004	June 30, 2003
Other current liabilities		
Warranty, installation and retrofit	$ 39,686	$ 36,827
Compensation and benefits	205,911	168,499
Income taxes payable	143,075	111,778
Restructuring accrual	973	3,240
Other accrued expenses	108,173	71,130
Total	$ 497,818	$ 391,474

NOTE 3 – STOCK REPURCHASE PROGRAM

The Company has adopted a plan to repurchase shares of its Common Stock in the open market for the purpose of partially offsetting dilution created by employee stock options and stock purchase plans. During the nine months ended March 31, 2004 and 2003 the Company repurchased 361,000 and 1,895,000 shares of its Common Stock at a cost of approximately $19 million and $63 million, respectively.

NOTE 4 – COMPREHENSIVE INCOME

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

	Three months ended March 31,		Nine months ended March 31,	
(in thousands)	2004	2003	2004	2003
Net income	$ 66,182	$ 27,339	$ 147,534	$ 107,832
Other comprehensive income (loss):				
Currency translation adjustments	1,504	(326)	13,151	1,274
Gain (loss) on cash flow hedging instruments, net	2,798	(271)	(4,443)	1,198
Unrealized gains (losses) on investments, net of taxes (benefits) of ($111) and ($3,567) for the three and nine months ended March 31, 2004 and ($2,688) and ($2,325) for the three and nine month months ended March 31, 2003	(175)	(4,227)	(5,650)	(3,683)
Other comprehensive gain (loss)	4,127	(4,824)	3,058	(1,211)
Total comprehensive income	$ 70,309	$ 22,515	$ 150,592	$ 106,621

NOTE 5 – NONRECURRING ACQUISITION, RESTRUCTURING AND OTHER COSTS

Restructuring and Other Costs

During the three months ended September 30, 2002, KLA-Tencor restructured certain of its operations to realign costs with planned business levels in light of the industry downturn. Restructuring costs were classified into two main categories: facilities and other charges of $4.6 million and severance and benefits of $1.1 million. As part of the facilities consolidation, KLA-Tencor exited several of its leased buildings and has included the remaining net book value of the related leasehold improvements as well as the future lease payments, net of anticipated sublease revenue, in the charge. Severance and benefit charges were related to the involuntary termination of approximately 70 personnel from manufacturing, engineering, sales, marketing, and administration in the United States, Japan and Europe. The restructuring actions taken in fiscal 2003 are proceeding as planned, with the termination of employees having been completed and the facilities related lease payments scheduled to be completed by the end of fiscal 2004. The annual estimated cost savings from these restructuring actions was $9 million, of which $7 million related to workforce reductions and $2 million related to consolidation of facilities and was not expected to have a material effect on our cost of goods sold or operating expenses. There were no material variances between the actual and anticipated costs of restructuring. The following table shows a summary of restructuring activity as of the nine months ended March 31, 2004:

(in thousands)	Balance at June 30, 2003	Non-recurring charges	Utilized	Balance at March 31, 2004
Facilities and other	$ 3,193	$ —	$ (2,220)	$ 973
Severance and benefits	47	—	(47)	—
Total	$ 3,240	$ —	$ (2,267)	$ 973

NOTE 6 – PENSION PLANS

KLA-Tencor sponsors various retirement and pension plans, including defined contribution and defined benefit plans which cover most employees worldwide. Several of KLA-Tencor's foreign subsidiaries have retirement plans for full time employees, some of which are defined benefit plans. There are no defined benefit plans in the United States.

Net periodic pension cost, determined in accordance with SFAS 87, for KLA-Tencor's defined benefit retirement plans for the three and nine months ended March 31, 2003, include the following components:

(in thousands)	Three months ended March 31,		Nine months ended March 31,	
Components of net periodic pension cost	**2004**	**2003**	**2004**	**2003**
Service Cost	$ 514	$ 544	$ 1,543	$ 1,632
Interest Cost	81	95	243	284
Expected Return on Assets	(18)	(16)	(55)	(48)
Amortization of Net Transitional Obligation	70	69	210	207
Amortization of Net Gain	22	4	67	13
Net periodic pension cost	$ 669	$ 696	$ 2,008	$ 2,088

KLA-Tencor contributed $0.1 million and $0.2 million to its defined benefit pension plans for the nine months ended March 31, 2004 and 2003, respectively, and expects to contribute $0.1 million during the fourth quarter of fiscal year 2004.

NOTE 7 – COMMITMENTS AND CONTINGENCIES

Facilities

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

The following is a schedule of operating leases payments as of March 31, 2004 (in thousands):

Fiscal year ending June 30,	Amount
2004	$ 2,081
2005	8,050
2006	5,107
2007	2,686
2008	1,706
Thereafter	5,002
Total minimum lease payments	$ 24,632

Factoring

KLA-Tencor has agreements with three banking institutions to sell certain of its trade receivables and promissory notes from Japanese customers without recourse. During the three months and nine months ended March 31, 2004, approximately $27 million and $72 million of receivables were sold under these arrangements, respectively. As of March 31, 2004, approximately $31 million was outstanding. The total amount available under the facility is the Japanese yen equivalent of $142 million based upon exchange rates as of March 31, 2004. KLA-Tencor does not believe it is at risk for any material losses as a result of this agreement. In addition from time to time KLA-Tencor will discount without recourse Letters of Credit ("LCs") received from customers in payment of goods. During the three and nine months ended March 31, 2004, several LCs were sold with proceeds totaling $7 million and $33 million, respectively. Discounting fees of $0.2 million for nine months ended March 31, 2004, were recorded in interest and other income net as interest expense.

Purchase Commitments

KLA-Tencor maintains certain open inventory purchase commitments with its suppliers to ensure a smooth and continuous supply chain for key components. KLA-Tencor's liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. KLA-Tencor estimates its open inventory purchase commitment as of March 31, 2004 to be approximately $125 million.

Derivative Instruments

KLA-Tencor's foreign subsidiaries operate and sell KLA-Tencor's products in various global markets. As a result, KLA-Tencor is exposed to changes in foreign currency exchange rates. KLA-Tencor utilizes foreign currency forward exchange contracts to hedge against certain future movements in foreign exchange rates that affect certain foreign currency denominated sales and purchase transactions. KLA-Tencor does not use derivative financial instruments for speculative or trading purposes. At March 31, 2004, KLA-Tencor had foreign exchange forward contracts maturing throughout fiscal 2004 to sell and purchase $241 million and $142 million, respectively, in foreign currency, primarily Japanese Yen and Euros.

Guarantees

The following table provides the changes in the product warranty accrual for the nine months ended March 31, 2004:

(in thousands)	Amount of Liability
Balance at June 30, 2003	$ 33,226
Accruals for warranties issued during the current period	29,382
Adjustments of prior period accrual estimates	(5,540)
Settlements on warranty claims made during the period	(22,783)
Balance at March 31, 2004	$ 34,285

In connection with certain business combinations and purchased technology transactions, KLA-Tencor was subject to certain contingent consideration arrangements at March 31, 2004. 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 total future payments are estimated to be approximately $2.3 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.

Variable Interest Entities

KLA-Tencor has a minority equity interest in a development stage company for which KLA-Tencor is considered to be the primary beneficiary within the provisions of FIN 46(R). KLA-Tencor consolidated this entity as of March 31, 2004. The impact of the consolidation did not have a material impact on KLA-Tencor's financial position or results of operations. KLA-Tencor has concluded that the rest of its equity investments, which are not material to KLA-Tencor's financial position, do not require consolidation as they are either not variable interest entities or in the event they are variable interest entities, that KLA-Tencor is not considered to be the primary beneficiary.

Legal Matters

KLA-Tencor is named from time to time as a party to lawsuits in the normal course of its business. Litigation, in general, and intellectual property and securities litigation in particular, can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. The Company believes that it has defenses in each of the matters 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 KLA-Tencor's patents. KLA-Tencor is seeking damages and a permanent injunction against ADE. In addition, KLA-Tencor is seeking a declaration from the District Court that the '525 patent is invalid. On October 22, 2001, KLA-Tencor filed a separate action for declaratory judgment against ADE in the Northern District of California requesting a declaration that U.S. Patent No. 6,292,259 ("'259 patent") is invalid and not infringed. That action was consolidated with the prior action in the Delaware proceeding and ADE amended its complaint in that proceeding to allege that KLA-Tencor is infringing the '259 patent. On August 8, 2002, the magistrate presiding over the action issued a recommendation that the court enter summary judgment in KLA-Tencor's favor on the issue of non-infringement under ADE's '525 patent. On the same day, the magistrate issued recommendations that the court enter summary judgment in favor of ADE on the issue of non-infringement of two of KLA-Tencor's patents. The district court judge subsequently substantially adopted the recommendations of the magistrate regarding claims construction. The district court judge has ruled in KLA-Tencor's favor and granted summary judgment of non-infringement regarding both the '525 and '259 patents. KLA-Tencor has voluntarily withdrawn one of its patents from this suit, and KLA-Tencor continued to pursue its claim that ADE infringes KLA-Tencor's US Patent No. 6,215,551 ("'551 patent"). KLA-Tencor's case against ADE's alleged infringement of our patent went to trial on January 27, 2004 and on February 4, 2004, the court entered judgment in favor of ADE, ruling that the '551 patent is invalid. KLA-Tencor has filed post-trial motions and is evaluating appeals, if needed.

NOTE 8 – GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

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 was $17.6 million as of March 31, 2004 and was allocated to KLA-Tencor's reporting units pursuant to SFAS 142. In accordance with SFAS 142, KLA-Tencor evaluated during the three months ended December 31 2003, the goodwill by reporting unit for impairment and concluded there was no impairment of goodwill.

Other Intangible Assets

The net carrying value of intangible assets other than goodwill as of March 31, 2004 was $3.4 million; the components of which are as follows (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Net Amount
Existing technology	$ 1,852	$ 880	$ 972
Patents	4,761	2,559	2,202
Trademark	625	386	239
Total	$ 7,238	$ 3,825	$ 3,413

Intangible assets other than goodwill are amortized on a straight-line basis over their estimated useful lives. For the three months and nine months ended March 31, 2004, amortization expense for intangible assets other than goodwill was $0.4 million and $1.1 million, respectively. During the quarter ended March 31, 2003, management evaluated certain intangible assets using a fair- value approach based on discounted cash flows and determined that these assets were impaired. For the three and nine months ended March 31, 2003, amortization expense was $2.6 million and $3.8 million, respectively, including an impairment charge of $2.0 million. 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 March 31, 2004, and assuming no subsequent additions to, or impairment of the underlying assets, the remaining estimated amortization expense is expected to be as follows (in thousands):

	Amount
Fiscal year ending June 30:	
2004	$ 407
2005	1,633
2006	889
2007 and thereafter	484
Total	$ 3,413

NOTE 9 – GEOGRAPHIC INFORMATION

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, "Disclosures About Segments of an Enterprise and Related Information" can be found in the Condensed Consolidated Financial Statements.

KLA-Tencor has significant operations outside the United States, which include a manufacturing facility in Israel and sales, marketing and service offices in Western Europe, Japan, and the Asia Pacific region. For geographical revenue reporting, revenues are attributed to the geographic regions in which the customer is located. Long-lived assets consist primarily of net property and equipment and are attributed to the geographic region in which they are located. The following is a summary of operations by entities located within the indicated geographic regions for three months and nine months ended March 31, 2004 and 2003, except where indicated.

	Three months ended March 31,		Nine months ended March 31,	
(in thousands)	2004	2003	2004	2003
Revenue:				
United States	$ 99,524	$ 105,797	$ 238,649	$ 287,854
Europe & Israel	33,419	24,731	156,223	137,462
Japan	114,428	69,851	276,456	227,729
Taiwan	70,738	63,321	151,377	214,011
Korea	23,153	17,603	104,131	63,870
Asia Pacific	48,510	22,995	119,444	83,810
Total	$ 389,772	$ 304,298	$ 1,046,280	$ 1,014,736

(in thousands)	March 31, 2004	June 30, 2003
Long-lived assets:		
United States	$ 365,265	$ 372,441
Europe & Israel	6,463	6,460
Japan	4,618	4,757
Taiwan	2,392	2,520
Asia Pacific	4,305	4,383
Total	$ 383,043	$ 390,561

The following is a summary of revenues by major products for three and nine months ended March 31, 2004 and 2003 (as a percentage of total revenue).

	Three months ended March 31,		Nine months ended March 31,	
	2004	2003	2004	2003
Revenue:				
Defect Inspection	65%	58%	63%	60%
Metrology	14%	16%	15%	17%
Service	20%	21%	21%	19%
Software and other	1%	5%	1%	4%
Total	100%	100%	100%	100%

In the three months ended March 31, 2004, no single customer accounted for 10% of revenue. For the nine months ended March 31, 2004, one customer, Intel Corporation, accounted for 10% of revenue. For the three and nine months ended March 31, 2003, one customer, Intel Corporation, accounted for 15% and 11% of revenue, respectively. As of March 31, 2004, no single customer accounted for 10% of the net accounts receivable balance. As of March 31, 2003, one customer accounted for approximately 11% of net accounts receivable.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

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

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

CRITICAL ACCOUNTING POLICIES

The preparation of our Condensed Consolidated Financial Statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We based these estimates and assumptions on historical experience and evaluate them on an on-going basis to help ensure they remain reasonable under current conditions. Actual results could differ from those estimates. We discuss the development and selection of the critical accounting estimates with the audit committee of our board of directors on a quarterly basis, and the audit committee has reviewed the Company's critical accounting estimates as described in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2003. For the nine months ended March 31, 2004, there were no changes to these critical accounting policies.

EXECUTIVE SUMMARY

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

The capital equipment growth cycle has begun to take shape after a three-year downturn. New system and service orders in the quarter ended March 31, 2004 were 90% higher than the same quarter last year. New system and service orders in the nine-months ended March 31, 2004 were 71% higher than the same period last year. The growth in orders is being driven by the need of our customers to expand both 200-mm and 300-mm capacity, advance existing capacity to next-generation processes, increase the efficiency of already operating production lines and overcome yield and reliability problems in next-generation pilot lines

For the quarter ended March 31, 2004 our total revenues increased approximately 28% over the same quarter last year, driven by increased customer demands. Total revenues for the nine-months ended March 31, 2004 were approximately 3% higher than the same period as last year. While our service revenue continues to grow in absolute dollar terms, most of the growth is being driven by increases in product revenues.

Gross margins for the quarter ended March 31, 2004 improved by 7.7% compared to the same quarter in the prior year while those for the nine months ended March 31, 2004 improved by 4.6% compared to the same period in the prior year. The main reason for the increase was the lower cost of building, installing and maintaining our products.

For the quarter ended March 31, 2004, research and development ("R&D") expenses were 13% higher compared to the same quarter last year as we funded new product development programs. On the other hand, selling, general and administrative expenses increased 3% in the quarter ended March 31, 2004 compared to the same quarter last year and decreased 6% in the nine month period ended March 31, 2004 compared with the same period last year on account of various cost controls initiatives and reduced overhead support costs.

During the nine months ended March 31, 2004, we generated $153 million in cash flow from operations. Cash, cash equivalents and marketable securities totaled $1.7 billion as of March 31, 2004.

We intend the discussion of our financial condition and results of operations that follows to provide information that will assist in understanding our financial statements, the changes in certain key items in those financial statements from year to year, and the primary factors that accounted for those changes, as well as how certain accounting principles, policies and estimates affect our financial statements.

Outlook

New orders for capital equipment have demonstrated substantial growth in the past two quarters, after a three year downturn. According to industry analysts, semiconductor sales are projected to grow approximately 24% for calendar year 2004, which industry analysts believe will translate into approximately 35% to 50% growth for the semiconductor capital equipment business. New system and service orders, which are new orders net of cancellations, grew sequentially by approximately $91 million or 18% in the three months ended March 31, 2004, compared to the previous quarter as a result of our customers ramping up their 300-millimeter fabs, starting new fab construction and expanding their 200-millimeter fabs to meet short-term capacity requirements. In the near term, the level of new system orders will depend significantly on the timing of system orders for major new 300mm fabs.

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

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

	Fiscal Quarter 2004			Fiscal Quarter 2003			
	Third	**Second**	**First**	**Fourth**	**Third**	**Second**	**First**
United States	$ 192	$ 129	$ 71	$ 104	$ 98	$ 92	$ 80
Europe	70	75	21	39	40	58	30
Japan	92	128	80	101	64	67	57
Taiwan	97	89	96	28	44	17	46
Asia Pacific	148	87	72	65	70	52	29
Total orders	$ 599	$ 508	$ 340	$ 337	$ 316	$ 286	$ 242

KLA-Tencor's backlog for unshipped system orders as of March 31, 2004, was approximately $799 million, a majority of which we expect to ship over the next six to nine months. In addition, we have $458 million of SAB 101 deferred revenue that is related to products that have been delivered but are awaiting written acceptance from the customer.

RESULTS OF OPERATIONS

Revenues and Gross Margin

Product revenue increased $74 million, or 31% to $313 million for the three months ended March 31, 2004, from $239 million for the three months ended March 31, 2003. Product revenue increased $8 million, or 1%, to $828 million for the nine months ended March 31, 2004 from $820 million for the nine months ended March 31, 2003. Product revenue increases were primarily the result of increased capital spending, which we believe was a result of the beginning of a semiconductor industry upturn. International revenue increased to 74% of revenue, in the three months ended March 31, 2004 from 65% in the same period of the prior fiscal year, due primarily to higher revenue in Japan, Korea, Europe and Asia Pacific. International revenue increased to 77% of revenue for the nine months ended March 31, 2004 from 72% in the same period of the prior fiscal year, due to relatively higher revenue in Japan, Korea, Europe and Asia Pacific partially offset by lower revenue in Taiwan. For the three months ended March 31, 2004, no single customer accounted for more than 10% of revenue. For the nine months ended March 31, 2004, one customer Intel Corporation, accounted for 10% of revenue. For the three and nine months ended March 31, 2003, one customer, Intel Corporation, accounted for 15% and 11% of revenue, respectively.

Service revenue is generated from maintenance service contracts, as well as time and material billable service calls made to our customers after the expiration of the warranty period. Service revenue was $77 million and $65 million for the three months ended March 31, 2004 and 2003, respectively. Service revenue was $219 million and $195 million for the nine months ended March 31, 2004 and 2003, respectively. Service revenue increased as our installed base of equipment at our customers' sites continued to grow. The amount of service revenue generated is generally proportional to the number of post-warranty systems installed at our customers' sites and the degree of utilization of those systems.

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

Gross margin, which is revenue less cost of goods sold, as a percentage of revenue was 56% for the three months ended March 31, 2004, compared to 49% for the same period in the prior fiscal year. Approximately 4% of the improvement can be attributed to streamlining of product manufacturing operations and cost management programs while approximately 3% of the improvement can be attributed to improvements in installation, customer service and support programs. Gross margin as a percentage of revenue was 54% for the nine months ended March 31, 2004, compared to 49% for the same period in the prior fiscal year. Most of the improvements are attributable to product manufacturing improvement initiatives. As the conditions in the semiconductor industry continue to strengthen, we expect gross margins to continue to improve with the further increase in sales volume, introduction of new models, streamlining manufacturing costs through the use of common platforms, leveraging manufacturing procurement through consolidation of vendors and further expanding on outsourcing initiatives.

Engineering, Research and Development

Net engineering, R&D expenses were $69 million and $203 million for the three and nine months ended March 31, 2004, compared to $61 million and $204 million for the same periods in the prior fiscal year. As a percentage of revenue, R&D expenses were 18% and 20% for the three and nine months ended March 31, 2004, compared to 20% for the same periods in the prior fiscal year. The gross dollars for R&D investment increased by $6 million for the quarter ended March 31, 2004 but were offset by $2 million lower of external funding received for certain strategic development programs conducted with several of our customers and from government grants. The increase in gross R&D expenses were primarily due to an increase in project material and labor costs as we focus on the development of new products and enhancements to existing products. The gross dollars for R&D investment decreased by $6 million for the nine months ended March 31, 2004 as did the external funding received during the same period, which decreased by $5 million. The reduction in gross R&D expenses was driven by cost reduction initiatives by us in response to the industry downturn, including lower project material and labor costs. We expect our net engineering, research and development expenses to increase in absolute dollars as we accelerate our investments in critical programs focusing on new technologies and enhancements to existing products and consolidation of the results of operations of a development stage semiconductor company as required by FIN 46(R).

As previously disclosed, on October 23, 2003, we received notice from the National Institute of Standards and Technology ("NIST") disallowing approximately $5 million of funding received under an Advanced Technology Cooperative Agreement. This notice has since been rescinded and the findings of the audit are currently under review; regardless of the ultimate resolution of the audit, we believe the impact will not be material to our consolidated financial statements.

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

Selling, General and Administrative

Selling, general and administrative expenses were $62 million and $184 million for the three and nine months ended March 31, 2004, compared to $61 million and $196 million for the same periods in the prior fiscal year. As a percentage of revenue, selling, general and administrative expenses were 16% and 18% for the three and nine months ended March 31, 2004, respectively, compared to 20% and 19% for the same periods in the prior fiscal year, respectively. Selling, general and administrative expenses increased by $1 million for the quarter ended March 31, 2004 compared to the same period in the prior year mainly from increased compensation costs as we ramped up the organization to take advantage of the rising customer demand. Selling, general and administrative expenses decreased by $12 million in the nine month period ended March 31, 2004 compared to the same period in the prior year primarily due to reductions in temporary labor and discretionary spending as well as other realization of savings from cost reduction measures implemented over the last several quarters in the prior fiscal year in response to the industry slowdown. We expect our selling, general and administrative expenses to increase as we build up our organization to meet increased customer demands.

Restructuring and Other Costs

During the three months ended September 30, 2002, we restructured certain of our operations to realign costs with planned business levels in light of the industry downturn. Restructuring costs were classified into two main categories: facilities and other charges of $4.6 million and severance and benefits of $1.1 million. As part of the facilities consolidation, we exited several of our leased buildings and have included the remaining net book value of the related leasehold improvements as well as the future lease payments, net of anticipated sublease revenue, in the charge. Severance and benefit charges were related to the involuntary termination of approximately 70 personnel from manufacturing, engineering, sales, marketing, and administration in the United States, Japan and Europe. The restructuring actions taken in fiscal 2003 are proceeding as planned, with the termination of employees having been completed and the facilities related lease payments scheduled to be completed by the end of fiscal 2004. The annual estimated cost savings from these restructuring actions was $9 million, of which $7 million related to workforce reductions and $2 million related to consolidation of facilities and was not expected to have a material effect on our cost of goods sold or operating expenses. There were no material variances between the actual and anticipated costs of restructuring. The following table shows a summary of restructuring activity as of the nine months ended March 31, 2004:

(in thousands)	Balance at June 30, 2003	Non-recurring charges	Utilized	Balance at March 31, 2004
Facilities and other	$ 3,193	$ —	$ (2,220)	$ 973
Severance and benefits	47	—	(47)	—
Total	$ 3,240	$ —	$ (2,267)	$ 973

Interest Income and Other, Net

Interest income and other, net, was $5 million and $21 million for the three and nine months ended March 31, 2004, compared to $10 million and $32 million in the same periods in the prior fiscal year. Interest income and other, net is comprised primarily of gains realized on sales of marketable securities, interest income earned on the investment and cash portfolio, as well as income recognized upon settlement of certain foreign currency contracts and unrealized gains and losses from marking to market investments classified as trading securities and losses associated with investments accounted for under the equity method. The decrease in interest income and other, net for the three months and nine months ended March 31, 2004 as compared to the three months and nine months ended March 31, 2003 was primarily due to decreased interest income resulting from declining interest rates and a decrease in gains realized on sales of marketable securities.

Provision for Income Taxes

Our effective tax rate for the three months and nine months ended March 31, 2004 was approximately 29% and 25%, respectively. The nine month effective tax rate of 25% includes a one time non-recurring benefit of $1.5 million related to the resolution of a prior year federal tax audit matter in the first fiscal quarter of 2004 and a non-recurring write-off of a deferred tax asset of $1.2 million related to an investment in the third quarter of 2004. The net benefit was offset by an upward revision of our projected on-going effective tax rate for fiscal year 2004 from 23% to 25% during the current quarter. The effective tax rates of 25% for the nine months ended March 31, 2004 and the revised on-going rate of 25% for fiscal year 2004 are higher than the effective tax rate of 24% realized in the same periods of the prior fiscal year as a result of more foreign tax benefits and state tax, and less tax exempt interest and research and development tax credits, compared relatively to these same items as a percentage of pre-tax income for the same periods during the prior fiscal year. Congress is considering legislation to repeal the existing export incentive provided by the United States Internal Revenue Code and replace it with a tax incentive tied to U.S. based manufacturing. If the legislation is enacted it will likely increase our effective tax rate in future periods.

Stock Option and Incentive Plans

KLA-Tencor's stock option program is a broad-based, long-term retention program that is intended to attract and retain qualified management and technical employees ("knowledge employees"), and align stockholder and employee interests. Under KLA-Tencor's stock option plans, options generally have a vesting period of five years, are exercisable for a period not to exceed ten years from the date of issuance and are granted at prices not less than the fair market value of KLA-Tencor's common stock at the grant date. This program consists of three plans: one under which non-employee directors may be granted options to purchase shares of our stock, another in which officers, key employees, consultants and all other employees may be granted options to purchase shares of our stock and a third in which consultants and all employees other than directors and officers may be granted options to purchase shares of our stock. Substantially all of our employees that meet established performance goals and that qualify as knowledge employees participate in one of our stock option plans. Options granted to officers and employees from fiscal year 2001 through March 31, 2004 are summarized as follows (in thousands):

	Nine months ended March 31 2004	Fiscal year ended June 30, 2003	2002	2001
Weighted average number of shares outstanding	194,519	189,817	187,677	185,860
Total options granted during the period	4,800	4,922	9,760	10,274
Less options forfeited	(786)	(2,416)	(1,786)	(2,418)
Net options granted	4,014	2,506	7,974	7,856
Net grants during the period as a percentage of weighted average shares outstanding	2.1%	1.3%	4.2%	4.2%
Grants to top five officers during the period as a percentage of weighted average shares outstanding	0.2%	0.2%	0.3%	0.2%
Grants to top five officers during the period as a percentage of total options granted	8.2%	6.0%	6.0%	4.0%

During the nine months ended March 31, 2004, the Company granted options to purchase approximately 4.8 million shares of stock to employees. After deducting options forfeited, the net grant of options was 4.0 million shares. The net options granted after forfeiture represented 2.0% of the weighted average outstanding shares of approximately 196.2 million as of March 31, 2004.

Options granted to the top five officers, who represent the chief executive officer and each of the four other most highly compensated executive officers whose salary plus bonus exceeded $100,000 for the fiscal year ended June 30, 2003, as a percentage of the total options granted to all employees, vary from quarter to quarter and year to year. In the nine months ended March 31, 2004, there were 394,000 options granted to the top five officers.

The following table summarizes stock options exercised by the top five officers during the nine months ended March 31, 2004:

	Shares Acquired on Exercise	Value Realized	Total Number of Securities Underlying Unexercised Options at March 31, 2004		Total Value of Unexercised, In-the-Money Options at March 31, 2004 (1)	
			Vested	Unvested	Exercisable	Unexercisable
Kenneth L. Schroeder Chief Executive Officer	274,100	$ 12,121,399	657,480	501,020	$ 16,114,083	$ 7,410,857
Gary E. Dickerson President & Chief Operating Officer	40,000	$ 1,591,734	301,072	232,293	$ 4,950,778	$ 2,484,652
John H. Kispert Executive Vice President and Chief Financial Officer	95,000	$ 2,019,069	36,923	131,277	$ 649,387	$ 1,384,024
Dennis J. Fortino Executive Vice President	83,541	$ 1,967,462	78,454	126,922	$ 805,616	$ 1,272,826
Richard P. Wallace Executive Vice President	60,000	$ 1,369,178	26,497	122,131	$ 222,624	$ 1,190,449

(1) Total Value of vested options based on fair market value of the Company's Common Stock of $50.28 per share as of March 31, 2004.

The following table summarizes KLA-Tencor's stock option plans as of March 31, 2004:

	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	20,003,943	$ 32.88	15,606,780
Stock option plan not approved by stockholders[1]	8,985,063	37.90	3,050,182
Total	28,989,006	$ 34.37	18,656,962

[1] Officers and directors are not eligible to receive options granted under this plan.

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

	Available For Grant	Options Outstanding	Weighted-Average Price
Balances at June 30, 2001	8,508,074	26,289,586	$ 26.18
Additional shares reserved	5,610,752	—	—
Options granted	(9,760,303)	9,760,303	31.83
Options canceled/expired	1,786,295	(1,786,295)	32.55
Options exercised	—	(4,173,887)	19.36
Balances at June 30, 2002	6,144,818	30,089,707	$ 28.60
Additional shares reserved	13,280,928	—	—
Options granted	(4,922,001)	4,922,001	35.26
Options canceled/expired	2,415,973	(2,415,973)	35.16
Options exercised	—	(2,861,777)	20.94
Balances at June 30, 2003	16,919,718	29,733,958	$ 29.94
Additional shares reserved	5,750,290	—	—
Options granted[(1)]	(4,799,438)	4,799,438	51.23
Options canceled/expired	786,392	(786,392)	36.70
Options exercised	—	(4,757,998)	25.00
Balances at March 31, 2004	18,656,962	28,989,006	$ 34.37

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

LIQUIDITY AND CAPITAL RESOURCES

Cash, cash equivalents and short-term marketable securities balances during the three months ended March 31, 2004 increased to $1.17 billion from $957 million at June 30, 2003. In addition marketable securities classified as long-term at March 31, 2004 increased to $552 million from $531 million at June 30, 2003. KLA-Tencor has historically financed its operations through cash generated from operations. Net cash provided by operating activities for the nine months ended March 31, 2004 was $153 million, compared to $187 million of net cash from operating activities for the same period of the prior fiscal year. The decrease in cash provided by operating activities in nine months ended March 31, 2004 compared to the same period in the prior fiscal year was primarily due to increases in accounts receivable and inventory balances partially offset by higher accounts payable balances. Inventories balances increased due to a ramping up of manufacturing of products in response to higher number of system orders. Accounts receivable balances increased due an increase in shipments during the last month of the quarter. Accounts payable balances increased due to timing of payments and build up of inventory.

Net cash used in investing activities for the nine months ended March 31, 2004 was $115 million, compared to $38 million used in investing activities for the same period of the prior fiscal year, primarily as a result of increased net purchases of short and long-term marketable securities partially offset by lower capital expenditures. Net cash provided by financing activities for the nine months ended March 31, 2004 was $122 million as compared to net cash used in financing activities of $12 million for the same period of the prior fiscal year. This change was primarily due to an increase in stock option exercises of $90 million and a decrease in stock repurchases of $44 million.

The following is a schedule summarizing our significant operating lease commitments as of March 31, 2004 (in millions):

	Payments Due by Fiscal Year						
	Total	2004	2005	2006	2007	2008	Thereafter
Operating leases	$ 24.6	$ 2.1	$ 8.0	$ 5.1	$ 2.7	$ 1.7	$ 5.0

We have agreements with three banking institutions to sell certain of our trade receivables and promissory notes from Japanese customers without recourse. During the three months and nine months ended March 31, 2004, approximately $27 million and $72 million of receivables were sold under these arrangements, respectively. As of March 31, 2004, approximately $31 million was outstanding. The total amount available under the facility is the Japanese yen equivalent of $142 million based upon exchange rates as of March 31, 2004. We do not believe we are at risk for any material losses as a result of this agreement. In addition, from time to time we will discount without recourse Letters of Credit (“LCs”) received from customers in payment of goods. During the three and nine months ended March 31, 2004 several LCs were sold with proceeds totaling $7 million and $33 million, respectively. Discounting fees of $0.2 million for the nine months ended March 31, 2004, respectively, were equivalent to interest expense and were recorded in interest and other income net.

We maintain certain open inventory purchase commitments with our suppliers to ensure a smooth and continuous supply chain for key components. Our liability in these purchase commitments is generally restricted to a forecasted time-horizon as mutually agreed upon between the parties. This forecast time-horizon can vary among different suppliers. We estimate our open inventory purchase commitment as of March 31, 2004 to be approximately $125 million.

Working capital increased to $1.39 billion as of March 31, 2004, compared to $1.16 billion at June 30, 2003. Our liquidity is affected by many factors, some of which are based on the normal ongoing operations of the business, and others of which relate to the uncertainties of global economies and the semiconductor and the semiconductor equipment industries. Although cash requirements will fluctuate based on the timing and extent of these factors, our management believes that cash generated from operations, together with the liquidity provided by existing cash balances, will be sufficient to satisfy our liquidity requirements for the next twelve months.

FACTORS AFFECTING RESULTS, INCLUDING RISKS AND UNCERTAINTIES

Fluctuations in Operating Results and Stock Price

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

- the cyclical nature of the semiconductor industry;
- global economic uncertainty;
- changing international economic conditions;
- competitive pressure;
- our ability to develop and implement new technologies and introduce new products;
- our customers’ acceptance and adoption of our new products and technologies;
- our ability to manage our manufacturing requirements;

- o our ability to protect our intellectual property;
- o our ability to attract, retain, and replace key employees;
- o worldwide political instability;
- o earthquake and other uninsured risks; and
- o future changes in accounting and tax standards or practices

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

Semiconductor Equipment Industry Volatility

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

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

Global Economic Uncertainty

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

International Trade, Operations and Economic Conditions

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

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

Competition

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

Technological Change and Customer Requirements

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

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

Key Suppliers

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

Manufacturing Disruption

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

Intellectual Property Obsolescence and Infringement

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

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

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

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

Key Employees

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

Acquisitions

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

Litigation

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

Terrorism and Political Instability

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

Earthquake and other uninsured risks

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

Future changes in accounting and taxation standards or practices

A change in accounting standards or practices or a change in existing taxation rules or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. New accounting pronouncements and taxation rules and varying interpretations of accounting pronouncements and taxation practice have occurred and may occur in the future. Changes to existing rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business.

For example, any changes requiring that we record compensation expense in the statement of operations for employee stock options using the fair value method or changes in existing taxation rules related to stock options could have a significant negative effect on our reported results. Several agencies and entities are considering, and the FASB has announced, proposals to change generally accepted accounting principles in the United States that, if implemented, would require us to record charges to earnings for employee stock option grants. This pending requirement would negatively impact our earnings.

Effects of Recent Accounting Pronouncements

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

In December 2003, the SEC issued SAB 104, which supercedes SAB 101. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The adoption of SAB 104 did not have a material effect on our financial condition or results of operations.

In December 2003, (SFAS 132) was issued and amends further the annual disclosure requirements and requires new quarterly disclosures for pensions and other postretirement benefits. The revised Statement addresses disclosures only. It does not address liability measurement or expense recognition, which is determined in accordance with SFAS 87, “Employers’ Accounting for Pensions” (SFAS 87). We have provided the quarterly disclosures pursuant to SFAS 132 in Note 6 to the Condensed Consolidated Financial Statements.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to financial market risks, including changes in interest rates, foreign currency exchange rates and marketable equity security prices. To mitigate these risks, we utilize derivative financial instruments. We do not use derivative financial instruments for speculative or trading purposes. All of the potential changes noted below are based on sensitivity analyses performed on our financial position at March 31, 2004. Actual results may differ materially.

At the end of March 31, 2004, we had an investment portfolio of fixed income securities of $943 million, excluding those classified as cash and cash equivalents. These securities, as with all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels as of March 31, 2004, the fair value of the portfolio would have declined by $3 million.

As of March 31, 2004, we had net forward contracts to sell $99 million in foreign currency in order to hedge currency exposures (see Note 7 of the Notes to the Consolidated Financial Statements under “Derivative Instruments.”) If we had entered into these contracts on March 31, 2004, the U.S. dollar equivalent would be $109 million. A 10% adverse move in all currency exchange rates affecting the contracts would decrease the fair value of the contracts by $35 million. However, if this occurred, the fair value of the underlying exposures hedged by the contracts would increase by a similar amount. Accordingly, we believe that the hedging of our foreign currency exposure should have no material impact on income or cash flows.

Item 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures

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

Changes in internal controls over financial reporting

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

PART II.   OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

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

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

Legal Matters

ADE Corporation

On October 11, 2000, ADE Corporation (“ADE”), a competitor, filed a patent infringement lawsuit against us in the U.S. District Court in Delaware. ADE claimed damages and sought an injunction under U.S. Patent No. 6,118,525 (“‘525 patent”). We filed a counterclaim in the same court alleging that ADE has infringed four of our patents. We are seeking damages and a permanent injunction against ADE. In addition, we are seeking a declaration from the District Court that the ‘525 patent is invalid. On October 22, 2001, we filed a separate action for declaratory judgment against ADE in the Northern District of California requesting a declaration that U.S. Patent No. 6,292,259 (“‘259 patent”) is invalid and not infringed. That action was consolidated with the prior action in the Delaware proceeding and ADE amended its complaint in that proceeding to allege that we are infringing the ‘259 patent. On August 8, 2002, the magistrate presiding over the action issued a recommendation that the court enter summary judgment in our favor on the issue of non-infringement under ADE’s ‘525 patent. On the same day, the magistrate issued recommendations that the court enter summary judgment in favor of ADE on the issue of non-infringement of two of our patents. The district court judge subsequently substantially adopted the recommendations of the magistrate regarding claims construction. The district court judge has ruled in our favor and granted summary judgment of non-infringement regarding both the ‘525 and ‘259 patents. We have voluntarily withdrawn one of our patents from this suit, and we continued to pursue our claim that ADE infringes our US Patent No. 6,215,551(“‘551 patent”). Our case against ADE’s alleged infringement of our patent went to trial on January 27, 2004 and on February 4, 2004, the court entered judgment in favor of ADE, ruling that the ‘551 patent is invalid. We have filed post-trial motions and are evaluating appeals, if needed.

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

ITEM 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

Following is a summary of stock repurchases for the quarter ended March 31, 2004 (in thousands, except average price per share).[1]

Period	Total Number of Shares (or Units) Purchased[2]	Average Price Paid per Share (or Unit)	Maximum Number of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
January 1, 2004 to January 31, 2004	14,500	$ 59.17	4,305,000
February 1, 2004 to February 29, 2004	35,000	$ 54.56	4,270,000
March 1, 2004 to March 31, 2004	160,000	$ 51.56	4,110,000
Total	209,500	$ 52.58	

(1) 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 in order 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. All such shares remain as treasury shares.

(2) All shares were purchased pursuant to the publicly announced plan.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

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

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

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

(b) Form 8-K

On January, 22, 2004, KLA-Tencor furnished a report on Form 8-K relating to its financial information for the quarter ended December 31, 2003, as presented in a press release of January 22, 2004.

SIGNATURES

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

KLA-TENCOR CORPORATION
(Registrant)

May 5, 2004	/s/ KENNETH L. SCHROEDER
(Date)	**Kenneth L. Schroeder** **Chief Executive Officer** **(Principal Executive Officer)**
May 5, 2004	/s/ JOHN H. KISPERT
(Date)	**John H. Kispert** **Executive Vice President** **and Chief Financial Officer** **(Principal Accounting Officer)**

EXHIBIT INDEX

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

Exhibit 31.1

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

I, Kenneth L. Schroeder, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of KLA-Tencor Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) omitted

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 5, 2004	/s/ KENNETH L. SCHROEDER
(Date)	**Kenneth L. Schroeder** **Chief Executive Officer** **(Principal Executive Officer)**

Exhibit 31.2

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

I, John H. Kispert, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of KLA-Tencor Corporation;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) omitted

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

May 5, 2004	/s/ JOHN H. KISPERT
(Date)	**John H. Kispert** **Executive Vice President** **and Chief Financial Officer** **(Principal Accounting Officer)**

Exhibit 32.1

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

I, Kenneth L. Schroeder, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the quarterly report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended March 31, 2004 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such quarterly report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

May 5, 2004	By:	/s/ KENNETH L. SCHROEDER
Dated	Name:	Kenneth L. Schroeder
	Title:	Chief Executive Officer

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

I, John H. Kispert, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the quarterly report of KLA-Tencor Corporation on Form 10-Q for the fiscal quarter ended March 31, 2004 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such quarterly report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of KLA-Tencor Corporation.

May 5, 2004	By:	/s/ JOHN H. KISPERT
Dated	Name:	John H. Kispert
	Title:	Chief Financial Officer