

PDF SOLUTIONS INC  
Form 10-Q  
May 10, 2011

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

FORM 10-Q

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

For the Quarterly Period ended March 31, 2011

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 000-31311

PDF SOLUTIONS, INC.

(Exact name of Registrant as Specified in its Charter)

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)

25-1701361  
(I.R.S. Employer  
Identification No.)

333 West San Carlos Street, Suite 700  
San Jose, California  
(Address of Principal Executive Offices)

95110  
(Zip Code)

(408) 280-7900

(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 R No £

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Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act.

|  |  |  |  |
|--|--|--|--|
| <input type="checkbox"/> Large accelerated filer | <input type="checkbox"/> Accelerated filer | <input type="checkbox"/> Non-accelerated filer | <input type="checkbox"/> Smaller reporting company |
| (Do not check if a smaller reporting company)    |  |  |  |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

The number of shares outstanding of the Registrant’s Common Stock as of May 2, 2011 was 28,102,770.

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## PART I — FINANCIAL INFORMATION

## Item 1. Financial Statements

PDF SOLUTIONS, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS(\*)  
(unaudited)  
(in thousands, except par values)

|  | March 31,<br>2011 | December 31,<br>2010 |
|--|-------------------|----------------------|
| <b>ASSETS</b>  |                   |                      |
| Current assets:  |                   |                      |
| Cash and cash equivalents  | \$39,396          | \$38,154             |
| Accounts receivable, net of allowance of \$254 in both 2011 and 2010   | 22,925            | 23,442               |
| Prepaid expenses and other current assets  | 3,967             | 3,246                |
| Total current assets   | 66,288            | 64,842               |
| Property and equipment, net  | 844               | 797                  |
| Non-current investments  | 718               | 718                  |
| Intangible assets, net   | 1,162             | 1,369                |
| Other non-current assets   | 748               | 727                  |
| Total assets   | \$69,760          | \$68,453             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                   |                      |
| Current liabilities:   |                   |                      |
| Current portion of long-term debt  | \$86              | \$108                |
| Accounts payable   | 1,100             | 1,080                |
| Accrued compensation and related benefits  | 3,927             | 3,964                |
| Accrued and other current liabilities  | 2,849             | 2,400                |
| Deferred revenues  | 3,586             | 3,021                |
| Billings in excess of recognized revenues  | 1,351             | 1,802                |
| Total current liabilities  | 12,899            | 12,375               |
| Long-term income taxes payable   | 3,262             | 3,668                |
| Other non-current liabilities  | 1,406             | 1,495                |
| Total liabilities  | 17,567            | 17,538               |
| Commitments and contingencies (Note 13)  |                   |                      |
| Preferred stock, \$0.00015 par value, 5,000 shares authorized, no shares issued and outstanding  | —                 | —                    |
| Common stock, \$0.00015 par value, 70,000 shares authorized: shares issued 31,817 and 31,276, respectively; shares outstanding 28,102 and 27,603, respectively | 4                 | 4                    |
| Additional paid-in-capital   | 201,865           | 200,144              |
| Treasury stock at cost, 3,715 and 3,673 shares, respectively   | (19,554 )         | (19,298 )            |
| Accumulated deficit  | (130,461 )        | (129,884 )           |
| Accumulated other comprehensive income (loss)  | 339               | (51 )                |
| Total stockholders' equity   | 52,193            | 50,915               |
| Total liabilities and stockholders' equity   | \$69,760          | \$68,453             |

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(\*) The Condensed Consolidated Balance Sheet at December 31, 2010 has been derived from the audited consolidated financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America.

See accompanying Notes to Condensed Consolidated Financial Statements (unaudited).

PDF SOLUTIONS, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(unaudited)  
(in thousands, except per share amounts)

|  | Three Months Ended March 31, |           |
|--|------------------------------|-----------|
|  | 2011                         | 2010      |
| <b>Revenues:</b>                                   |                              |           |
| Design-to-silicon-yield solutions                  | \$10,567                     | \$10,417  |
| Gainshare performance incentives                   | 4,450                        | 4,835     |
| Total revenues                                     | 15,017                       | 15,252    |
| <b>Cost of design-to-silicon-yield solutions:</b>  |                              |           |
| Direct costs of design-to-silicon-yield solutions  | 5,793                        | 6,322     |
| Amortization of acquired technology                | 156                          | 359       |
| Total cost of design-to silicon-yield solutions    | 5,949                        | 6,681     |
| Gross profit                                       | 9,068                        | 8,571     |
| <b>Operating expenses:</b>                         |                              |           |
| Research and development                           | 4,349                        | 3,962     |
| Selling, general and administrative                | 4,745                        | 4,579     |
| Amortization of other acquired intangible assets   | 51                           | 86        |
| Restructuring charges (credits)                    | (11                          | ) 1       |
| Total operating expenses                           | 9,134                        | 8,628     |
| Loss from operations                               | (66                          | ) (57     |
| Interest and other income (expense), net           | (359                         | ) 262     |
| Income (loss) before income taxes                  | (425                         | ) 205     |
| Income tax provision                               | 152                          | 501       |
| Net loss   | \$(577                       | ) \$(296  |
| Net loss per share — basic and diluted             | \$(0.02                      | ) \$(0.01 |
| Weighted average common shares — basic and diluted | 27,810                       | 26,929    |

See accompanying Notes to Condensed Consolidated Financial Statements (unaudited).

PDF SOLUTIONS, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (unaudited)  
 (in thousands)

|  | Three Months Ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2011                            | 2010     |
| <b>Operating activities:</b>   |                                 |          |
| Net loss   | \$(577                          | ) \$(296 |
| <b>Adjustments to reconcile net loss to net cash used in operating activities:</b>         |                                 |          |
| Depreciation and amortization  | 131                             | 271      |
| Stock-based compensation expense   | 1,003                           | 1,505    |
| Amortization of acquired intangible assets   | 207                             | 445      |
| Deferred taxes   | (84                             | ) —      |
| Purchases of treasury stock in connection with tax withholdings on restricted stock grants | (256                            | ) (273   |
| <b>Changes in operating assets and liabilities:</b>  |                                 |          |
| Accounts receivable, net of allowances   | 517                             | 799      |
| Prepaid expenses and other assets  | (621                            | ) (804   |
| Accounts payable   | 81                              | 144      |
| Accrued compensation and related benefits  | (102                            | ) (799   |
| Accrued and other liabilities  | 49                              | (730     |
| Deferred revenues  | 648                             | 183      |
| Billings in excess of recognized revenues  | (451                            | ) (503   |
| Net cash provided by (used in) operating activities  | 545                             | (58      |
| <b>Investing activities:</b>   |                                 |          |
| Purchases of property and equipment  | (42                             | ) (37    |
| Net cash used in investing activities  | (42                             | ) (37    |
| <b>Financing activities:</b>   |                                 |          |
| Proceeds from exercise of stock options  | 290                             | —        |
| Proceeds from employee stock purchase plan   | 429                             | 411      |
| Principal payments on long-term obligations  | (27                             | ) (31    |
| Net cash provided by financing activities  | 692                             | 380      |
| Effect of exchange rate changes on cash and cash equivalents                               | 47                              | (285     |
| Net change in cash and cash equivalents  | 1,242                           | —        |
| Cash and cash equivalents, beginning of period   | 38,154                          | 34,899   |
| Cash and cash equivalents, end of period   | \$39,396                        | \$34,899 |
| <b>Supplemental disclosure of cash flow information:</b>                                   |                                 |          |
| <b>Cash paid during the period for:</b>  |                                 |          |
| Income Taxes   | \$648                           | \$811    |
| Interest   | \$—                             | \$3      |

See accompanying Notes to Condensed Consolidated Financial Statements (unaudited).

PDF SOLUTIONS, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

1. BASIS OF PRESENTATION

Basis of Presentation

The interim unaudited condensed consolidated financial statements included herein have been prepared by PDF Solutions, Inc. (“the Company”) pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”), including the instructions to the Quarterly Report on Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The interim unaudited condensed consolidated financial statements reflect, in the opinion of management, all adjustments necessary (consisting only of normal recurring adjustments), to present a fair statement of results for the interim periods presented. The operating results for any interim period are not necessarily indicative of the results that may be expected for other interim periods or the full fiscal year. The accompanying interim unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto in the Company’s Annual Report on Form 10-K for the year ended December 31, 2010.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries after the elimination of all significant intercompany balances and transactions.

Out-of-Period Adjustments — In the three months ended March 31, 2011, the Company recorded out-of-period adjustments to reduce stock-based compensation expense of \$106,000 and net adjustments to reduce foreign currency loss of \$20,000 that were incorrectly recorded in previous periods. The correction of these errors resulted in a reduction to the Company's net loss of \$126,000 for the three months ended March 31, 2011. The resulting errors also increased net income for the three and twelve months ended December 31, 2010 by \$126,000. Management has assessed the impact of these adjustments and does not believe that these amounts were material, either individually or in the aggregate, to any prior period financial statements, and the impact of correcting these errors in the three months ended March 31, 2011 is not material to the financial statements for the three months ended March 31, 2011.

In the three months ended March 31, 2010, the Company recorded out-of-period adjustments to reverse an accrual for fringe benefits of \$155,000 and adjust for software license fee amortization of \$42,000. The correction of these prior period errors in the current quarter resulted in a reduction to the Company's net loss of \$197,000 for the three months ended March 31, 2010. The resulting errors also increased net loss for the year ended December 31, 2008 by \$155,000 and increased net loss for the three and twelve months ended December 31, 2009 by \$83,000. Management has assessed the impact of these adjustments and does not believe that these amounts were material, either individually or in the aggregate, to any prior period financial statements, and the impact of correcting these errors in the three months ended March 31, 2010 is not material to the financial statements for the three months ended March 31, 2010.

Significant Estimates — The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (“U.S. GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. A significant portion of the Company’s revenues require estimates with respect to total costs which may be incurred and revenues earned. Actual results could differ from these estimates.

Revenue Recognition — The Company derives revenue from two sources: Design-to-silicon-yield Solutions, which includes Services and Software Licenses, and Gainshare Performance Incentives.



**Design-to-Silicon-Yield Solutions** — Revenues that are derived from Design-to-silicon-yield solutions come from services and software licenses. The Company recognizes revenue for each element of Design-to-Silicon-Yield solutions as follows:

**Services** — The Company generates a significant portion of its Design-to-silicon-yield solutions revenue from fixed-price solution implementation service contracts delivered over a specific period of time. These contracts require reliable estimation of costs to perform obligations and the overall scope of each engagement. Revenues under contracts for solution implementation services are recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting. Losses on solution implementation contracts are recognized in the period when they become probable. Revisions in profit estimates are reflected in the period in which the conditions that require the revisions become known and can be estimated.

On occasion, the Company licenses its software products that are not essential to the provision of these services as a component of its fixed-price service contract. In such instances, the software products are licensed to customers over a specified term of the agreement with support and maintenance to be provided over the license term.

In October 2009, the Financial Accounting Standards Board (“FASB”) amended the accounting standards for multiple-deliverable revenue arrangements to:

- provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- require an entity to allocate revenue in an arrangement using best estimate of selling prices (“BESP”) of deliverables if a vendor does not have vendor-specific objective evidence of fair value (“VSOE”) or third-party evidence of selling price (“TPE”); and
- eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

The Company elected to early adopt this accounting standard on April 1, 2010 on a prospective basis for applicable transactions originating or materially modified after January 1, 2010.

The Company’s adoption of this guidance does not generally change the accounting for the Company’s software transactions. It only affects certain revenue arrangements that include both solution implementation services and software products that are not essential to the provision of these services. The amount of product and service revenue recognized in a given period is affected by the Company’s judgment as to whether an arrangement includes multiple deliverables and, if so, its determination of the fair value of each deliverable. In general, VSOE does not exist for the Company’s solution implementation services and software products. Because its services and products include its unique technology, the Company is not able to determine TPE. Therefore, the Company used BESP in its allocation of arrangement consideration. In determining BESP, the Company applies significant judgment as it weighs a variety of factors, based on the facts and circumstances of the arrangement. The Company typically arrives at an BESP for a product or service that is not sold separately by considering company-specific factors such as geographies, internal costs, gross margin objectives, pricing practices used to establish bundled pricing, and existing portfolio pricing and discounting.

After fair value is established for each deliverable, the total transaction amount is allocated to each deliverable based upon its fair value. Fees allocated to solution implementation services are recognized using the cost-to-cost percentage of completion method of contract accounting. Fees allocated to software and related support and maintenance are recognized under software revenue recognition guidance.

Prior to the adoption of this new accounting standard, under these arrangements, where VSOE of fair value existed for the support and maintenance element, the support and maintenance revenue was recognized separately over the term of the supporting period and the remaining fee was recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting.

**Software Licenses** — The Company also licenses its software products separately from its integrated solution implementations. For software license arrangements that do not require significant modification or customization of the underlying software, software license revenue is recognized under the residual method when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, (4) collectability is probable, and (5) the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for its fixed price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by the Company’s VSOE and such services are recorded as services revenue. VSOE for maintenance is generally established based upon negotiated renewal rates while VSOE for consulting, installation, and training services is established based upon the Company’s customary pricing for such services when sold separately. Revenue for software licenses with extended payment terms is not recognized in excess of amounts due. For software license arrangements that require significant modification or customization of the underlying software, the software license revenue is recognized as services are performed using the cost-to-cost percentage of completion

method of contract accounting, and such revenue is recorded as services revenue.

Gainshare Performance Incentives — When the Company enters into a contract to provide yield improvement services, the contract usually includes two components: (1) a fixed fee for performance by the Company of services delivered over a specific period of time; and (2) a gainshare performance incentives component where the customer may pay a variable fee, usually after the fixed fee period has ended. Revenue derived from gainshare performance incentives represents profit sharing and performance incentives earned based upon the Company's customers reaching certain defined operational levels established in related solution implementation service contracts. Gainshare performance incentives periods are usually subsequent to the delivery of all contractual services and therefore have no cost to the Company. Due to the uncertainties surrounding attainment of such operational levels, the Company recognizes gainshare performance incentives revenue (to the extent of completion of the related solution implementation contract) upon receipt of performance reports or other related information from the customer supporting the determination of amounts and probability of collection.

## 2. RECENT ACCOUNTING PRONOUNCEMENTS

In April 2010, the Financial Accounting Standards Board (“FASB”) amended its guidance on share-based payment awards with an exercise price denominated in the currency of a market in which the underlying equity security trades. The amendment clarifies that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity’s equity securities trades shall not be considered to contain a condition that is not a market performance, or service condition. Therefore, an entity would not classify such an award as a liability if it is otherwise qualifies as equity. This amendment is effective for fiscal years and interim periods within those fiscal years beginning on or after December 15, 2010. The guidance is effective for the Company’s interim period ended March 31, 2011. The adoption of this guidance did not have a material impact on the Company’s financial results and position.

In January 2010, the FASB amended its guidance on fair value measurements. This guidance requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers. This guidance also requires disclosure of activity in Level 3 fair value measurements. The new disclosures and clarifications of the existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward activity in Level 3 fair value measurements. Those disclosures are effective for fiscal year beginning after December 15, 2010, and the interim periods within those fiscal years. The Company adopted the guidance related to Level 1 and Level 2 fair value measurements on January 1, 2010. The guidance for Level 3 fair value measurements and disclosures is effective for the Company’s interim period ended March 31, 2011. The adoption of this standard did not have a material impact on the Company’s consolidated financial statement disclosures.

## 3. INVESTMENTS

The following table summarizes the Company’s investments at both March 31, 2011 and December 31, 2010 (in thousands):

|                         | Amortized<br>Cost | Unrealized<br>Holding<br>Gains | Unrealized<br>Holding<br>Losses | Fair<br>Value |
|-------------------------|-------------------|--------------------------------|---------------------------------|---------------|
| Auction-rate securities | \$1,000           | \$—                            | \$(282 )                        | \$718         |

As of March 31, 2011 and December 31, 2010, the Company’s investments consisted entirely of auction-rate securities. Please refer to Note 12 “Fair Value” for further discussion of auction-rate securities.

## 4. ACCOUNTS RECEIVABLE

Accounts receivable include amounts that are unbilled at the end of the period. Unbilled accounts receivable are determined on an individual contract basis and were approximately \$5.0 million and \$6.0 million as of March 31, 2011 and December 31, 2010, respectively.

## 5. INTANGIBLE ASSETS

Intangible assets are amortized over their useful lives unless these lives are determined to be indefinite. During the three months ended March 31, 2011, there were no indicators of impairment related to the Company’s intangible assets.

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The following tables provide information relating to the intangible assets as of March 31, 2011 and December 31, 2010 (in thousands):

| Acquired Identifiable Intangible   | Amortization Period (Years) | March 31, 2011<br>Gross Carrying Amount | Accumulated Amortization | March 31, 2011<br>Net Carrying Amount |
|------------------------------------|-----------------------------|---|--------------------------|---------------------------------------|
| Acquired technology                | 4-5                         | \$11,800                                | \$(11,070)               | \$730                                 |
| Brand name                         | 4                           | 510                                     | (510)                    | —                                     |
| Customer relationships and backlog | 1-6                         | 3,420                                   | (3,222)                  | 198                                   |
| Patents and applications           | 7                           | 1,400                                   | (1,166)                  | 234                                   |
| Other acquired intangibles         | 4                           | 255                                     | (255)                    | —                                     |
| Total                              |                             | \$17,385                                | \$(16,223)               | \$1,162                               |

| Acquired Identifiable Intangible   | Amortization Period (Years) | December 31, 2010     |                          | December 31, 2010   |
|------------------------------------|-----------------------------|-----------------------|--------------------------|---------------------|
|                                    |                             | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount |
| Acquired technology                | 4-5                         | \$11,800              | \$(10,915)               | ) \$885             |
| Brand name                         | 4                           | 510                   | (510)                    | ) —                 |
| Customer relationships and backlog | 1-6                         | 3,420                 | (3,188)                  | ) 232               |
| Patents and applications           | 7                           | 1,400                 | (1,148)                  | ) 252               |
| Other acquired intangibles         | 4                           | 255                   | (255)                    | ) —                 |
| Total                              |                             | \$17,385              | \$(16,016)               | ) \$1,369           |

For the three months ended March 31, 2011 and 2010, intangible asset amortization expense was \$207,000 and \$431,000, respectively.

The Company expects the annual amortization of intangible assets to be as follows (in thousands):

| Year Ending December 31,           | Amount  |
|------------------------------------|---------|
| 2011 (remaining nine-month period) | \$623   |
| 2012                               | 435     |
| 2013                               | 74      |
| 2014                               | 30      |
| Thereafter                         | —       |
| Total                              | \$1,162 |

## 6. STOCKHOLDERS' EQUITY

Stock-based compensation is estimated at the grant date based on the award's fair value and is recognized on a straight-line basis over the vesting periods of the applicable stock purchase rights and stock options, generally four years. Stock-based compensation expenses before taxes related to the Company's employee stock purchase plan and stock-option plans were allocated as follows (in thousands):

|   | Three Months Ended March 31, |         |
|---|------------------------------|---------|
|   | 2011                         | 2010    |
| Cost of design-to-silicon-yield solutions | \$462                        | \$602   |
| Research and development                  | 339                          | 347     |
| Selling, general and administrative       | 202                          | 556     |
| Stock-based compensation expenses         | \$1,003                      | \$1,505 |

The Company estimated the fair value of share-based awards granted during the period using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions, resulting in the following weighted average fair values:

|                          | Stock Plans<br>Three Months Ended March 31, |        | Employee Stock Purchase Plan<br>Three Months Ended March 31, |        |   |
|--------------------------|---|--------|--|--------|---|
|                          | 2011  | 2010   | 2011   | 2010   |   |
| Expected life (in years) | 4.74  | 5.24   | 1.25   | 1.25   |   |
| Volatility               | 62.2  | % 62.8 | % 48.7   | % 72.6 | % |

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|  |        |   |        |   |        |   |        |   |
|--|--------|---|--------|---|--------|---|--------|---|
| Risk-free interest rate  | 1.80   | % | 2.23   | % | 0.37   | % | 0.58   | % |
| Expected dividend  | —      |   | —      |   | —      |   | —      |   |
| Weighted average fair value per share of options granted during the period                     | \$2.90 |   | \$2.20 |   | —      |   | —      |   |
| Weighted average fair value per share of employee stock purchase plan rights during the period | —      |   | —      |   | \$1.87 |   | \$1.40 |   |

On March 31, 2011, the Company has in effect the following stock-based compensation plans:

Stock Plans — In 2001, the Company terminated the 1996 and 1997 Stock Plans with respect to future option grants, and adopted the 2001 Stock Plan. Under the 2001 Stock Plan, on January 1 of each year starting with year 2002, the number of shares in the reserve will increase by the lesser of (1) 3,000,000 shares, (2) 5% of the outstanding common stock on the last day of the immediately preceding year, or (3) the number of shares determined by the board of directors. Under the 2001 Stock Plan, the Company may grant stock purchase rights and stock options to purchase shares of common stock to employees, directors and consultants. The exercise price for stock options must generally be at prices not less than the fair market value at the date of grant for incentive stock options. Stock options generally expire ten years from the date of grant and become vested and exercisable ratably over a four-year period. The 2001 Stock Plan will expire on June 12, 2011.

Stock option activity under the Company's plans during the three months ended March 31, 2011 was as follows:

|   | Number of<br>Options<br>(in thousands) | Weighted<br>Average<br>Exercise Price<br>per Share | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (years) | Aggregate<br>Intrinsic Value<br>(in thousands) |
|---|--|--|---|--|
| Outstanding, January 1, 2011                | 3,453                                  | \$5.60   |   |  |
| Granted                                     | 133                                    | 5.48   |   |  |
| Exercised                                   | (80)                                   | 3.61   |   |  |
| Canceled                                    | (9)                                    | 4.27   |   |  |
| Expired                                     | (31)                                   | 9.39   |   |  |
| Outstanding, March 31, 2011                 | 3,466                                  | 5.61   | 7.09  | \$6,450  |
| Vested and expected to vest, March 31, 2011 | 3,219                                  | 5.72   | 6.98  | \$5,847  |
| Exercisable, March 31, 2011                 | 1,830                                  | 6.79   | 5.88  | \$2,487  |

The aggregate intrinsic value in the table above represents the total intrinsic value based on the Company's closing stock price of \$6.65 per share as of March 31, 2011, which would have been received by the option holders had all "in-the-money" option holders exercised their options as of that date. The total intrinsic value of options exercised during the three months ended March 31, 2011 was \$244,000.

As of March 31, 2011, there was \$3.2 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted average period of 2.5 years. The total fair value of shares vested during the three months ended March 31, 2011 was \$479,000.

Nonvested restricted stock units activity during the three months ended March 31, 2011 was as follows:

|                            | Shares<br>(in thousands) | Weighted<br>Average<br>Grant Date<br>Fair Value Per<br>Share |
|----------------------------|--------------------------|--|
| Nonvested, January 1, 2011 | 453                      | \$7.29   |
| Granted                    | —                        | —  |
| Vested                     | (150)                    | 4.66   |
| Forfeited                  | (2)                      | 7.61   |
| Nonvested, March 31, 2011  | 301                      | 8.58   |

As of March 31, 2011, there was \$2.0 million of total unrecognized compensation cost related to nonvested restricted stock units. That cost is expected to be recognized over a weighted average period of 1.3 years. The total compensation expense related to shares vested during the three months ended March 31, 2011 was \$490,000.

Employee Stock Purchase Plan — In July 2001, the Company adopted an Employee Stock Purchase Plan ("Purchase Plan") under which eligible employees can contribute up to 10% of their compensation, as defined in the Purchase Plan, towards the purchase of shares of PDF common stock at a price of 85% of the lower of the fair market value at the beginning of the offering period or the end of the purchase period. The Purchase Plan consists of twenty-four-month offering periods with four six-month purchase periods in each offering period. Under the Purchase Plan, on January 1 of each year, starting with 2002, the number of shares reserved for issuance will automatically increase by the lesser of (1) 675,000 shares, (2) 2% of the Company's outstanding common stock on the last day of the



immediately preceding year, or (3) the number of shares determined by the board of directors. At the annual meeting of stockholders on May 18, 2010, the Company's stockholders approved an amendment to the Purchase Plan to extend it through May 17, 2020. For the three months ended March 31, 2011, the Purchase Plan compensation expense was \$97,000.

**Stock Repurchase Program** — On October 29, 2007, the Board of Directors approved a program to repurchase up to \$10.0 million of the Company's common stock on the open market. The right to repurchase stock under this program expired on October 29, 2010. On October 19, 2010, the Board of Directors authorized an extension of, and an increase in, the stock repurchase program. Pursuant to such action taken by the Board of Directors, the stock repurchase program has been extended for two more years to October 29, 2012 and the aggregate amount available to repurchase has been increased to \$10.0 million of the Company's common stock. As of March 31, 2011, 2.7 million shares had been repurchased at the average price of \$3.50 per share under this program and \$9.70 million remained available for future repurchases.

## 7. RESTRUCTURING

In 2008, the Company announced two restructuring plans to better allocate its resources to improve its operational results in light of current market conditions, one on April 29, 2008 and the other on October 28, 2008.

For the plan announced on April 29, 2008, the Company recorded restructuring charges of \$1.5 million during the three months ended June 30, 2008, which primarily consisted of employee severance costs of \$1.4 million. All severance costs and related fees were paid out and the activities were completed as of March 31, 2009.

For the plan announced on October 28, 2008, the Company recorded restructuring charges of \$7.6 million, primarily consisting of employee severance costs of \$4.8 million and facility exit costs of \$2.6 million. The facility exit cost consists primarily of the cost of future obligations related to the locations. Discounted liabilities for future lease costs and the fair value of the related subleases of closed locations that are recorded is subject to adjustments as liabilities are settled. In assessing the discounted liabilities for future costs of obligations related to the locations, the Company made assumptions regarding the amounts of future subleases. If these assumptions or their related estimates change in the future, the Company may be required to record additional exit costs or reduce exit costs previously recorded. Exit costs recorded for each period presented include the effect of such changes in estimates. The following table summarizes the activities of these restructuring liabilities (in thousands):

|  | Three Months<br>Ended March 31, |         |
|--|---------------------------------|---------|
|  | 2011                            | 2010    |
| Beginning balance                                    | \$1,379                         | \$1,619 |
| R e s t r u c t u r i n g c h a r g e s<br>(credits) | (11 )                           | 1       |
| Adjustments  | 10                              | —       |
| C a s h<br>payments                                  | (159 )                          | (213 )  |
| Ending balance                                       | \$1,219                         | \$1,407 |

The balance as of March 31, 2011 consists of \$1.1 million of facility exit costs and \$0.1 million of severance costs. The balance as of March 30, 2010 consists of \$1.2 million of facility exit costs and \$0.2 million of severance costs.

As of March 31, 2011, of the remaining accrual of \$1.2 million, \$707,000 was included in accrued liabilities and other current liabilities and \$512,000 was included in other non-current liabilities. Accrued facility exit expenses will be paid in accordance with the lease payment schedule through 2013.

## 8. INCOME TAXES

The Company accounts for temporary differences between the book and tax basis of assets and liabilities by recording deferred tax assets and liabilities. The Company must assess the likelihood that its deferred tax assets will be recovered from future taxable income and, to the extent the Company believes that recovery is not likely, the Company must establish a valuation allowance. Changes in the Company's net deferred tax assets and valuation allowance in a period are recorded through the income tax provision in the condensed consolidated statements of operations.

The Company classifies its liabilities related to unrecognized tax benefits as long-term. The Company includes interest and penalties related to unrecognized tax benefits within the Company's income tax provision. As of March 31, 2011 and December 31, 2010, the Company had accrued for payment of interest and penalties related to unrecognized tax benefits of \$409,000 and \$461,000, respectively.

Income tax provision decreased \$349,000 for the three months ended March 31, 2011 to \$152,000 as compared to an income tax provision of \$501,000 for the three months ended March 31, 2010. The income tax provision for both the three months ended March 31, 2011 and the three months ended March 31, 2010 primarily consisted of foreign withholding taxes and changes in unrecognized tax benefits.

The Company's total amount of unrecognized tax benefits as of March 31, 2011 was \$9.1 million, of which \$2.8 million, if recognized, would affect the Company's effective tax rate. The Company's total amount of unrecognized tax benefits as of December 31, 2010 was \$9.4 million, of which \$2.7 million, if recognized, would affect the Company's effective tax rate. As of March 31, 2011, the Company has recognized a net amount of \$3.3 million as long-term taxes payable for unrecognized tax benefits in its condensed consolidated balance sheet. The Company does not believe that it is reasonably possible that the change in unrecognized tax benefits over the next twelve months will materially impact its results of operations and financial position.

The Company conducts business globally and, as a result, files numerous consolidated and separate income tax returns in the U.S. federal, various state and foreign jurisdictions. Because the Company used some of the tax attributes carried forward from previous years to tax years that are still open, statutes of limitation remain open for all tax years to the extent of the attributes carried forward into tax year 2002 for federal and California tax purposes.

The Company is not currently undergoing income tax examinations by any taxing authorities in the United States. The Company's California income tax examinations for 2006 and 2007 were closed during the three months ended March 31, 2011, with no adjustments. The Company is currently undergoing an income tax examination in France for 2009. The Company is not currently undergoing income tax examinations in any other of its major foreign subsidiaries' jurisdictions.

## 9. NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss by weighted average number of common shares outstanding for the period (excluding outstanding stock options and shares subject to repurchase). Diluted net loss per share is computed using the weighted-average number of common shares outstanding for the period plus the potential effect of dilutive securities which are convertible into common shares (using the treasury stock method), except in cases in which the effect would be anti-dilutive. There are no dilutive shares included during the three months ended March 31, 2011 and 2010 due to the net loss for the period. Under the treasury stock method, the amount that the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of the tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares. The following is a reconciliation of the numerators and denominators used in computing basic and diluted net loss per share (in thousands except per share amount):

|  | Three Months<br>Ended March 31, |           |
|--|---------------------------------|-----------|
|  | 2011                            | 2010      |
| Net loss                                       | \$(577                          | ) \$(296  |
| Denominator for basic and diluted calculation: |                                 |           |
| Weighted average common shares outstanding     | 27,810                          | 26,929    |
| Net loss per share — basic and diluted         | \$(0.02                         | ) \$(0.01 |

The following table sets forth potential shares of common stock that are not included in the diluted net loss per share calculation above because to do so would be anti-dilutive for the periods indicated (in thousands):

|                                  | Three Months<br>Ended March 31, |       |
|----------------------------------|---------------------------------|-------|
|                                  | 2011                            | 2010  |
| Outstanding options              | 1,091                           | 3,870 |
| Nonvested restricted stock units | 90                              | 821   |
| Total                            | 1,181                           | 4,691 |

## 10. COMPREHENSIVE LOSS

The components of comprehensive loss are as follows (in thousands):

|  | Three Months<br>Ended March 31, |      |
|--|---------------------------------|------|
|  | 2011                            | 2010 |

|   |         |   |         |   |
|---|---------|---|---------|---|
| Net loss  | \$ (577 | ) | \$ (296 | ) |
| Foreign currency translation adjustments, net of income tax effects | 391     |   | (294    | ) |
| Comprehensive loss  | \$ (186 | ) | \$ (590 | ) |

## 11. CUSTOMER AND GEOGRAPHIC INFORMATION

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or group, in deciding how to allocate resources and in assessing performance.

The Company's chief operating decision maker, the Chief Executive Officer, reviews discrete financial information presented on a consolidated basis for purposes of making operating decisions and assessing financial performance. Accordingly the Company considers itself to be in one operating segment, specifically the licensing and implementation of yield improvement solutions for integrated circuit manufacturers.

The Company had revenues from individual customers in excess of 10% of total revenues as follows:

| Customer | Three Months<br>Ended March 31, |   |      |   |
|----------|---------------------------------|---|------|---|
|          | 2011                            |   | 2010 |   |
| A        | 20                              | % | 15   | % |
| B        | 19                              | % | 12   | % |
| C        | 17                              | % | *    | % |
| D        | 13                              | % | 20   | % |

\* represents less than 10%

The Company had gross accounts receivable from the following individual customers in excess of 10% of gross accounts receivable as follows:

| Customer | March 31, |   | December 31, |   |
|----------|-----------|---|--------------|---|
|          | 2011      |   | 2010         |   |
| A        | 11        | % | 16           | % |
| B        | 18        | % | 13           | % |
| C        | 11        | % | 10           | % |
| D        | 22        | % | 14           | % |
| E        | *         | % | 11           | % |
| F        | *         | % | 11           | % |

\* represents less than 10%

Revenues from customers by geographic area based on the location of the contracting party are as follows (in thousands):

|               | Three Months<br>Ended March 31, |          |
|---------------|---------------------------------|----------|
|               | 2011                            | 2010     |
| Asia          | \$7,558                         | \$10,297 |
| Europe        | 3,037                           | 1,574    |
| United States | 4,422                           | 3,381    |
| Total         | \$15,017                        | \$15,252 |

Long-lived assets, net by geographic area are as follows (in thousands):

|               | March 31,<br>2011 | December 31,<br>2010 |
|---------------|-------------------|----------------------|
| United States | \$1,795           | \$1,935              |
| Europe        | 114               | 121                  |
| Asia          | 97                | 110                  |
| Total         | \$2,006           | \$2,166              |

## 12. FAIR VALUE

Fair value is the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. The multiple assumptions used to value financial instruments are referred to as inputs, and a hierarchy for inputs used in measuring fair value is established, that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon its own market assumptions. These inputs are ranked according to a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels.

Level 1 —Inputs are quoted prices in active markets for identical assets or liabilities.

Level 2 —Inputs are quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable and market-corroborated inputs which are derived principally from or corroborated by observable market data.

Level 3 —Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.

The following table represents the Company’s assets measured at fair value on a recurring basis as of March 31, 2011 and the basis for that measurement (in thousands):

| Assets                    | Total           | Quoted Prices<br>in                                       |   |  |
|---------------------------|-----------------|---|---|--|
|                           |                 | Active Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Money market mutual funds | \$25,315        | \$25,315  | \$—   | \$—  |
| Auction-rate securities   | 718             | —   | —   | 718  |
| <b>Total</b>              | <b>\$26,033</b> | <b>\$25,315</b>   | <b>\$—</b>  | <b>\$718</b>                                       |

The following table represents the Company’s assets measured at fair value on a recurring basis as of December 31, 2010 and the basis for that measurement (in thousands):

| Assets                    | Total           | Quoted Prices<br>in                                       |   |  |
|---------------------------|-----------------|---|---|--|
|                           |                 | Active Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Money market mutual funds | \$25,304        | \$25,304  | \$—   | \$—  |
| Auction-rate securities   | 718             | —   | —   | 718  |
| <b>Total</b>              | <b>\$26,022</b> | <b>\$25,304</b>   | <b>\$—</b>  | <b>\$718</b>                                       |

The Company holds investments in auction-rate securities (“ARS”), which are variable rate debt instruments whose interest rates are reset through a “Dutch” auction process at regular intervals, typically every 28 days. All ARS are backed by pools of student loans guaranteed by governmental agencies and private entities, and were rated AAA/Aaa at the date of acquisition. The liquidity and fair value of these securities has been reduced by the uncertainty in the credit markets and the exposure of these securities to the financial condition of bond insurance companies, as evidenced by the rating downgrade of MBIA (bond insurer on one of the Company’s ARS) from Aaa to A2, by Moody’s Investor Services on June 19, 2008. All ARS have failed to sell at auction since February 2008, and as a result, their interest rates were reset to the maximum LIBOR + 150 basis points. The only activity associated with these instruments since February 2008 was the repurchase of \$500,000 of ARS at par by issuers. As a result of these auction failures, there was limited active market with observable prices for these securities. Therefore, the Company computed the fair value of these securities based on a discounted cash flow model, using significant level 3 inputs, to take into account the lack of liquidity. The cumulative impairment for these securities as of March 31, 2011 and



December 31, 2010 was \$282,000, which is included in other comprehensive income. No gain or loss was recorded during the three months ended March 31, 2011. The Company does not believe that the student loans backing these securities, the principal of these assets, is at risk. Furthermore, the Company intends to hold these securities until the credit markets recover and these securities resume pricing at or near par and it is not more likely than not that the Company will be required to sell the securities before recovery of the principal. As a result, the Company recorded a temporary impairment to other comprehensive income and classified these securities as non-current investments. The valuation may be revised in future periods as market conditions evolve.

There was no change in the beginning and ending balance of assets measured at fair value on recurring basis using significant observable inputs (Level 3) during the three months ended March 31, 2011.

### 13. Commitments and Contingencies

Item 3, "Legal Proceedings," on page 15 of our Annual Report on Form 10-K for the year ended December 31, 2010, provides information on certain legal proceedings and claims in which we are involved.

Following the dismissal with prejudice of the complaint filed by Global Software Services, Inc. ("GSSI"), which occurred in December 2010, on April 14, 2011, Global Software Systems, LLC ("GSS LLC") filed a Notice of Motion to Intervene in the same matter before the Superior Court for Santa Clara County. On May 4, 2011, Andre Hawit, chief executive officer of GSSI and president of GSS LLC, filed a complaint (as a cross-cross complainant) against both the Company and our Chief Executive Officer in the same matter before the Superior Court for Santa Clara County. Both Mr. Hawit and GSS LLC are continuing to pursue claims arising in connection with the subject matter of the lawsuit originally filed by GSSI. Specifically, Mr. Hawit's cross-cross complaint alleges that we interfered with his economic relationship with GSSI and that we engaged in unfair business practices in violation of Business and Professions Code Section 17200. He is seeking compensatory damages, punitive damages, restitution and attorney fees and costs. GSS LLC is alleging that it was an assignee of the rights of GSSI and that the court should grant it relief from the default judgment entered against GSSI and permit it to pursue those claims as an assignee. We believe the cross-cross complaint and the motion to intervene are without merit and intend to vigorously oppose them.

There are no other subsequent material developments to these matters.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Forward-Looking Statements

The following discussion of our financial condition and results of operations contains 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. In some cases, you can identify forward-looking statements by terminology such as "may," "could," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential", "target" or "continue," the negative effect of terms like these and similar expressions. Any statement concerning future financial performance (including future revenues, earnings or growth rates), ongoing business strategies or prospects, and possible actions taken by us or our subsidiaries, which may be provided by us are also forward-looking statements. These forward-looking statements are only predictions. Forward-looking statements are based on current expectations and projections about future events and are inherently subject to a variety of risks and uncertainties, many of which are beyond our control, which could cause actual results to differ materially from those anticipated or projected. All forward-looking statements included in this document are based on information available to us on the date of filing and we further caution investors that our business and financial performance are subject to substantial risks and uncertainties. We assume no obligation to update any such forward-looking statements. In evaluating these statements, you should specifically consider various factors, including the risk factors set forth at the end of Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2010 filed with the Securities and Exchange Commission on March 23, 2011.

### Overview

We analyze our customers' IC design and manufacturing processes to identify, quantify, and correct the issues that cause yield loss to improve our customers' profitability by improving time-to-market, increasing yield and reducing total design and manufacturing costs. We package our solutions in various ways to meet our customers' specific business and budgetary needs, each of which provides us various revenue streams. We receive a mix of fixed fees and variable, performance-based fees for the vast majority of our yield improvement solutions. The fixed fees are typically reflective of the length of time and the resources needed to characterize a customer's manufacturing process and receive preliminary results of proposed yield improvement suggestions. The variable fee, or what we call gainshare, usually depends on our achieving certain yield targets by a deadline. Variable fees are currently typically tied to wafer volume on the node, size of the manufacturing facility where we performed the yield improvement solutions. We receive license fees and service fees for related installation, integration, training, and maintenance and support services for our software that we license on a stand-alone basis.

### Industry Trend

Despite the general economic turmoil beginning in 2008 and continuing through 2009, the semiconductor market rebounded in 2010. We believe that logic foundries were running at or near capacity at times during the year, and a supply constraint at advanced nodes developed. With high utilization rates, foundries appeared to increase spending during the year. This trend resulted in an increase in our business and improved results of operations in 2010 and continued strong business activity in the first quarter of 2011. Growth may, however, lessen overall in 2011 when compared to 2010 growth over 2009.

Generally, the demand for consumer electronics and communications devices continues to drive technological innovation in the semiconductor industry as the need for products with greater performance, lower power consumption, reduced costs and smaller size continues to grow with each new product generation. In addition, advances in computing systems and mobile devices have fueled demand for higher capacity memory chips. To meet these demands, IC manufacturers and designers are constantly challenged to improve the overall performance of their ICs by designing and manufacturing ICs with more embedded applications to create greater functionality while

lowering cost per transistor. As a result, both logic and memory manufacturers have migrated to more and more advanced manufacturing nodes, capable of integrating more devices with higher performance, higher density, and lower power. As this trend continues, companies will continually be challenged to improve process capabilities to optimally produce ICs with minimal random and systematic yield loss, which is driven by the lack of compatibility between the design and its respective manufacturing process. We believe that as volume production of deep submicron ICs continues to grow, the difficulties of integrating IC designs with their respective processes and ramping new manufacturing processes will create a greater need for products and services that address the yield loss and escalating cost issues the semiconductor industry is facing today and will face in the future.

## Financial Highlights

Financial highlights for the three months ended March 31, 2011 were as follows:

Total revenues for the three months ended March 31, 2011 was \$15.0 million, a decrease of \$0.3 million, or 2%, compared to total revenues of \$15.3 million for the three months ended March 31, 2010. Design-to-silicon-yield solutions revenues for the three months ended March 31, 2011 was \$10.6 million, an increase of \$0.1 million, or 1%, compared to \$10.5 million for the three months ended March 31, 2010. The increase in Design-to-silicon-yield solutions revenues was primarily the result of increased bookings. Gainshare performance incentives revenues for the three months ended March 31, 2011 was \$4.4 million, a decrease of \$0.4 million, or 8%, compared to gainshare performance incentive revenues of \$4.8 million for the three months ended March 31, 2010. This decrease was primarily due to lower reported wafer production by a customer.

Net loss for the three months ended March 31, 2011 was \$(577,000), compared to \$(296,000) for the three months ended March 31, 2010. The decrease in net loss was primarily attributable to a decrease in revenues and an increase in operating expenses during the three months ended March 31, 2011.

Net loss per basic and diluted share was \$(0.02) for the three months ended March 31, 2011 compared to \$(0.01) for the three months ended March 31, 2010, an increase in net loss of \$(0.01) per basic and diluted share.

Cash, cash equivalents and non-current investments increased \$1.2 million from \$38.9 million at December 31, 2010 to \$40.1 million at March 31, 2011, primarily due to cash from operating and financing activities during the period.

### Critical Accounting Policies

There were no significant changes in our critical accounting policies. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2010. The following is a brief discussion of the more significant accounting policies and methods that we use.

#### General

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Our preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The most significant estimates and assumptions relate to revenue recognition, recoverability of acquired intangible assets, estimated useful lives of acquired intangibles and the realization of deferred tax assets. Actual amounts may differ from such estimates under different assumptions or conditions.

#### Revenue Recognition

We derive revenues from two sources: Design-to-silicon-yield Solutions, which include Services and Software Licenses, and Gainshare Performance Incentives.

**Design-to-Silicon-Yield Solutions** — Revenues that are derived from Design-to-silicon-yield solutions comes from services and software licenses. We recognize revenue for each element of Design-to-silicon-yield solutions as follows:

**Services** — We generate a significant portion of our Design-to-silicon-yield solutions revenues from fixed-price solution implementation service contracts delivered over a specific period of time. These contracts require reliable estimation of costs to perform obligations and the overall scope of each engagement. Revenues under contracts for solution implementation services are recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting. Losses on solution implementation contracts are recognized in the period when they become evident. Revisions in profit estimates are reflected in the period in which the conditions that require the revisions become known and can be estimated. If we do not accurately estimate the resources required or the scope of work to be performed, or do not manage the projects properly within the planned period of time or satisfy our obligations under contracts, resulting contract margins could be materially different than those anticipated when the contracts were executed. Any such reductions in contract margin could have a material negative impact on our operating results.

On occasion, we license our software products as a component of our fixed price service contracts. In such instances, the software products are licensed to customers over a specified term of the agreement with support and maintenance to be provided over the license term.

In October 2009, the Financial Accounting Standards Board (“FASB”) amended the accounting standards for multiple-deliverable revenue arrangements to:

- provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;
- require an entity to allocate revenue in an arrangement using best estimate of selling prices (“BESP”) of deliverables if a vendor does not have vendor-specific objective evidence of fair value (“VSOE”) or third-party evidence of selling price (“TPE”); and
- eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

We elected to early adopt this accounting standard on April 1, 2010 on a prospective basis for applicable transactions originating or materially modified after January 1, 2010.

The Company’s adoption of this guidance does not generally change the accounting for the Company’s software transactions. It only affects certain revenue arrangements that include both solution implementation services and software products that are not essential to the provision of these services. The amount of product and service revenue recognized in a given period is affected by our judgment as to whether an arrangement includes multiple deliverables and, if so, our determination of the fair value of each deliverable. In general, VSOE does not exist for our solution implementation services and software products. Because our services and products include our unique technology, we are not able to determine TPE. Therefore, we used BESP in our allocation of arrangement consideration. In determining BESP, we apply significant judgment as we weigh a variety of factors, based on the facts and circumstances of the arrangement. We typically arrive at an BESP for a product or service that is not sold separately by considering company-specific factors such as geographies, internal costs, gross margin objectives, pricing practices used to establish bundled pricing, and existing portfolio pricing and discounting.

After fair value is established for each deliverable, the total transaction amount is allocated to each deliverable based upon its relative fair value. Fees allocated to solution implementation services are recognized using the cost-to-cost percentage of completion method of contract accounting. Fees allocated to software and related support and maintenance are recognized under software revenue recognition guidance.

Prior to the adoption of this new accounting standard, under these arrangements, where VSOE of fair value existed for the support and maintenance element, the support and maintenance revenue was recognized separately over the term of the supporting period and the remaining fee was recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting.

**Software Licenses** — We also license our software products separately from our solution implementation services. For software license arrangements that do not require significant modification or customization of the underlying software, software license revenue is recognized under the residual method when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, (4) collectability is probable, and (5) the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for our fixed price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by our VSOE and such services are recorded as services revenues. VSOE for maintenance is generally established based upon negotiated renewal rates while VSOE for consulting, installation, and training services is established based upon our customary pricing for such services when sold separately. Revenues for software licenses with extended payment terms are not recognized in excess of amounts due. For software license arrangements that require significant modification or customization of the underlying software, the software license revenues are recognized as services are performed using the cost-to-cost percentage of completion method of contract

accounting, and such revenues are recorded as services revenue.

**Gainshare Performance Incentives** — When we enter into a contract to provide yield improvement services, the contract usually includes two components: (1) a fixed fee for performance by us of services delivered over a specific period of time; and (2) a gainshare performance incentives component where the customer may pay a variable fee, usually after the fixed fee period has ended. Revenues derived from gainshare performance incentives represent profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels established in related solution implementation service contracts. Gainshare performance incentives periods are usually subsequent to the delivery of all contractual services and therefore have no cost to us. Due to the uncertainties surrounding attainment of such operational levels, we recognize gainshare performance incentives revenues (to the extent of completion of the related solution implementation services) upon receipt of performance reports or other related information from our customers supporting the determination of amounts and probability of collection. Gainshare performance incentives revenues are dependent on many factors which are outside our control, which can include among others, continued production of the related ICs by our customers, sustained yield improvements by our customers, and our ability to enter into new Design-to-silicon-yield solutions contracts containing provisions for gainshare performance incentives.

## Intangible Assets

Long-lived intangible assets are tested for recoverability whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. During the three months ended March 31, 2011, there were no indicators of impairment related to the Company's intangible assets.

## Income Taxes

Realization of deferred tax assets is dependent on our ability to generate future taxable income and utilize tax planning strategies. We have recorded a deferred tax asset in the amount that is more likely than not to be realized based on current estimations and assumptions. We evaluate the valuation allowance on a quarterly basis. Any resulting changes to the valuation allowance will result in an adjustment to income in the period the determination is made.

## Recent Accounting Pronouncements and Accounting Changes

See Note 2 of "Notes to Condensed Consolidated Financial Statements (Unaudited)" of this Quarterly Report on Form 10-Q for a description of recent accounting pronouncements and accounting changes, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements.

## Results of Operations

The following table sets forth, for the periods indicated, the percentage of total revenues represented by the line items reflected in our condensed consolidated statements of operations:

|   | Three Months Ended<br>March 31, |    |      |    |
|---|---------------------------------|----|------|----|
|   | 2011                            |    | 2010 |    |
| <b>Revenues:</b>                                  |                                 |    |      |    |
| Design-to-silicon-yield solutions                 | 70                              | %  | 68   | %  |
| Gainshare performance incentives                  | 30                              |    | 32   |    |
| Total revenues                                    | 100                             | %  | 100  | %  |
| <b>Cost of design-to-silicon-yield solutions:</b> |                                 |    |      |    |
| Direct costs of design-to-silicon-yield solutions | 39                              |    | 42   |    |
| Amortization of acquired technology               | 1                               |    | 2    |    |
| Total cost of design-to-silicon-yield solutions   | 40                              |    | 44   |    |
| Gross margin                                      | 60                              |    | 56   |    |
| <b>Operating expenses:</b>                        |                                 |    |      |    |
| Research and development                          | 29                              |    | 26   |    |
| Selling, general and administrative               | 32                              |    | 30   |    |
| Amortization of other acquired intangible assets  | —                               |    | 1    |    |
| Restructuring charges                             | —                               |    | —    |    |
| Total operating expenses                          | 61                              |    | 57   |    |
| Loss from operations                              | (1                              | )  | (1   | )  |
| Interest and other income (expense), net          | (2                              | )  | 2    |    |
| Income (loss) before taxes                        | (3                              | )  | 1    |    |
| Income tax provision                              | 1                               |    | 3    |    |
| Net loss  | (4                              | )% | (2   | )% |





## Comparison of the Three Months Ended March 31, 2011 and 2010

|  | Three Months Ended March 31, |           | \$       | %      | Three Months Ended March 31, |               |
|--|------------------------------|-----------|----------|--------|------------------------------|---------------|
|  | 2011                         | 2010      |          |        | 2011                         | 2010          |
| Revenues                               |                              |           | Change   | Change | % of Revenues                | % of Revenues |
| (in thousands, except for percentages) |                              |           |          |        |                              |               |
| Design-to-silicon-yield solutions      | \$ 10,567                    | \$ 10,417 | \$ 150   | 1 %    | 70 %                         | 68 %          |
| Gainshare performance incentives       | 4,450                        | 4,835     | (385 )   | (8 )%  | 30 %                         | 32 %          |
| Total                                  | \$ 15,017                    | \$ 15,252 | \$(235 ) | (2 )%  | 100 %                        | 100 %         |

**Design-to-Silicon-Yield Solutions.** Design-to-silicon-yield solutions revenue is derived from services (including solution implementations, software support and maintenance, consulting, and training) and software licenses, provided during our customer yield improvement engagements as well as during solution product sales. Design-to-silicon-yield solutions revenue increased \$150,000 for the three months ended March 31, 2011 compared to the three months ended March 31, 2010, primarily due to an increase in software and software related services, the result of increased software license sales. Our Design-to-silicon-yield Solutions revenue may fluctuate in the future and is dependent on a number of factors including our ability to obtain new customers at emerging technology nodes.

**Gainshare Performance Incentives.** Gainshare performance incentives revenue represents profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels. Revenue derived from gainshare performance incentives decreased \$385,000 for the three months ended March 31, 2011 compared to the three months ended March 31, 2010. The decrease was due to lower wafer production by two of our customers. The revenue from gainshare performance incentives was generated from six customers and six engagements for the three months ended March 31, 2011 and six customers and six engagements for the three months ended March 31, 2010. Our gainshare performance incentives revenue may continue to fluctuate from period to period. Gainshare performance incentives revenue is dependent on many factors that are outside our control, including among others, continued production of ICs by our customers, sustained yield improvements by our customers, and our ability to enter into new Design-to-silicon-yield solutions contracts containing provisions for gainshare performance incentives.

|   | Three Months Ended March 31, |          | \$       | %      | Three Months Ended March 30, |               |
|---|------------------------------|----------|----------|--------|------------------------------|---------------|
|   | 2011                         | 2010     |          |        | 2011                         | 2010          |
| Cost of Design-to-Silicon-Yield Solutions         |                              |          | Change   | Change | % of Revenues                | % of Revenues |
| (in thousands, except for percentages)            |                              |          |          |        |                              |               |
| Direct costs of design-to-silicon-yield solutions | \$ 5,793                     | \$ 6,322 | \$(529 ) | (8 )%  | 39 %                         | 42 %          |
| Amortization of acquired technology               | 156                          | 359      | (203 )   | (56 )% | 1 %                          | 2 %           |
| Total   | \$ 5,949                     | \$ 6,681 | \$(732 ) | (11 )% | 40 %                         | 44 %          |

**Costs of Design-to-Silicon-Yield Solutions.** Costs of Design-to-silicon-yield solutions consist of costs incurred to provide and support our services, costs recognized in connection with licensing our software, and amortization of acquired technology.

**Direct Costs of Design-to-Silicon-Yield Solutions.** Direct costs of Design-to-silicon-yield solutions consist of services costs and software licenses costs. Services costs consist of material, labor, overhead costs, and stock-based compensation charges associated with solution implementations. Costs include purchased materials, employee compensation and related benefits, travel and facilities-related costs. Software license costs consist of costs associated with licensing third-party software sold in conjunction with our software products and expenses incurred to produce and distribute our product documentation. Direct costs of Design-to-silicon-yield solutions decreased \$529,000 for the three months ended March 31, 2011 compared to the three months ended March 31, 2010. The decrease was primarily due to a decrease of \$424,000 of labor expense due to fewer hours worked on revenue generating engagements and a decrease of \$140,000 in stock-based compensation charges. The direct costs of Design-to-silicon-yield solutions decreased as a percentage of revenues in the three months ended March 31, 2011 to 39%, compared to 42% in the three months ended March 31, 2010. Because certain costs are relatively fixed in nature, even though total costs had decreased due to decreased engagement activity, the decrease in costs had a greater effect on our gross margin.

**Amortization of Acquired Technology.** Amortization of acquired technology consists of amortization of intangible assets acquired as a result of certain business combinations. Amortization of acquired technology expense was \$156,000 for the three months ended March 31, 2011 and \$359,000 for the three months ended March 31, 2010. We anticipate amortization of acquired technology to be \$470,000 for the remaining nine months in 2011, and \$261,000 in 2012.

|  | Three Months Ended |         | \$     | %      | Three Months Ended |          |      |      |
|--|--------------------|---------|--------|--------|--------------------|----------|------|------|
|  | March 31,          |         |        |        | 2011               | 2010     | 2011 | 2010 |
|  | 2011               | 2010    |        |        |                    |          |      |      |
| Research and Development<br>(in thousands, except for percentages) |                    |         | Change | Change | Revenues           | Revenues |      |      |
| Research and development   | \$4,349            | \$3,962 | \$387  | 10     | % 29               | % 26     | %    |      |

Research and Development. Research and development expenses consist primarily of personnel-related costs to support product development activities, including compensation and benefits, outside development services, travel and facilities cost allocations, and stock-based compensation charges. Research and development expenses increased \$387,000 for the three months ended March 31, 2011 compared to the three months ended March 31, 2010, primarily due to an increase of \$343,000 in personnel expenses due to more hours worked on research and development activities, an increase of \$217,000 in outside services, offset by a decrease of \$179,000 in facilities and travel expense as a result of our cost control efforts. We anticipate our expenses in research and development will fluctuate in absolute dollars from period to period as a result of cost control initiatives and the timing of when we hire personnel as a result of the size and the timing of product development projects.

|   | Three Months Ended |         | \$     | %      | Three Months Ended |         |      |      |
|---|--------------------|---------|--------|--------|--------------------|---------|------|------|
|   | March 31,          |         |        |        | 2011               | 2010    | 2011 | 2010 |
|   | 2011               | 2010    |        |        |                    |         |      |      |
| Selling, General and Administrative<br>(in thousands, except for percentages) |                    |         | Change | Change | Revenue            | Revenue |      |      |
| Selling, general and administrative   | \$4,745            | \$4,579 | \$166  | 4      | % 32               | % 30    | %    |      |

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of compensation and benefits for sales, marketing and general and administrative personnel in addition to outside sales commissions, legal and accounting services, marketing communications, travel and facilities cost allocations, and stock-based compensation charges. Selling, general and administrative expenses increased \$166,000 for the three months ended March 31, 2011 compared to the three months ended March 31, 2010, primarily due to an increase of \$130,000 in bonus expenses, \$260,000 in accounting and legal fees, \$103,000 in outside services, offset by a decrease of \$354,000 in stock-based compensation charges. We anticipate our selling, general and administrative expenses will fluctuate in absolute dollars from period to period as a result of cost control initiatives and to support increased selling efforts in the future.

|   | Three Months Ended |      | \$     | %      | Three Months Ended |          |      |      |
|---|--------------------|------|--------|--------|--------------------|----------|------|------|
|   | March 31,          |      |        |        | 2011               | 2010     | 2011 | 2010 |
|   | 2011               | 2010 |        |        |                    |          |      |      |
| Amortization of Other Acquired<br>Intangible Assets<br>(in thousands, except for percentages) |                    |      | Change | Change | Revenues           | Revenues |      |      |
| Amortization of other acquired<br>intangible assets   | \$51               | \$86 | \$(35) | (41)   | % —                | % 1      | %    |      |

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets consists of amortization of intangibles acquired as a result of certain business combinations. Amortization of other acquired intangible assets decreased slightly for the three months ended March 31, 2011 compared to the three months ended March 31, 2010. We anticipate amortization of other acquired intangible assets to be \$153,000 in the remaining nine months in 2011, \$174,000 in 2012, \$74,000 in 2013, and \$30,000 in 2014.

|   | Three Months Ended |      | \$      | %         | Three Months Ended |      | %        | %        |
|---|--------------------|------|---------|-----------|--------------------|------|----------|----------|
|   | 2011               | 2010 |         |           | 2011               | 2010 |          |          |
| Restructuring Charges<br>(in thousands, except for percentages) |                    |      | Change  | Change    | % of               | % of | Revenues | Revenues |
| Restructuring charges (credits)                                 | \$(11 )            | \$1  | \$(12 ) | (1,238 )% | —                  | %    | —        | %        |

Restructuring Charges (credits). During the three months ended March 31, 2011, we recorded credits of \$11,000, primarily due to the sublease of certain previously restructured facilities. Restructuring expenses for the three months ended March 31, 2011 and 2010 consisted primarily of facilities and severance costs.

|  | Three Months Ended |       | \$       | %       | Three Months Ended |      | %        | %        |
|--|--------------------|-------|----------|---------|--------------------|------|----------|----------|
|  | 2011               | 2010  |          |         | 2011               | 2010 |          |          |
| Interest and Other Income, net<br>(in thousands, except for percentages) |                    |       | Change   | Change  | % of               | % of | Revenues | Revenues |
| Interest and other income (loss), net                                    | \$(359 )           | \$262 | \$(621 ) | (237 )% | 2                  | %    | 2        | %        |

Interest and Other Income (expense), net. Interest and other income (expense), net decreased \$621,000 for the three months ended March 31, 2011 compared to the three months ended March 31, 2010, primarily due to an increase of \$616,000 in losses on foreign currency exchange. We anticipate interest and other income (loss) will fluctuate in future periods as a result of our projected use of cash and fluctuations of foreign exchange rates.

|  | Three Months Ended |        | \$       | %      | Three Months Ended |               |
|--|--------------------|--------|----------|--------|--------------------|---------------|
|  | March 31,          |        |          |        | 2011               | 2010          |
|  | 2011               | 2010   | Change   | Change | % of Revenues      | % of Revenues |
| Income Tax Provision<br>(in thousands, except for percentages) |                    |        |          |        |                    |               |
| Income tax provision   | \$ 152             | \$ 501 | \$(349 ) | 70     | % 1                | % 3           |

Income Tax Provision. Income tax provision decreased \$349,000 for the three months ended March 31, 2011 compared to three months ended March 31, 2010, primarily due to a decrease of foreign withholding taxes of \$248,000. Income tax provision for the three months ended March 31, 2011 and 2010 primarily consisted of foreign withholding taxes, statutory taxes associated with our foreign subsidiaries, and changes in unrecognized tax benefits.

#### Liquidity and Capital Resources

##### Operating Activities

Cash flows from operating activities consist of a net loss adjusted for certain non-cash items and changes in assets and liabilities. Net cash provided by operating activities was \$545,000 for the three months ended March 31, 2011, a change of \$603,000 compared to net cash used by operating activities of \$(58,000) for the three months ended March 31, 2010, primarily due to the decrease in accounts receivable, increase in prepaid expenses and other assets, increase in accrued compensation and related benefits, decrease in deferred revenue and increase in billings in excess of recognized revenues.

Accounts receivable decreased \$517,000 during the three months ended March 31, 2011 compared to a decrease of \$799,000 during the three months ended March 31, 2010. The decrease in accounts receivable during the three months ended March 31, 2011 and 2010 was primarily due to the timing of billing milestones and payments received. Prepaid expenses and other assets increased \$621,000 during the three months ended March 31, 2011 compared to an increase of \$804,000 during the three months ended March 31, 2010. The increase in prepaid expenses and other assets during the three months ended March 31, 2011 was primarily due to equipment purchased for future deployment, costs deferred in connection with future revenues and increase of value-added tax receivables. The increase in prepaid expenses and other assets during the three months ended March 31, 2010 was primarily due to purchases of software license rights. Accrued compensation and benefits increased \$102,000 during the three months ended March 31, 2011, primarily due to an increase in accrued vacation due to the timing of vacation taken by our employees. Accrued compensation and benefits decreased \$799,000 during the three months ended March 31, 2010, primarily due to decrease in accrued compensation and benefits, the result of our cost control efforts. Deferred revenue increased \$648,000 during the three months ended March 31, 2011 compared to an increase of \$183,000 during the three months ended March 31, 2010. The increase in deferred revenues was primarily due to the timing of billings and service performed. Billings in excess of recognized revenue decreased \$451,000 during the three months ended March 31, 2010 compared to a decrease of \$503,000 during the three months ended March 31, 2010. The decrease in billings in excess of recognized revenue was primarily due to the timing of billings and service performed.

##### Investing Activities

Cash flows from investing activities consist of payments for capital expenditures. Net cash used in investing activities was \$42,000 for the three months ended March 31, 2011, compared to net cash used in investing activities of \$37,000 for the three months ended March 31, 2010.

#### Financing Activities

Cash flows from financing activities consist primarily of proceeds from sales of shares through employee equity incentive plans, offset by payments for principal payments on long-term obligations. Net cash provided by financing activities was \$692,000 for the three months ended March 31, 2011, an increase of \$312,000 compared to net cash provided by financing activities of \$380,000 for the three months ended March 31, 2010. The increase was primarily due to proceeds from exercise of stock options of \$290,000 during the three months ended March 31, 2011 compared to zero during the three months ended March 31, 2010.

#### Liquidity

As of March 31, 2011, our working capital, defined as total current assets less total current liabilities, was \$53.4 million, compared with \$52.5 million as of December 31, 2010. Cash and cash equivalents were \$39.4 million as of March 31, 2011, compared to \$38.2 million as of December 31, 2010. We anticipate that our overall expenses, as well as planned capital expenditures, may constitute a material use of our cash resources. In addition, we may use cash resources to repurchase common stock or fund potential investments in, or acquisitions of complementary products, technologies or businesses. We believe that our existing cash resources and anticipated funds from operations will satisfy our cash requirements to fund our operating activities, capital expenditures and other obligations for at least the next twelve months. However, in the event that during such period, or thereafter, we are not successful in generating sufficient cash flows from operations we may need to raise additional capital through private or public financings, strategic relationships or other arrangements, which may not be available to us on acceptable terms or at all.

As of March 31, 2011, our non-current investments included auction-rate securities with a fair value of \$718,000. The auction-rate securities are measured at fair value using significant unobservable inputs (Level 3 inputs) and accounted for approximately 3% of total assets that are measured at fair value on a recurring basis. See Note 12 to “Notes to Condensed Consolidated Financial Statements (Unaudited)” in Part I, and Item 3. “Quantitative and Qualitative Disclosures About Market Risk” in this Quarterly Report on Form 10-Q for further discussion.

#### Off-Balance Sheet Agreements

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt, other than operating leases on our facilities.

We indemnify certain customers from third-party claims of intellectual property infringement relating to the use of our products. Historically, costs related to these guarantees of indemnification have not been significant. We are unable to estimate the maximum potential impact of these guarantees on our future results of operations.

#### Contractual Obligations

The following table summarizes our known contractual obligations (in thousands):

|                                 | 2011<br>(nine<br>months<br>remaining) | 2012    | 2013    | 2014 | Total   |
|---------------------------------|---------------------------------------|---------|---------|------|---------|
| Contractual obligations         |                                       |         |         |      |         |
| Debt principal (1)              | \$85                                  | \$—     | \$—     | \$—  | \$85    |
| Debt interest (1)               | 1                                     | —       | —       | —    | 1       |
| Operating lease obligations (2) | 2,680                                 | 2,402   | 1,729   | 48   | 6,859   |
| Purchase obligations (3)        | 2,300                                 | 333     | —       | —    | 2,633   |
| Total (4)                       | \$5,066                               | \$2,735 | \$1,729 | \$48 | \$9,578 |

- (1) Amount represents the repayment of a €400,000 loan with a variable interest rate based on the EURIBOR plus 160 basis points.
- (2) Operating lease amounts include minimum rental payments under our operating leases for our office facilities, as well as computers, office equipment, and vehicles that we utilize under lease agreements. These minimum rental payments include payments on those facilities abandoned as part of the restructuring activities. These agreements expire at various dates through 2014.
- (3) Purchase obligations consist of agreements to purchase goods and services entered in the ordinary course of business.
- (4) The contractual obligation table above excludes liabilities for uncertain tax positions of \$3.3 million, which are not practicable to assign to any particular years, due to the inherent uncertainty of the tax positions. See Note 8 of “Notes to Condensed Consolidated Financial Statements (Unaudited)” for further discussion.

#### Item 3. Quantitative and Qualitative Disclosures About Market Risk

The following discusses our exposure to market risk related to changes in interest rates and foreign currency exchange rates. We do not currently own any equity investments, nor do we expect to own any in the foreseeable future. This discussion contains forward-looking statements that are subject to risks and uncertainties. Actual results could vary materially as a result of a number of factors.



Interest Rate Risk. As of March 31, 2011, we had cash and cash equivalents of \$39.4 million. Cash and cash equivalents consisted of cash and highly liquid money market instruments. We would not expect our operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest on our portfolio. A hypothetical increase in market interest rates of 100 basis points from the market rates in effect at March 31, 2011 would cause the fair value of these investments to decrease by an immaterial amount which would not have significantly impacted our financial position or results of operations. Declines in interest rates over time will result in lower interest income and interest expense.

As of March 31, 2011, we held auction-rate securities with a par value of \$1.0 million. Auction-rate securities are variable rate debt instruments whose interest rates are reset through a “Dutch” auction process at regular intervals, typically every 28 days. A portion of these securities are insured by third party bond insurers and are collateralized by student loans guaranteed by governmental agencies and private entities. The liquidity of the securities has been negatively impacted by the uncertainty in the credit markets and the exposure of these securities to the financial condition of bond insurance companies. All auction-rate securities we hold have been failing to sell at auction since February 2008 due to an insufficient number of bidders. Therefore we reviewed the value of these securities for impairment. The cumulative impairment for these securities as of March 31, 2011 was \$282,000, which is included in other comprehensive income (loss). In future periods, the estimated fair value of our auction-rate securities could decline further based on market conditions, which could result in additional impairment.

**Foreign Currency and Exchange Risk.** Certain of our payables for our international offices are denominated in the local currency, including the Euro. Therefore, a portion of our operating expenditures is subject to foreign currency risks. The effect of an immediate 10% adverse change in exchange rates on foreign denominated payables as of March 31, 2011 would result in a loss of approximately \$466,000. As of March 31, 2011, we did not have outstanding hedging contracts, although we may enter into such contracts in the future. We intend to monitor our foreign currency exposure. Future exchange rate fluctuations may have a material negative impact on our business.

#### Item 4. Controls and Procedures

As described in more detail in our Annual Report on Form 10-K for the year ended December 31, 2010, during the course of preparing our financial statements for the year ended December 31, 2010, we identified material weaknesses in connection with the evaluation of the effectiveness of our internal control over financial reporting pursuant to Section 404 of the Sarbanes-Oxley Act. Our management, with the participation of our principal executive officer and our principal financial officer, has evaluated the effectiveness of our “disclosure controls and procedures” (as such items are defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (“the Exchange Act”)), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on that evaluation, our principal executive officer and our principal financial officer have concluded that, due to the material weaknesses disclosed in our Annual Report on Form 10-K for the year ended December 31, 2010, our disclosure controls and procedures were not effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

In the first quarter ended March 31, 2011, we commenced a process of developing, adopting and implementing policies and procedures to address such material weaknesses including:

- Hiring personnel with requisite experience for non-routine or complex transactions, including with respect to the application of generally accepted accounting principles for percentage of completion contracts, certain multi-element revenue arrangements, and stock-based compensation transactions;
- Expanding controls to include identification of non-routine and complex transactions for increased periodic and on-going review by high-level personnel with the requisite expertise;
- Implementing procedures to ensure that our revenue controls are enhanced to include specific consideration of the accounting for contract costs and the cost estimation process for the Company's design-to-silicon yield services contracts; and,
- Providing on-going training of our employees on generally accepted accounting principles in general, and existing and new policies and procedures around revenue and stock-based compensation in particular.

There have not been any other changes in internal control over financial reporting in the period covered by this Quarterly Report on Form 10-Q which have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

Item 3, "Legal Proceedings," on page 15 of our Annual Report on Form 10-K for the year ended December 31, 2010, provides information on certain legal proceedings and claims in which we are involved.

Following the dismissal with prejudice of the complaint filed by Global Software Services, Inc. ("GSSI"), which occurred in December 2010, on April 14, 2011, Global Software Systems, LLC ("GSS LLC") filed a Notice of Motion to Intervene in the same matter before the Superior Court for Santa Clara County. On May 4, 2011, Andre Hawit, chief executive officer of GSSI and president of GSS LLC, filed a complaint (as a cross-cross complainant) against both the Company and our Chief Executive Officer in the same matter before the Superior Court for Santa Clara County. Both Mr. Hawit and GSS LLC are continuing to pursue claims arising in connection with the subject matter of the lawsuit originally filed by GSSI. Specifically, Mr. Hawit's cross-cross complaint alleges that we interfered with his economic relationship with GSSI and that we engaged in unfair business practices in violation of Business and Professions Code Section 17200. He is seeking compensatory damages, punitive damages, restitution and attorney fees and costs. GSS LLC is alleging that it was an assignee of the rights of GSSI and that the court should grant it relief from the default judgment entered against GSSI and permit it to pursue those claims as an assignee. We believe the cross-cross complaint and the motion to intervene are without merit and intend to vigorously oppose them.

There are no other subsequent material developments to these matters.

## Item 1A. Risk Factors

Item 1A, "Risk Factors," on pages 9 through 15 of the Company's Annual Report on Form 10-K for the year ended December 31, 2010, provides information on the significant risks associated with our business. There have been no subsequent material changes to these risks.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The table below sets forth the information with respect to purchases made by or on behalf of the Company or any "affiliated purchaser" (as the term is defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934) of our common stock during the three months ended March 31, 2011 (in thousands except per share amounts):

## ISSUER PURCHASES OF EQUITY SECURITIES

| Period  | Total<br>Number of<br>Shares<br>Purchased<br>(2) | Average<br>Price Paid<br>Per Share | Total<br>Number of<br>Shares<br>Purchased as<br>Part of<br>Publicly<br>Announced<br>Plans<br>or Programs<br>(1) | Approximate<br>Dollar<br>Value of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs(1) |
|---|--|------------------------------------|---|---|
| Month #1 (January 1, 2011 through January 31, 2011)   | —  | \$—                                | —   | \$9,954   |
| Month #2 (February 1, 2011 through February 28, 2011) | 2  | 6.03                               | 2   | \$9,944   |
| Month #3 (March 1, 2011 through March 31, 2011)       | 41   | 5.96                               | 41  | \$9,698   |
| Total   | 43   | \$5.97                             | 43  |   |

- (1) On October 29, 2007, the Board of Directors approved a program to repurchase up to \$10.0 million of the Company's common stock on the open market. The right to repurchase stock under this program expired on October 29, 2010. An amendment to this repurchase program was approved by the Board of Directors on October 19, 2010 that extended the program's term for two more years to October 29, 2012 and increased the aggregate amount available for repurchase under the program to \$10.0 million. As of March 31, 2010, 2.7 million shares were repurchased at the average price of \$3.50 per share under this program and \$9.70 million remained available for repurchases.
- (2) Included in the shares indicated in the table above are shares that the Company withheld through net share settlements to cover tax withholding obligations upon the vesting of restricted stock unit awards under the Company's equity compensation plans.

## Item 3. Defaults Upon Senior Securities

None

## Item 4. (Removed and Reserved)

## Item 5. Other Information

None

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Item 6. Exhibits

Exhibit

Number Description

31.01 Certification of the Chief Executive Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.02 Certification of the Chief Financial Officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.01 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. \*

32.02 Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. \*

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\* As contemplated by SEC Release No. 33-8212, these exhibits are furnished with this Quarterly Report on Form 10-Q and are not deemed filed with the Securities and Exchange Commission and are not incorporated by reference in any filing of PDF Solutions, Inc. under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

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.

PDF SOLUTIONS, INC.

Date: May 10, 2011

By: /s/ JOHN K. KIBARIAN  
John K. Kibarian  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 10, 2011

By: /s/ JOY E. LEO  
Joy E. Leo  
EVP, Chief Administration Officer and Acting Chief  
Financial Officer  
(Principal Financial Officer)

INDEX TO EXHIBITS

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