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

FORM 10-Q

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

For the Quarterly Period ended September 30, 2005

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 ☑ No ☐

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

Yes ☑ No ☐

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 November 4, 2005 was 26,264,741.

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PART I
FINANCIAL INFORMATION

Item 1. Financial Statements.

PDF SOLUTIONS, INC.
CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(In thousands, except par value amounts)

	September 30, 2005	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 59,341	$ 45,660
Accounts receivable, net of allowances of $254 in 2005 and 2004	17,627	15,978
Prepaid expenses and other current assets	2,399	2,685
Deferred tax assets	2,265	1,586
Total current assets	81,632	65,909
Property and equipment, net	3,525	3,321
Goodwill	39,886	39,886
Intangible assets, net	11,288	15,791
Other assets	448	500
Total assets	$ 136,779	$ 125,407
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,443	$ 1,023
Accrued compensation and related benefits	4,296	3,209
Other accrued liabilities	1,767	2,593
Taxes payable	4,961	3,286
Deferred revenue	2,378	2,905
Billings in excess of recognized revenue	2,425	1,581
Total current liabilities	17,270	14,597
Long-term liabilities	272	311
Deferred tax liabilities	847	1,701
Total liabilities	18,389	16,609
Stockholders' equity:		
Preferred stock, $0.00015 par value per share, 5,000 shares authorized, no shares issued and outstanding in 2005 and 2004	—	—
Common stock, $0.00015 par value per share, 70,000 shares authorized, shares issued and outstanding: 26,193 in 2005 and 25,645 in 2004	4	4
Additional paid-in-capital	139,676	134,191
Treasury stock, at cost, 551 shares in 2005 and 506 in 2004	(5,549)	(4,806)
Deferred stock-based compensation	(45)	(148)
Notes receivable from stockholders	—	(550)
Accumulated deficit	(15,703)	(19,975)
Accumulated other comprehensive income	7	82
Total stockholders' equity	118,390	108,798
Total liabilities and stockholders' equity	$ 136,779	$ 125,407

See notes to unaudited consolidated financial statements

PDF SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share amounts)

	Three Months Ended		Nine Months Ended	
	September 30, 2005	September 30, 2004	September 30, 2005	September 30, 2004
Revenue:				
Design-to-silicon-yield solutions:				
Integrated solutions	$ 13,834	$ 13,224	$ 38,658	$ 36,082
Software licenses	1,533	812	8,179	3,162
Gain share	3,090	2,414	8,069	5,051
Total revenue	18,457	16,450	54,906	44,295
Costs and expenses:				
Cost of design-to-silicon-yield solutions:				
Direct costs of design-to-silicon-yield solutions:				
Integrated solutions	6,382	5,881	17,898	15,541
Software licenses	15	6	273	69
Amortization of acquired core technology	1,266	1,266	3,798	3,943
Research and development	5,474	4,940	16,465	14,980
Selling, general and administrative	3,971	3,801	12,174	11,220
Stock-based compensation amortization*	19	134	93	681
Amortization of other acquired intangible assets	235	351	705	1,171
Total costs and expenses	17,362	16,379	51,406	47,605
Income (loss) from operations	1,095	71	3,500	(3,310)
Interest and other income	463	150	1,085	441
Income (loss) before taxes	1,558	221	4,585	(2,869)
Tax provision (benefit)	22	86	313	(702)
Net income (loss)	$ 1,536	$ 135	$ 4,272	$ (2,167)
Net income (loss) per share:				
Basic	$ 0.06	$ 0.01	$ 0.17	$ (0.09)
Diluted	$ 0.06	$ 0.01	$ 0.16	$ (0.09)
Weighted average common shares:				
Basic	26,101	25,293	25,887	25,310
Diluted	27,779	25,983	27,298	25,310
* Stock-based compensation amortization:				
Cost of design-to-silicon-yield solutions	$ —	$ 2	$ —	$ 39
Research and development	11	130	85	606
Selling, general and administrative	8	2	8	36
	$ 19	$ 134	$ 93	$ 681

See notes to unaudited consolidated financial statements

PDF SOLUTIONS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

	Nine Months Ended	
	September 30, 2005	September 30, 2004
Operating activities:		
Net income (loss)	$ 4,272	$ (2,167)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	1,690	1,905
Stock-based compensation expense	93	681
Amortization of acquired intangible assets	4,503	5,114
Deferred taxes	(1,533)	(1,381)
Changes in operating assets and liabilities:		
Accounts receivable	(1,649)	(3,599)
Prepaid expenses and other assets	146	165
Accounts payable	310	748
Accrued compensation and related benefits	1,087	1,018
Other accrued liabilities	(826)	16
Taxes payable	1,675	414
Deferred revenue	(527)	46
Billings in excess of recognized revenue	844	2,342
Net cash provided by operating activities	10,085	5,302
Investing activities:		
Purchases of property and equipment	(1,784)	(1,228)
Net cash used in investing activities	(1,784)	(1,228)
Financing activities:		
Proceeds from exercise of stock options	4,687	1,450
Proceeds from employee stock purchase plan	808	689
Collection of notes receivable from stockholders	—	2,475
Repurchase of common stock	—	(4,806)
Principal payments on long-term obligations	(40)	(39)
Net cash provided by (used in) financing activities	5,455	(231)
Effect of exchange rate changes on cash and cash equivalents	(75)	(14)
Net increase in cash and cash equivalents	13,681	3,829
Cash and cash equivalents, beginning of period	45,660	39,110
Cash and cash equivalents, end of period	$ 59,341	$ 42,939
Supplemental disclosure of cash flow information —		
Cash paid during the period for:		
Taxes	$ 153	$ 267
Interest	—	$ 1
Supplemental disclosure of non-cash activity:		
Deferred stock compensation	$ 10	—
Repurchase of common stock in exchange for shareholder note receivable	$ 742	—
Purchase of property and equipment on account	$ 210	$ 68

See notes to unaudited consolidated financial statements

PDF SOLUTIONS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The interim unaudited consolidated financial statements included herein have been prepared by PDF Solutions, Inc. (the "Company"), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"), including the instructions to 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 unaudited interim 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 unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2004.

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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. 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 and gain share. The Company recognizes revenue in accordance with the provisions of American Institute of Certified Public Accountants Statement of Position ("SOP") No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* and SOP No. 97-2, *Software Revenue Recognition,* as amended.

Design-to-Silicon-Yield Solutions — Design-to-Silicon-Yield solutions revenue is derived from integrated solutions and software licenses. Revenue recognition for each element of Design-to-Silicon-Yield solutions is summarized as follows:

Integrated Solutions — The Company generates a significant portion of its revenue from fixed-price contracts delivered over a specific period of time. These contracts require the accurate estimation of the cost to perform obligations and the overall scope of each engagement. Revenue under contracts for solution implementation services is recognized as the services are performed using the cost-to-cost percentage of completion method of contract accounting. Losses on solution implementation contracts are recognized when determined. 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 has licensed its software products as a component of its fixed price integrated solutions implementations. In such instances, the software products are licensed to the customer over the specified term of the agreement with support and maintenance to be provided over the license term. Under these arrangements, where vendor-specific objective evidence of fair value ("VSOE") does not exist to allocate a portion of the total fee to the undelivered elements, revenue is recognized ratably over the term of the agreement. Costs incurred under these arrangements are deferred and recognized in proportion to revenue recognized under these arrangements.

Revenue from support and maintenance services is recognized ratably over the term of the support and maintenance contract, generally one year, while revenue from consulting, installation and training services is recognized as the services are performed. When bundled with software licenses in multiple element arrangements, 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 the Company's VSOE. VSOE is generally established for maintenance based upon negotiated renewal rates while VSOE for consulting, installation, and training is established based upon the Company's customary pricing for such services when sold separately. When VSOE does not exist to allocate a portion of the total fee to the undelivered elements, revenue is recognized ratably over the term of the underlying element for which VSOE does not exist.

Software Licenses — The Company also licenses its software products separately from its integrated solution implementations. In such cases revenue is recognized under the residual method when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, (iv) collectibility is probable and 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 the Company's VSOE and such services are recorded as integrated solutions. VSOE is generally established for maintenance 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. No revenue has been recognized for software licenses with extended payment terms in excess of amounts due.

Gain Share — Gain share revenue represents profit sharing and performance incentives earned based upon the Company's customer reaching certain defined operational levels. Upon achieving such operational levels, the Company receives either a fixed fee and/or variable fee based on the units manufactured by the customer. Due to the uncertainties surrounding attainment of such operational levels, the Company recognizes gain share 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.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25 *Accounting for Stock Issued to Employees* ("APB No. 25"), and complies with the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 *, Accounting for Stock-Based Compensation,* ("SFAS No. 123") as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosures*. Deferred compensation recognized under APB No. 25 is amortized to expense using the graded vesting method. The Company accounts for stock options and warrants issued to non-employees in accordance with the provisions of SFAS No. 123 and its related interpretations under the fair value based method.

The Company adopted the disclosure-only provisions of SFAS No. 123, and accordingly, no expense has been recognized for options granted to employees under the various stock plans. The Company amortizes deferred stock-based compensation on the graded vesting method over the vesting periods of the applicable stock purchase rights and stock options, generally four years. The graded vesting method provides for vesting of portions of the overall awards at interim dates and results in greater vesting in earlier years than the straight-line method. Had compensation expense been determined for employee awards based on the fair value at the grant date for the awards, consistent with the provisions of SFAS No. 123, the Company's pro forma net loss and pro forma net loss per share would be as follows (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss) as reported:	$ 1,536	$ 135	$ 4,272	$ (2,167)
Add: stock-based employee compensation expense included in reported net income (loss) under APB No. 25	19	89	93	636
Deduct: total employee stock-based compensation determined under fair value based method for all awards, net of related tax effects	(1,636)	(2,264)	(4,396)	(4,959)
Pro forma net loss	$ (81)	$ (2,040)	$ (31)	$ (6,490)
Basic net income (loss) per share:				
As reported	$ 0.06	$ 0.01	$ 0.17	$ (0.09)
Proforma	$ (0.00)	$ (0.08)	$ (0.00)	$ (0.26)
Diluted net income (loss) per share:				
As reported	$ 0.06	$ 0.01	$ 0.16	$ (0.09)
Proforma	$ (0.00)	$ (0.08)	$ (0.00)	$ (0.26)

During the nine months ended September 30, 2004, the Company recorded $45,000 in compensation expense for the fair value of options granted to a non-employee associated with the grant of 10,000 options to purchase common shares. Such options were granted at an exercise price of $9.04 per share, the fair market value on the grant date and were fully vested at the date of grant. Such options were valued using the Black-Scholes option pricing model with the following assumptions: contractual life of 2.5 years; risk-free interest rate of 4.14%; volatility of 80%; and no dividends during the expected term. Additionally, during the nine months ended September 30, 2004 the Company recorded $158,000 of compensation associated with the acceleration of vesting of certain options to a former employee of the Company. The compensation expense reflected the intrinsic value of such options at time of acceleration.

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123 (R), *Share-Based Payment* ("SFAS No. 123(R)"), which revised SFAS No. 123. Under the provision of SFAS No. 123(R), all companies will be required to expense the estimated fair value of equity instruments including stock options and similar awards. The accounting provisions of SFAS No. 123(R) will be effective for the Company beginning on January 1, 2006.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (R), *Share-Based Payment* ("SFAS No. 123 (R)"), an amendment of SFAS No. 123 and SFAS No. 95, *Statement of Cash Flows*. The statement eliminates the ability to account for share-based compensation transactions using APB No. 25 and requires that the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. SFAS No. 123 (R) applies to all share-based payment transactions in which an entity acquires goods or services by issuing its shares, share options, or other equity instruments or by incurring liabilities based on the price of an entity's shares or that require settlement by the issuance of equity instruments. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) 107 ("SAB No. 107") which expresses views of the SEC staff regarding the application of SFAS No. 123 (R). Among other things, SAB No. 107 provides interpretive guidance related to the interaction between SFAS No. 123 (R) and certain SEC rules and regulations, as well as provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies.

In April 2005, the SEC amended the compliance dates for SFAS No. 123 (R) to provide that the provisions of this statement will be effective for the Company beginning on January 1, 2006. Although the Company is currently assessing the application of SFAS No. 123 (R), the Company believes that the adoption of this statement will have a material impact on its financial position, results of operations and cash flows.

On June 1, 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3* ("SFAS No. 154"). This statement applies to all voluntary changes in accounting principles and changes required by an accounting pronouncement where no specific transition provisions are included. SFAS No. 154 requires retrospective application to prior period financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 carries forward the guidance set forth in Opinion 20 for reporting the correction of an error included in previously issued financial statements. The provisions of SFAS No. 154 are effective for accounting changes and correction of errors made in fiscal periods beginning January 1, 2006. The Company does not believe that the adoption of this statement will have a material impact on its financial position, results of operations or cash flows.

Reclassifications — Certain reclassifications have been made to the prior year financial statements to conform to the current year presentation.

3. 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 $3.5 million and $2.8 million at September 30, 2005 and December 31, 2004, respectively.

4. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted-average common shares outstanding for the period (excluding outstanding stock options and shares subject to repurchase). Diluted net income per share reflects the weighted-average common shares outstanding plus the potential effect of dilutive securities which are convertible into common shares (using the treasury stock method), except in cases where the effect would be anti-dilutive. The following is a reconciliation of the numerators and denominators used in computing basic and diluted net income (loss) per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	$ 1,536	$ 135	$ 4,272	$ (2,167)
Denominator:				
Weighted average common shares outstanding	26,101	25,320	25,891	25,393
Weighted average common shares outstanding subject to repurchase	—	(27)	(4)	(83)
Denominator for basic calculation, weighted average shares	26,101	25,293	25,887	25,310
Weighted average shares subject to repurchase	—	27	4	—
Stock options outstanding	1,678	663	1,407	—
Denominator for diluted calculation, weighted average shares	27,779	25,983	27,298	25,310
Net income (loss) per share — basic	$ 0.06	$ 0.01	$ 0.17	$ (0.09)
Net income (loss) per share — diluted	$ 0.06	$ 0.01	$ 0.16	$ (0.09)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Shares of common stock subject to repurchase	—	—	—	83
Common stock options	157	998	546	878
	157	998	546	961

5. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Net income (loss)	$ 1,536	$ 135	$ 4,272	$ (2,167)
Foreign currency translation adjustments	(6)	(8)	(75)	(14)
Comprehensive income (loss)	$ 1,530	$ 127	$ 4,197	$ (2,181)

6. GOODWILL AND PURCHASED INTANGIBLE ASSETS

The Company applies the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS No. 142") in accounting for goodwill and other intangible assets acquired in business combinations. SFAS No. 142 requires goodwill to be tested for impairment under certain circumstances, written down when impaired, and requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite. The following table provides information relating to the intangible assets and goodwill contained within the Company's consolidated balance sheets as of September 30, 2005 and December 31, 2004 (in thousands):

	September 30, 2005			
	Cost	Purchase Price Adjustments	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 41,282	$ (834)	$ (562)	$ 39,886
Acquired identifiable intangibles:				
Acquired core technology	$ 21,602	$ (500)	$ (11,615)	$ 9,487
Brand name	2,000	—	(1,042)	958
Other acquired intangibles	2,460	—	(1,617)	843
Total	$ 26,062	$ (500)	$ (14,274)	$ 11,288

	December 31, 2004			
	Cost	Purchase Price Adjustments	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 41,282	$ (834)	$ (562)	$ 39,886
Acquired identifiable intangibles:				
Acquired core technology	$ 21,602	$ (500)	$ (7,817)	$ 13,285
Brand name	2,000	—	(667)	1,333
Other acquired intangibles	2,460	—	(1,287)	1,173
Total	$ 26,062	$ (500)	$ (9,771)	$ 15,791

SFAS No. 142 requires that goodwill be tested for impairment on an annual basis and more frequently in certain circumstances. Accordingly, the Company has selected December 31, to perform the annual testing requirements. As of December 31, 2004, the Company completed its annual testing requirements and determined that the carrying value of goodwill had not been impaired.

During the year ended December 31, 2003, the Company recorded a non-cash adjustment of $172,000, relating to the reversal of excess accruals for acquisition-related expenses. Such adjustment resulted in a reduction of goodwill. During the year ended December 31, 2004, the Company recorded a non-cash adjustment of $704,000 relating to the reversal of estimated tax liabilities, which were resolved. Such adjustment resulted in a reduction of goodwill. Additionally, during the twelve months ended December 31, 2004, the Company recorded a non-cash adjustment of $42,000 relating to a change in estimate on abandoned leased facilities assumed during the acquisition of IDS Software Systems, Inc. ("IDS"). This adjustment resulted in an increase in goodwill.

During the year ended December 31, 2004, the Company recorded a non-cash adjustment of $500,000 associated with a reversal of contingent incentive performance amounts originally recorded to acquired core technology in connection with the acquisition of WaferYield, Inc. ("WaferYield").

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

Year Ending December 31,	Amount
2005 (remaining three months)	$ 1,501
2006	6,004
2007	3,783
Total	$ 11,288

7. CUSTOMER AND GEOGRAPHIC INFORMATION

The Company has adopted the disclosure requirements of SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, which establishes standards for reporting information about operating segments. 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:

	Three Months Ended September 30,		Nine Months Ended September 30,	
Customer	2005	2004	2005	2004
A	11%	15%	11%	18%
C	8%	12%	9%	12%
G	1%	12%	1%	13%
J	9%	6%	13%	10%
M	4%	6%	11%	4%
P	20%	7%	11%	4%

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

Customer	September 30, 2005	December 31, 2004
A	14%	13%
C	6%	14%
P	20%	5%

Revenues from customers by geographic area are as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Asia	$ 9,522	$ 10,772	$ 32,400	$ 28,239
United States	6,729	3,752	16,804	11,695
Europe	2,206	1,926	5,702	4,361
Total	$ 18,457	$ 16,450	$ 54,906	$ 44,295

As of September 30, 2005 and December 31, 2004, long-lived assets related to PDF Solutions GmbH (formerly AISS), located in Germany, totaled $908,000 and $795,000, respectively, of which $659,000 and $659,000, respectively, relates to acquired intangibles and goodwill. The majority of the Company's remaining long-lived assets are in the United States.

8. STOCK REPURCHASE PROGRAM

In February 2003, the Board of Directors approved a program to repurchase up to $10.0 million of the Company's common stock in the open market. During the three months ended September 30, 2005, the Company repurchased 44,942 shares of common stock from a Director of the Company at the closing price on the date of repurchase, which was $16.52 per share, in exchange for the repayment of a stockholder note receivable in the amount of approximately $742,000 consisting of the principal amount of the note and accrued interest. As of September 30, 2005, the Company has repurchased an aggregate of 550,521 shares at a weighted average price of $10.08 per share for a total cost of $5.5 million since the inception of the program. Under this authorization, the Company may continue to make additional stock repurchases from time to time, depending on market conditions, stock price and other factors. At September 30, 2005, $4.5 million remained available under the program to repurchase additional shares.

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. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential" or "continue", the negative effect of terms like these or other comparable terminology. These statements are only predictions. These statements involve known and unknown risks and uncertainties and other factors that may cause actual events or results to differ materially. All forward-looking statements included in this document are based on information available to us on the date of filing, and we assume no obligation to update any such forward-looking statements. In evaluating these statements, you should specifically consider various factors, including the risks outlined under the caption "Certain Risks Which May Affect Our Future Results" set forth at the end of this Item 2 and set forth at the end of Item 7 in our Annual Report on Form 10-K for the year ended December 31, 2004. We caution investors that our business and financial performance are subject to substantial risks and uncertainties.

Overview

Our technologies and services enable semiconductor companies to improve the yield and performance of integrated circuits, or ICs, by integrating the design and manufacturing processes. We believe that our solutions improve a semiconductor company's time-to-market, yield and ultimately product profitability. Our solutions combine proprietary manufacturing process simulation software, yield and performance modeling software, design-for-manufacturability software, test chips, a proprietary electrical wafer test system, yield and performance enhancement methodologies, yield management systems, and professional services. We analyze yield loss

mechanisms to identify, quantify and correct the issues that cause yield loss, as an integral part of the IC design process. This drives IC design and manufacturing improvements that enable our customers to have higher initial yields and achieve and exceed targeted IC yield and performance throughout product life cycles. Our solution is designed to increase the initial yield when a design first enters a manufacturing line, to increase the rate at which that yield improves, and to allow subsequent product designs to be added to manufacturing lines more quickly and easily.

The result of implementing our solutions is the creation of value that can be measured based on improvements to our customers' actual yield. We align our financial interests with the yield and performance improvements realized by our customers, and receive revenue based on this value. To date, we have sold our technologies and services to semiconductor companies including leading integrated device manufacturers, fabless semiconductor companies and foundries.

From our incorporation in 1992 through late 1995, we were primarily focused on research and development of our proprietary manufacturing process simulation and yield and performance modeling software. From late 1995 through late 1998, we continued to refine and sell our software, while expanding our offering to include yield and performance improvement consulting services. In late 1998, we began to sell our software and consulting services, together with our newly developed proprietary technologies, as Design-to-Silicon-Yield solutions, reflecting our current business model. In April 2000, we expanded our research and development team and gained additional technology by acquiring AISS, now operating as PDF Solutions, GmbH, which continues to develop software and provide development services to the semiconductor industry. In July 2001, we completed the initial public offering of our common stock. In 2003, we further enhanced our product and service offerings through the acquisitions of IDS and WaferYield.

Industry Trend

Demand for consumer electronics continues to drive technological innovation as the need for products which have greater performance, lower power consumption, reduced costs and smaller size continues to grow with each new product generation. To meet this demand, IC manufacturers and designers are constantly challenged to improve the overall performance of ICs by designing and manufacturing ICs with more embedded applications to create greater functionality. As a result, in 2004 and through 2005 more and more companies have expanded or advanced their design and manufacturing processes to develop and produce deep submicron ICs containing component sizes measured at 130 nanometers and below. As this trend continues, companies will continually be challenged to improve process capabilities to optimally produce ICs with minimal systematic and yield loss, which is driven by the lack of compatibility between the design and its respective manufacturing process. We believe as volume production of deep submicron ICs continues to grow, the difficulties of integrating IC designs with their respective processes will create a greater need for products and services that address the performance yield loss issues the semiconductor industry is facing today and will face in the future.

Financial Highlights

Financial highlights for the three months ended September 30, 2005 were as follows:

- Total revenue for the three months ended September 30, 2005, was $18.5 million, an increase of 12% compared to the three months ended September 30, 2004. Revenue from Design-to-Silicon-Yield integrated solutions for the three months ended September, 2005, increased to $13.8 million compared to $13.2 million for the three months ended September 30, 2004. This increase was the result of an overall increase in the total contract value of our solution implementation and of an increase in software maintenance revenues. Revenue from Design-to-Silicon-Yield software licenses for the three months ended September 30, 2005 increased to $1.5 million compared to $812,000 for the three months ended September 30, 2004. This increase was due to greater adoption of our software applications from our installed base of customers. Gain share revenue for the three months ended September 30, 2005 increased to $3.1 million compared to $2.4 million for the three months ended September 30, 2004. Our gain share revenue may continue to fluctuate from quarter to quarter as a result of each customer's contractual performance measures for achieving gain share as well as each customer's production volumes in any given period.

- We reported net income of $1.5 million for the three months ended September 30, 2005, compared to net income of $135,000 for the three months ended September 30, 2004. The increase in net income was primarily attributable to increased revenues more than offsetting the increase in expenses. The increase in expenses was mainly due to a growth in headcount and was partially offset by the slight decrease in stock-based compensation amortization and in the amortization of other acquired intangible assets. We will continue to monitor and control costs, relative to our revenue growth.

- Net income per share was $0.06 for the three months ended September 30, 2005 compared to net income per share of $0.01 for the three months ended September 30, 2004, an improvement of $0.05 per share.

Financial highlights for the nine months ended September 30, 2005 were as follows:

- Total revenue for the nine months ended September 30, 2005, was $54.9 million, an increase of 24% compared to the nine months ended September 30, 2004. Revenue from Design-to-Silicon-Yield integrated solutions for the nine months ended September 30, 2005, increased to $38.7 million compared to $36.1 million for the nine months ended September 30, 2004. This increase was the result of increases in the total contract value of our solution implementations and in software maintenance revenues from the prior period. Revenue from Design-to-Silicon-Yield software licenses for the nine months ended September 30, 2005 increased to $8.2 million compared to $3.2 million for the nine months ended September 30, 2004. This increase was due to greater adoption of our software applications from our installed base of customers. Gain share revenue for the nine months ended September 30, 2005 increased to $8.1 million compared to $5.1 million for the nine months ended September 30, 2004.

- We reported net income of $4.3 million for the nine months ended September 30, 2005, compared to a net loss of $2.2 million for the nine months ended September 30, 2004. The increase in net income was primarily attributable to increased revenues more than offsetting the increase in expenses. The increase in expenses was mainly due to a growth in headcount and was partially offset by the decrease in stock-based compensation amortization and in the amortization of other acquired intangible assets. We will continue to monitor and control costs, relative to our revenue growth.

- Net income per share was $0.16 for the nine months ended September 30, 2005 compared to a net loss per share of $0.09 for the nine months ended September 30, 2004, an improvement of $0.25 per share.

- Cash increased $13.7 million, to $59.3 million, during the nine months ended September 30, 2005. Net cash provided by operating activities and used in investing activities for the nine months ended September 30, 2005 totaled $10.1 million and $1.8 million, respectively. Net cash provided by financing activities for the nine months ended September 30, 2005 totaled $5.5 million.

- During the nine months ended September 30, 2005, we released shares for distribution which had remained held in escrow in connection with the IDS acquisition.

Critical Accounting Policies

Financial Reporting Release No. 60 requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. The notes to the unaudited consolidated financial statements include a summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements. 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 base 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, software development costs, recoverability of goodwill and 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 revenue from two sources: Design-to-Silicon-Yield solutions and gain share. We recognize revenue in accordance with the provisions of American Institute of Certified Public Accountants Statement of Position ("SOP") No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* and SOP No. 97-2, *Software Revenue Recognition*, as amended.

Design-to-Silicon-Yield Solutions — Design-to-Silicon-Yield solutions revenue is derived from integrated solutions and software licenses. Revenue recognition for each element of Design-to-Silicon-Yield solutions is as follows:

Integrated Solutions — We generate a significant portion our revenue from fixed-price contracts delivered over a specific period of time. These contracts require the accurate estimation of the cost to perform obligations and the overall scope of each engagement. Revenue under contracts for solution implementation services is recognized as the services are performed using the cost-to-cost percentage of completion method of contract accounting. Losses on solution implementation contracts are recognized when determined. 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 contract was executed. Any such reductions in contract margin could have a material negative impact on our operating results.

On occasion, we have licensed our software products as a component of our fixed price solutions implementations. In such instances, the software products are licensed to the customer over the specified term of the agreement with support and maintenance to be provided over the license term. Under these arrangements, where vendor-specific objective evidence of fair value ("VSOE") does not exist to allocate a portion of the total fee to the undelivered elements, revenue is recognized ratably over the term of the agreement. Costs incurred under these arrangements are deferred and recognized in proportion to revenue recognized under these arrangements.

Revenue from support and maintenance services is recognized ratably over the term of the support and maintenance contract, generally one year, while revenue from consulting, installation and training services is recognized as the services are performed. When bundled with software licenses in multiple element arrangements, 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. VSOE is generally established for maintenance based upon negotiated renewal rates while VSOE for consulting, installation, and training is established based upon our customary pricing for such services when sold separately. When VSOE does not exist to allocate a portion of the total fee to the undelivered elements, revenue is recognized ratably over the term of the underlying element for which VSOE does not exist.

Software Licenses — We also license our software products separate from our integrated solutions. In such cases revenue is recognized under the residual method when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, (iv) collectibility is probable and 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 integrated solutions. VSOE is generally established for maintenance 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. No revenue has been recognized for software licenses with extended payment terms in excess of amounts due.

Gain Share — Gain share revenue represents profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels. Upon achieving such operational levels, we receive either a fixed fee and/or variable fee based on the units sold by the customer. Due to the uncertainties surrounding attainment of such operational levels, we recognize gain share revenue (to the extent of completion of the related solution implementation contract) upon receipt of performance reports or other related information from our customers supporting the determination of amounts and probability of collection. Gain share revenue is dependent on many factors which are outside our control, including 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 gain share provisions.

Software Development Costs

Costs for the development of new software products and substantial enhancements to existing software products are expensed as incurred until technological feasibility has been established, at which time any additional costs would be capitalized in accordance with Statement of Financial Accounting Standards ("SFAS") No. 86, *Computer Software to be Sold, Leased or Otherwise Marketed*. Because we believe our current process for developing software is essentially completed concurrently with the establishment of technological feasibility, no costs have been capitalized to date.

Goodwill and Acquired Intangible Assets

As of September 30, 2005, we had $51.2 million of goodwill and intangible assets. In assessing the recoverability of our goodwill and intangible assets, we must make assumptions regarding estimated future cash flows and other factors. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets, which would have a material adverse effect on our operating results. We evaluate goodwill for impairment pursuant to the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. We have selected December 31 as the date upon which to perform our annual testing for impairment. As of December 31, 2004, we completed our annual testing requirements and determined that the carrying value of goodwill had not been impaired.

We are currently amortizing our acquired intangible assets over estimated useful lives of 4 years, which is based on the estimated period of benefit to be delivered from such assets. However, a decrease in the estimated useful lives of such assets would cause additional amortization expense or an impairment of such asset in future periods.

Realization of Deferred Tax Assets

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 need for a 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.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
Revenue:				
Design-to-silicon-yield solutions:				
Integrated solutions	75%	80%	70%	82%
Software licenses	8	5	15	7
Gain share	17	15	15	11
Total revenue	100	100	100	100
Costs and expenses:				
Cost of design-to-silicon-yield solutions:				
Direct costs of design-to-silicon-yield solutions				
Integrated solutions	35	36	33	35
Software licenses	—	—	—	—
Amortization of acquired core technology	7	8	7	9
Research and development	30	30	30	34
Selling, general and administrative	22	23	22	25
Stock-based compensation amortization	—	1	—	2
Amortization of other acquired intangible assets	1	2	1	3
Total costs and expenses	95	100	93	108
Income (loss) from operations	5	—	7	(8)
Interest and other income, net	3	1	2	1
Income (loss) before taxes	8	1	9	(7)
Tax provision (benefit)	—	—	1	(2)
Net income (loss)	8%	1%	8%	(5)%

Comparison of the Three Months Ended September 30, 2005 and 2004

Revenue	Three Months Ended September 30, 2005	2004	$ Change	Three Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Design-to-silicon-yield solutions						
Integrated solutions	$ 13,834	$ 13,224	$ 610	5%	75%	80%
Software licenses	1,533	812	721	89%	8%	5%
Gain share	3,090	2,414	676	28%	17%	15%
Total	$ 18,457	$ 16,450	$ 2,007	12%	100%	100%

Design-to-Silicon-Yield Solutions. Design-to-Silicon-Yield solutions revenue is derived from integrated solutions (including solution implementations, software support and maintenance and training) and software licenses, provided during our customer yield improvement engagements and solution product sales.

Integrated solutions. The increase in integrated solutions revenue of $610,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily attributable to an overall increase in the total contract value of our solution implementations and to an increase in software maintenance revenues as a result of our increased application customer base. Our integrated 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.

Software licenses. The increase in software licenses revenue of $721,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was due to greater adoption of our software applications, principally from our existing customers, who continue to expand their usage of our software products. Software license revenue may fluctuate in the future and is dependent upon a number of factors including the semiconductor industry's acceptance of our products, our ability to attract new customers and further penetration of our current customer base.

Gain Share. Gain share revenue represents profit sharing and performance incentives earned based upon our customer reaching certain defined operational levels. Gain share revenue grew approximately $676,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004. The increase in gain share revenue was primarily due to a greater number of engagements contributing to gain share at newer technology nodes, as well as a greater number of wafer starts at our customers' sites. Our gain share revenue may continue to fluctuate from period to period. Gain share 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 gain share provisions.

Cost of Design-to-Silicon Yield Solutions	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	$ Change	% Change	Three Months Ended September 30, 2005 % of Revenue	Three Months Ended September 30, 2004 % of Revenue
(In thousands, except for %'s)						
Direct costs of design-to-silicon- yield solutions						
Integrated solutions	$ 6,382	$ 5,881	$ 501	9%	35%	36%
Software licenses	15	6	9	150%	—	—
Amortization of acquired core technology	1,266	1,266	—	—	7%	8%
Total	$ 7,663	$ 7,153	$ 510	7%	42%	44%

Direct Costs of Design-to-Silicon-Yield Solutions. Direct costs of Design-to-Silicon-Yield solutions consists of costs incurred to provide and support our integrated solutions and costs recognized in connection with licensing our software.

Integrated solutions. Integrated solutions costs consist of material, labor and overhead costs associated with solution implementations. Costs include purchased material, employee compensation and benefits, travel and facilities-related costs. The increase in direct costs of Design-to-Silicon-Yield integrated solutions of $501,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily attributable to increased personnel-related costs and increased purchases of materials used in customer engagements. If we do not accurately estimate the resources required or the scope of work to be performed, or we 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 contract was executed. Any such reductions in contract margin could have a material negative impact on our operating results.

Software Licenses. 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. The increase in direct costs of Design-to-Silicon-Yield solutions software licenses of $9,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily attributable to an increase in license fees and royalties incurred associated with third party software licenses sold in conjunction with our software. We expect the cost of software licenses to fluctuate in the future as a result of royalties and license fees paid for third party applications incorporated in our software products.

Amortization of Acquired Core Technology. Amortization of acquired core technology consists of the amortization of intangibles acquired as a result of certain business combinations. The amortization of acquired core technology expense remained unchanged at $1.3 million for both the three months ended September 30, 2005 and the three months ended September 30, 2004. We anticipate amortization of acquired core technology to be $1.3 million for the remaining three months in 2005, $5.1 million in 2006 and $3.2 million in 2007.

Research and Development	Three Months Ended September 30, 2005	2004	$ Change	% Change	Three Months Ended September 30, 2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Research and development	$ 5,474	$ 4,940	$ 534	11%	30%	30%

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. The increase in research and development expenses of $534,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily due to increased personnel-related expenses, a result of our growth in headcount. We anticipate that we will continue to commit considerable resources to research and development in the future and that these expenses may increase in absolute dollars.

Selling, General and Administrative	Three Months Ended September 30, 2005	2004	$ Change	% Change	Three Months Ended September 30, 2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Selling, general and administrative	$ 3,971	$ 3,801	$ 170	4%	22%	23%

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. The increase in selling, general and administrative expenses of $170,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily due to increases in personnel-related costs, as a result of our growth in headcount, and professional fees, partially offset by a decrease in outside sales commissions. We expect that selling, general and administrative expenses will increase in absolute dollars to support increased selling and administrative efforts in the future as we expand our operations to support our growing customer base.

Stock-Based Compensation Amortization	Three Months Ended September 30, 2005	2004	$ Change	% Change	Three Months Ended September 30, 2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Stock-based compensation amortization	$ 19	$ 134	$ (115)	(86)%	—	1%

Stock-Based Compensation Amortization. The Company recognizes deferred stock-based compensation expense under the provisions of APB No. 25 *Accounting for Stock Issued to Employees*, using the graded vesting method for amortization purposes. The decrease in stock-based compensation amortization of $115,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily due to the effects of the graded vesting method of amortization which results in higher amortization expense during the initial periods following the respective option grants and due to the recognition of $45,000 associated with the grant of 10,000 fully-vested stock options to a non-employee during the three months ended September 30, 2004. We anticipate amortization of stock-based compensation to continue to decrease throughout 2005.

Amortization of Other Acquired Intangible Assets	Three Months Ended September 30, 2005	2004	$ Change	% Change	Three Months Ended September 30, 2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Amortization of other acquired intangible assets	$ 235	$ 351	$ (116)	(33)%	1%	2%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets consists of the amortization of intangibles acquired as a result of certain business combinations. Amortization of other acquired intangible assets decreased $116,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004, as a result of certain intangible assets being fully amortized in prior periods. We anticipate amortization of these other acquired intangible assets to continue to decrease in future periods.

Interest and Other Income, Net	Three Months Ended September 30, 2005	2004	$ Change	Three Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Interest and other income, net	$ 463	$ 150	$ 313	209%	3%	1%

Interest and Other Income, Net. The increase in interest and other income, net of $313,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily due to increased interest earned on higher average cash and cash equivalent balances during the period coupled with higher interest rates earned during the period.

Tax Provision	Three Months Ended September 30, 2005	2004	$ Change	Three Months Ended September 30, % Change	2005 % of Revenue	2004% of Revenue
(In thousands, except for %'s)						
Tax provision for income taxes	$ 22	$ 86	$ (64)	(74)%	—	—

Tax Provision. The decrease in the tax provision of $64,000 for the three months ended September 30, 2005 compared to the three months ended September 30, 2004 was primarily due to a an decrease in the expected tax rate as a result of increased credits and other tax benefits earned.

Comparison of the Nine Months Ended September 30, 2005 and 2004

Revenue	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Design-to-silicon-yield solutions						
Integrated solutions	$ 38,658	$ 36,082	$ 2,576	7%	70%	82%
Software licenses	8,179	3,162	5,017	159%	15%	7%
Gain share	8,069	5,051	3,018	60%	15%	11%
Total	$ 54,906	$ 44,295	$ 10,611	24%	100%	100%

Design-to-Silicon-Yield Solutions:

Integrated solutions. The increase in integrated solutions revenue of $2.6 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was attributable to an overall increase in the total contract value of solution implementations and an increase in available capacity to deliver upon such solution implementations, as well as an increase in software maintenance revenue, as a result of our growing application customer base.

Software licenses. The increase in software licenses revenue of $5.0 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was due to greater adoption of our software applications, principally from our existing customers, who continue to expand their usage of our software products.

Gain Share. Gain share revenue increased $3.0 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004. The increase in gain share revenue was primarily due to a greater number of engagements contributing to gain share at newer technology nodes, as well as a greater number of wafer starts at our customers' sites.

Cost of Design-to-Silicon Yield Solutions	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Direct costs of design-to-silicon- yield solutions						
Integrated solutions	$ 17,898	$ 15,541	$ 2,357	15%	33%	35%
Software licenses	273	69	204	296%	—	—
Amortization of acquired core technology	3,798	3,943	(145)	(4)%	7%	9%
Total	$ 21,969	$ 19,553	$ 2,416	12%	40%	44%

Direct Costs of Design-to-Silicon-Yield Solutions:

Integrated solutions. Costs include purchased material, employee compensation and benefits, travel and facilities-related costs. The increase in direct costs of Design-to-Silicon-Yield integrated solutions of $2.4 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily attributable to increased personnel-related costs and higher travel expenses needed to support our increased integrated solutions revenues.

Software Licenses. The increase in direct costs of Design-to-Silicon-Yield solutions software licenses of $204,000 for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily attributable to an increase in license fees and royalties incurred associated with third party software licenses sold in conjunction with our software during the period.

Amortization of Acquired Core Technology. The decrease in amortization of acquired core technology of $145,000 for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily attributable to certain acquired core technology being fully amortized in prior periods.

Research and Development	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Research and development	$ 16,465	$ 14,980	$ 1,485	10%	30%	34%

Research and Development. The increase in research and development expenses of $1.5 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily due to increased personnel-related expenses, primarily as a result of the growth in headcount.

Selling, General and Administrative	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Selling, general and administrative	$ 12,174	$ 11,220	$ 954	9%	22%	25%

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Selling, General and Administrative. The increase in selling, general and administrative expenses of $954,000 for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily due to an increase in personnel related expenses, as a result of growth in our headcount, and to a reduction in our allowance for doubtful accounts recorded in the prior year, partially offset by a decrease in outside sales commissions and travel expenses.

Stock-Based Compensation Amortization	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Stock-based compensation amortization	$ 93	$ 681	$ (588)	(86)%	—	2%

Stock-Based Compensation Amortization. The decrease in stock-based compensation amortization of $588,000 for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily attributable to the effects of the graded vesting method of amortization which results in higher amortization expense during the initial periods following the respective option grants. Additionally, during the nine months ended September 2004, we recognized $45,000 in compensation expense associated with the grant of stock options to non-employees and $158,000 in compensation expense associated with the acceleration of stock options granted to a former employee.

Amortization of Other Acquired Intangible Assets	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Amortization of other acquired intangible assets	$ 705	$ 1,171	$ (466)	(40)%	1%	3%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets decreased $466,000 for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004, as a result of certain intangible assets being fully amortized in prior periods.

Interest and Other Income, net	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004% of Revenue
(In thousands, except for %'s)						
Interest and other income, net	$ 1,085	$ 441	$ 644	146%	2%	1%

Interest and Other Income, Net. The increase in interest and other income, net of $644,000 for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily due to increased interest earned on higher average cash and cash equivalent balances during the period coupled with higher interest rates earned during the period.

Tax Provision (Benefit)	Nine Months Ended September 30, 2005	2004	$ Change	Nine Months Ended September 30, % Change	2005 % of Revenue	2004 % of Revenue
(In thousands, except for %'s)						
Tax provision (benefit) for income taxes	$ 313	$ (702)	$ 1,015	(145)%	1%	(2)%

Tax Provision (Benefit). The increase in the tax provision of $1.0 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004 was primarily due to taxes on operating income earned during the nine months ended September 30, 2005, partially offset by certain tax credits and other tax benefits realized during the period. During the nine month ended September 30, 2004, we recognized a tax benefit based on the realization of certain tax credits and the recognition of an operating loss during the period.

Liquidity and Capital Resources

Net cash provided by operating activities was $10.1 million for the nine months ended September 30, 2005 compared to net cash provided by operating activities of $5.3 million for the nine months ended September 30, 2004. After adjusting the net income of $4.3 million by the amortization of acquired intangible assets of $4.5 million, depreciation and amortization of $1.7 million, stock-based compensation of $93,000, and the change in deferred taxes of $1.5 million, our adjusted results provided approximately $9.0 million in cash. Net cash was also provided by increases in billings in excess of recognized revenue of $844,000, accrued compensation and benefits of $1.1 million, accounts payable of $310,000, taxes payable of $1.7 million and decreases in prepaid expenses and other assets of $146,000 offset by an increase in accounts receivable of $1.6 million and decreases in accrued liabilities of $826,000 and deferred revenues of $527,000. The increase in accounts receivable and in billings in excess of revenue recognized was due to increased revenues during the period as well as the timing of billing milestones specified in the contract agreements. The net increase in accrued liabilities was primarily the result of accruals for personnel costs and variable compensation. The increase in accounts payable was due to the timing of vendor payments coupled with moderate increases in our operating activities. The decrease in prepaid expenses and other assets was primarily the result of the recognition of certain capitalized costs associated with our yield ramp engagements which was partially offset by an increase in prepaid insurance. The decrease in deferred revenue was primarily the result of timing of software support and maintenance contracts renewal billings. The increase in taxes payable was primarily due to the increase in taxable income.

Net cash used in investing activities was $1.8 million for the nine months ended September 30, 2005 compared to $1.2 million for the nine months ended September 30, 2004. During the nine months ended September 30, 2005, net cash used in investing activities consisted of the purchase of property and equipment to help support our growing operations.

Net cash provided by financing activities was $5.5 million for the nine months ended September 30, 2005 compared to net cash used in financing activities of $231,000 for the nine months ended September 30, 2004. Net cash provided by financing activities during the nine months ended September 30, 2005 primarily consisted of $4.7 million in proceeds from the exercise of employee stock options and $808,000 in proceeds from the issuance of shares under the Employee Stock Purchase Plan. Net cash used in financing activities during the nine months ended September 30, 2004 primarily consisted of the repurchase of 505,579 shares of our common stock at a weighted average purchase price of $9.51 per share for a total cost of $4.8 million, partially offset by the collection of employee notes receivable of $2.5 million, proceeds from the exercise of employee stock options of $1.5 million and proceeds from the issuance of shares under the Employee Stock Purchase Plan of $689,000.

As of September 30, 2005, our working capital was $64.4 million, compared with $51.3 million as of December 31, 2004. Cash and cash equivalents as of September 30, 2005 were $59.3 million compared to $45.7 million as of December 31, 2004, an increase of $13.6 million. Increases in cash were primarily attributable to operating activities and to a lesser extent to proceeds from the exercise of stock options and issuance of common stock under our equity plan. We expect to experience growth in our overall expenses, in order to execute our business plan. As a result, 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 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.

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. Additionally, we have not entered into any derivative contracts. As of September 30, 2005, we had no foreign currency contracts outstanding.

We lease our facilities under operating lease agreements that expire at various dates through 2012. The following table represents our future minimum annual lease payments (in thousands):

Year Ending December 31,	Amount
2005 (remaining three months)	$ 619
2006	2,423
2007	2,407
2008	707
2009	466
Thereafter	928
Total	$ 7,550

Recent Accounting Pronouncements

In December 2004, the FASB issued SFAS No. 123 (R), *Share-Based Payment* ("SFAS No. 123 (R)"), an amendment of SFAS No. 123 and SFAS No. 95, *Statement of Cash Flows*. The statement eliminates the ability to account for share-based compensation transactions using APB No. 25 and requires that the cost of share-based payment transactions (including those with employees and non-employees) be recognized in the financial statements. SFAS No. 123(R) applies to all share-based payment transactions in which an entity acquires goods or services by issuing its shares, share options, or other equity instruments or by incurring liabilities based on the price of an entity's shares or that require settlement by the issuance of equity instruments. In March 2005, the SEC issued Staff Accounting Bulletin (SAB) No. 107 ("SAB No. 107") which expresses views of the SEC staff regarding the application of SFAS No. 123(R). Among other things, SAB No. 107 provides interpretive guidance related to the interaction between SFAS No. 123 (R) and certain SEC rules and regulations, as well as provides the SEC staff's views regarding the valuation of share-based payment arrangements for public companies. In April 2005, the SEC amended the compliance dates for SFAS No. 123 (R) to provide that the provisions of this statement will be effective for fiscal years beginning on January 1, 2006 for calendar year companies. Although we are currently assessing the application of SFAS No. 123 (R), we believe that the adoption of this statement will have a material impact on our financial position, results of operations and cash flows.

On June 1, 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3* ("SFAS No. 154"). This statement applies to all voluntary changes in accounting principles and changes required by an accounting pronouncement where no specific transition provisions are included. SFAS No. 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 carries forward the guidance set forth in Opinion 20 for reporting the correction of an error included in previously issued financial statements. The provisions of SFAS No. 154 are effective for accounting changes and correction of errors made in fiscal periods beginning January 1, 2006. We do not believe that the adoption of this statement will have a material impact on our financial position, results of operations or cash flows.

CERTAIN RISKS WHICH MAY AFFECT OUR FUTURE RESULTS

If semiconductor designers and manufacturers do not continue to adopt our Design-to-Silicon-Yield solutions, we may be unable to increase or maintain our revenue.

If semiconductor designers and manufacturers do not continue to adopt our Design-to-Silicon-Yield solutions, our revenue could decline. To date, we have worked with a limited number of semiconductor companies on a limited number of IC products and processes. To be successful, we will need to continue to enter into agreements covering a larger number of IC products and processes with existing customers and new customers. Our existing customers are primarily large integrated device manufacturers, or IDMs. We target as new customers additional IDMs, fabless semiconductor companies and foundries, as well as system manufacturers. Factors that may limit adoption of our Design-to-Silicon-Yield solutions by semiconductor companies include:

- our customers' failure to achieve satisfactory yield improvements using our Design-to-Silicon-Yield solutions;
- a decrease in demand for semiconductors generally or the demand for deep submicron semiconductors failing to grow as rapidly as expected;

- the industry may develop alternative methods to enhance the integration between the semiconductor design and manufacturing processes due to a rapidly evolving market and the likely emergence of new technologies;
- our existing and potential customers' reluctance to understand and accept our innovative gain share fee component; and
- our customers' concern about our ability to keep highly competitive information confidential.

Our earnings per share and other key operating results may be unusually high in a given quarter, thereby raising investors' expectations, and then unusually low in the next quarter, thereby disappointing investors, which could cause our stock price to drop.

Historically, our quarterly operating results have fluctuated. Our future quarterly operating results will likely fluctuate from time to time and may not meet the expectations of securities analysts and investors in some future period. The price of our common stock could decline due to such fluctuations. The following factors may cause significant fluctuations in our future quarterly operating results:

- the size and timing of sales volumes achieved by our customers' products;
- the loss of any of our large customers or an adverse change in any of our large customers' businesses;
- the size of improvements in our customers' yield and the timing of agreement as to those improvements;
- our long and variable sales cycle;
- changes in the mix of our revenue;
- changes in the level of our operating expenses needed to support our projected growth; and
- delays in completing solution implementations for our customers.

Our gain share revenue is dependent on factors outside of our control, including the volume of integrated circuits, or ICs, our customers are able to sell to their customers.

Our gain share revenue for a particular product is largely determined by the volume of that product our customer is able to sell to its customers, which is outside of our control. We have limited ability to predict the success or failure of our customers' IC products. Further, our customers may implement changes to their manufacturing processes during the gain share period, which could negatively affect yield results, which is beyond our control. We may commit a significant amount of time and resources to a customer who is ultimately unable to sell as many units as we had anticipated when contracting with them or who makes unplanned changes to their processes. Since we currently work on a small number of large projects, any product that does not achieve commercial viability or a significant increase in yield could significantly reduce our revenue and results of operations below expectations. In addition, if we work with two directly competitive products, volume in one may offset volume, and any of our related gain share, in the other product. Further, decreased demand for semiconductor products decreases the volume of products our customers are able to sell, which may adversely affect our gain share revenue.

Gain share measurement requires data collection and is subject to customer agreement, which can result in uncertainty and cause quarterly results to fluctuate.

We can only recognize gain share revenue once we have reached agreement with our customers on their level of yield performance improvements. Because measuring the amount of yield improvement is inherently complicated and dependent on our customers' internal information systems, there may be uncertainty as to some components of measurement. This could result in our recognition of less revenue than expected. In addition, any delay in measuring gain share could cause all of the associated revenue to be delayed until the next quarter. Since we currently have only a few large customers and we are relying on gain share as a significant component of our total revenue, any delay could significantly harm our quarterly results.

Changes in the structure of our customer contracts, including the mix between fixed and variable revenue and the mix of elements, can adversely affect the size and timing of our total revenue.

Our long-term success is largely dependent upon our ability to structure our future customer contracts to include a larger gain share component relative to the fixed fee component. If we are successful in increasing the gain share component of our customer contracts, we will experience an adverse impact on our operating results in the short term as we reduce the fixed fee component, which we typically recognize earlier than gain share fees. Due to acquisitions and expanded business strategies, the mix of elements in some of our contracts has changed recently and the relative importance of the software component in some of our contracts has increased. We have experienced, and may in the future experience, delays in the expected recognition of revenue associated with generally accepted accounting principles regarding the timing of revenue recognition in multi-element software arrangements, including the effect of acceptance criteria. If we fail to meet contractual acceptance criteria on time or at all, the total revenue we receive under a contract could be delayed or decline. In addition, by increasing the gain share or the software component, we may increase the variability or timing of recognition of our revenue, and therefore increase the risk that our total future revenue will be lower than expected and fluctuate significantly from period to period.

We generate a large percentage of our total revenue from a limited number of customers, so the loss of any one of these customers could significantly reduce our revenue and results of operations below expectations.

Historically, we have had a small number of large customers for our core Design-to-Silicon-Yield solutions and we expect this to continue in the near term. In the nine months ended September 30, 2005, four customers accounted for 46% of our total net revenue, with Texas Instruments representing 13%, Hiroshima Elpida representing 11%, IBM representing 11% and Toshiba representing 11%, respectively. In the nine months ended September 30, 2004, four customers accounted for 53% of our total net revenue, with Toshiba representing 18%, Matsushita representing 13%, Sony representing 12% and Texas Instruments representing 10%, respectively. The loss of any of these customers or a decrease in the sales volumes of their products could significantly reduce our total revenue below expectations. In particular, such a loss could cause significant fluctuations in results of operations because our expenses are fixed in the short term and it takes us a long time to replace customers.

It typically takes us a long time to sell our unique solutions to new customers, which can result in uncertainty and delays in generating additional revenue.

Because our gain share business model is unique and our Design-to-Silicon-Yield solutions are unfamiliar, our sales cycle is lengthy and requires a significant amount of our senior management's time and effort. Furthermore, we need to target those individuals within a customer's organization who have overall responsibility for the profitability of an IC. These individuals tend to be senior management or executive officers. We may face difficulty identifying and establishing contact with such individuals. Even after initial acceptance, due to the complexity of structuring the gain share component, the negotiation and documentation processes can be lengthy. It can take nine months or more to reach a signed contract with a customer. Unexpected delays in our sales cycle could cause our revenue to fall short of expectations.

We have a history of losses, we may incur losses in the future and we may be unable to maintain profitability.

While we were profitable in our five most recent quarters, we have experienced losses in the past. We may not maintain profitability if our revenue increases more slowly than we expect or not at all. In addition, virtually all of our operating expenses are fixed in the short term, so any shortfall in anticipated revenue in a given period could significantly reduce our operating results below expectations. Our accumulated deficit was $15.7 million as of September 30, 2005. We expect to continue to incur significant expenses in connection with:

- funding for research and development;
- expansion of our solution implementation teams;
- expansion of our sales and marketing efforts; and
- additional non-cash charges relating to amortization of intangibles and deferred stock compensation.

As a result, we will need to significantly increase revenue to maintain profitability on a quarterly or annual basis. Any of these factors could cause our stock price to decline.

The semiconductor industry is cyclical in nature.

Our revenue is highly dependent upon the overall condition of the semiconductor industry, especially in light of our gain share revenue component. The semiconductor industry is highly cyclical and subject to rapid technological change and has been subject to significant economic downturns at various times, characterized by diminished product demand, accelerated erosion of average selling prices and production overcapacity. The semiconductor industry also periodically experiences increased demand and production capacity constraints. As a result, we may experience significant fluctuations in operating results due to general semiconductor industry conditions and overall economic conditions.

We must continually attract and retain highly talented executives, engineers and research and development personnel or we will be unable to expand our business as planned.

We will need to continue to hire highly talented executives, engineers and research and development personnel to support our planned growth. We have experienced, and we expect to continue to experience, delays and limitations in hiring and retaining highly skilled individuals with appropriate qualifications. We intend to continue to hire foreign nationals, particularly as we expand our operations internationally. We have had, and expect to continue to have, difficulty in obtaining visas permitting entry into the United States for several of our key personnel, which disrupts our ability to strategically locate our personnel. If we lose the services of any of our key executives or a significant number of our engineers, it could disrupt our ability to implement our business strategy. Competition for executives and qualified engineers can be intense, especially in Silicon Valley where we are principally based.

If our products, technologies, services and integrated solutions fail to keep pace with the rapid technological changes in the semiconductor industry, we could lose customers and revenue.

We must continually devote significant engineering resources to enable us to keep up with the rapidly evolving technologies and equipment used in the semiconductor design and manufacturing processes. These innovations are inherently complex and require long development cycles. Not only do we need the technical expertise to implement the changes necessary to keep our technologies current, we also rely heavily on the judgment of our advisors and management to anticipate future market trends. Our customers expect us to stay ahead of the technology curve and expect that our products, technologies, services and integrated solutions will support any new design or manufacturing processes or materials as soon as they are deployed. If we are not able to timely predict industry changes, or if we are unable to modify our products, technologies, services and integrated solutions on a timely basis, our existing solutions will be rendered obsolete and we may lose customers. If we do not keep pace with technology, our existing and potential customers may choose to develop their own solutions internally as an alternative to ours and we could lose market share, which could adversely affect our operating results.

We intend to pursue additional strategic relationships, which are necessary to maximize our growth, but could substantially divert management attention and resources.

In order to establish and maintain strategic relationships with industry leaders at each stage of the IC design and manufacturing processes, we may need to expend significant resources and will need to commit a significant amount of management's time and attention, with no guarantee of success. If we are unable to enter into strategic relationships with these companies, we will not be as effective at modeling existing technologies or at keeping ahead of the technology curve as new technologies are introduced. In the past, the absence of an established working relationship with key companies in the industry has meant that we have had to exclude the effect of their component parts from our modeling analysis, which reduces the overall effectiveness of our analysis and limits our ability to improve yield. We may be unable to establish key industry strategic relationships if any of the following occur:

- potential industry partners become concerned about our ability to protect their intellectual property;
- potential industry partners develop their own solutions to address the need for yield improvement;
- our potential competitors establish relationships with industry partners with which we seek to establish a relationship; or
- potential industry partners attempt to restrict our ability to enter into relationships with their competitors.

We may not be able to expand our proprietary technologies if we do not consummate potential acquisitions or investments or successfully integrate them with our business.

To expand our proprietary technologies, we may acquire or make investments in complementary businesses, technologies or products if appropriate opportunities arise. We may be unable to identify suitable acquisition or investment candidates at reasonable prices or on reasonable terms, or consummate future acquisitions or investments, each of which could slow our growth strategy. We may have difficulty integrating the acquired products, personnel or technologies of any acquisitions we might make. These difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses.

Competition in the market for solutions that address yield improvement and integration between IC design and manufacturing may intensify in the future, which could slow our ability to grow or execute our strategy.

Competition in our market may intensify in the future, which could slow our ability to grow or execute our strategy. Our current and potential customers may choose to develop their own solutions internally, particularly if we are slow in deploying our solutions. Many of these companies have the financial and technical capability to develop their own solutions. Also, competitors could establish non-domestic operations with a lower cost structure than our engineering organization, which would give any such competitor's products a competitive advantage over our solutions. There may be other providers of commercial solutions for systematic IC yield and performance enhancement of which we are not aware. We currently face indirect competition from the internal groups at IC companies and some direct competition from providers of yield management software such as Spotfire or Synopsys through their acquisition of HPL Technologies. Some providers of yield management software or inspection equipment may seek to broaden their product offerings and compete with us. For example, KLA-Tencor has announced adding the use of test structures to one of their inspection product lines. In addition, we believe that the demand for solutions that address the need for better integration between the silicon design and manufacturing processes may encourage direct competitors to enter into our market. For example, large integrated organizations, such as IDMs, electronic design automation software providers, IC design service companies or semiconductor equipment vendors, may decide to spin-off a business unit that competes with us. Other potential competitors include fabrication facilities that may decide to offer solutions competitive with ours as part of their value proposition to their customers. If these potential competitors are able to attract industry partners or customers faster than we can, we may not be able to grow and execute our strategy as quickly or at all. In addition, customer preferences may shift away from our solutions as a result of the increase in competition.

We face operational and financial risks associated with international operations.

We derive a majority of our revenue from international sales, principally from customers based in Asia. Revenue generated from customers in Asia accounted for 59% of total revenue in the nine months ended September 30, 2005. During the nine months ended September 30, 2004 revenue generated from customers in Asia was 64% of total revenue. We expect that a significant portion of our total future revenue will continue to be derived from companies based in Asia. We are subject to risks inherent in doing business in international markets. These risks include:

- some of our key engineers and other personnel who are foreign nationals may have difficulty gaining access to the United States and other countries in which our customers or our offices may be located;
- greater difficulty in collecting account receivables resulting in longer collection periods;
- language and other cultural differences may inhibit our sales and marketing efforts and create internal communication problems among our U.S. and foreign research and development teams;
- compliance with, and unexpected changes in, a wide variety of foreign laws and regulatory environments with which we are not familiar;
- currency risk due to the fact that expenses for our international offices are denominated in the local currency, including the Euro, while virtually all of our revenue is denominated in U.S. dollars;

- in the event a larger portion of our revenue becomes denominated in foreign currencies, we would be subject to a potentially significant exchange rate risk; and
- economic or political instability.

In Japan, in particular, we face the following additional risks:

- any recurrence of an overall downturn in Asian economies could limit our ability to retain existing customers and attract new ones in Asia;
- if the U.S. dollar increases in value relative to the Japanese Yen, the cost of our solutions will be more expensive to existing and potential Japanese customers and therefore less competitive; and
- if any of these risks materialize, we may be unable to continue to market our solutions successfully in international markets.

We must effectively manage and support our operations and recent and planned growth in order for our business strategy to succeed.

We will need to continue to grow in all areas of operation and successfully integrate and support our existing and new employees into our operations, or we may be unable to implement our business strategy in the time frame we anticipate, if at all. We have in the past, and may in the future, experience interruptions in our information systems. Further, physical damage to, failure of, or digital damage (such as significant viruses or worms) to, our information systems could delay time-sensitive services or computing operations that we perform for our customers, which could negatively impact our business results and reputation. We may need to switch to a new accounting system in the near future, which could disrupt our business operations and distract management. In addition, we will need to expand our intranet to support new data centers to enhance our research and development efforts. Our intranet is expensive to expand and must be highly secure due to the sensitive nature of our customers' information that we transmit. Building and managing the support necessary for our growth places significant demands on our management and resources. These demands may divert these resources from the continued growth of our business and implementation of our business strategy. Further, we must adequately train our new personnel, especially our client service and technical support personnel, to adequately, and accurately, respond to and support our customers. If we fail to do this, it could lead to dissatisfaction among our customers, which could slow our growth.

Our solution implementations may take longer than we anticipate, which could cause us to lose customers and may result in adjustments to our operating results.

Our solution implementations require a team of engineers to collaborate with our customers to address complex yield loss issues by using our software and other technologies. We must estimate the amount of time needed to complete an existing solution implementation in order to estimate when the engineers will be able to commence a new solution implementation. In addition, our accounting for solution implementation contracts, which generate fixed fees, sometimes require adjustments to profit and loss based on revised estimates during the performance of the contract. These adjustments may have a material effect on our results of operations in the period in which they are made. The estimates giving rise to these risks, which are inherent in fixed-price contracts, include the forecasting of costs and schedules, and contract revenues related to contract performance.

Key executives, including our chief executive officer and our chief strategy officer, are critical to our business and we cannot guarantee that they will remain with us indefinitely.

Our future success will depend to a significant extent on the continued services of our key executives, including John Kibarian, our President and Chief Executive Officer, and David Joseph, our Chief Strategy Officer. If we lose the services of any of our key executives, it could slow execution of our business plan, hinder our product development processes and impair our sales efforts. Searching for replacements could divert other senior management's time and increase our operating expenses. In addition, our industry partners and customers could become concerned about our future operations, which could injure our reputation. We do not have long-term employment agreements with our executives and we do not maintain any key person life insurance policies on their lives.

Inadvertent disclosure of our customers' confidential information could result in costly litigation and cause us to lose existing and potential customers.

Our customers consider their product yield information and other confidential information, which we must gather in the course of our engagement with the customer, to be extremely competitively sensitive. If we inadvertently disclosed or were required to disclose this information, we would likely lose existing and potential customers, and could be subject to costly litigation. In addition, to avoid potential disclosure of confidential information to competitors, some of our customers may, in the future, ask us not to work with key competitive products.

If we fail to protect our intellectual property rights, customers or potential competitors may be able to use our technologies to develop their own solutions which could weaken our competitive position, reduce our revenue or increase our costs.

Our success depends largely on the proprietary nature of our technologies. We currently rely primarily on copyright, trademark and trade secret protection. Whether or not patents are granted to us, litigation may be necessary to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. As a result of any such litigation, we could lose our proprietary rights and incur substantial unexpected operating costs. Litigation could also divert our resources, including our managerial and engineering resources. In the future, we intend to rely primarily on a combination of patents, copyrights, trademarks and trade secrets to protect our proprietary rights and prevent competitors from using our proprietary technologies in their products. These laws and procedures provide only limited protection. Our pending patent applications may not result in issued patents, and even if issued, they may not be sufficiently broad to protect our proprietary technologies. Also, patent protection in foreign countries may be limited or unavailable where we need such protection.

Our technologies could infringe the intellectual property rights of others causing costly litigation and the loss of significant rights.

Significant litigation regarding intellectual property rights exists in the semiconductor industry. It is possible that a third party may claim that our technologies infringe their intellectual property rights or misappropriate their trade secrets. Any claim, even if without merit, could be time consuming to defend, result in costly litigation or require us to enter into royalty or licensing agreements, which may not be available to us on acceptable terms, or at all. A successful claim of infringement against us in connection with the use of our technologies could adversely affect our business.

Defects in our proprietary technologies, hardware and software tools and the cost of support to remedy any such defects could decrease our revenue and our competitive market share.

If the software, hardware or proprietary technologies we provide to a customer contain defects that increase our customer's cost of goods sold and time to market, these defects could significantly decrease the market acceptance of our solutions. Further, the cost of support resources required to remedy any defects in our technologies, hardware or software tools could exceed our expectations. Any actual or perceived defects with our software, hardware or proprietary technologies may also hinder our ability to attract or retain industry partners or customers, leading to a decrease in our revenue. These defects are frequently found during the period following introduction of new software, hardware or proprietary technologies or enhancements to existing software, hardware or proprietary technologies. Our software, hardware or proprietary technologies may contain errors not discovered until after customer implementation of the silicon design and manufacturing process recommended by us. If our software, hardware or proprietary technologies contain errors or defects, it could require us to expend significant resources to alleviate these problems, which could reduce margins, and result in the diversion of technical and other resources from our other development efforts.

We may have difficulty maintaining the effectiveness of our internal financial controls.

Pursuant to Section 404 of the Sarbanes-Oxley Act, we were required to furnish a report on our management's assessment of the design and effectiveness of our system of internal controls over financial reporting as part of our Annual Report on Form 10-K for the fiscal year ending December 31, 2004. Our auditors were also required to attest to, and report on, our management's assessment. In order to issue their report, our management documented both the design of our system of internal controls and our testing processes that support our management's evaluation and conclusion. During the course of future testing, we may identify deficiencies, including those arising from turnover of qualified personnel or arising as a result of acquisitions, which we may not be able to remediate in

time to meet the continuing reporting deadlines imposed by Section 404 and the costs of which may have a material adverse impact of our results of operations. In addition, if we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that our management can conclude on an ongoing basis that we have effective internal controls. We also may not be able to retain independent auditors with sufficient resources to attest to and report on our internal controls in a timely manner. Moreover, our auditors may not agree with our management's future assessments and may send us a deficiency notice that we are unable to remediate on a timely basis. If we are unable to assert as of December 31, 2005 and beyond, that we maintain effective internal controls, our investors could lose confidence in the accuracy and completeness in our financial reports that in turn could cause our stock price to decline.

Change in stock option accounting rules may adversely impact our reported operating results prepared in accordance with generally accepted accounting principles, our stock price and our competitiveness in the employee marketplace.

Technology companies in general and PDF in particular have a history of depending upon and using broad based employee stock option programs to hire, incentivize and retain employees in a competitive marketplace. In December 2004, FASB released SFAS No. 123(R), which will require all companies to measure compensation costs for all share-based payments, including employee stock options, at fair value. The provisions of SFAS No. 123(R) may be applied in one of two retroactive or prospective transition and is effective for PDF beginning January 1, 2006. We are currently evaluating the effect that the adoption of SFAS No. 123(R) will have on our financial position and results of operations. While we have not determined which transition method we will apply to measure such compensation costs, we believe that our adoption of SFAS No. 123(R) will have a material impact on our financial position and results of operations. In addition, we believe that the adoption of SFAS No. 123(R) may impact our ability to utilize broad based employee stock option plans to hire, incentivize and retain employees and could result in a competitive disadvantage to us in the employee marketplace.

Worldwide events may reduce our revenues and harm our business.

Future political or related events similar or comparable to the September 11, 2001 terrorist attacks, or significant military conflicts or long-term reactions of governments and society to such events, may cause significant delays or reductions in technology purchases or limit our ability to travel to certain parts of the world. In addition, such events have had and may continue to have negative effects on financial markets, including significant price and volume fluctuations in securities markets. If such events continue or escalate, our business and results of operations could be harmed and the market price of our common stock could decline.

We may not be able to raise necessary funds to support our growth or execute our strategy.

We currently anticipate that our available cash resources will be sufficient to meet our presently anticipated working capital and capital expenditure requirements for at least the next 12 months. However, unanticipated efforts to support more rapid expansion, develop or enhance Design-to-Silicon-Yield solutions, respond to competitive pressures or acquire complementary businesses or technologies could impact our future capital requirements and the adequacy of our available funds. In such event, we may need to raise additional funds through public or private financings, strategic relationships or other arrangements. We may not be able to raise any necessary funds on terms favorable to us, or at all.

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. Our actual results could vary materially as a result of a number of factors.

Interest Rate Risk. As of September 30, 2005, we had cash and cash equivalents of $59.3 million, consisting of cash and highly liquid money market instruments with maturities of 90 days or less. Because of the short maturities of those instruments, a sudden change in market interest rates would not have a material impact on the fair value of the portfolio. 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 10% from the market rates in effect at September 30, 2005 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 increased interest expense.

Foreign Currency and Exchange Risk. Virtually all of our revenue is denominated in U.S. dollars, although such revenue is derived substantially from foreign customers. Foreign sales to date, generated by our German subsidiary PDF Solutions GmbH since the date of its acquisition, have for the most part, been invoiced in local currencies, creating receivables denominated in currencies other than the U.S. dollar. The risk due to foreign currency fluctuations associated with these receivables is partially reduced by local payables denominated in the same currencies, and presently we do not consider it necessary to hedge these exposures. We intend to monitor our foreign currency exposure. There can be no assurance that exchange rate fluctuations will not have a materially negative impact on our business.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures. Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our “disclosure controls and procedures” (as 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 the quarterly report on Form 10-Q, have concluded that our disclosure controls and procedures are effective and designed to ensure that information required to be disclosed by us in the reports we file and submit under the Exchange Act is recorded, processed, summarized and reported within the timeframes specified in the SEC’s rules and forms.

Changes in Internal Controls Over Financial Reporting. There were no significant changes in our internal controls or to our knowledge, in other factors that could significantly affect our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) of the Exchange Act) during the period covered by this Quarterly Report on Form 10-Q.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings.

Not Applicable.

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

(b) *Use of Proceeds.* Our first registration statement, filed on Form S-1 (Registration No. 333-43192) related to our initial public offering was declared effective by the SEC on July 26, 2001. There has been no change to the disclosure contained in our report on Form 10-K for the year ended December 31, 2004, as amended, with respect to the use of proceeds generated by our initial public offering.

(c) *Stock Repurchases.* 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 September 30, 2005:

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased(1)	(b) Average Price Paid Per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs (1)	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs(1)
Month #1 (July 1, 2005 through July 31, 2005)	—	—	505,579	$ 5,193,678
Month #2 (August 1, 2005 through August 31, 2005)	—	—	505,579	$ 5,193,678
Month #3 (September 1, 2005 through September 30, 2005)	44,942	$ 16.52	550,521	$ 4,451,236
Total	44,942	$ 16.52	550,521	

(1) On March 26, 2003, we announced that our Board of Directors had approved a share repurchase program, pursuant to which up to $10.0 million of our outstanding common stock may be repurchased; the repurchase program has no set expiration or termination date. As of September 30, 2005, 550,521 shares had been repurchased under this program at a weighted average per share price of $10.08 and approximately $4.5 million remained available for repurchases.

Item 3. Defaults on Senior Securities.

Not Applicable.

Item 4. Submission of Matters to a Vote of Security Holders.

Not Applicable.

Item 5. Other Information.

Not Applicable.

Item 6. Exhibits

(a) Exhibits:

Exhibit Number	Description
3.1	Third Amended and Restated Certificate of Incorporation of PDF Solutions, Inc. *
3.2	Amended and Restated Bylaws of PDF Solutions, Inc. †
4.1	Specimen Stock Certificate**
4.2	Second Amended and Restated Rights Agreement dated July 6, 2001*
21.01	Subsidiaries of Registrant
31.01	Certification of the President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.02	Certification of the Chief Financial Officer and Vice President of Finance and Administration pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.01	Certification of the President and Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002***
32.02	Certification the Chief Financial Officer and Vice President of Finance and Administration pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002***

* Incorporated by reference to PDF's Registration Statement on Form S-1, Amendment No. 7 filed July 9, 2001 (File No. 333-43192).

** Incorporated by reference to PDF's Report on Form 10-Q filed September 6, 2001 (File No. 000-31311).

*** 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.

† Incorporated by reference to PDF's Report on Form 10-Q filed August 9, 2005 (File No. 000-31311).

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.

Date: November 9, 2005

By: /s/ John K. Kibarian
John K. Kibarian
President and Chief Executive Officer

By: /s/ P. Steven Melman
P. Steven Melman
Chief Financial Officer and Vice President, Finance and Administration

EXHIBIT INDEX

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† Incorporated by reference to PDF's Report on Form 10-Q filed August 9, 2005 (File No. 000-31311).

EXHIBIT 21.01

Subsidiaries of Registrant

Name of Entity	Jurisdiction of Incorporation or Organization
PDF Solutions GmbH	Germany
PDF Solutions KK	Japan
PDF Solutions International Services, Inc.	Delaware

EXHIBIT 31.01

CERTIFICATIONS

I, John K. Kibarian, certify that:

1. I have reviewed this quarterly report on Form 10-Q of PDF Solutions, Inc.;

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

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

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

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

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

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

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

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

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

/s/ JOHN K. KIBARIAN

John K. Kibarian
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 9, 2005

EXHIBIT 31.02

CERTIFICATIONS

I, P. Steven Melman, certify that:

1. I have reviewed this quarterly report on Form 10-Q of PDF Solutions, Inc.;

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

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

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

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

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

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

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

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

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

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

/s/ P. STEVEN MELMAN

P. Steven Melman
Chief Financial Officer and Vice President
of Finance and Administration
(Principal Financial Officer)

Date: November 9, 2005

EXHIBIT 32.01

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

In connection with the Quarterly Report of PDF Solutions, Inc. (the “Company”) on Form 10-Q for the quarter ended September 30, 2005 as filed with the Securities and Exchange Commission on November 9, 2005 (the “Report”), I, John K. Kibarian, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ JOHN K. KIBARIAN

John K. Kibarian
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 9, 2005

EXHIBIT 32.02

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

In connection with the Quarterly Report of PDF Solutions, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2005 as filed with the Securities and Exchange Commission on November 9, 2005 (the "Report"), I, P. Steven Melman, Chief Financial Officer and Vice President of Finance and Administration of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ P. STEVEN MELMAN

P. Steven Melman
Chief Financial Officer and Vice President
of Finance and Administration
(Principal Executive Officer)

Date: November 9, 2005