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 June 30, 2006

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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Act (Check one):

Large accelerated filer ☐ Accelerated filer ☑ Non-accelerated filer ☐

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 August 4, 2006 was 27,392,127

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Item 1. Financial Statements.

PDF SOLUTIONS, INC.
CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(In thousands, except per share amounts)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 39,986	$ 60,506
Short-term investments	29,118	—
Accounts receivable, net of allowances of $254 in 2006 and 2005	20,583	22,082
Prepaid expenses and other current assets	1,864	1,992
Deferred tax assets	726	908
Total current assets	92,277	85,488
Property and equipment, net	3,595	3,328
Goodwill	39,886	39,886
Intangible assets, net	6,785	9,787
Deferred tax assets	1,139	877
Other assets	644	526
Total assets	$ 144,326	$ 139,892
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,443	$ 1,728
Accrued compensation and related benefits	2,091	4,922
Other accrued liabilities	1,399	1,469
Taxes payable	4,744	4,950
Deferred revenue	2,989	2,281
Billings in excess of recognized revenue	80	1,604
Total current liabilities	13,746	16,954
Long-term liabilities	231	257
Total liabilities	13,977	17,211
Stockholders' equity:		
Preferred stock, $0.00015 par value, 5,000 shares authorized: no shares issued and outstanding in 2006 and 2005	—	—
Common stock, $0.00015 par value, 70,000 shares authorized: shares issued and outstanding 26,811 in 2006 and 26,433 in 2005	4	4
Additional paid-in-capital	149,932	141,720
Treasury stock at cost, 551 shares in 2006 and 2005	(5,549)	(5,549)
Deferred stock-based compensation	—	(27)
Accumulated deficit	(14,030)	(13,451)
Accumulated other comprehensive income	(8)	(16)
Total stockholders' equity	130,349	122,681
Total liabilities and stockholders' equity	$ 144,326	$ 139,892

See notes to unaudited consolidated financial statements

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

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Revenue:				
Design-to-silicon-yield solutions				
Integrated solutions	$ 10,477	$ 12,267	$ 22,706	$ 24,824
Software licenses	1,794	3,197	4,406	6,646
Gain share	5,739	2,892	10,755	4,979
Total revenue	18,010	18,356	37,867	36,449
Cost and expenses:				
Cost of design-to-silicon-yield solutions:				
Direct costs of design-to-silicon-yield solutions				
Integrated solutions	6,645(1)	5,766	13,074(1)	11,516
Software licenses	29	101	40	258
Amortization of acquired core technology	1,266	1,266	2,532	2,532
Research and development	6,871(1)	5,687	13,127(1)	11,065
Selling, general and administrative	4,866(1)	4,289	9,822(1)	8,203
Amortization of other acquired intangible assets	235	235	470	470
Total costs and expenses	19,912	17,344	39,065	34,044
Income (loss) from operations	(1,902)	1,012	(1,198)	2,405
Interest and other income, net	811	350	1,446	622
Income (loss) before taxes	(1,091)	1,362	248	3,027
Tax provision (benefit)	(244) (2)	20	827(2)	291
Net income (loss)	$ (847)	$ 1,342	$ (579)	$ 2,736
Net income (loss) per share:				
Basic	$ (0.03)	$ 0.05	$ (0.02)	$ 0.11
Diluted	$ (0.03)	$ 0.05	$ (0.02)	$ 0.10
Weighted average common shares:				
Basic	26,680	25,862	26,611	25,779
Diluted	26,680	26,986	26,611	27,057

(1) Costs and expenses for the three months and for the six months ended June 30, 2006, include SFAS No. 123(R) stock-based compensation expense. See Note 1 and Note 9 to the consolidated financial statements for additional information.

(2) The tax provision (benefit) includes income tax expense from stock-based compensation.

See notes to unaudited consolidated financial statements

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

	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005
Operating activities:		
Net income (loss)	$ (579)	$ 2,736
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,160	1,116
Stock-based compensation	3,954	74
Amortization of acquired intangible assets	3,002	3,002
Tax benefit related to stock-based compensation plans	513	—
Excess tax benefit from stock-based compensation	(265)	—
Deferred taxes	(80)	(644)
Changes in operating assets and liabilities:		
Accounts receivable	1,499	(2,874)
Prepaid expenses and other assets	10	141
Accounts payable	551	728
Accrued compensation and related benefits	(2,831)	(197)
Other accrued liabilities	(70)	(557)
Taxes payable	(206)	727
Deferred revenue	708	44
Billings in excess of recognized revenue	(1,524)	340
Net cash provided by operating activities	5,842	4,636
Investing activities:		
Purchases of available-for-sale securities and other investments	(40,654)	—
Maturities and sales of available-for-sale securities and other investments	11,500	—
Purchases of property and equipment	(1,263)	(1,333)
Net cash used in investing activities	(30,417)	(1,333)
Financing activities:		
Proceeds from exercise of stock options	2,794	2,182
Proceeds from employee stock purchase plan	978	808
Principal payments on long-term obligations	(26)	(22)
Excess tax benefit from stock-based compensation	265	—
Net cash provided by financing activities	4,011	2,968
Effect of exchange rate changes on cash and cash equivalents	44	(69)
Net increase (decrease) in cash and cash equivalents	(20,520)	6,202
Cash and cash equivalents, beginning of period	60,506	45,660
Cash and cash equivalents, end of period	$ 39,986	$ 51,862
Non-cash investing activities:		
Purchase of property and equipment on account	$ 186	$ 176
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Taxes	$ 659	$ 192
Interest	$ 1	$ —

See notes to unaudited consolidated financial statements

PDF SOLUTIONS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

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, 2005.

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, 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.

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 stock-based compensation expense from the prior year has been reclassified to research and development expenses to conform to current-year presentation.

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

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "*Share-Based Payment*" ("SFAS No.123(R)"). The statement eliminates the ability to account for share-based compensation transactions using Accounting Principles Board ("APB") Opinion No. 25, "*Accounting for Stock Issued to Employees*" ("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 based on estimated fair values. SFAS No. 123(R) applies to all share-based payment transactions in which the Company acquires goods or services by issuing its shares, share options, or other equity instruments or by incurring liabilities based on the price of the Company's shares or that require settlement by the issuance of equity instruments. The Company elected to use the modified prospective transition method upon adopting this statement and accordingly prior periods have not been restated to reflect the impact of SFAS No.123(R). Under this transition method, stock-based compensation expense for the first quarter of fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provision of SFAS No. 123, "*Accounting for Stock-Based Compensation*" ("SFAS No. 123"). Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). The Company recognizes the compensation costs of options granted after January 1, 2006 on a straight-line basis over the vesting periods of the applicable stock purchase rights and stock options, generally four years. Prior to adoption of SFAS No. 123(R), the Company presented all tax benefits resulting from stock options as operating cash flow in its statement of cash flows. In accordance with SFAS No. l23(R), the cash flows resulting from excess tax benefits are classified as financing cash flows.

Prior to the adoption of SFAS No. 123(R), the Company accounted for stock-based compensation in accordance with APB No. 25, and complied with the disclosure provisions of SFAS No. 123 as amended by SFAS No. 148, "*Accounting for Stock-Based Compensation — Transition and Disclosures"*. Deferred compensation recognized under APB No. 25 was amortized to expense using the graded vesting method. In March 2005, the Securities and Exchange Commission (the "SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") regarding the SEC's interpretation of SFAS No. 123(R) and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS No. 123(R). See Note 9 to the Unaudited Consolidated Financial Statements for a further discussion on stock-based compensation.

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2. RECENT ACCOUNTING PRONOUNCEMENTS

In November 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which amends SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and Accounting Principle Boards (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. FSP FAS 115-1 and FSP FAS 124-1 provide guidance for determining whether impairments of certain debt and equity investments are deemed other-than-temporary. The provisions of FSP FAS 115-1 and FSP FAS 124-1 are effective for reporting periods beginning after December 15, 2005. The adoption of FSP FAS 115-1 and FAS 124-1 did not have a material effect on the Company's financial position, results of operation or cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109*. This interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a more-likely-than not recognition threshold that a tax position will be sustained upon examination and a measurement attribute for the financial statement recognition of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying the provisions of this Interpretation shall be reported as an adjustment to the opening balance of retained earnings in 2007. The Company is currently evaluating the requirements of FIN 48 and has not yet determined the impact on the consolidated financial statements.

3. INVESTMENTS

The following tables summarize the Company's investments (in thousands):

	June 30, 2006			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Market Value
Commercial paper	$ 32,306	$ —	$ (9)	$ 32,297
Auction rate securities	5,900	—	—	5,900
Corporate bonds and notes	13,389	—	(32)	13,357
Money market funds	13,293	—	—	13,293
	$ 64,888	—	$ (41)	$ 64,847
Included in cash and cash equivalents				$ 35,729
Included in short-term investments				29,118
Total available-for-sale securities				$ 64,847

As of June 30, 2006 all securities held by the Company had a maturity of one year or less.

	June 30, 2005			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Market Value
Money market funds	$ 49,269	$ —	$ —	$ 49,269
Included in cash and cash equivalents				$ 49,269
Included in short-term investments				—
Total available-for-sale securities				$ 49,269

4. ACCOUNTS RECEIVABLE

Accounts receivable include amounts that are unbilled at the end of the period. Unbilled accounts receivable are determined on an individual contract basis and were approximately $5.3 million and $1.8 million at June 30, 2006 and December 31, 2005, respectively.

5. 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 (loss) 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 June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss)	$ (847)	$ 1,342	$ (579)	$ 2,736
Denominator:				
Weighted average common shares outstanding	26,680	25,864	26,611	25,785
Weighted average common shares outstanding subject to repurchase	—	(2)	—	(6)
Denominator for basic calculation	26,680	25,862	26,611	25,779
Weighted average shares subject to repurchase	—	2	—	6
Stock options outstanding	—	1,122	—	1,272
Denominator for diluted computation	26,680	26,986	26,611	27,057
Net income (loss) per share — basic	$ (0.03)	$ 0.05	$ (0.02)	$ 0.11
Net income (loss) per share — diluted	$ (0.03)	$ 0.05	$ (0.02)	$ 0.10

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 June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Common stock options	5,609	1,121	5,604	741

6. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Net income (loss)	$ (847)	$ 1,342	$ (579)	$ 2,736
Unrealized loss on short term investments	(11)	—	(41)	—
Foreign currency translation adjustments	35	(29)	49	(69)
Comprehensive income (loss)	$ (823)	$ 1,313	$ (571)	$ 2,667

7. GOODWILL AND PURCHASED INTANGIBLE ASSETS

SFAS No. 142*, Goodwill and other Intangible Assets,* 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 June 30, 2006 and December 31, 2005 (in thousands):

	December 31, 2005 Net Carrying Amount	Purchase Price Adjustments	Amortization	June 30, 2006 Net Carrying Amount
Goodwill	$ 39,886	$ —	$ —	$ 39,886
Acquired identifiable intangibles:				
Acquired core technology	$ 8,221	$ —	$ (2,532)	$ 5,689
Brand name	833	—	(250)	583
Other acquired intangibles	733	—	(220)	513
Total	$ 9,787	$ —	$ (3,002)	$ 6,785

	December 31, 2004 Net Carrying Amount	Purchase Price Adjustments	Amortization	December 31, 2005 Net Carrying Amount
Goodwill	$ 39,886	$ —	$ —	$ 39,886
Acquired identifiable intangibles:				
Acquired core technology	$ 13,285	$ —	$ (5,064)	$ 8,221
Brand name	1,333	—	(500)	833
Other acquired intangibles	1,173	—	(440)	733
Total	$ 15,791	$ —	$ (6,004)	$ 9,787

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, 2005, the Company completed its annual testing requirements and determined that the carrying value of goodwill had not been impaired.

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

Year Ending December 31,	Amount
2006 (six-month period ending December 31, 2006)	$ 3,002
2007	3,783
Total	$ 6,785

8. 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 June 30,		Six Months Ended June 30,	
Customer	**2006**	**2005**	**2006**	**2005**
A	15%	11%	13%	11%
C	3%	7%	5%	10%
G	2%	11%	7%	12%
J	1%	22%	1%	15%
M	4%	11%	3%	15%
O	13%	3%	11%	3%
P	32%	8%	31%	7%

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

Customer	**June 30, 2006**	**December 31, 2005**
A	14%	5%
J	1%	18%
O	15%	8%
P	33%	25%

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
Asia	$ 8,401	$ 10,178	$ 18,230	$ 22,879
United States	7,621	6,526	16,489	10,074
Europe	1,988	1,652	3,148	3,496
Total	$ 18,010	$ 18,356	$ 37,867	$ 36,449

As of June 30, 2006 and December 31, 2005, long-lived assets related to PDF Solutions GmbH (formerly AISS), located in Germany, totaled $842,000 and $880,000, respectively, of which $659,000 and $659,000, respectively, relates to acquired intangible assets and goodwill. The majority of the Company's remaining long-lived assets are in the United States.

9. STOCKHOLDERS' EQUITY

Effective January 1, 2006 the Company adopted SFAS No. 123(R). As a result, the Company recorded total stock-based compensation and related income tax expense of $1.8 million and $214,000 respectively, for the three months ended June 30, 2006, and $4.0 million and $64,000 respectively, for the six months ended June 30, 2006. The deferred compensation expense computed under APB No. 25 and unamortized as of January 1, 2006 was reversed to equity upon adopting SFAS No. 123(R). For the three and six months ended June 30, 2006, the Company incurred additional stock-based compensation expense of $ 2.0 million and $ 4.0 million respectively, compared to the expense the Company would have incurred under APB No. 25.

For the three and six months ended June 30, 2006 and June 30, 2005, stock-based compensation expense related to the Company's ESPP and stock-option plans was allocated as follows (in thousands):

	Three Months Ended June 30, 2006 (1)	Six Months Ended June 30, 2006 (1)	Three Months Ended June 30, 2005 (2)	Six Months Ended June 30, 2005 (2)
Cost of design-to-silicon yield solutions	$ 455	$ 1,076	$ —	$ —
Research and development	568	1,186	32	74
Selling, general and administrative	764	1,692	—	—
Stock based compensation before income taxes	1,787	3,954	32	74
Income tax expense associated with stock options	214	64	—	—
Stock-based compensation, net of taxes	$ 2,001	$ 4,018	$ 32	$ 74
Effect on net income (loss) per share:				
Basic	$ 0.08	$ 0.15	$ 0.00	$ 0.00
Diluted	$ 0.07	$ 0.14	$ 0.00	$ 0.00

(1) Stock-based compensation expense computed under SFAS No. 123(R)

(2) Stock-based compensation expense computed under APB No.25

Prior to January 1, 2006, the Company accounted for stock-based compensation in accordance with the provisions of APB No. 25 and complied with the disclosure only provisions of SFAS No. 123 as amended by SFAS No. 148, and accordingly, no expense computed under SFAS No. 123 had been recognized for options granted to employees under the various stock plans. Deferred compensation recognized under APB No. 25 was amortized to expense over the vesting period, usually four years, using the graded vesting method. For SFAS No. 123 as amended by SFAS No. 148 disclosure purposes, the Company amortized 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 provided 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 income and pro forma net income per share for the three months and six months ended June 30, 2005 would have been as follows (in thousands, except per share data):

	Three Months Ended June 30, 2005	Six Months Ended June 30, 2005
Net income as reported:	$ 1,342	$ 2,736
Add: stock-based employee compensation expense included in reported net loss under APB No. 25, net of related tax effects	32	74
Deduct: total employee stock-based compensation determined under fair value based method for all awards, net of related tax effects	(1,432)	(2,760)
Pro forma net income (loss)	$ (58)	$ 50
Basic net income (loss) per share:		
As reported	$ 0.05	$ 0.11
Pro forma	$ (0.00)	$ 0.00
Diluted net income per share:		
As reported	$ 0.05	$ 0.10
Pro forma	$ (0.00)	$ 0.00

Upon its adoption of the fair value recognition provisions of SFAS No.123(R), the Company elected to use the modified prospective transition method, and accordingly prior periods have not been restated to reflect the impact of SFAS No. 123(R). Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Under the modified prospective transition method, stock-based compensation expense recognized in the Company's unaudited consolidated statement of income for the three months and the six months ended June 30, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS No. 123, and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123(R). In conjunction with the adoption of SFAS No. 123(R), the Company changed its method of attributing the value of stock-based compensation to expense from the graded vesting method to the straight-line method. Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 will continue to be recognized using the graded vesting method while compensation expense for all share-based payment awards granted subsequent to December 31, 2005 is recognized using the straight-line method. As stock-based compensation expense recognized in the unaudited consolidated statement of income for the three months and six months ended June 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS No. 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred. The Company estimated the forfeiture rate based on its employee turnover history over the last two fiscal years.

The Company has elected to use the Black-Scholes-Merton (BSM) option-pricing model, which incorporates various assumptions including volatility, expected life, and interest rates. The expected volatility is based on the historical volatility of the Company's common stock over the most recent period commensurate with the estimated expected life of the Company's stock options. The expected life of an award is based on historical experience and on the terms and conditions of the stock awards granted to employees. The interest rate assumption is based upon observed Treasury yield curve rates appropriate for the expected life of the Company's stock options.

The assumptions used for the three months and six months ended June 30, 2006 and the resulting estimates of weighted average fair value of options granted and for stock purchases during the period are as follows:

	Stock Plans Three Months Ended June 30, 2006	Employee Stock Purchase Plan Three Months Ended June 30, 2006	Stock Plans Six Months Ended June 30, 2006	Employee Stock Purchase Plan Six Months Ended June 30, 2006
Expected life (in years)	4.26	1.21	4.26	1.21
Volatility	58.1%	49.5%	58.3%	49.5%
Risk-free interest rate	4.94%	3.35%	4.78%	3.35%
Expected dividend	—	—	—	—
Weighted average fair value of options granted during the period	$ 6.93	n/a	$ 7.93	n/a
Weighted average fair value of employee stock	n/a	$ 4.32	n/a	$ 4.32

Stock option activity under the Company plans as of June 30, 2006 and changes during the six months ended June 30, 2006 were as follows:

	Number of Options	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in 000's)
Outstanding, January 1, 2006	5,674,045	$ 11.13		
Granted	310,000	15.75		
Exercised	(274,930)	10.16		
Forfeited or expired	(100,382)	13.90		
Outstanding at June 30, 2006	5,608,733	11.39	7.42	$ 10,949
Exercisable at June 30, 2006	3,134,526	$ 10.14	6.38	$ 8,473

The aggregate intrinsic value in the table above represents the total pretax intrinsic value based on the Company's closing stock price of $12.41 as of June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date.

The total intrinsic value of options exercised during the six months ended June 30, 2006 was $1.9 million.

Nonvested options as of June 30, 2006 and changes during the six months ended June 30, 2006 were as follows:

	Number of Options	Weighted Average Grant Date Fair Value
Nonvested, January 1, 2006	2,796,371	$ 6.94
Granted	310,000	7.93
Vested	(532,096)	6.35
Forfeited	(100,068)	7.51
Nonvested at June 30, 2006	2,474,207	7.17

As of June 30, 2006, there was $8.0 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted average period of 3.13 years. The total fair value of shares vested during the six months ended June 30, 2006 was $3.4 million.

On June 30, 2006, the Company has in effect the following stock-based compensation plans:

Stock Plans — During 2001, the Company terminated the 1996 and 1997 Stock Plans as to future option grants, and adopted the 2001 Stock Plan. Under the 2001 Stock Plan, on January 1 of each year, starting with year 2002, the number of shares in the reserve will increase by the lesser of (i) 3,000,000 shares, (ii) 5% of the outstanding common stock on the last day of the immediately preceding year, or (iii) the number of shares determined by the board of directors. Under the 2001 Stock Plan, the Company may grant options to purchase shares of common stock to employees, directors and consultants at prices not less than the fair market value at the date of grant for incentive stock options and not less than 85% of fair market value for nonstatutory stock options. These options generally expire ten years from the date of grant and become vested and exercisable ratably over a four-year period. Certain option grants under the 1996 and 1997 Stock Plans provide for the immediate exercise by the optionee with the resulting shares issued subject to a right of repurchase by the Company which lapses based on the original vesting provisions.

Employee Stock Purchase Plan — In July 2001, the Company adopted an Employee Stock Purchase Plan, ("Purchase Plan") under which eligible employees can contribute up to 10% of their compensation, as defined in the Purchase Plan, towards the purchase of shares of PDF common stock at a price of 85% of the lower of the fair market value at the beginning of the offering period or the end of each six-month offering period. For the three months ended June 30, 2006, the purchase plan compensation expense was $226,000.

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. As of June 30, 2006, the Company has repurchased 550,521 shares at a weighted average price of $10.08 per share for a total cost of $5.5 million. 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 June 30, 2006, $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 risk factors set forth in Item 1A and set forth at the end of Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2005. 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, throughout 2004, 2005, and into the first half of 2006 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 June 30, 2006 were as follows:

Total revenue for the three months ended June 30, 2006, was $18.0 million, a decrease of 2% compared to the three months ended June 30, 2005. Revenue from Design-to-Silicon-Yield integrated solutions for the three months ended June 30, 2006 decreased 15% to $10.5 million compared to $12.3 million for the three months ended June 30, 2005. This decrease was the result of a slower booking rate for new integrated solution engagements in late 2005 which would have contributed to revenue in 2006 and delays in signing certain new engagements until the second half of the current year, partially offset by an increase in software maintenance revenue. Revenue from Design-to-Silicon-Yield software licenses for the three months ended June 30, 2006 decreased to $1.8 million compared to $3.2 million for the three months ended June 30, 2005. Gain share revenue for the three months ended June 30, 2006 increased to $5.7 million compared to $2.9 million for the three months ended June 30, 2005. 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 a net loss of $847,000 for the three months ended June 30, 2006, compared to a net income of $1.3 million for the three months ended June 30, 2005. The decrease in net income was primarily attributable to an overall $1.8 million increase in stock-based compensation expense recognized and allocated to all functional expense categories as a result of our adoption of SFAS No. 123(R), higher direct cost of integrated solutions, and increased research and development expenses partially offset by a greater tax benefit. Direct cost of Design-to-Silicon-Yield solutions increased 14% to $6.7 million in the three months ended June 30, 2006 from $5.9 million in the comparable period in 2005, primarily as the result of the increase in stock-based compensation expense under SFAS No. 123(R), greater expenses for work performed on expected engagements that were delayed to a subsequent quarter, and the distribution of expanded pdFasTest products. Research and development expenses increased 21% to $6.9 million for the three months ended June 30, 2006, from $5.7 million for the three months ended June 30, 2005, as a result of the increase in stock-based compensation expense under SFAS No. 123(R) and increased use of outside resources on strategic product initiatives. Selling, general and administrative expenses increased to $4.9 million from $4.3 million as a result of the increase in stock-based compensation expense under SFAS No. 123(R) and legal fees, partially offset by lower outside sales commissions and accounting fees. We will continue to monitor and control costs, relative to our revenue growth.

Financial highlights for the six months ended June 30, 2006 were as follows:

Total revenue for the six months ended June 30, 2006, was $37.9 million, an increase of 4% compared to the six months ended June 30, 2005. Revenue from Design-to-Silicon-Yield integrated solutions for the six months ended June 30, 2006 decreased 9% to $22.7 million compared to $24.8 million for the six months ended June 30, 2005. This decrease was the result of a slower booking rate for new integrated solution engagements in late 2005 which would have contributed to revenue in 2006 and delays in signing certain new engagements until the second half of in the current year, and was partially offset by an increase in software maintenance revenue. Revenue from Design-to-Silicon-Yield software licenses for the six months ended June 30, 2006 decreased to $4.4 million compared to $6.6 million for the six months ended June 30, 2005. Gain share revenue for the six months ended June 30, 2006 increased to $10.8 million compared to $5.0 million for the six months ended June 30, 2005. 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 loss of $579,000 for the six months ended June 30, 2006, compared to a net income of $2.7 million for the six months ended June 30, 2005. The decrease in net income was primarily attributable to an overall $4.0 million increase in stock-based compensation expense recognized and allocated to all functional expense categories as a result of our adoption of SFAS No. 123(R), an increase in research and development expenses, and a higher effective tax rate. Direct cost of Design-to-Silicon-Yield solutions increased 11% to $13.1 million in the six months ended June 30, 2006 from $11.8 million in the comparable period in 2005, primarily as the result of the increase in stock-based compensation expense under SFAS No. 123(R), and the distribution of expanded pdFasTest products. Research and development expenses increased 19% to $13.1 million for the six months ended June 30, 2006, from $11.1 million for the six months ended June 30, 2005, as a result of the increase in stock-based compensation expense under SFAS No. 123(R) and increased personnel-related and third party developer expenses. Selling, general and administrative expenses increased to $9.8 million from $8.2 million as a result of the increase in stock-based compensation expense under SFAS No. 123(R), increased personnel-related expenses, and increased legal expenses, partially offset by lower outside sales commissions. We will continue to monitor and control costs, relative to our revenue growth.

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. Our continued receipt of 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 June 30, 2006, we had $46.7 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. We evaluate goodwill for impairment pursuant to the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. As of December 31, 2005, 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.

Stock-Based Compensation

Effective January 1, 2006, we adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123 (revised 2004), "*Share-Based Payment*" ("SFAS No.123(R)"). The statement eliminates the ability to account for share-based compensation transactions using Accounting Principles Board ("APB") Opinion No. 25, "*Accounting for Stock Issued to Employees*" ("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 based on estimated fair values. SFAS No. 123(R) applies to all share-based payment transactions in which we acquire goods or services by issuing our shares, share options, or other equity instruments or by incurring liabilities based on the price of our shares or that require settlement by the issuance of equity instruments. We elected to use the modified prospective transition method upon adopting this statement and accordingly prior periods have not been restated to reflect the impact of SFAS No.123(R). Under this transition method, stock-based compensation expense for the first quarter of fiscal 2006 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provision of SFAS No. 123, "*Accounting for Stock-Based Compensation*" ("SFAS No. 123"). Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). We recognize the compensation costs of options granted after January 1, 2006 on a straight-line basis over the vesting periods of the applicable stock purchase rights and stock options, generally four years. Prior to adoption of SFAS No. 123(R), we presented all tax benefits resulting from stock options as operating cash flow in our statement of cash flows. In accordance with SFAS No. l23(R), the cash flows resulting from excess tax benefits are classified as financing cash flows.

Prior to the adoption of SFAS No. 123(R), we accounted for stock-based compensation in accordance with APB No. 25, and complied with the disclosure provisions of SFAS No. 123 as amended by SFAS No. 148, "*Accounting for Stock-Based Compensation — Transition and Disclosures*". Deferred compensation recognized under APB No. 25 was amortized to expense using the graded vesting method. In March 2005, the Securities and Exchange Commission (the "SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") regarding the SEC's interpretation of SFAS No. 123(R) and the valuation of share-based payments for public companies. We have applied the provisions of SAB 107 in its adoption of SFAS No. 123(R). See Note 9 to the Unaudited Consolidated Financial Statements for a further discussion on stock-based compensation.

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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 June 30,		Six Months Ended June 30,	
	2006	2005	2006	2005
Revenue:				
Design-to-silicon-yield solutions				
Integrated solutions	58%	67%	60%	68%
Software licenses	10	17	12	18
Gain share	32	16	28	14
Total revenue	100	100	100	100
Cost and expenses:				
Cost of design-to-silicon-yield solutions:				
Direct costs of design-to-silicon-yield solutions				
Integrated solutions	37	31	35	32
Software licenses	—	1	—	1
Amortization of acquired core technology	7	7	7	7
Research and development	39	31	35	30
Selling, general and administrative	27	23	26	23
Amortization of other acquired intangible assets	1	1	1	1
Total costs and expenses	111	94	104	94
Income (loss) from operations	(11)	6	(4)	6
Interest and other income, net	5	2	4	2
Income (loss) before taxes	(6)	8	—	8
Tax provision (benefit)	(1)	—	2	1
Net income (loss)	(5)%	8%	(2)%	7%

Comparison of the Three Months Ended June 30, 2006 and 2005

Revenue	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	$ Change	% Change	Three Months Ended June 30, 2006 % of Revenue	Three Months Ended June 30, 2005 % of Revenue
(In thousands, except for %'s)						
Design-to-silicon-yield solutions						
Integrated solutions	$ 10,477	$ 12,267	$ (1,790)	(15)%	58%	67%
Software licenses	1,794	3,197	(1,403)	(44)%	10%	17%
Gain share	5,739	2,892	2,847	98%	32%	16%
Total	$ 18,010	$ 18,356	$ (346)	(2)%	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 decrease in integrated solutions revenue of $1.8 million for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was primarily attributable to a slower booking rate for new integrated solution engagements in late 2005 which would have contributed to revenue in 2006 and delays in signing certain new engagements until the second half of the current year, and was partially offset by an increase in software maintenance revenue. 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 and our ability to estimate costs associated with such contracts.

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Software licenses. The decrease in software licenses revenue of $1.4 million for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was due to a decrease in the number of license seats sold versus the comparable period in 2005 that included one very significant license agreement. 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 $2.8 million for the three months ended June 30, 2006 compared to the three months ended June 30, 2005, a representation of the value our technology continues to deliver to our customers, for the most part, after our solution implementations are complete. 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. Our continued receipt of 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 June 30, 2006	Three Months Ended June 30, 2005	$ Change	% Change	Three Months Ended June 30, 2006 % of Revenue	Three Months Ended June 30, 2005 % of Revenue
(In thousands, except for %'s)						
Direct costs of design-to-silicon- yield solutions Integrated solutions	$ 6,645	$ 5,766	$ 879	15%	37%	31%
Software licenses	29	101	(72)	(71)%	—	1%
Amortization of acquired core technology	1,266	1,266	—	—	7%	7%
Total	$ 7,940	$ 7,133	$ 807	11%	44%	39%

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 $879,000 for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was primarily attributable to the increase of $455,000 in stock-based compensation expense under SFAS No. 123(R), greater expenses for work performed on expected engagements that were delayed to a subsequent quarter, and the distribution of expanded pdFasTest products. 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 decrease in direct costs of Design-to-Silicon-Yield solutions software licenses of $72,000 for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was attributable to a decrease in third party software license fees and royalties resulting from decreased license seat sales. 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 June 30, 2006 and the three months ended June 30, 2005. We anticipate amortization of acquired core technology to be $2.5 million for the remaining six months in 2006 and $3.2 million in 2007.

Research and Development	Three Months Ended June 30, 2006	2005	$ Change	% Change	Three Months Ended June 30, 2006 % of Revenue	2005 % of Revenue
(In thousands, except for %'s)						
Research and development	$ 6,871	$ 5,687	$ 1,184	21%	39%	31%

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 $1.2 million for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was primarily due to the increase of $536,000 in stock-based compensation expense under SFAS No. 123(R) and increased use of outside resources on strategic product initiatives. 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 June 30, 2006	2005	$ Change	% Change	Three Months Ended June 30, 2006 % of Revenue	2005 % of Revenue
(In thousands, except for %'s)						
Selling, general and administrative	$ 4,866	$ 4,289	$ 577	13%	27%	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 $577,000 for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was primarily due to the increase of $764,000 in stock-based compensation expense under SFAS No. 123(R) and higher legal fees, partially offset by a decrease in outside sales commissions and accounting fees. We expect that selling, general and administrative expenses will increase in absolute dollars to support increased selling and administrative efforts in the future.

Amortization of Other Acquired Intangible Assets	Three Months Ended June 30, 2006	2005	$ Change	% Change	Three Months Ended June 30, 2006 % of Revenue	2005 % of Revenue
(In thousands, except for %'s)						
Amortization of Other Acquired Intangible Assets	$ 235	$ 235	—	—	1%	1%

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 remained unchanged at $235,000 for the three months ended June 30, 2006 and the three months ended June 30, 2005. We anticipate amortization of these other acquired intangible assets to continue to decrease in future periods.

Interest and Other Income, net	Three Months Ended June 30, 2006	2005	$ Change	% Change	Three Months Ended June 30, 2006 % of Revenue	2005 % of Revenue
(In thousands, except for %'s)						
Interest and Other Income, net	$ 811	$ 350	$ 461	132%	5%	2%

Interest and Other Income, Net. The increase in interest and other income, net of $461,000 for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was primarily due to increased interest earned on higher average cash and cash equivalent balances and short term investments during the period coupled with higher interest rates earned during the period.

Provision/(Benefit)it) for Income Taxes	Three Months Ended June 30, 2006	Three Months Ended June 30, 2005	$ Change	% Change	Three Months Ended June 30, 2006 % of Revenue	Three Months Ended June 30, 2005 % of Revenue
(In thousands, except for %'s)						
Provision (Benefit) for Income Tax	$ (244)	$ 20	$ (264)	(1,320)%	(1)%	—

Provision/(Benefit) for Income Taxes. The decrease in the tax provision of $264,000 for the three months ended June 30, 2006 compared to the three months ended June 30, 2005 was primarily due to the decrease in taxable operating income and the higher effective tax rate resulting from the Federal government's delay in passing certain tax credits applicable for 2006.

Comparison of the Six Months Ended June 30, 2006 and 2005

Revenue	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005	$ Change	% Change	Six Months Ended June 30, 2006 % of Revenue	Six Months Ended June 30, 2005 % of Revenue
(In thousands, except for %'s)						
Design-to-silicon-yield solutions						
Integrated solutions	$ 22,706	$ 24,824	$ (2,118)	(9)%	60%	68%
Software licenses	4,406	6,646	(2,240)	(34)%	12%	18%
Gain share	10,755	4,979	5,776	116%	28%	14%
Total	$ 37,867	$ 36,449	$ 1,418	4%	100%	100%

Design-to-Silicon-Yield Solutions.

Integrated solutions. The decrease in integrated solutions revenue of $2.1 million for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was attributable to a slower booking rate for new integrated solution engagements in late 2005 which would have contributed to revenue in 2005 and delays in signing certain new engagements until the second half of the current year, and was partially offset by an increase in software maintenance revenue.

Software licenses. The decrease in software licenses revenue of $2.2 million for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was due to a decrease in the number of license seats sold versus the comparable period in 2005 that included one very significant license agreement.

Gain Share. Gain share revenue increased $5.8 million for the six months ended June 30, 2006 compared to the six months ended June 30, 2005. 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	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005	$ Change	% Change	Six Months Ended June 30, 2006 % of Revenue	Six Months Ended June 30, 2005 % of Revenue
(In thousands, except for %'s)						
Direct costs of design-to-silicon- yield solutions						
Integrated solutions	$ 13,074	$ 11,516	$ 1,558	14%	35%	32%
Software licenses	40	258	(218)	(84)%	—	1%
Amortization of acquired core technology	2,532	2,532	—	—	7%	7%
Total	$ 15,646	$ 14,306	$ 1,340	9%	42%	40%

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

Integrated solutions. The increase in direct costs of Design-to-Silicon-Yield integrated solutions of $1.6 million for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was primarily attributable to the increase of $1.1 million in stock-based compensation expense under SFAS No. 123(R), greater expenses for work performed on expected engagements that were delayed to a subsequent quarter, and the distribution of expanded pdFasTest products.

Software Licenses. The decrease in direct costs of Design-to-Silicon-Yield solutions software licenses of $218,000 for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was primarily attributable to a decrease in third party software license fees and royalties resulting from decreased license seat sales..

Amortization of Acquired Core Technology. The amortization of acquired core technology expense remained unchanged at $2.5 million for both the six months ended June 30, 2006 and the six months ended June 30, 2005.

Research and Development	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005	$ Change	% Change	Six Months Ended June 30, 2006 % of Revenue	Six Months Ended June 30, 2005 % of Revenue
(In thousands, except for %'s)						
Research and development	$ 13,127	$ 11,065	$ 2,062	19%	35%	30%

Research and Development. The increase in research and development expenses of $2.1 million for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was primarily due to the increase of $1.1 million in stock-based compensation expense under SFAS No. 123(R), and increased personnel-related and third party developer expenses.

Selling, General and Administrative	Six Months Ended June 30, 2006	Six Months Ended June 30, 2005	$ Change	% Change	Six Months Ended June 30, 2006 % of Revenue	Six Months Ended June 30, 2005 % of Revenue
(In thousands, except for %'s)						
Selling, general and administrative	$ 9,822	$ 8,203	$ 1,619	20%	26%	23%

Selling, General and Administrative. The increase in selling, general and administrative expenses of $1.6 million for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was primarily due to the increase of $1.7 million in stock-based compensation expense under SFAS No. 123(R), increased personnel-related expenses, and higher legal and accounting fees, partially offset by a decrease in outside sales commissions.

Amortization of Other Acquired Intangible Assets	Six Months Ended June 30, 2006	2005	$ Change	% Change	Six Months Ended June 30, 2006 % of Revenue	2005 % of Revenue
(In thousands, except for %'s)						
Amortization of Other Acquired Intangible Assets	$ 470	$ 470	—	—	1%	1%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets remained unchanged at $470,000 for the six months ended June 30, 2006 and the six months ended June 30, 2005

Interest and Other Income, net	Six Months Ended June 30, 2006	2005	$ Change	% Change	Six Months Ended June 30, 2006 % of Revenue	2005 % of Revenue
(In thousands, except for %'s)						
Interest and Other Income, net	$ 1,446	$ 622	$ 824	132%	4%	2%

Interest and Other Income, Net. The increase in interest and other income, net of $824,000 for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was primarily attributable to increased interest earned on higher average cash and cash equivalent balances and short term investments during the period coupled with higher interest rates earned during the period.

Provision for Income Taxes	Six Months Ended June 30, 2006	2005	$ Change	% Change	Six Months Ended June 30, 2006 % of Revenue	2005 % of Revenue
(In thousands, except for %'s)						
Provision for Income Tax	$ 827	$ 291	$ 536	184%	2%	1%

Provision for Income Taxes. The increase in the tax provision of $536,000 for the six months ended June 30, 2006 compared to the six months ended June 30, 2005 was primarily due to a higher tax rate as a result of an increase in non tax deductible stock-based compensation expense and the Federal government's delay in passing certain tax credits for 2006.

Liquidity and Capital Resources

Net cash provided by operating activities was $5.8 million for the six months ended June 30, 2006 compared to net cash provided by operating activities of $4.6 million for the six months ended June 30, 2005. After adjusting the net loss of $579,000 by the amortization of acquired intangible assets of $3.0 million, depreciation and amortization of $1.2 million, stock-based compensation of $4.0 million, the increase in deferred taxes of $80,000, the tax benefit related to stock-based compensation plans of $513,000, and the excess tax benefit from stock-based compensation of $265,000, our adjusted results provided approximately $7.7 million in cash. Net cash was also provided by decreases in account receivables of $1.5 million, prepaid expenses and other assets of $10,000 and increases in accounts payable of $551,000, and deferred revenue of $708,000, offset by a decrease in accrued compensation and related benefits of $2.8 million, accrued liabilities of $70,000, billings in excess of revenue recognized of $1.5 million, and taxes payable of $206,000. The decrease in accounts receivable and in billings in excess of revenue recognized was due to decreased revenues during the period as well as the timing of billing milestones specified in the contract agreements. The increase in accounts payable was due to the timing of vendor payments coupled with moderate increases in our operating activities. The increase in deferred revenue was primarily the result of renewals of software support and maintenance contracts. The decrease in accrued compensation and related benefits was primarily the result of payments made associated with employee variable compensation. The decrease in taxes payable was primarily due to the decrease in taxable income and tax payments made during the period.

Net cash used in investing activities was $30.4 million for the six months ended June 30, 2006 compared to $1.3 million for the six months ended June 30, 2005. The increase in net cash used in investing activities was primarily due to purchases of short-term investments and property and equipment to support our growing operations. Short-term investments totaled $29.1 million at June 30, 2006.

Net cash provided by financing activities was $4.0 million for the six months ended June 30, 2006 compared to $3.0 million for the six months ended June 30, 2005. Net cash provided by financing activities during the six months ended June 30, 2006 primarily consisted of $2.8 million in proceeds from the exercise of employee stock options, $978,000 in proceeds from the issuance of shares under the Employee Stock Purchase Plan and $265,000 in excess tax benefit derived from stock-based compensation. Net cash provided by financing activities during the six months ended June 30, 2005 primarily consisted of proceeds from the exercise of employee stock options of $2.2 million and proceeds from the issuance of shares under the Employee Stock Purchase Plan of $808,000.

As of June 30, 2006, our working capital was $78.5 million, compared with $68.5 million as of December 31, 2005. Cash and cash equivalents, and short term investments as of June 30, 2006 were $69.1 million compared to $60.5 million as of December 31, 2005, an increase of $8.6 million. Increases in cash and short term investments were primarily attributable to operating activities and proceeds from the exercise of stock options. 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 June 30, 2006, we had no foreign currency contracts outstanding.

We lease our facilities under operating lease agreements that expire at various dates through 2011. The following table represents our future minimum annual lease payments (in thousands):

Year Ending December 31,	Amount
2006 (remaining six months)	$ 1,339
2007	2,481
2008	466
2009	150
2010	148
Thereafter	141
Total	$ 4,725

Recent Accounting Pronouncements

In November 2005, the FASB issued FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments*, which amends SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, SFAS No. 124, *Accounting for Certain Investments Held by Not-for-Profit Organizations*, and Accounting Principle Boards (APB) Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*. FSP FAS 115-1 and FSP FAS 124-1 provide guidance for determining whether impairments of certain debt and equity investments are deemed other-than-temporary. The provisions of FSP FAS 115-1 and FSP FAS 124-1 are effective for reporting periods beginning after December 15, 2005. The adoption of FSP FAS 115-1 and FAS 124-1 did not have a material effect on our financial position, results of operation or cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48 (FIN 48), *Accounting for Uncertainty in Income Taxes — an interpretation of FASB Statement No. 109*. This interpretation clarifies the accounting for uncertainty in income taxes recognized in accordance with SFAS No. 109, *Accounting for Income Taxes*. This Interpretation prescribes a more-likely-than not recognition threshold that a tax position will be sustained upon examination and a measurement attribute for the financial statement recognition of a tax position taken or expected to be taken in a tax return. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This Interpretation is effective for fiscal years beginning after December 15, 2006. The cumulative effect of applying the provisions of this Interpretation shall be reported as an adjustment to the opening balance of retained earnings in 2007. We are currently evaluating the requirements of FIN 48 and have not yet determined the impact on the consolidated financial statements.

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 June 30, 2006, we had cash and cash equivalents and short term investments of $69.1 million. Cash and cash equivalents consisted of cash, highly liquid money market instruments and commercial paper with maturities of 90 days or less. Short-term investments consisted of debt securities with maturities of more than three months but less than twelve months. 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 100 basis points from the market rates in effect at June 30, 2006 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 (i) recorded, processed, summarized and reported within the timeframes specified in the SEC’s rules and forms, and (ii) is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

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 1A. Risk Factors

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.

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 six months ended June 30, 2006, three customers accounted for 55% of our total net revenue, with IBM representing 31%, Toshiba representing 13%, and Chartered Semiconductor representing 11%, respectively. In the six months ended June 30, 2005, five customers accounted for 63% of our total net revenue, with Texas Instruments representing 15%, Hiroshima Elpida Memory representing 15%, Matsushita representing 12%, Toshiba representing 11%, and Sony 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.

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 on which our global operations depend. Further, physical damage to, failure of, or digital damage (such as significant viruses or worms) to, our information systems could disrupt and 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 effectively 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.

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.

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, unless we also establish lower cost non- domestic operations, 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 or prediction software such as Knights Technology (a part of FEI Company), Ponte Solutions, Predictions Software, Syntricity, Spotfire and 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. In addition, Synopsys, Inc. now appears to offer directly competing DFM capability, while other EDA suppliers provide alternative DFM solutions that may compete for the same budgetary funds. If these potential competitors are able to attract industry partners or customers faster than we can or change the pricing environment, 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 48% of total revenue in the six months ended June 30, 2006. During the six months ended June 30, 2005 revenue generated from customers in Asia was 63% of total revenue. We expect that a significant portion of our total future revenue will continue to be derived from companies based in Asia. In addition, we have expanded our non-U.S. operations recently and plan to continue such expansion by establishing overseas subsidiaries, offices, or contractor relationships in locations, and when, deemed appropriate by our management. The success of our business is subject to risks inherent in doing business internationally, including third-party vendors that provide certain software quality assurance and other services that have operations in the Middle East. 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 and it may be difficult for us to recruit and retain qualified technical and managerial employees in foreign offices;
- 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, increasing the difficulty of managing multiple, remote locations performing various development, quality assurance, and yield ramp analysis projects;
- compliance with, and unexpected changes in, a wide variety of foreign laws and regulatory environments with which we are not familiar, including, among other issues, with respect to protection of our intellectual property, and a wide variety of trade and export controls under domestic, foreign, and international law;
- 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;
- quarantine, private travel limitation, or business disruption in regions affecting our operations, stemming from actual, imminent or perceived outbreak of human pandemic or contagious disease;
- 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, including but not limited to armed conflict, terrorism, and the resulting disruption to economic activity and business operations.

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; and
- 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.

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 that 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.

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 on a GAAP basis in prior quarters, we have experienced losses in the past and in the current quarter. We may not achieve and thereafter 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 $14.0 million as of June 30, 2006. 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.

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.

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, and 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 control over financial reporting.

Pursuant to Section 404 of the Sarbanes-Oxley Act, we are required to furnish a report on our management's assessment of the design and effectiveness of our system of internal control over financial reporting as part of our Annual Report on Form 10-K. Our auditors are also required to attest to, and report on, our management's assessment. In order to issue their report, our management is required to document both the design of our system of internal controls and our testing processes that support our management's evaluation and conclusion. While our management and independent auditors have been able to conclude that our internal control over financial reporting has been effective in each of the last two years, 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 harm 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, 2006 and beyond, that we maintain effective internal controls, our investors could lose confidence in the accuracy and completeness of our financial reports that in turn could cause our stock price to decline.

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

Technology companies have, in general, and our company has, in particular, 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, the Financial Accounting Standards Board ("FASB") released Statement of Financial Accounting Standard No. 123(R), *Share-Based Payments* ("SFAS No. 123(R)"), which requires 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) are effective for us beginning January 1, 2006. Upon adopting SFAS No. 123(R), we recorded a stock-based compensation expense of $4.0 million in the six months ended June 30, 2006, and we believe that our adoption of SFAS No. 123(R) will continue to have a significant negative 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 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.

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 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, 2005, 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 six months ended June 30, 2006:

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares (or Units) Purchased	Average Price Paid Per Share (or Unit)	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs(1)
Month #1 (April 1, 2006 through April 30, 2006)	—	—	—	$ 4,451,236
Month #2 (May 1, 2006 through May 31, 2006)	—	—	—	$ 4,451,236
Month #3 (June 1, 2006 through June 30, 2006)	—	—	—	$ 4,451,236
Total	—	—	—	

(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 June 30, 2006, 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 Upon Senior Securities.

Not Applicable.

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

During the quarter ended June 30, 2006, we submitted the following matters to our stockholders for approval at our Annual Meeting of Stockholders held on May 24, 2006 and the following proposals were adopted by our stockholders by the margins indicated:

Proposals:

1. To elect two (2) Class II nominees to the Board of Directors.

Election of Director	Votes For	Votes Withheld
Lucio L. Lanza — Class II Director	23,847,540	573,641
Kimon Michaels, Ph. D. — Class II Director	15,130,099	9,291,082

As a result, Mr. Lanza and Mr. Michaels were re-elected as Class II directors of the Company for a three year term expiring upon the Annual Meeting next following the fiscal year ending December 31, 2008, or until their respective successors have been duly qualified and elected. B.J. Cassin, Albert Y. C. Yu, R. Stephen Heinrichs, Susan Billat and John K. Kibarian continued as directors of the Company.

2. To ratify the appointment by the Audit Committee of Deloitte & Touche LLP as the independent auditors of the Company for the fiscal year ending December 31, 2006.

Votes for	Votes Against	Votes Abstained	Broker Non-votes
24,226,412	194,586	183	0

Item 5. Other Information.

Not Applicable.

Item 6. Exhibits.

Exhibit Number	Description
3.01	Third Amended and Restated Certificate of Incorporation of PDF Solutions, Inc. *
3.02	Amended and Restated Bylaws of PDF Solutions, Inc. †
4.01	Specimen Stock Certificate**
4.02	Second Amended and Restated Rights Agreement dated July 6, 2001*
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 Report on Form 10-Q filed August 9, 2005 (File No. 000-31311).

* 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.

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: August 9, 2006	By: /s/ JOHN K. KIBARIAN John K. Kibarian President and Chief Executive Officer
	By: /s/ KEITH A. JONES Keith A. Jones Chief Financial Officer and Vice President of Finance

EXHIBIT INDEX

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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: August 9, 2006

EXHIBIT 31.02

CERTIFICATIONS

I, Keith A. Jones, 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/ KEITH A. JONES

Keith A. Jones
Chief Financial Officer and Vice President of Finance
(Principal Financial Officer)

Date: August 9, 2006

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 June 30, 2006 as filed with the Securities and Exchange Commission on August 9, 2006 (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: August 9, 2006

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 June 30, 2006 as filed with the Securities and Exchange Commission on August 9, 2006 (the "Report"), I, Keith A. Jones, Chief Financial Officer and Vice President of Finance 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/ KEITH A. JONES

Keith A. Jones
Chief Financial Officer and Vice President of Finance
(Principal Financial Officer)

Date: August 9, 2006