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

FORM 10-Q

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

For the Quarterly Period ended September 30, 2008

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, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐ Accelerated filer ☑ Non-accelerated filer ☐ (Do not check if a smaller reporting company) Smaller reporting company ☐

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

The number of shares outstanding of the Registrant's Common Stock as of October 31, 2008 was 27,582,940.

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Item 1. Financial Statements.

PDF SOLUTIONS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	September 30, 2008	December 31, 2007
	(In thousands, except par values)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 27,026	$ 35,315
Short-term investments	15,178	9,949
Accounts receivable, net of allowance of $254 in 2008 and 2007	33,355	38,526
Prepaid expenses and other current assets	5,543	5,030
Total current assets	81,102	88,820
Property and equipment, net	3,049	3,621
Non-current investments	841	—
Goodwill	64,103	65,170
Intangible assets, net	10,342	12,818
Deferred tax assets and other non-current assets	600	8,922
Total assets	$ 160,037	$ 179,351
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 393	$ 421
Accounts payable	1,810	3,469
Accrued compensation and related benefits	5,874	5,950
Other accrued liabilities	2,292	2,604
Taxes payable	31	208
Deferred revenue	2,966	3,159
Billings in excess of recognized revenue	115	553
Total current liabilities	13,481	16,364
Long-term debt	550	907
Long-term taxes payable	3,339	5,581
Other liabilities	1,295	29
Total liabilities	18,665	22,881
Stockholders' equity:		
Preferred stock, $0.00015 par value, 5,000 shares authorized: no shares issued and outstanding	—	—
Common stock, $0.00015 par value, 70,000 shares authorized: shares issued 29,331 in 2008 and 29,122 in 2007; shares outstanding 27,580 in 2008 and 27,933 in 2007	4	4
Additional paid-in-capital	187,373	181,566
Treasury stock at cost, 1,751 shares in 2008 and 1,190 shares in 2007	(14,632)	(11,524)
Accumulated deficit	(33,569)	(16,892)
Accumulated other comprehensive income	2,196	3,316
Total stockholders' equity	141,372	156,470
Total liabilities and stockholders' equity	$ 160,037	$ 179,351

See notes to unaudited condensed consolidated financial statements

PDF SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
	(In thousands, except per share amounts)			
Revenues:				
Design-to-silicon-yield solutions	$ 13,348	$ 17,261	$ 43,824	$ 52,318
Gainshare performance incentives	5,417	6,807	16,402	17,590
Total revenues	18,765	24,068	60,226	69,908
Cost of design-to-silicon-yield solutions:				
Direct costs of design-to-silicon-yield solutions	7,152	8,100	22,185	22,976
Amortization of acquired technology	631	1,331	1,893	4,516
Total cost of design-to silicon-yield solutions	7,783	9,431	24,078	27,492
Gross margin	10,982	14,637	36,148	42,416
Operating expenses:				
Research and development	7,835	9,008	26,045	26,175
Selling, general and administrative	5,401	5,789	17,346	18,278
Amortization of other acquired intangible assets	194	985	583	3,029
Restructuring charges	—	—	1,471	—
Total operating expenses	13,430	15,782	45,445	47,482
Loss from operations	(2,448)	(1,145)	(9,297)	(5,066)
Interest and other income (loss), net	(343)	322	397	1,347
Loss before taxes	(2,791)	(823)	(8,900)	(3,719)
Income tax provision	9,433	116	7,777	276
Net loss	$ (12,224)	$ (939)	$ (16,677)	$ (3,995)
Net loss per share — basic and diluted	$ (0.44)	$ (0.03)	$ (0.60)	$ (0.14)
Weighted average common shares — basic and diluted	27,540	28,223	27,663	28,127

See notes to unaudited condensed consolidated financial statements

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

	Nine Months Ended September 30, 2008	2007
	(In thousands)	
Operating activities:		
Net loss	$ (16,677)	$ (3,995)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	1,447	1,513
Stock-based compensation expense	5,450	5,453
Losses on sale of investment security and disposal of fixed assets	450	—
Amortization of acquired intangible assets	2,476	7,594
Tax benefit related to stock-based compensation expense	—	223
Excess tax benefit from stock-based compensation expense	—	(43)
Deferred taxes	8,446	(3,706)
Changes in operating assets and liabilities, net of effect of acquisition:		
Accounts receivable	5,213	(5,034)
Prepaid expenses and other assets	189	11
Accounts payable	(1,638)	(1,081)
Accrued compensation and related benefits	(28)	662
Other accrued liabilities	983	(489)
Taxes payable	(2,496)	3,815
Deferred revenues	(232)	516
Billings in excess of recognized revenue	(438)	206
Net cash provided by operating activities	3,145	5,645
Investing activities:		
Purchases of available-for-sale securities	(27,094)	(20,840)
Maturities and sales of available-for-sale securities	20,665	26,221
Purchases of property and equipment	(1,007)	(1,654)
Payments on business acquired, net of cash acquired	—	(4,584)
Net cash used in investing activities	(7,436)	(857)
Financing activities:		
Proceeds from exercise of stock options	63	1,337
Proceeds from employee stock purchase plan	590	782
Purchases of treasury stock	(3,108)	(4,452)
Principal payments on long-term obligations	(361)	(267)
Principal payments on notes to stockholders	—	(416)
Excess tax benefit from stock-based compensation expense	—	43
Net cash used in financing activities	(2,816)	(2,973)
Effect of exchange rate changes on cash	(1,182)	195
Net increase (decrease) in cash and cash equivalents	(8,289)	2,010
Cash and cash equivalents, beginning of period	35,315	36,451
Cash and cash equivalents, end of period	$ 27,026	$ 38,461
Non-cash investing and financing activities:		
Stock issued for business acquired	$ —	$ 2,874
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Taxes	$ 1,837	$ 518
Interest	$ 31	$ 36

See notes to unaudited condensed consolidated financial statements

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

1. BASIS OF PRESENTATION

Basis of Presentation

The interim unaudited condensed consolidated financial statements included herein have been prepared by PDF Solutions, Inc., or the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, or the 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 interim unaudited condensed consolidated financial statements reflect, in the opinion of management, a fair statement of results for the interim periods presented taking into account all adjustments necessary (consisting only of normal recurring adjustments). The operating results for any interim period are not necessarily indicative of the results that may be expected for other interim periods or the full fiscal year. The accompanying interim unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

The preparation of the condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. 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 condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries after the elimination of all significant intercompany balances and transactions.

The Company has chosen to replace the term "Integrated Solutions" with "Services" and "Gain Share" with "Gainshare Performance Incentives" in its condensed consolidated statements of operations to better describe the arrangements provided to its customers. Furthermore, the Company opted to combine "Services" revenue and "Software Licenses" revenue into one line item "Design-to-Silicon-Yield Solutions" in its condensed consolidated statements of operations.

Revenue Recognition

The Company derives revenue from two sources: Design-to-Silicon-Yield Solutions, which includes Services and Software Licenses, and Gainshare Performance Incentives. The Company recognizes revenue in accordance with the provisions of American Institute of Certified Public Accountants Statement of Position, or 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 — Revenue that is derived from Design-to-Silicon-Yield solutions comes from services and software licenses. The Company recognizes revenue for each element of Design-to-Silicon-Yield solutions as follows:

Services — The Company generates a significant portion of its Design-to-Silicon-Yield solutions revenue from fixed-price solution implementation service contracts delivered over a specific period of time. These contracts require accurate estimation of cost to perform obligations and overall scope of each engagement. Revenue under contracts for solution implementation services is recognized as 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 services contracts. In such instances, software products are licensed to customers over a 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, or VSOE, exists for the support and maintenance element, the support and maintenance revenue is recognized separately over the term of the supporting period. The remaining fee is recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting. VSOE for maintenance, in these instances, is generally established based upon a negotiated renewal rate. Under arrangements where software products are licensed as a component of its fixed-price service contract and where VSOE does not exist to allocate a portion of the total fixed-price to the undelivered elements, revenue is recognized for the total fixed-price as the lesser of either the percentage of completion method of contract accounting or 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 related 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 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 are 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. For software license arrangements that do not require significant modification or customization of the underlying software, software license revenue is recognized under the residual method when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, (4) collectibility is probable, and (5) the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for its fixed-price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by the Company's VSOE and such services are recorded as services. 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. 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, and such revenue is recorded as services. No revenue has been recognized for software licenses with extended payment terms in excess of amounts due. For software license arrangements that require significant modification or customization of the underlying software, the software license revenue is recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting, and such revenue is recorded as services.

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

2. RECENT ACCOUNTING PRONOUNCEMENTS AND ACCOUNTING CHANGES

In March 2008, the Financial Accounting Standard Board, or FASB, issued Statement of Financial Accounting Standards, or SFAS, No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, or SFAS No. 161. SFAS No. 161 enhances the disclosure about the Company's derivative and hedging activities. This Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 does not change the accounting treatment for derivative instruments. SFAS No. 161 is effective for the Company beginning in the first quarter of fiscal year 2009. The adoption of SFAS No. 161 is not expected to have a significant impact on the Company's results of operations, cash flow or financial position.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations,* or SFAS No. 141R. SFAS No. 141R establishes principles and requirements for how an acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree, and the goodwill acquired. SFAS No. 141R also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141R is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008, and will be adopted by the Company in the first quarter of fiscal 2009. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS No. 141R on its financial statements.

In December 2007, the SEC issued Staff Accounting Bulletin No. 110, or SAB 110, to amend the SEC's views discussed in SAB 107 regarding the use of the simplified method in developing an estimate of expected life of share options in accordance with SFAS No. 123(R). SAB 110 is effective for the Company beginning in the first quarter of fiscal year 2008. Effective January 1, 2008, the Company adopted the provisions of SAB 110 and determined that it had enough historical data to determine the expected life of its share options, in lieu of using the simplified method.

Effective January 1, 2008, the Company adopted the provisions of the FASB's SFAS No. 157, *Fair Value Measurement,* or SFAS No. 157, for financial assets and liabilities. SFAS No. 157 establishes a framework for measuring fair value and expands disclosures about fair value measurements. Additionally, the statement provides guidance on definition, measurement, methodology and use of assumptions and inputs in determining fair value. The Company applied the provisions of SFAS No. 157 to its financial assets which included its investments accounted for under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. See Note 12 "Fair Value" below. In February 2008, the FASB issued FASB Staff Position, or FSP, 157-1, *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13,* or FSP 157-1, and FSP 157-2, *Effective Date of FASB Statement No. 157*, or FSP 157-2. FSP 157-1 removes certain leasing transactions from the scope of SFAS No. 157. FSP 157-2 delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. The Company is currently evaluating the potential impact, if any, of the adoption of SFAS No. 157 with respect to nonfinancial assets and liabilities on its financial statements. Nonfinancial assets and liabilities for which the Company has not applied the provisions of SFAS No. 157 include those measured at fair value in impairment testing and those initially measured at fair value in a business combination. In October 2008, the FASB issued FSP 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active,* or FSP 157-3. FSP 157-3 provides guidance for the valuation of financial assets in an inactive market, the use of internal assumptions when relevant observable data does not exist, the use of observable market information when the market is not active, and the use of market quotes when assessing the relevance of observable and unobservable data. FSP 157-3 is effective for all periods presented in accordance with SFAS No. 157. The adoption of FAS 157-3 did not have a material impact on the Company's financial results and position.

Effective January 1, 2008, the Company adopted the provisions of the FASB's SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities — Including an amendment of FASB Statement No. 115*, or SFAS No. 159. SFAS No. 159 permits companies to choose to measure at fair value many financial instruments and certain other items that are not currently required to be measured at fair value. Entities choosing the fair value option would be required to recognize subsequent changes in the fair value of those instruments and other items directly in earnings. This standard also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The adoption of SFAS No. 159 did not have an effect on the Company's financial statements as the Company did not elect this fair value option, nor is it expected to have a material impact on future periods as the election of this option for the Company's financial instruments is expected to be limited.

3. INVESTMENTS

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

		September 30, 2008		
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Market Value
Commercial paper	$ 11,687	$ —	$ (10)	$ 11,677
Agency obligations	6,510	—	(8)	6,502
Auction-rate securities	1,000	—	(159)	841
Corporate securities	400	—	(2)	398
	$ 19,597	$ —	$ (179)	$ 19,418
Included in cash and cash equivalents				$ 3,399
Included in short-term investments				15,178
Included in non-current investments				841
Total				$ 19,418

	December 31, 2007			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Market Value
Commercial paper	$ 12,500	$ 3	$ —	$ 12,503
Auction-rate securities	4,450	—	—	4,450
Agency discount notes	1,543	—	—	1,543
	$ 18,493	$ 3	$ —	$ 18,496
Included in cash and cash equivalents				$ 8,547
Included in short-term investments				9,949
Total				$ 18,496

As of September 30, 2008, all securities other than auction-rate securities held by the Company had a maturity of one year or less. As of December 31, 2007, all securities held by the Company had a maturity of one year or less. Please refer to Note 12 “Fair Value” below for further discussion of auction-rate securities.

4. ACCOUNTS RECEIVABLE

Accounts receivable include amounts that are unbilled at the end of the period. Unbilled accounts receivable are determined on an individual contract basis and were approximately $13.0 million and $12.1 million as of September 30, 2008 and December 31, 2007, respectively.

5. NET LOSS PER SHARE

Basic net loss per share is computed by dividing net loss by the weighted average common shares outstanding for the period (excluding outstanding stock options and shares subject to repurchase). Diluted net 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 loss per share (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net loss	$ (12,224)	$ (939)	$ (16,677)	$ (3,995)
Denominator for basic calculation:				
Weighted average common shares outstanding	27,540	28,223	27,663	28,127
Dilutive items				
Stock options outstanding	—	—	—	—
Denominator for diluted computation	27,540	28,223	27,663	28,127
Net loss per share — basic and diluted	$ (0.44)	$ (0.03)	$ (0.60)	$ (0.14)

6. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Net loss	$ (12,224)	$ (939)	$ (16,677)	$ (3,995)
Unrealized gain (loss) on investments, net of income tax effects	(97)	—	(182)	1
Foreign currency translation adjustments, net of income tax effects	(3,002)	1,066	(938)	2,463
Comprehensive income (loss)	$ (15,323)	$ 127	$ (17,797)	$ (1,531)

7. GOODWILL AND ACQUIRED INTANGIBLE ASSETS

SFAS No. 142*, Goodwill and other Intangible Assets,* requires goodwill to be tested for impairment on an annual basis (or more frequently if indicators of impairment exist) and requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite. The Company completed its annual impairment test on December 31, 2007 and concluded that goodwill was not impaired.

The following table provides information relating to the intangible assets and goodwill as of September 30, 2008 and December 31, 2007 (in thousands):

	Amortization Period (Years)	December 31, 2007 Net Carrying Amount	Acquisition	Purchase Price Adjustments	Amortization	Foreign Currency Translation	September 30, 2008 Net Carrying Amount
Goodwill	N/A	$ 65,170	$ —	$ (215)	$ —	$ (852)	$ 64,103
Acquired identifiable intangibles:							
Acquired technology	4-5	$ 9,184	$ —	$ —	$ (1,893)	$ —	$ 7,291
Brand name	4	361	—	—	(96)	—	265
Customer relationships and backlog	6	1,812	—	—	(282)	—	1,530
Patent and applications	7	1,283	—	—	(150)	—	1,133
Other acquired intangibles	4	178	—	—	(55)	—	122
Total		$ 12,818	$ —	$ —	$ (2,476)	$ —	$ 10,342

	Amortization Period (Years)	December 31, 2006 Net Carrying Amount	Acquisition	Purchase Price Adjustments	Amortization	Foreign Currency Translation	December 31, 2007 Net Carrying Amount
Goodwill	N/A	$ 60,034	$ 2,155	$ 6	$ —	$ 2,975	$ 65,170
Acquired identifiable intangibles:							
Acquired technology	4-5	$ 7,901	$ 6,430	$ —	$ (5,147)	$ —	$ 9,184
Brand name	4	822	—	—	(461)	—	361
Customer relationships and backlog	1-6	4,362	—	—	(2,550)	—	1,812
Patent and applications	7	—	1,400	—	(117)	—	1,283
Other acquired intangibles	4	520	—	—	(362)	20	178
Total		$ 13,605	$ 7,830	$ —	$ (8,637)	$ 20	$ 12,818

During the nine months ended September 30, 2008, the Company recorded adjustments to goodwill of $852,000 related to the effect of changes in exchange rates.

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

Year Ending December 31,	Amount
2008 (remaining three-month period)	$ 825
2009	3,296
2010	3,029
2011	1,861
2012	1,048
2013 and thereafter	283
Total	$ 10,342

8. INCOME TAXES

The Company accounts for temporary differences between the book and tax entries by recording deferred tax assets and liabilities in accordance with SFAS No. 109, *Accounting for Income Taxes*, which established financial accounting and reporting standards for the effect of income taxes. The Company must assess the likelihood that its deferred tax assets will be recovered from future taxable income and, to the extent the Company believes that recovery is not likely, the Company must establish a valuation allowance. Changes in the Company's net deferred tax assets, less offsetting valuation allowance, in a period are recorded through the income tax provision in the condensed consolidated statements of operations.

Based on the available objective evidence, both positive and negative, including the recent history of losses, forecasted U.S. pre tax income (loss), and the net operating losses that can be carried back to prior taxable years, management concluded as of September 30, 2008, that it is more likely than not that the Company's net deferred tax assets would not be fully realizable. Accordingly, the Company recorded a valuation allowance of $7.5 million to reduce its net deferred tax assets to the estimated recoverable amount. This change in the Company's valuation allowance was recorded in the income tax provision in the condensed consolidated statements of operations.

The Company's gross unrecognized tax benefits as of September 30, 2008 were $2.8 million, which if recognized, would affect the Company's effective tax rate. As of December 31, 2007, the Company's gross unrecognized tax benefits were $7.9 million, of which $4.1 million, if recognized, would affect the Company's effective tax rate. The change in the effective tax rate impact is related to the Company's position that certain deferred tax assets are no longer more likely than not to be realized.

The Company conducts business globally and, as a result, files numerous consolidated and separate income tax returns in the U.S. federal, various state and foreign jurisdictions. Because the Company used some of the tax attributes carried forward from previous years to tax years that are still open, statutes of limitation remain open for all tax years to the extent of the attributes carried forward into tax year 2001 for federal tax purposes and tax year 2002 for California tax purposes. With few exceptions, the Company is no longer subject to income tax examinations in its major foreign subsidiaries' jurisdictions for years before 2003. During the second fiscal quarter of 2008, the Company received the final German tax authority audit report for the years 2002 through 2004. The Company reviewed the results of the audit, noting no material adjustments to the prior years' tax returns, and as a result, the Company recorded a $205,000 tax benefit related to previously recorded uncertain tax positions and accrued interest.

9. STOCKHOLDERS' EQUITY

The Company accounts for stock-based compensation in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment*. Stock-based compensation expenses before taxes related to the Company's employee stock purchase plan and stock-option plans were allocated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Cost of design-to-silicon yield solutions	$ 453	$ 435	$ 1,383	$ 1,405
Research and development	537	553	1,843	1,731
Selling, general and administrative	723	682	2,224	2,317
Stock-based compensation expenses	$ 1,713	$ 1,670	$ 5,450	$ 5,453

The Company estimated the fair value of share-based payments using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions and weighted average fair values:

Stock Plans:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Expected life (in years)	5.77	6.07	5.77	6.05
Volatility	58.6%	59.4%	58.6%	59.9%
Risk-free interest rate	3.48%	4.88%	3.27%	4.92%
Expected dividend	—	—	—	—
Weighted average fair value of options granted during the period	$ 2.75	$ 7.14	$ 3.13	$ 6.53

Employee Stock Purchase Plan:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Expected life (in years)	1.26	0.25	1.31	0.76
Volatility	69.8%	57.4%	60.8%	52.2%
Risk-free interest rate	2.33%	5.02%	2.80%	5.15%
Expected dividend	—	—	—	—
Weighted average fair value of employee stock issued during the period	$ 2.43	$ 3.14	$ 3.13	$ 4.00

On September 30, 2008, the Company has the following stock-based compensation plans:

Stock Plans — In 2001, the Company terminated the 1996 and 1997 Stock Plans with respect to future option grants, and adopted the 2001 Stock Plan. Under the 2001 Stock Plan, on January 1 of each year starting with year 2002, the number of shares in the reserve will increase by the lesser of (1) 3,000,000 shares, (2) 5% of the outstanding common stock on the last day of the immediately preceding year, or (3) the number of shares determined by the board of directors. Under the 2001 Stock Plan, the Company may grant 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 non-statutory stock options. These options generally expire ten years from the date of grant and become vested and exercisable ratably over a four-year period.

Stock option activity under the Company stock plans as of September 30, 2008 and changes during the nine months ended September 30, 2008 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 at January 1, 2008	8,014,920	$ 11.42		
Granted	659,500	5.60		
Exercised	(12,115)	5.21		
Forfeited or expired	(4,250,993)	13.04		
Outstanding at September 30, 2008	4,411,312	9.02	7.38	$ 297
Vested and expected to vest	4,095,845	9.09	7.24	$ 278
Exercisable at September 30, 2008	2,019,430	9.26	5.46	$ 199

The aggregate intrinsic value in the table above represents the total intrinsic value based on the Company's closing stock price of $5.20 as of September 30, 2008, 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 nine months ended September 30, 2008 was $27,000.

As of September 30, 2008, there was $8.4 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted average period of 2.9 years.

On September 10, 2008, the Company filed a tender offer on Form SC TO-I, or the Offer, with the SEC under which holders of options with exercise prices equal to or greater than $10.00 per share could tender their options in exchange for restricted stock rights granted under the 2001 Stock Plan based upon a 4.2 option shares to 1.0 restricted stock right exchange ratio. Restricted stock rights received in exchange for eligible options are subject to new vesting schedules, ranging from 15 months to 51 months, depending on when stock options exchanged were granted.

The Company completed the Offer on August 18, 2008. As a result, the Company accepted for exchange options to purchase an aggregate of 3,331,557 shares of the Company's common stock from 210 eligible participants, representing 73% of the shares subject to options that were eligible to be exchanged in the Offer as of August 18, 2008. Upon the terms and subject to the conditions set forth in the Offer, the Company issued restricted stock rights covering an aggregate of 793,480 shares of the Company's common stock in exchange for the options surrendered pursuant to the Offer.

The fair value of the restricted stock rights awarded was measured as the total of the unrecognized compensation cost of the original options tendered and the incremental compensation cost of the restricted stock rights awarded on August 18, 2008, the date of cancellation. The incremental compensation cost was measured as the excess of the fair value of the restricted stock rights awards over the fair value of the options immediately before cancellation based on the share price and other pertinent factors at that date. The incremental cost of the 793,480 restricted stock rights awards was $984,000. The unrecognized compensation costs of the tendered options cancelled were $5.9 million. The total fair value of the restricted stock right awarded on August 18, 2008 was $6.8 million and these costs will be amortized over the service period of the restricted stock rights.

Nonvested shares (restricted stock rights) as of September 30, 2008 and changes during the nine months ended September 30, 2008 were as follows:

	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2008	133,000	$ 10.73
Granted	793,480	8.54
Vested	(44,330)	10.73
Forfeited	—	—
Nonvested at September 30, 2008	882,150	8.76

As of September 30, 2008, there was $5.6 million of total unrecognized compensation cost related to restricted stock. That cost is expected to be recognized over a weighted average period of 3.72 years. The total compensation expense related to shares vested during the nine months ended September 30, 2008 was $250,000. As of September 30, 2008, there were 120,000 unvested shares with a total of $625,000 unrecognized compensation cost for non-employees.

Employee Stock Purchase Plan — In July 2001, the Company adopted an Employee Stock Purchase Plan, or the 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 the Company's 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 nine months ended September 30, 2008, the Purchase Plan compensation expense was $370,000.

Stock Repurchase Program — On March 26, 2003, the Company's Board of Directors approved a share repurchase program to purchase up to $10.0 million of its outstanding common stock. The program was completed in August 2007 with 988,000 shares repurchased at the average price of $10.12. On October 29, 2007, the Board of Directors approved a new program to repurchase up to an additional $10.0 million of the Company's common stock on the open market. The right of repurchase stock under this program will expire on October 29, 2010. As of September 30, 2008, 763,000 shares have been repurchased at the average price of $6.07 under this program and $5.4 million remained available for repurchase.

The stock repurchase activity for the nine months ended September 30, 2008 is summarized as follows (in thousands, except per share amounts):

	Shares Repurchased	Weighted-Average Price per Share	Amount Repurchased
Cumulative balance at January 1, 2008	201	$ 7.57	$ 1,523
Repurchase of common stock	562	5.53	3,108
Cumulative balance at September 30, 2008	763	6.07	$ 4,631

10. RESTRUCTURING

On April 29, 2008, the Company announced a restructuring plan in an effort to better allocate its resources to improve its operational results in light of the current market conditions. As a result of this plan, the Company recorded restructuring charges of

$1.5 million during the three months ended June 30, 2008, of which $1.4 million related to employee severance costs and $121,000 related to professional and other fees. The following table summarizes the activities of these restructuring liabilities (in thousands):

Restructuring	Severance	Professional and Others Fees
Balance at January 1, 2008	$ —	$ —
Restructuring charges	1,350	121
Payments	(1,263)	(121)
Balance at September 30, 2008	$ 87	$ 0

The remaining accrual for severance is expected to be paid out in the fourth fiscal quarter of 2008. At September 30, 2008, $87,000 was included in other accrued liabilities.

11. CUSTOMER AND GEOGRAPHIC INFORMATION

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, 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 sole chief operating decision maker or group of decision makers in deciding how to allocate resources and in assessing performance.

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
Customer	2008	2007	2008	2007
A	21%	20%	19%	18%
B	19%	16%	16%	16%
C	4%	10%	5%	9%

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

Customer	September 30, 2008	December 31, 2007
A	29%	27%
B	16%	15%
C	7%	11%

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Asia	$ 10,499	$ 13,792	$ 33,032	$ 37,820
United States	5,307	6,668	16,072	22,377
Europe	2,959	3,608	11,122	9,711
Total	$ 18,765	$ 24,608	$ 60,226	$ 69,908

As of September 30, 2008 and December 31, 2007, long-lived assets related to PDF Solutions S.A.S. (formerly Si Automation S.A.), located in France, totaled $409,000 and $446,000, respectively. The majority of the Company's remaining long-lived assets are in the United States.

12. FAIR VALUE

Effective January 1, 2008, the Company adopted SFAS No. 157 (as impacted by FSP 157-1 and FSP 157-2) with respect to fair value measurements of (1) nonfinancial assets and liabilities that are recognized or disclosed at fair value in the Company's consolidated financial statements on a recurring basis (at least annually) and (2) all financial assets and liabilities. The adoption was limited to financial assets, which primarily relate to cash, cash equivalent, and available-for-sale securities and did not have material impact on the Company's financial condition, results of operations or cash flows.

Under SFAS No. 157, fair value is defined as the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. SFAS No. 157 refers to the multiple assumptions used to value financial instruments as inputs, and establishes hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon its own market assumptions. These inputs are ranked according to a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels.

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

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

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

The following table represents the Company's assets measured at fair value on a recurring basis as of September 30, 2008 and the basis for that measurement (in thousands):

Assets	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market mutual funds	$ 2,025	$ 2,025	$ —	$ —
Commercial paper	11,677	—	11,677	—
Agency obligations	6,502	—	6,502	—
Auction-rate securities	841	—	—	841
Corporate securities	398	—	398	—
Total	$ 21,443	$ 2,025	$ 18,577	$ 841

The Company holds investments in auction-rate securities, or ARS, which are variable rate debt instruments whose interest rates are reset through a "dutch" auction process at regular intervals, typically every 28 days. All ARS are backed by pools of student loans guaranteed by governmental agencies and private entities, and were rated AAA/Aaa or A as of September 30, 2008. The liquidity and fair value of these securities has been reduced by the uncertainty in the credit markets and the exposure of these securities to the financial condition of bond insurance companies, as evidenced by the rating downgrade of MBIA (bond insurer on one of the Company's ARS) from Aaa to A2, by Moody's Investor Services on June 19, 2008. All ARS have failed to sell at auction since February 2008, and as a result, their interest rates were reset to the maximum LIBOR + 150 basis points. The only activity since February 2008 was the repurchase of $500,000 of ARS at par by issuers. As a result of these auction failures, there was limited active market with observable prices for these securities as of September 30, 2008, and therefore the Company computed the fair value of these securities based on a discounted cash flow model, using significant Level 3 inputs, to take into account the lack of liquidity. The Company does not believe that the student loans backing these securities, the principal of these assets, is at risk. Furthermore, the Company is able to hold these securities until the credit markets recover and these securities resume pricing at or near par, and as a result, the Company recorded a temporary impairment to other comprehensive income and classified these securities as non-current assets. The valuation may be revised in future periods as market conditions evolve.

The following represents the reconciliation of the beginning and ending balance of assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the nine months ended September 30, 2008 (in thousands):

	Available-For-Sale Securities
Beginning balance at January 1, 2008	$ —
Total gains and losses (realized / unrealized):	
Included in earnings	—
Included in other comprehensive income	(159)
Purchases, issuances, and settlements	(500)
Transfers, in Level 3	1,500
Ending balance at September 30, 2008	$ 841
The amount of total gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at September 30, 2008	$ —

13. SUBSEQUENT EVENTS

On October 7, 2008, the Company completed a transaction with Triant Holdings Inc. (TSX: TNT), or Triant, a British Columbia corporation and a provider of Fault Detection and Classification technologies, pursuant to which the Company acquired substantially all of the assets, excluding certain receivables, but including certain customer contracts, of Triant's Canadian operating subsidiary. With the purchase, the Company creates additional opportunities for its leading process control solutions within the installed customer base. The purchase price was $1.6 million in cash.

On October 28, 2008, the Company announced a restructuring plan in an effort to better allocate its resources to improve its operational results in light of the current market conditions. As a result of this plan, the Company will incur restructuring charges of approximately $1.6 million primarily related to personnel costs and facility exit costs. The actual amount spent by the Company in connection with the restructuring could be materially different from the initial estimation.

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

Forward-Looking Statements

The following discussion of our financial condition and results of operations contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. In some cases, you can identify forward-looking statements by terminology such as "may," "could," "will," "should," "expect," "plan," "anticipate," "believe," "estimate," "predict," "potential," or "continue," the negative effect of terms like these or other similar expressions. Any statement concerning future financial performance (including future revenues, earnings or growth rates), ongoing business strategies or prospects, and possible actions taken by us or our subsidiaries, which may be provided by us are also forward-looking statements. These forward-looking statements are only predictions. Forward-looking statements are based on current expectations and projections about future events and are inherently subject to a variety of risks and uncertainties, many of which are beyond our control, which could cause actual results to differ materially from those anticipated or projected. All forward-looking statements included in this document are based on information available to us on the date of filing and we further caution investors that our business and financial performance are subject to substantial risks and uncertainties. We assume no obligation to update any such forward-looking statements. In evaluating these statements, you should specifically consider various factors, including the risk factors set forth in Item 1A herein and set forth at the end of Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2007.

Overview

Our technologies and services enable semiconductor companies to improve profitability across the entire "process lifecycle," which is the term we have coined for the time from the design of an integrated circuit, or IC, and design of a manufacturing process for ICs, through that IC's volume manufacturing. Our solutions improve profitability by improving a semiconductor company's time-to-market, increasing yield and reducing total design and manufacturing costs. Our solutions combine proprietary software, physical intellectual property in the form of cell libraries for IC designs, test chips, an electrical wafer test system, proven methodologies, and professional services. We analyze yield loss mechanisms to identify, quantify, and correct the issues that cause yield loss. This drives IC design and manufacturing improvements that enable our customers to optimize the technology development process, increase the initial yield when an IC design first enters a manufacturing line, increase the rate at which yield improves, and minimize excursions and process variability that cause yield loss throughout mass production.

The result of successfully implementing our solutions is the creation of value that can be measured based on improvements to our customers' actual yield. Through our gainshare performance incentives component, we have aligned our financial interests with the yield and performance improvements realized by our customers, and we receive revenue based on this value. Our technologies and services have been sold to 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, under the term 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. AISS now operates as PDF Solutions GmbH, a German company, 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 enhanced our product and service offerings, including increased software applications, through the acquisitions of IDS and WaferYield. In 2006, we further complemented our technology offering by acquiring Si Automation S.A., or SiA, and adding its fault detection and classification software capabilities to our integrated solution. In 2007, we increased our intellectual property solutions portfolio, particularly in logic design technology, through the acquisition of Fabbrix, Inc., or Fabbrix.

Industry Trend

Demand for consumer electronics and communications devices continues to drive technological innovation in the semiconductor industry as the need for products with greater performance, lower power consumption, reduced costs and smaller size continues to grow with each new product generation. In addition, advances in computing systems and mobile devices have fueled demand for higher capacity memory chips. To meet these demands, IC manufacturers and designers are constantly challenged to improve the overall performance of their ICs by designing and manufacturing ICs with more embedded applications to create greater functionality while lowering cost per transistor. As a result, both logic and memory manufacturers have migrated to more and more advanced manufacturing nodes, capable of integrating more devices with higher performance, higher density, and lower power. As this trend continues, companies will continually be challenged to improve process capabilities to optimally produce ICs with minimal random and systematic yield loss, which is driven by the lack of compatibility between the design and its respective manufacturing process. We believe that as volume production of nanometer scale ICs continues to grow, the difficulties of integrating IC designs with their respective processes and ramping new manufacturing processes will create a greater need for products and services that address the yield loss and escalating cost issues the semiconductor industry is facing today and will face in the future.

Financial Highlights

Financial highlights for the three months ended September 30, 2008 were as follows:

- Total revenue for the three months ended September 30, 2008 was $18.8 million, a decrease of $5.3 million, or 22% compared to the three months ended September 30, 2007. Revenue from Design-to-Silicon-Yield solutions for the three months ended September 30, 2008 decreased $3.9 million to $13.3 million from the three months ended September 30, 2007. Revenue from gainshare performance incentives for the three months ended September 30, 2008 decreased $1.4 million to $5.4 million from the three months ended September 30, 2007. The decrease in Design-to-Silicon Yield solutions revenue was primarily the result of lower bookings, as customers have delayed purchases for capacity expansion and investment in leading-edge technology. The dramatic downturn in the semiconductor industry combined with weakness in worldwide economies has been the primary contributors to this shortfall. The decrease in revenue from gainshare performance incentives was primarily the result of reduced volumes in customer manufacturing facilities.

- Net loss for the three months ended September 30, 2008 was $12.2 million, an increase of $11.3 million compared to $939,000 for the three months ended September 30, 2007. The increase in net loss was primarily attributable to the establishment of a valuation allowance against deferred tax assets and decreases in revenue, partially offset by decreases in operating expenses, the result of cost control efforts.

- Net loss per basic and diluted share was $0.44 for the three months ended September 30, 2008 compared to $0.03 for the three months ended September 30, 2007, an increase in net loss of $0.41 per basic and diluted share.

Financial highlights for the nine months ended September 30, 2008 were as follows:

- Total revenue for the nine months ended September 30, 2008 was $60.2 million, a decrease of $9.7 million, or 14% compared to the nine months ended September 30, 2007. Revenue from Design-to-Silicon-Yield solutions for the nine months ended September 30, 2008 decreased $8.5 million to $43.8 million from the nine months ended September 30, 2007. Revenue from gainshare performance incentives for the nine months ended September 30, 2008 decreased $1.2 million to $16.4 million from the nine months ended September 30, 2007. The decrease in revenue for the nine months ended September 30, 2008 was primarily due to the aforementioned circumstances impacting the most recent three months' results.
- Net loss for the nine months ended September 30, 2008 was $16.7 million, increased $12.7 million compared to $4.0 million for the nine months ended September 30, 2007. The increase in net loss was primarily attributable to the establishment of a valuation allowance against deferred tax assets, decreases in revenue, and increased expenses associated with our restructuring plan, partially offset by decreases in operating expenses, the result of such restructuring.
- Net loss per basic and diluted share was $0.60 for the nine months ended September 30, 2008 compared to $0.14 for the nine months ended September 30, 2007, an increase in net loss of $0.46 per basic and diluted share.
- Cash, cash equivalents and investments decreased $2.2 million to $43.0 million during the nine months ended September 30, 2008, primarily due to the repurchase of $3.1 million of our common stock.

Critical Accounting Policies

The SEC's 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. Note 1 to the condensed consolidated financial statements accompanying this Quarterly Report on Form 10-Q includes a summary of the significant accounting policies and methods used in the preparation of our condensed consolidated financial statements. The following is a brief discussion of 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 condensed consolidated financial statements, which have been prepared in conformity with generally accepted accounting principles in the United States of America. Our preparation of these condensed consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The most significant estimates and assumptions relate to revenue recognition, 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, which includes Services and Software Licenses, and Gainshare Performance Incentives. We recognize revenue in accordance with the provisions of American Institute of Certified Public Accountants' Statement of Position, or 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 — Revenue that is derived from Design-to-Silicon-Yield solutions comes from services and software licenses. We recognize revenue for each element of Design-to-Silicon-Yield solutions as follows:

Services — We generate a significant portion of our Design-to-Silicon-Yield solutions revenue from fixed-price solution implementation service contracts delivered over a specific period of time. These contracts require accurate estimation of cost to perform obligations and overall scope of each engagement. Revenue under contracts for solution implementation services is recognized as 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 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 services contracts. In such instances, software products are licensed to customers over a 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, or VSOE, exists for the support and maintenance element, the support and maintenance revenue is recognized separately over the term of the supporting period. The remaining fee is recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting. VSOE for maintenance, in these instances, is generally established based upon a negotiated renewal rate. Under arrangements where software products are licensed as a component of its fixed-price service contract and where VSOE does not exist to allocate a portion of the total fixed-price to the undelivered elements, revenue is recognized for the total fixed-price as the lesser of either the percentage of completion method of contract accounting or 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 related 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 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 are 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 separately from our integrated solution implementations. For software license arrangements that do not require significant modification or customization of the underlying software, software license revenue is recognized under the residual method when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, (4) collectibility is probable, and (5) the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for our fixed-price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by our VSOE and such services are recorded as services. 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. 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. No revenue has been recognized for software licenses with extended payment terms in excess of amounts due. For software license arrangements that require significant modification or customization of the underlying software, the software license revenue is recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting, and such revenue is recorded as services.

Gainshare Performance Incentives — When we enter into a contract to provide yield improvement services, the contract usually includes two components: (1) a fixed fee for performance by us of services delivered over a specific period of time, and (2) a gainshare performance incentives component where the customer may pay a variable fee, usually after the fixed fee period has ended. Revenue derived from gainshare performance incentives represents profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels established in related solution implementation service contracts. Gainshare performance incentives periods are usually subsequent to the delivery of all contractual services and therefore have no cost to us. Due to the uncertainties surrounding attainment of such operational levels, we recognize gainshare performance incentives 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. Gainshare performance incentives 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 provisions for gainshare performance incentives.

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, or SFAS, No. 86, *Computer Software to be Sold, Leased or Otherwise Marketed*. Because we believe our current process for developing software is essentially completed concurrently with the establishment of technological feasibility, no costs have been capitalized to date.

Goodwill and Acquired Intangible Assets

As of September 30, 2008, we had $64.1 million of goodwill and $10.3 million of intangible assets. When valuing our goodwill and intangible assets, we make assumptions regarding estimated future cash flows to be derived from the acquired assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets, which would have a material adverse effect on our operating results. We evaluate goodwill for impairment pursuant to the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets*. We have selected December 31 as the date upon which to perform our annual testing for impairment. As of December 31, 2007, we completed our annual testing requirements and determined that the carrying value of goodwill had not been impaired. During the nine months ended September 30, 2008, we had a significant decline in trading price of our common stock; should we continue to experience a decline in the price of our common stock, a further analysis may be required and impairment charges, if any, could be recorded.

We are currently amortizing our acquired intangible assets over estimated useful lives of four to seven years, which are 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.

Income Taxes

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

Stock-Based Compensation

We account for stock-based compensation in accordance with SFAS No. 123 (revised 2004), *Share-Based Payment*, or SFAS No. 123(R). Under the provisions of SFAS No. 123(R), stock-based compensation cost is estimated at the grant date based on the award's fair-value as calculated by the Black-Scholes-Merton, or BSM, option-pricing model and is recognized as expense ratably over the requisite service period. The BSM model requires various highly judgmental assumptions including volatility, forfeiture rates, and expected option life. If any of the assumptions used in the BSM model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

Recent Accounting Pronouncements and Accounting Changes

See Note 2 to the condensed consolidated financial statements accompanying this Quarterly Report on Form 10-Q for a description of recent accounting pronouncements and accounting changes, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues:				
Design-to-silicon-yield solutions	71%	72%	73%	75%
Gainshare performance incentives	29	28	27	25
Total revenues	100	100	100	100
Cost of design-to-silicon-yield solutions:				
Direct cost of design-to-silicon-yield solutions	38	33	37	33
Amortization of acquired technology	3	6	3	6
Total cost of design-to-silicon-yield solutions	41	39	40	39
Gross margin	59	61	60	61
Operating expenses:				
Research and development	42	38	43	38
Selling, general and administrative	29	24	29	26
Amortization of other acquired intangible assets	1	4	1	4
Restructuring charges	—	—	2	—
Total operating expenses	72	66	75	68
Loss from operations	(13)	(5)	(15)	(7)
Interest and other income (loss), net	(2)	1	—	2
Loss before taxes	(15)	(4)	(15)	(5)
Income tax provision	50	—	13	—
Net loss	(65)%	(4)%	(28)%	(5)%

Comparison of the Three Months Ended September 30, 2008 and 2007

Revenue	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	$ Change	% Change	Three Months Ended September 30, 2008 % of Revenue	Three Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Design-to-silicon-yield solutions	$ 13,348	$ 17,261	$ (3,913)	(23)%	71%	72%
Gainshare performance incentives	5,417	6,807	(1,390)	(20)%	29%	28%
Total	$ 18,765	$ 24,068	$ (5,303)	(22)%	100%	100%

Design-to-Silicon-Yield Solutions. Design-to-Silicon-Yield solutions revenue is derived from services (including solution implementations, software support and maintenance, consulting, and training) and software licenses, provided during our customer yield improvement engagements and solution product sales. Design-to-Silicon-Yield solutions revenue decreased $3.9 million for the three months ended September 30, 2008 compared to the three months ended September 30, 2007, primarily due to a decrease of $2.8 million in fixed fee integrated solutions and a decrease of $1.0 million in revenue from software related consulting services. The decreases were primarily the result of lower bookings, as customers have delayed purchases for capacity expansion and investment in leading edge technology. The dramatic downturn in the semiconductor industry combined with weakness in worldwide economies has been the primary contributors to this shortfall. Our Design-to-Silicon-Yield solutions revenue may fluctuate in the future and is dependent on a number of factors, including our ability to obtain new customers.

Gainshare Performance Incentives. Gainshare performance incentives revenue represents profit sharing and performance incentives earned based upon our customer reaching certain defined operational levels. Revenue derived from gainshare performance incentives decreased $1.4 million for the three months ended September 30, 2008 compared to the three months ended September 30, 2007, primarily due to fluctuations in customer wafer volumes, relative to our performance targets at our customer sites. The revenues from gainshare performance incentives were generated from six customers and eight engagements for the three months ended September 30, 2008 and seven customers and ten engagements for the three months ended September 30, 2007. Our gainshare performance incentives revenue may continue to fluctuate from period to period. Gainshare performance incentives revenue is dependent on many factors that are outside our control, including among others, continued production of ICs by our customers, sustained yield improvements by our customers and our ability to enter into new Design-to-Silicon-Yield solutions contracts containing provisions for gainshare performance incentives.

Cost of Design-to-Silicon-Yield Solutions	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	$ Change	% Change	Three Months Ended September 30, 2008 % of Revenue	Three Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Direct costs of design-to-silicon-yield solutions	$ 7,152	$ 8,100	$ (948)	(12)%	38%	33%
Amortization of acquired technology	631	1,331	(700)	(53)%	3%	6%
Total	$ 7,783	$ 9,431	$ (1,648)	(17)%	41%	39%

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

Direct costs of Design-to-Silicon-Yield Solutions. Direct costs of Design-to-Silicon-Yield solutions consist of services costs and software licenses costs. Services costs consist of material, labor, overhead costs, and stock-based compensation charges associated with solution implementations. Costs include purchased materials, employee compensation and benefits, travel and facilities-related costs. Software license costs consist of costs associated with licensing third-party software sold in conjunction with our software products and expenses incurred to produce and distribute our product documentation. The direct costs of Design-to-Silicon-Yield solutions decreased $948,000 for the three months ended September 30, 2008 compared to the three months ended September 30, 2007. The decrease was primarily due to a decrease of $912,000 in deployment of our pdFasTest products and a decrease of $209,000 in travel expenses, the result of our cost control efforts, partially offset by an increase of $374,000 in the use of local outside consultants. 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.

Amortization of Acquired Technology. Amortization of acquired technology consists of amortization of intangibles acquired as a result of certain business combinations. Amortization of acquired technology expense decreased $700,000 for the three months ended September 30, 2008 compared to the three months ended September 30, 2007. The decrease in amortization of acquired technology was due to certain intangible assets becoming fully amortized. We anticipate amortization of acquired technology to be $631,000 for the remaining three months in 2008, $2.5 million in 2009, $2.3 million in 2010, $1.3 million in 2011, and $536,000 in 2012.

Research and Development	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	$ Change	% Change	Three Months Ended September 30, 2008 % of Revenue	Three Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Research and development	$ 7,835	$ 9,008	$ (1,173)	(13)%	42%	38%

Research and Development. Research and development expenses consist primarily of personnel-related costs to support product development activities, including compensation and benefits, outside development services, travel and facilities cost allocations, and stock-based compensation charges. Research and development expenses decreased $1.2 million for the three months ended September 30, 2008 compared to the three months ended September 30, 2007, primarily due to decreased personnel expenses as a result of our cost control efforts. We anticipate our expenses in research and development will fluctuate in absolute dollars from period to period as a result of cost control initiatives and the timing of when we hire personnel based on the size and timing of product development projects.

Selling, General and Administrative	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	$ Change	% Change	Three Months Ended September 30, 2008 % of Revenue	Three Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Selling, general and administrative	$ 5,401	$ 5,789	$ (388)	(7)%	29%	24%

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of compensation and benefits for sales, marketing and general and administrative personnel in addition to outside sales commissions, legal and accounting services, marketing communications, travel and facilities cost allocations, and stock-based compensation charges. The selling, general and administrative expenses decreased $388,000 for the three months ended September 30, 2008 compared to the three months ended September 30, 2007, primarily due to decreased personnel expenses as a result of our cost control efforts. We anticipate our selling, general and administrative expenses will fluctuate in absolute dollars from period to period as a result of cost control initiatives and to support increased sales efforts in the future.

Amortization of Other Acquired Intangible Assets	Three Months Ended September 30, 2008	2007	$ Change	% Change	Three Months Ended September 30, 2008 % of Revenue	2007 % of Revenue
(In thousands, except for %'s)						
Amortization of other acquired intangible assets	$ 194	$ 985	$ (791)	(80)%	1%	4%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets consists of amortization of intangibles acquired as a result of certain business combinations. Amortization of other acquired intangible assets for the three months ended September 30, 2008 decreased $791,000 compared to the three months ended September 30, 2007, primarily the result of certain intangible assets becoming fully amortized. We anticipate amortization of other acquired intangible assets to be $193,000 in the remaining three months in 2008, $773,000 in 2009, $712,000 in 2010, $575,000 in 2011, and $796,000 in 2012 and thereafter.

Interest and Other Income (Loss), net	Three Months Ended September 30, 2008	2007	$ Change	% Change	Three Months Ended September 30, 2008 % of Revenue	2007 % of Revenue
(In thousands, except for %'s)						
Interest and other income (loss), net	$ (343)	$ 322	$ (665)	(207)%	(2)%	1%

Interest and Other Income (loss), net. Interest and other income (loss), net, decreased $665,000 for the three months ended September 30, 2008 compared to the three months ended September 30, 2007, primarily due to a decrease in interest income of $399,000 from lower average cash, cash equivalent, and investments balances and lower interest rates combined with a loss of $445,000 on the sale of commercial paper from a company that went bankrupt. We anticipate interest and other income will fluctuate in future periods as a result of our projected use of cash.

Income Tax Provision	Three Months Ended September 30, 2008	2007	$ Change	% Change	Three Months Ended September 30, 2008 % of Revenue	2007 % of Revenue
(In thousands, except for %'s)						
Income tax provision	$ 9,433	$ 116	$ 9,317	8,032%	50%	—%

Income Tax Provision. Income tax provision increased $9.3 million for the three months ended September 30, 2008 compared to the three months ended September 30, 2007, primarily due to the establishment of a valuation allowance against deferred tax assets during the three months ended September 30, 2008. This valuation allowance was recorded after management concluded that, based on the objective evidence available at September 30, 2008, it was more likely than not that the Company's net deferred tax assets would not be fully realizable.

Comparison of the Nine Months Ended September 30, 2008 and 2007

Revenue	Nine Months Ended September 30, 2008	2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	2007 % of Revenue
(In thousands, except for %'s)						
Design-to-silicon-yield solutions	$ 43,824	$ 52,318	$ (8,494)	(16)%	73%	75%
Gainshare performance incentives	16,402	17,590	(1,188)	(7)%	27%	25%
Total	$ 60,226	$ 69,908	$ (9,682)	(14)%	100%	100%

Design-to-Silicon-Yield Solutions. Design-to-Silicon-Yield solutions revenue decreased $8.5 million for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007, primarily due to a decrease of $7.7 million in software licenses and associated consulting services revenue and a decrease of $1.9 million in revenue related to fixed fee integrated solutions, partially offset by an increase of $740,000 in revenue from software support and maintenance.

Gainshare Performance Incentives. Revenue derived from gainshare performance incentives decreased $1.2 million for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007, primarily due to fluctuations in customer wafer volumes relative to our performance targets at our customer sites. Revenues derived from gainshare performance incentives were generated from seven customers and eleven engagements for both the nine months ended September 30, 2008 and 2007.

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Cost of Design-to-Silicon-Yield Solutions	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	Nine Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Direct costs of design-to-silicon-yield solutions	$ 22,185	$ 22,976	$ (791)	(3)%	37%	33%
Amortization of acquired technology	1,893	4,516	(2,623)	(58)%	3%	6%
Total	$ 24,078	$ 27,492	$ (3,414)	(12)%	40%	39%

Costs of Design-to-Silicon-Yield Solutions.

Direct Costs of Design-to-Silicon-Yield Solutions. The direct costs of Design-to-Silicon-Yield solutions decreased by $791,000 for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007. The decrease was primarily due to a decrease of $1.5 million in the deployment of our pdFasTest products, partially offset by an increase of $543,000 in the use of local outside consultants.

Amortization of Acquired Technology. Amortization of acquired technology expense decreased $2.6 million for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007. The decrease in amortization of acquired technology was primarily due to a decrease of $3.2 million, the result of certain intangible assets becoming fully amortized, partially offset by an increase of $537,000 in amortization of technology acquired as a result of our acquisition of Fabbrix in May 2007.

Research and Development	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	Nine Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Research and development	$ 26,045	$ 26,175	$ (130)	—%	43%	38%

Research and Development. Research and development expenses decreased by $130,000 for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007.

Selling, General and Administrative	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	Nine Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Selling, general and administrative	$ 17,346	$ 18,278	$ (932)	(5)%	29%	26%

Selling, General and Administrative. Selling, general and administrative expenses decreased $932,000 for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007, primarily due to a decrease of $739,000 in outside commissions, the result of reduced reliance on third-party distributors.

Amortization of Other Acquired Intangible Assets	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	Nine Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Amortization of other acquired intangible assets	$ 583	$ 3,029	$ (2,446)	(81)%	1%	4%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets decreased $2.4 million for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007, primarily the result of certain intangible assets becoming fully amortized.

Restructuring Charges	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	Nine Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Restructuring charges	$ 1,471	$ —	$ 1,471	N/A	2%	—%

Restructuring Charges. Restructuring charges of $1.5 million during the nine months ended September 30, 2008 consisted of employee severance costs of $1.4 million and professional and other fees of $121,000 and were the result of the restructuring plan announced on April 29, 2008.

Interest and Other Income, net	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	Nine Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Interest and other income, net	$ 397	$ 1,347	$ (950)	(71)%	—%	2%

Interest and Other Income, net. Interest and other income, net, decreased $950,000 for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007, primarily due to a decrease of $1.2 million in interest income from lower average cash, cash equivalent, and investments balances and lower interest rates combined with a loss of $445,000 on the sale of commercial paper from a company that went bankrupt, partially offset by an increase of $632,000 in foreign currency exchange gains.

Income Tax Provision	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007	$ Change	% Change	Nine Months Ended September 30, 2008 % of Revenue	Nine Months Ended September 30, 2007 % of Revenue
(In thousands, except for %'s)						
Income tax provision	$ 7,777	$ 276	$ 7,501	2,718%	13%	—%

Income Tax Provision. Income tax provision increased $7.5 million for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007, primarily due to the establishment of a valuation allowance against deferred tax assets during the nine months ended September 30, 2008. This valuation allowance was recorded after management concluded that, based on the objective evidence available at September 30, 2008, it was more likely than not that the Company's net deferred tax assets would not be fully realizable.

Liquidity and Capital Resources

Operating Activities

Cash flows from operating activities consist of net loss adjusted for certain non-cash items and changes in assets and liabilities. Net cash provided by operating activities was $3.1 million for the nine months ended September 30, 2008 compared to $5.6 million for the nine months ended September 30, 2007. The decrease in cash flows from operating activities of $2.5 million compared to the nine months ended September 30, 2007 was primarily due to a greater net loss, decreased amortization of acquired intangible assets, and a change in taxes payable, partially offset by increased cash provided by the change of accounts receivable and other accrued liabilities. Amortization of acquired intangible assets decreased $5.1 million as a result of certain intangible assets becoming fully amortized.

The impact of greater net loss on cash flow during the nine months ended September 30, 2008 was reduced by the decreased deferred tax assets primarily resulting from the establishment of a valuation allowance. The increase in deferred tax assets during the nine months ended September 30, 2007 was primarily due to the recognition of additional tax credits. Taxes payable decreased $2.5 million during the nine months ended September 30, 2008 compared to an increase of $3.8 million during the nine months ended September 30, 2007. The decrease in taxes payable during the nine months ended September 30, 2008 was primarily the result of the Company's determination that it was not more likely than not that it could recognize certain tax attributes in the future. This determination impacted long-term taxes payable. The increase in taxes payable during the nine months ended September 30, 2007 was due to higher expected taxable income for that year and the increase in uncertain tax benefits related to tax credits earned during the period. The changes in accounts receivable during the nine months ended September 30, 2008 and 2007 were primarily due to the timing of billing milestones and payments received. The increase of $983,000 in other accrued liabilities for the nine months ended September 30, 2008 was primarily due to increased deferred rent, a result of abated short-term rental payment for office lease renewals. The decrease of $489,000 in other accrued liabilities for the nine months ended September 30, 2007 was primarily due to the payment of $1.9 million associated with the acquisition of SiA, partially offset by an increase of $524,000 in accrued outside sales commissions.

Investing Activities

Cash flows from investing activities consist of proceeds from investment maturities and sales, offset by payments for investments acquired, payments for businesses acquired, and payments for capital expenditures. Net cash used in investing activities was $7.4 million for the nine months ended September 30, 2008 compared to $857,000 for the nine months ended September 30, 2007. The increase of $6.6 million used in investing activities was primarily due to increased purchase of investments of $6.3 million, to $27.1 million during the nine months ended September 30, 2008 compared to $20.1 million during the nine months ended September 30, 2007, and decreased maturities and sales of investments of $5.6 million, to $20.7 million during the nine months ended September 30, 2008 compared to $26.2 million during the nine months ended September 30, 2007, partially offset by the impact of the payment of $4.6 million associated with the SiA and Fabbrix acquisitions during the nine months ended September 30, 2007, whereas there was no such payment during the nine months ended September 30, 2008.

Financing Activities

Cash flows from financing activities consist of proceeds from sales of shares through employee equity incentive plans, offset by payments for purchase of treasury stock, and principal payments on long-term obligations. Net cash used in financing activities was $2.8 million for the nine months ended September 30, 2008 compared to $3.0 million for the nine months ended September 30, 2007. During both the nine months ended September 30, 2008 and 2007, cash was primarily used for repurchasing shares of the Company's common stocks. Additionally, proceeds from the exercise of stock options decreased to $63,000 for the nine months ended September 30, 2008 from $1.3 million for the nine months ended September 30, 2007.

Liquidity

As of September 30, 2008, our working capital was $67.6 million, compared with $72.5 million as of December 31, 2007. Cash and cash equivalents, and short-term investments were $42.2 million as of September 30, 2008 compared to $45.3 million as of December 31, 2007, a decrease of $3.1 million. The decrease in cash and short-term investments was primarily attributable to the repurchase of $3.1 million of our common stock. We anticipate that our overall expenses, as well as planned capital expenditures, may constitute a material use of our cash resources. In addition, we may use cash resources to repurchase common stock or fund potential investments in, or acquisitions of, complementary products, technologies or businesses. We believe that our existing cash resources and anticipated funds from operations will satisfy our cash requirements to fund our operating activities, capital expenditures and other obligations for at least the next twelve months. However, in the event that during such period, or thereafter, we are not successful in generating sufficient cash flows from operations we may need to raise additional capital through private or public financings, strategic relationships or other arrangements, which may not be available to us on acceptable terms or at all, particularly in the current capital markets environment.

As of September 30, 2008, our investments included auction-rate securities with a par value of $1.0 million, which are variable rate debt instruments whose interest rates are reset through a "dutch" auction process at regular intervals, typically every 28 days. See Note 3 to condensed consolidated financial statements and Item 3 "Quantitative and Qualitative Disclosures About Market Risk" in Part I in this Quarterly Report on Form 10-Q for further discussion.

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 and foreign currency forward exchange contracts designed to reduce our exposure to currency fluctuations in the Euro. As of September 30, 2008, our Euro denominated cash balances held in foreign subsidiaries totaled $18.1 million based on the spot foreign exchange rate on that date. The effect of the fluctuation in exchange rates had a negative impact of $1.2 million on the cash balance during the nine months ended September 30, 2008 primarily as a result of the decrease of the Euro versus the US dollar during the period. If the Euro continues to weaken against the US Dollar, our foreign cash balance will be negatively impacted when translated back to US Dollar.

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

	Payments due by period					
Contractual obligations	**2008 (Three months remaining)**	**2009-2010**	**2011-2012**	**Thereafter**	**Other**	**Total**
Debt principal (1)	$ 28	$ 732	$ 113	$ —	$ —	$ 873
Debt interest	6	32	5	—	—	43
Capital lease obligations (including interest)	25	48	2	—	—	75
Operating lease obligations	783	5,534	4,828	1,679	—	12,824
Unrecognized tax benefits (2)	—	—	—	—	3,339	3,339
Total	$ 842	$ 6,346	$ 4,948	$ 1,679	$ 3,339	$ 17,154

(1) Amount represents the repayment of an interest free loan of €550,000 and a €400,000 Euros loan with a variable interest rate based on the EURIBOR plus 160 basis points.

(2) Due to the inherent uncertainty of the tax positions, it is not practicable to assign this liability to any particular years in the table.

Operating lease amounts include minimum rental payments under our operating leases for our office facilities, as well as computers, office equipment, and vehicles that we utilize under lease agreements. These agreements expire at various dates through 2013. Capital leases were contracted to purchase computer, software, office equipment, and vehicles in our French subsidiary.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Interest Rate Risk. As of September 30, 2008, we had cash and cash equivalents and short term investments of $42.2 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 September 30, 2008 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.

As of September 30, 2008, we held auction-rate securities with a par value of $1.0 million. Auction-rate securities are variable rate debt instruments whose interest rates are reset through a “dutch” auction process at regular intervals, typically every 28 days. A portion of these securities are insured by third party bond insurers and are collateralized by student loans guaranteed by governmental agencies and private entities. The liquidity of the securities has been negatively impacted by the uncertainty in the credit markets and the exposure of these securities to the financial condition of bond insurance companies. All auction-rate securities we hold have been failing to sell at auction since February 2008 due to an insufficient number of bidders. We reviewed the value of these securities for impairment as of September 30, 2008, and concluded that these securities were temporarily impaired, and recorded an unrealized loss of $159,000. In future periods, the estimated fair value of our auction-rate securities could decline further based on market conditions, which could result in additional impairment.

Foreign Currency and Exchange Risk. Certain of our sales contracts are denominated in a currency other than the functional currency of the selling entity. Therefore, a portion of our revenue is subject to foreign currency risks. In June 2008, we began entering into foreign currency forward exchange contracts, or forward contracts, designed to reduce our exposure to changes in the Euro. The outstanding forward contracts generally have maturities of approximately one month from the date into which they were entered and are entered into at or near the end of the month. These contracts are re-measured monthly using spot rates, with any gain or loss from rate fluctuations recorded in the consolidated statements of operations. As of September 30, 2008, we held a forward contract to purchase 920,000 Euros at the exchange rate of 1.4657 USD per Euro for a total value US$1.3 million. The change in the values of the forward contracts was not material for the quarter ended September 30, 2008.

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, or the Exchange Act) as of the end of the period covered by this 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 (1) recorded, processed, summarized and reported within the timeframes specified in the rules and forms of the Securities and Exchange Commission, and (2) 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 changes in the our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Rule 13a-15 or Rule 15d-15 under the Exchange Act that occurred during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time, we are subject to various legal proceedings and claims that arise in the ordinary course of business. In accordance with SFAS No. 5, *Accounting for Contingencies*, the Company records a contingent liability when the probable outcome of a claim against the Company can be reasonably assessed. In management's opinion, the probable outcome of any current claim against the Company cannot be reasonably estimated. Also, in management's opinion, the ultimate resolution of these claims will not materially impact our financial statements.

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, both as currently constituted and as we may offer them in the future, our revenue could decline. 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. We need to develop new customer relationships with companies that are integrated device manufacturers, fabless semiconductor companies, and foundries, as well as system manufacturers so that we can continue to implement our Design-to-Silicon-Yield solutions and experience greater market acceptance of our solutions. 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 slowing of demand for nanometer scale semiconductors;
- our inability to develop, market, or sell effective solutions that are outside of our traditional MPS logic focus;
- our existing and potential customers' delay in their adoption of the next process technology;
- the development in the industry of alternative methods to enhance the integration between the semiconductor design and manufacturing processes due to a rapidly evolving market and the emergence of new technologies;
- our existing and potential customers' reluctance to understand and accept our innovative gainshare performance incentives 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 nine months ended September 30, 2008, two customers accounted for 40% of our total net revenue, with Toshiba Corporation, or Toshiba, representing 21% and International Business Machines Corporation, or IBM, representing 19%. In the nine months ended September 30, 2007, two customers accounted for 34% of our total net revenue, with Toshiba representing 18% and IBM representing 16%. We could lose a customer due to its decision not to engage us on future process nodes, its decision not to develop its own future process node, or as a result of industry consolidation. 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.

If integrated device manufacturers of logic integrated circuits reduce investment in new process technology as a result of a shift to a fabless manufacturing business model, the pool of potential logic customers for our yield ramp solutions will shrink and our results of operations may suffer.

Historically, the majority of our revenue from integrated yield ramps has been derived from integrated device manufacturers, or IDMs, of logic ICs. If IDMs decide to discontinue or significantly cut back their investment in the development of new process technology as a result of a shift to a model of outsourcing a larger proportion, or all, of the mass production of their ICs, there may be fewer IDMs that are potential customers for our solutions that integrate product designs with in-house manufacturing processes. As a result, the revenue we are able to generate from integrated yield ramps for logic ICs could fall below levels that are currently expected. Also, because our expenses are fixed in the short term and it takes a long time for us to replace customers, such a reduction in revenue could cause significant fluctuations in results of operations.

If we do not effectively manage and support our operations and integrate recent and planned growth, our business strategy may fail.

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, experienced 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. In addition, we must frequently expand our internal information system to meet increasing demand in storage, computing and communication. Our internal information system 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. In addition, we may need to switch to a new accounting system in the near future, which could disrupt our business operations and distract management. 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 contractual, patent, copyright, trademark, and trade secret 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. Litigation may be necessary from time to time 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.

Competition in the market for yield improvement solutions and increased integration between IC design and manufacturing may intensify in the future, which could impede 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 and could lead to increased pricing pressure. 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 KLA-Tencor, MKS Instruments, inc., or MKS (through its acquisition of Yield Dynamics, Inc.), Mentor Graphics (through its acquisition of Ponte Solutions), Syntricity Inc., TIBCO Software Inc. (through its acquisition of Spotfire Inc.), and Synopsys, Inc., and process control software, such as Applied Materials, Inc., Triant Holdings Inc., Straatum Processware Ltd., and MKS. Further, ARM Ltd. and Virage Logic Corporation provide standard cells in the physical IP space, which could compete with our pdBRIX solution. 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 Design-for-Manufacturability, or DFM, while other Electronic Design Automation suppliers provide alternative DFM solutions that may compete for the same budgetary funds. If these potential competitors change the pricing environment or are able to attract industry partners or customers faster than we can, we may not be able to grow and execute our strategy as quickly or at all. In addition, customer preferences may shift away from our solutions as a result of the increase in competition.

We face operational and financial risks associated with international operations that could negatively impact our revenue.

We derive a majority of our revenue from international sales, principally from customers based in Asia. Revenue generated from customers in Asia accounted for 55% of total revenue in the nine months ended September 30, 2008 and 54% in the nine months ended September 30, 2007. 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. These risks include:

- some of our key engineers and other personnel are foreign nationals and they 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, inconsistencies among, 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 operational regulations and 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;
- currency risk associated with cash denominated in foreign currencies, including the Euro, held by foreign subsidiaries we have acquired;
- 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, interference with information or communication networks or systems, and the resulting disruption to economic activity and business operations.

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

- a downturn in Asian economies which 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.

In the Middle East, we use a third-party service provider, whose operations are not located in a U.S. embargoed country, to provide certain software quality assurance and other services for certain of our software products. The political uncertainty surrounding the region could disrupt our third-party service provider's operations and thus negatively affect the range of services we are able to provide.

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.

Revenue from our gainshare performance incentives is dependent on factors outside of our control, including the volume of integrated circuits that our customers are able to sell to their customers.

Our gainshare performance incentives fee component ties the profits of our customers to our own. Through this component, 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 decide to implement changes to their manufacturing processes during the period that is covered by gainshare performance incentives component, which could negatively affect yield results; a decision which is beyond our control. In addition, 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 thus any of our related gainshare performance incentives, 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 gainshare performance incentives revenue.

Measurement of our gainshare performance incentives requires data collection and is subject to customer agreement, which can result in uncertainty and cause quarterly results to fluctuate.

We can only recognize revenue based on gainshare performance incentives 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 revenue attributable to our gainshare performance incentives 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 gainshare performance incentives 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 gainshare performance incentives component relative to the fixed fee component. We typically recognize the fixed fee component earlier than the gainshare performance incentives component so if we are successful in increasing the gainshare performance incentives 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. 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 as a result of the change in our contracts. 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 gainshare performance incentives 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 gainshare performance incentives business model is unique and our Design-to-Silicon-Yield solutions are unfamiliar to some new customers, 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 gainshare performance incentives 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.

We have experienced losses in the nine months ended September 30, 2008, the year ended December 31, 2007, and in the past. 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 $33.6 million as of September 30, 2008. 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 stock-based 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.

We may experience significant fluctuations in our operating results due to the cyclical nature of the semiconductor industry.

Our revenue is highly dependent upon the overall condition of the semiconductor industry, especially because of our gainshare performance incentives 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.

In order to stay competitive, 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, and delays in obtaining visas permitting entry into other key countries, 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 requires 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 executive officers 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 executive officers. If we lose the services of any of our key executive officers, it could slow execution of our business plan, hinder our product development processes and impair our sales efforts. Searching for replacements could divert our 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 and cause our stock price to drop. 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, which could limit our revenue opportunities.

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 or damage our customer's property, 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.

Failing to maintain the effectiveness of our internal control over financial reporting could cause the cost related to remediation to increase and could cause our stock price to decline.

In the future, our management may identify deficiencies regarding the design and effectiveness of our system of internal control over financial reporting that we engage in pursuant to Section 404 of the Sarbanes-Oxley Act, or Section 404, as part of our Form 10-K. Such deficiencies could include 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 our independent registered public accounting firm with sufficient resources to attest to and report on our internal controls in a timely manner. Moreover, our registered public accounting firm may not agree with our management's future assessments and may deem our controls as ineffective if we are unable to remediate on a timely basis. If in the future we are unable to assert 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.

We may not be able to expand our business and 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.

Unanticipated efforts to support more rapid expansion, develop or enhance our 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.

Recent acquisitions may adversely affect our business by diverting management's attention, increasing our expenses or by being more difficult to integrate than expected.

Our success in realizing the strategic benefits, the timing of this realization, and growth opportunities to be gained from incorporating into PDF the operations of recently acquired businesses, including SiA, a French company, acquired in October 2006, and Fabbrix, a U.S. company, acquired in May 2007, depend upon our ability to successfully integrate those businesses. The integration of acquired businesses is a complex, costly and time-consuming process. The difficulties of combining our existing operations associated with acquired businesses include:

- consolidating research and development operations;
- retaining key employees;
- incorporating acquired products and business technology into our existing product lines;
- coordinating effective sales and marketing functions;
- preserving research and development, marketing, customer and other important relationships; and
- minimizing the diversion of management's attention from ongoing business concerns.

If we were required to write down all or part of our goodwill, our net earnings and net worth could be significantly, negatively affected.

We had $64.1 million of goodwill recorded on our consolidated balance sheet as of September 30, 2008. Goodwill represents the excess of cost over the fair market value of net assets acquired in business combinations. If our market capitalization drops significantly below the amount of net equity recorded on our balance sheet, it would indicate a decline in the fair value of the Company and would require us to further evaluate whether our goodwill has been impaired. We also perform an annual review of our goodwill on December 31 of each year to determine if it has become impaired, in which case we would write down the impaired portion of our goodwill. If we were required to write down all or a significant part of our goodwill, our net earnings and net worth could be significantly, negatively affected.

Changes in effective tax rates could negatively affect our operating results.

We conduct our business globally and, as a result, are subject to taxation in the United States and foreign countries. Our future tax rates could be affected by numerous factors, including changes in tax laws or the interpretation of such tax laws and changes in accounting policies. Our filings are subject to reviews or audit by the Internal Revenue Service and state, local and foreign taxing authorities. We cannot be sure that any final determination in an audit would not be materially different than the treatment reflected in our historical income tax provisions and accruals. If additional taxes are assessed as a result of an audit, there could be a significant negative effect on our income tax provision and net income in the period or periods for which that determination is made.

The uncertainty in the credit markets might impact the value of certain auction-rate securities we have and we might have to record impairment charges in the future.

Credit concerns in the capital markets have significantly reduced our ability to liquidate auction-rate securities that we classify as available-for-sale securities on our balance sheet. The liquidity of the securities has been reduced by the uncertainty in the credit markets and the exposure of these securities to the financial condition of bond insurance companies. All auction-rate securities we hold have been failing to sell at auction since February 2008 due to an insufficient number of bidders. We reviewed the value of these securities for impairment as of September 30, 2008, and concluded that these securities were temporarily impaired, and recorded an unrealized loss of $159,000. In future periods, the estimated fair value of our auction-rate securities could decline further based on market conditions, which could result in additional impairment.

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 and was declared effective by the SEC on July 26, 2001. There has been no change in our use of proceeds from the disclosure made in our report on Form 10-Q for the quarter ended September 30, 2005 with respect to the use of proceeds generated by our initial public offering.

(c) *Stock Repurchase*. The table below sets forth the information with respect to purchases made by or on behalf of the Company or any "affiliated purchaser" (as the term is defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934) of our common stock during the three months ended September 30, 2008:

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 (July 1, 2008 through July 31, 2008)	—	—	—	$ 5,866,140
Month 2 (August 1, 2008 through August 31, 2008)	81,300	$ 6.11	81,300	$ 5,369,356
Month 3 (September 1, 2008 through September 30, 2008)	—	—	—	$ 5,369,356
Total	81,300	$ 6.11	81,300	

(1) On March 26, 2003, our Board of Directors approved a share repurchase program to purchase up to $10.0 million of our outstanding common stock. The program was completed in August 2007 with 988,000 shares repurchased at the average price of $10.12. On October 29, 2007, the Board of Directors approved a new program to repurchase up to an additional $10.0 million of the Company's common stock on the open market. The right of repurchase stock under this program will expire on October 29, 2010. As of September 30, 2008, 763,000 shares had been repurchased at the average price of $6.07 under this program and $5.4 million remained available for repurchase.

Item 3. Defaults Upon Senior Securities.

Not applicable.

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

None.

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. dated July 31, 2000. (1)
3.02	Amended and Restated Bylaws of PDF Solutions, Inc., effective as of August 1, 2005. (2)
4.01	Specimen Stock Certificate. (3)
4.02	Second Amended and Restated Rights Agreement dated July 6, 2001. (1)
10.01	2001 Stock Plan and related agreements, effective as of July 31, 2001, as amended on October 31, 2006. (4)
10.02	2001 Employee Stock Purchase Plan and related agreements, as adopted on September 12, 2001. (1)
10.03	Asset Purchase Agreement among PDF Solutions, Inc. and Triant Holdings, Inc. and Triant Technologies (2005) Inc., dated August 27, 2008. (5)
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 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. (6)
32.02	Certification the Chief Financial Officer and Vice President of Finance pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (6)

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

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

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

(4) Incorporated by reference to PDF's Report on Form 10-Q filed May 10, 2007 (File No. 000-31311).

(5) Incorporated by reference to PDF's Report on Form 8-K filed September 4, 2008 (File No. 000-31311).

(6) 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.

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

Date: November 10, 2008

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4.02	Second Amended and Restated Rights Agreement dated July 6, 2001. (1)
10.01	2001 Stock Plan and related agreements, effective as of July 31, 2001, as amended on October 31, 2006. (4)
10.02	2001 Employee Stock Purchase Plan and related agreements, as adopted on September 12, 2001. (1)
10.03	Asset Purchase Agreement among PDF Solutions, Inc. and Triant Holdings, Inc. and Triant Technologies (2005) Inc., dated August 27, 2008. (5)
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 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. (6)
32.02	Certification the Chief Financial Officer and Vice President of Finance pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (6)

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

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

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

(4) Incorporated by reference to PDF’s Report on Form 10-Q filed May 10, 2007 (File No. 000-31311).

(5) Incorporated by reference to PDF’s Report on Form 8-K filed September 4, 2008 (File No. 000-31311).

(6) 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.

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

Date: November 10, 2008

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: November 10, 2008

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., or the Company, on Form 10-Q for the quarter ended September 30, 2008 as filed with the Securities and Exchange Commission on November 10, 2008, or the Report, I, John K. Kibarian, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

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

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

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

Date: November 10, 2008

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., or the Company, on Form 10-Q for the quarter ended September 30, 2008 as filed with the Securities and Exchange Commission on November 10, 2008, or 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: November 10, 2008