SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2002 or

[ ] **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ______ to ______

000-31311
(Commission File Number)

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 Registrant’s 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 [X] No [ ]

The number of shares outstanding of the Registrant’s Common Stock as of August 8, 2002 was 23,047,250.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

PDF SOLUTIONS, INC.
CONSOLIDATED BALANCE SHEETS
(Unaudited)
(In thousands, except per share data)

	June 30, 2002	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 66,633	$ 70,835
Accounts receivable, net of allowance of $504 in 2002 and $292 in 2001	11,103	5,546
Prepaid expenses and other current assets	4,379	3,439
Total current assets	82,115	79,820
Property and equipment, net	3,187	2,179
Goodwill	662	784
Intangible assets, net	303	385
Other assets	174	148
Total assets	$ 86,441	$ 83,316
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$ 611	$ 738
Accrued compensation and related benefits	2,091	4,061
Other accrued liabilities	1,505	1,826
Taxes payable	1,318	230
Deferred revenues	2,622	2,773
Billings in excess of recognized revenue	129	174
Current portion of long-term debt	16	24
Total current liabilities	8,292	9,826
Long-term debt	24	31
Deferred tax liabilities	684	505
Deferred rent	70	70
Stockholders’ equity:		
Preferred stock, $0.00015 par value, 5,000 shares authorized; no shares issued and outstanding; in 2002 and 2001	—	—
Common stock, $0.00015 par value, 75,000 shares authorized; shares issued and outstanding: 22,899 in 2002 and 22,980 in 2001	3	3
Additional paid-in-capital	99,417	98,651
Deferred stock-based compensation	(2,531)	(4,326)
Notes receivable from stockholders	(5,308)	(6,052)
Accumulated deficit	(14,224)	(15,369)
Cumulative other comprehensive loss	14	(23)
Total stockholders’ equity	77,371	72,884
Total liabilities and stockholders’ equity	$ 86,441	$ 83,316

See notes to consolidated financial statements.

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

	Three Months Ended		Six Months Ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
Revenue:				
Design-to-silicon-yield solutions	$ 9,505	$ 6,531	$17,885	$12,618
Gain share	2,731	2,213	5,808	3,994
Total revenue	12,236	8,744	23,693	16,612
Costs and expenses:				
Cost of design-to-silicon-yield solutions	4,110	3,335	7,974	6,225
Research and development	3,964	2,887	7,154	5,544
Selling, general and administrative	2,614	2,603	5,168	5,057
Stock-based compensation amortization*	770	2,121	1,558	4,678
Total costs and expenses	11,458	10,946	21,854	21,504
Income (loss) from operations	778	(2,202)	1,839	(4,892)
Interest and other income, net	338	147	697	279
Income (loss) before taxes	1,116	(2,055)	2,536	(4,613)
Tax provision	551	97	1,391	282
Net income (loss)	$ 565	$ (2,152)	$ 1,145	$ (4,895)
Net income (loss) per share:				
Basic	$ 0.03	$ (0.25)	$ 0.05	$ (0.59)
Diluted	$ 0.02	$ (0.25)	$ 0.05	$ (0.59)
Weighted average common shares:				
Basic	21,814	8,521	21,726	8,292
Diluted	22,943	8,521	23,192	8,292
* Stock-based compensation amortization:				
Cost of design-to-silicon-yield solutions	$ 223	$ 621	$ 486	$ 1,339
Research and development	366	888	804	2,070
Selling, general and administrative	181	612	268	1,269
	$ 770	$ 2,121	$ 1,558	$ 4,678

See notes to consolidated financial statements.

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

	Six Months Ended	
	June 30, 2002	June 30, 2001
Operating activities:		
Net income (loss)	$ 1,145	$(4,895)
Adjustments to reconcile net income (loss) to net cash used by operating activities:		
Depreciation and amortization	787	631
Stock-based compensation amortization	1,558	4,678
Deferred taxes	(226)	—
Deferred revenues	(151)	144
Changes in assets and liabilities:		
Accounts receivable	(5,557)	(1,063)
Prepaid expenses and other assets	(439)	(728)
Accounts payable	(127)	33
Accrued compensation and related benefits	(1,970)	132
Billings in excess of recognized revenue	(45)	(245)
Other accrued liabilities	(321)	788
Taxes payable	1,088	(21)
Net cash used by operating activities	(4,258)	(546)
Investing activities:		
Purchases of property and equipment	(1,713)	(738)
Net cash used in investing activities	(1,713)	(738)
Financing activities:		
Exercise of stock options	179	—
Proceeds from employee stock purchase plan	889	—
Repayment of notes payable	—	(995)
Collection of notes receivable from shareholders	679	3
Principal payments on long-term debt and capital lease obligations	(15)	(12)
Net cash provided by (used in) financing activities	1,732	(1,004)
Effect of exchange rate changes on cash	37	(18)
Net decrease in cash and cash equivalents	(4,202)	(2,306)
Cash and cash equivalents, beginning of period	70,835	7,626
Cash and cash equivalents, end of period	$66,633	$ 5,320
Noncash financing activity:		
Repurchase of common stock through cancellation of notes receivable	$ 65	$ —
Supplemental disclosure of cash flow information —		
Cash paid during the period for:		
Taxes	$ 110	$ 100
Interest	$ 2	$ 72

See notes to consolidated financial statements.

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

1. BASIS OF PRESENTATION

The interim 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 (SEC). 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 consolidated financial statements reflect, in the opinion of management, all adjustments necessary (consisting only of normal recurring adjustments) to present a fair statement of results for the interim periods presented. The operating results for any interim period are not necessarily indicative of the results that may be expected for the entire fiscal year ended December 31, 2002. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements in our Annual Report on Form 10-K for the year ended December 31, 2001.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. A significant portion of the Company’s revenues require estimates in regards to total costs which may be incurred and revenues earned. Actual results could differ from these estimates. See “Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations-Critical Accounting Policies” for additional information regarding the estimates and assumptions the Company makes that affect its financial statements.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries after the elimination of all significant intercompany balances and transactions. Certain amounts from prior years have been reclassified to conform to current-year presentation. These reclassifications did not change previously reported total assets, liabilities, stockholders’ equity or net loss.

2. RECENT ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 143, *Accounting for Asset Retirement Obligations*. SFAS No. 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement is effective for fiscal years beginning after June 15, 2002, however earlier application is permitted. The Company will adopt SFAS No. 143 on January 1, 2003. The Company believes the adoption of this statement will not have an impact on its financial position or operating results.

In October 2001, the FASB issued SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. SFAS No. 144 supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*, and addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement is effective for fiscal years beginning after December 15, 2001. The Company adopted SFAS No. 144 on January 1, 2002. The adoption of this statement did not have an effect on the Company’s financial position or operating results.

In November 2001, the FASB issued Emerging Issues Task Force, Issue No. 01-14 (EITF 01-14), *Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred.* EITF 01-14 establishes that reimbursements received for out-of-pocket expenses should be reported as revenue in the statement of operations. The Company was required to adopt this guidance effective in the first quarter of fiscal 2002. Reclassification required pursuant to the Company’s adoption of EITF 01-14 resulted in an increase in design-to-silicon-yield solutions revenue of $399,000 for the three months ending June 30, 2001 and $733,000 for the six months ended June 30, 2001. The adoption of EITF 01-14 will not affect the Company’s net income or loss in any past periods.

In June 2002, the FASB issued SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which addresses accounting for restructuring and similar costs. SFAS 146 supersedes previous accounting guidance, Principally Emerging Issues Task Force Issue No. 94-3. The Company will adopt the Provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of the Company’s commitment to an exit plan. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized. The Company believes the adoption of this statement will not have an impact on its financial position or operating results.

3. ACCOUNTS RECEIVABLE

Accounts receivable include amounts that are unbilled at the end of the period. Unbilled accounts receivable are determined on an individual contract basis and were approximately $1.5 million and $1.9 million at June 30, 2002 and December 31, 2001, respectively.

4. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted-average common shares outstanding for the period (excluding shares subject to repurchase). Diluted net income (loss) per share reflects the weighted-average common shares outstanding plus the potential effect of dilutive securities which are convertible into common shares (using the treasury stock method), except in cases where the effect would be anti-dilutive.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(unaudited)		(unaudited)	
Net income (loss)	$ 565	$ (2,152)	$ 1,145	$ (4,895)
Shares:				
Weighted average common shares outstanding	22,902	10,869	22,925	10,876
Weighted average common shares outstanding subject to repurchase	(1,088)	(2,348)	(1,199)	(2,584)
Shares used in computation — basic	21,814	8,521	21,726	8,292
Dilutive common equivalent shares:				
Weighted average common shares outstanding subject to repurchase	1,088	—	1,199	—
Stock options	41	—	267	—
Shares used in computation — diluted	22,943	8,521	23,192	8,292
Net income (loss) per share — basic	$ 0.03	$ (0.25)	$ 0.05	$ (0.59)
Net income (loss) per share — diluted	$ 0.02	$ (0.25)	$ 0.05	$ (0.59)

For the three month period ended June 30, 2002, the calculation of diluted net income per share does not include 1.1 million outstanding common stock options as the effect would be anti-dilutive for the period presented. For the three and six month periods ended June 30, 2001, the calculation of diluted net loss per share does not include, respectively, 339,000 and 300,000 outstanding common stock options, 2.3 million and 2.6 million shares of common stock subject to repurchase, and 6.3 million of convertible preferred stock as the effect would be anti-dilutive for the periods presented.

5. INITIAL PUBLIC OFFERING AND CONCURRENT PRIVATE PLACEMENT

On July 6, 2001 the Company amended and restated its articles of incorporation to effect a two-for-three reverse stock split of the Company's common and preferred stock. All share and per share amounts reflected in the consolidated financial statements have been restated to give effect to the two-for-three reverse stock split.

On July 6, 2001 the Company amended and restated its articles of incorporation to provide for the automatic conversion of all outstanding Series A and Series B convertible preferred stock upon consummation of the public offering in which the Company receives proceeds equal to or greater than $7,500,000; provided that in the event the public offering price was less than $14.25 per share, the Series B preferred stock would be converted into an aggregate of 499,987 shares of common stock.

On July 26, 2001 the Company completed its initial public offering in which it sold 5,175,000 shares of its common stock. The net proceeds from the offering totaled $56.5 million. Concurrent with this offering, the Company completed the private placement of 500,000 shares of its common stock to Applied Materials Inc. Net proceeds of this concurrent private placement totaled $5.9 million. Based on the initial public offering price of $12 per share the Company recorded a one time dividend charge of $1.6 million in the third quarter of 2001, representing the fair value of additional shares issued to the Series B convertible preferred stockholders in excess of the shares issuable pursuant to the original terms of the Series B convertible preferred stock.

6. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
	(Unaudited)		(Unaudited)	
Net income (loss)	$565	$(2,152)	$1,145	$(4,895)
Foreign currency translation adjustments	45	(8)	37	(18)
Comprehensive income (loss)	$610	$(2,160)	$1,182	$(4,913)

7. GOODWILL AND PURCHASED INTANGIBLE ASSETS

On January 1, 2002, the Company adopted SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 requires goodwill to be tested for impairment under certain circumstances, written down when impaired, and requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite.

On January 1, 2002, the Company ceased amortization of goodwill with a net book value totaling $662,000, which includes $192,000 of acquired workforce intangibles, net of related deferred tax liabilities which were reclassified to goodwill pursuant to the requirements of SFAS No. 142.

Purchased intangible assets are carried at cost less accumulated amortization. Intangible assets at June 30, 2002 consisted entirely of acquired technology with a cost of $660,000 and accumulated amortization of $357,000. Amortization is computed over the estimated useful life of four years. The amortization expense on acquired technology is expected to be $165,000 for fiscal 2002 and 2003, and $55,000 in fiscal 2004, at which time it will be fully amortized.

The Company has performed its transition impairment test of goodwill as of January 1, 2002 which did not indicate any impairment. In addition, the Company will be required to perform an annual impairment test.

The following table presents the impact of SFAS No. 142 on net income (loss) and net income (loss) per share as if the standard had in effect for the three and six months ended June 30, 2001 (in thousands, except per-share amounts):

	Three Months Ended		Six Months Ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
Reported net income (loss)	$ 565	$ (2,152)	$1,145	$(4,895)
Add back goodwill amortization, net of taxes	—	24	—	45
Add back workforce amortization, net of taxes	—	36	—	67
Adjusted net income (loss)	$ 565	$ (2,092)	$1,145	$(4,783)
Basic net income (loss) per share:				
Reported basic net income (loss) per share	$ 0.03	$ (0.25)	$ 0.05	$ (0.59)
Add back goodwill amortization per share	—	—	—	—
Add back workforce amortization per share	—	—	—	—
Adjusted basic net income (loss) per share	$ 0.03	$ (0.25)	$ 0.05	$ (0.59)
Diluted net income (loss) per share:				
Reported diluted net income (loss) per share	$ 0.02	$ (0.25)	$ 0.05	$ (0.59)
Add back goodwill amortization per share	—	—	—	—
Add back workforce amortization per share	—	—	—	—
Adjusted diluted net income (loss) per share	$ 0.02	$ (0.25)	$ 0.05	$ (0.59)

8. CUSTOMER AND GEOGRAPHIC INFORMATION

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

Customer	Three Months Ended June 30, 2002	Three Months Ended June 30, 2001	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001
	(Unaudited)		(Unaudited)	
A	20%	31%	24%	32%
C	19%	9%	14%	12%
G	21%	40%	22%	30%

The Company had accounts receivable from individual customers in excess of 10% of gross accounts receivable during the three month ended June 30, 3002, as follows:

Customer	June 30, 2002	December 31, 2001
	(Unaudited)	
A	25%	37%
C	11%	5%
F	14%	23%
G	0%	11%
J	15%	—%

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

	Three Months Ended June 30, 2002	Three Months Ended June 30, 2001	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001
	(Unaudited)			
Japan	$8,262	$6,996	$16,185	$12,180
United States	1,666	658	3,775	2,990
Europe	2,308	1,090	3,733	1,442

As of June 30, 2002 and December 31, 2001, long-lived assets related to PDF Solutions GmbH (formerly AISS), located in Germany, totaled $1.2 million and $1.4 million, respectively, of which $1.0 million and $1.2 million, respectively, relates to acquired intangibles (see Note 7). The majority of the Company's remaining long-lived assets are in the United States.

9. LITIGATION

In May 2001 the Company was named as a defendant in a lawsuit claiming, among other things, that it misappropriated trade secrets in connection with hiring an employee. This litigation was settled by all parties in the quarter ending June 30, 2002. All expenses related to the lawsuit have been reflected in the current financial statements.

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

Forward-Looking Statements

The following discussion of our financial condition and results of operations contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, plan, anticipate, believe, estimate, predict, potential or continue, the negative of terms like these or other comparable terminology. These statements are only predictions. These statements involve known and unknown risks and uncertainties and other factors that may cause actual events or results to differ materially. All forward-looking statements included in this document are based on information available to us on the date of filing, and we assume no obligation to update any such forward-looking statements. In evaluating these statements, you should specifically consider various factors,

including the risks outlined under the caption “Factors that May Affect Future Results” set forth at the end of this Item 2 and the Risk Factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2001 and on Form 10-Q for the quarter ending March 31, 2002. We caution investors that our business and financial performance are subject to substantial risks and uncertainties.

Overview

Our comprehensive technologies and services enable semiconductor companies to improve yield and performance of integrated circuits by providing infrastructure to integrate the design and manufacturing processes. Our solutions combine proprietary manufacturing process simulation software, yield and performance modeling software, comprehensive test chips, proven yield and performance enhancement methodologies, and professional services.

From our incorporation in 1992 through late 1995, we were primarily focused on research and development of our proprietary manufacturing process simulation and yield and performance modeling software. From late 1995 through late 1998, we continued to refine and sell our software, while expanding our offering to include yield and performance improvement consulting services. In late 1998, we began to sell our software and consulting services, together with our newly developed proprietary technologies, as complete 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 Applied Integrated Systems and Software GmbH, which develops software and provides development services to the semiconductor industry. In July 2001, we completed the initial public offering of our common stock.

Critical Accounting Policies

Financial Reporting Release No. 60 (Release No. 33-8040), which was recently released by the Securities and Exchange Commission (SEC) in December 2001, suggests that all companies include a discussion of critical accounting policies or methods used in the preparation of financial statements. Note 1 of the notes to our consolidated financial statements included in our annual report on Form 10-K for the year ended December 31, 2001 includes a summary of the significant accounting policies and methods used in the preparation of our consolidated financial statements. The following is a brief discussion of the more significant accounting policies and methods that we use.

General

Our discussion and analysis of our financial condition and result of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Our preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The most significant estimates and assumptions relate to revenue recognition, impairment of goodwill, the realization of deferred tax assets and the allowance for doubtful accounts. Actual amounts may differ from such estimates under different assumptions or conditions. The following summarizes our critical accounting policies and significant estimates used in preparing our consolidated financial statements:

Revenue Recognition

We derive revenue from two sources: Design-to-Silicon-Yield solutions and gain share. We recognize revenue in accordance with the provisions of American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, *Software Revenue Recognition*, as amended, and SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.

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

Solution Implementations — Our solution implementations generate a significant portion of revenue from fixed-price contracts delivered over a specific period of time. These contracts require the accurate estimation of the cost to perform obligations and the overall scope of each engagement. Revenue under contracts for solution implementation services is recognized as the services are performed using the cost-to-cost percentage of completion method of accounting. Losses on solution implementation contracts are recognized when determined. Revisions in profit estimates are reflected in the period in which the conditions that require the revisions become known and can be estimated. If we do not accurately estimate the resources required or the scope of work to be performed, or do not manage the projects properly within the planned period of time or satisfy our obligations under contracts, resulting contract margins could be materially different than those anticipated when the contract was executed. Any such reductions in contract margin could have a material negative impact on our operating results.

Software Licenses — We have entered into a few multi-year time-based licenses, with a contractual term of generally three years. Revenue under arrangements which require us to provide support and maintenance over a period of time, where vendor-specific objective evidence of fair value does not exist to allocate a portion of the total fee to the undelivered elements, are recognized ratably over the term of the agreement. No revenue under arrangements with extended payment terms has been recognized in excess of amounts due.

Other license fees are recognized on the residual value method: (i) when an agreement has been signed, the software has been delivered, the license fee is fixed or determinable and collection of the fee is probable or (ii) as a component of a related solution implementation contract.

Software Support and Maintenance — Amounts allocated to undelivered support and maintenance are based on vendor specific objective evidence, generally negotiated renewal rates. Revenue from allocated support and maintenance and renewals is recognized ratably over the term of the support and maintenance contract, generally one year.

Gain Share — Gain share revenue represents profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels. Upon achieving such operational levels, we receive either a fixed fee and/or royalties based on the units sold by the customer. Due to the uncertainties surrounding attainment of such operational levels, we recognize gain share revenue (to the extent of completion

of the related solution implementation contract) upon receipt of performance reports or other related information from the customer supporting the determination of amounts and probability of collection. Our continued receipt of gain share revenue is dependent on many factors which are outside our control, including among others, continued production of the related integrated circuits (IC's) by our customers, sustained yield improvements by our customers and our ability to enter into new Design-to-Silicon-Yield solutions contracts containing gain share provisions.

Goodwill and Intangible Assets — As of June 30, 2002, we had $1.0 million of goodwill and intangible assets. In assessing the recoverability of the our goodwill and intangible assets, we must make assumptions regarding estimated future cash flows and other factors to determine the fair value of the respective assets. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for these assets. On January 1, 2002 we adopted Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets,* and have performed our transition impairment test of goodwill as of January 1, 2002 and which did not indicate any impairment. Going forward the Company will be required to perform an annual impairment test. During the six months ending June 30, 2002, we did not record any impairment losses related to goodwill.

Realization of Deferred Tax Assets — As of June 30, 2002, we had net deferred tax assets of $2.2 million. Realization of deferred tax assets is dependent on our ability to generate future taxable income and utilize tax planning strategies. We have recorded a deferred tax asset to the amount that is more likely than not to be realized based on current estimations and assumptions. We evaluate the need for a valuation allowance against such deferred tax assets 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. In 2001, we reversed our deferred tax asset valuation allowance of $2.1 million due to our evaluation of current evidence and its effect on our estimate of future earnings.

Results of Operations

We have historically experienced fluctuations from period to period. We expect these fluctuations to continue, therefore, historical results are not indicative of future results.

Three and Six Months Ended June 30, 2002

Total revenue for the three months ended June 30, 2002 was $12.2 million, compared with $8.7 million for the three months ended June 30, 2001, an increase of 40%. Total revenue for the six months ended June 30, 2002 was $23.7 million, compared with $16.6 million for the six months ended June 30, 2001, an increase of 43%.

Design-to-Silicon Yield Solutions. Design-to-Silicon-Yield solutions revenue for the three months ended June 30, 2002 was $9.5 million, compared with $6.5 million for the three months ended June 30, 2001, an increase of 46%. Design-to-Silicon-Yield solutions revenue for the six months ended June 30, 2002 was $17.9 million, compared with $12.6 million for the six months ended June 30, 2001, an increase of 42%. The increases for both the three-month and six-month periods ended June 30, 2002 were attributable to a greater number of solution implementations during the first six months of fiscal 2002 compared with the first six months of fiscal 2001.

Gain Share. Gain share revenue for the three months ended June 30, 2002 was $2.7 million, compared with $2.2 million for the three months ended June 30, 2001, an increase of 23%. Gain share revenue for the six months ended June 30, 2002 was $5.8 million, compared with $4.0 million for the six months ended June 30, 2001, an increase of 45%. The increases for both the three-month and six-month periods ended June 30, 2002 were the result of attaining increases in gain share from both existing customers who have and have not contributed to gain share revenues in previous periods.

Cost and Expenses. Cost of Design-to-Silicon Yield solutions for the three months ended June 30, 2002 was $4.1 million, compared with $3.3 million for the three months ended June 30, 2001, an increase of 23%. Cost of Design-to-Silicon Yield solutions for the six months ended June 30, 2002 was $8.0 million, compared with $6.2 million for the six months ended June 30, 2001, an increase of 28%. The absolute dollar increases in cost of Design-to-Silicon Yield Solutions for both the three-month and six-month periods ending June 30, 2002 were primarily due to a greater number of solution implementations. As a percentage of Design-to-Silicon Yield solutions revenue, cost of Design-to-Silicon Yield solutions for the three months ended June 30, 2002 was 43%, compared with 51% for the three months ended June 30, 2001. As a percentage of Design-to-Silicon Yield solutions revenue, cost of Design-to-Silicon Yield solutions for the six months ended June 30, 2002 was 45%, compared with 49% for the six months ended June 30, 2001. The percentage decreases for both the three-month and six-month periods ended June 30, 2002 were primarily the result of an increase in higher margin Design-to-Silicon Yield solutions contracts, partially offset by the cost of increasing capacity.

Research and Development. Research and development expenses for the three months ended June 30, 2002 were $4.0 million, compared with $2.9 million for the three months ended June 30, 2001, an increase of 37%. Research and development expenses for the six months ended June 30, 2002 were $7.2 million, compared with $5.5 million for the six months ended June 30, 2001, an increase of 29%. The absolute dollar increases in research and development expenses were primarily due to increases in personnel related costs and increases in non-recurring engineering expenses for joint development of new products under a collaborative business arrangement. As a percentage of total revenue, research and development expenses for the three months ended June 30, 2002 were 32%, compared with 33% for the three months ended June 30, 2001. As a percentage of total revenue, research and development expenses for the six months ended June 30, 2002 were 30%, compared with 33% for the six months ended June 30, 2001. The percentage decreases for both the three-month and six-month periods ended June 30, 2002 were primarily the result of revenue growth exceeding the increase in research and development expenses. We anticipate we will continue to commit considerable resources to research and development in the future and that these expenses will continue to increase in absolute dollars.

Selling, General and Administrative. Selling, general and administrative expenses for the three months ended June 30, 2002 were $2.6 million, compared with $2.6 million for the three months ended June 30, 2001. Selling, general and administrative expenses for the six months ended June 30, 2002 were $5.2 million, compared with $5.1 million for the six months ended June 30, 2001, an increase of 2%. The absolute dollar increase in selling, general and administrative for the six months ending June 30, 2002 was primarily due to increases in the allowance for doubtful accounts resulting from higher accounts receivable balances and an increase in professional services expenses, partially offset by decreases in sales commissions and the reduction of goodwill amortization expense due to the adoption of SFAS 142 on January 1, 2002 according to which we will no longer amortize the carrying value of goodwill. As a percentage of total revenue, selling, general and administrative expenses for the three months ended June 30, 2002 were 21%, compared with 30% for the three months ended June 30, 2001. As a percentage of total revenue, selling, general and administrative expenses for the six months ended June 30, 2002 were 22%, compared with 30% for the six months ended June 30, 2001. The percentage decreases for both the three-month and six-month periods ended June 30, 2002 were primarily the result of revenue growth exceeding the increase in selling, general and administrative expenses. We expect that selling, general and administrative expenses will increase in absolute dollars to support increased selling and administrative efforts.

Stock-based compensation amortization. Stock-based compensation amortization for the three months ended June 30, 2002 was $770,000, compared with $2.1 million for the three months ended June 30, 2001, a decrease of 64%. Stock-based compensation amortization for the six months ended June 30, 2002 was $1.6 million, compared with $4.7 million for the six months ended June 30, 2001, a decrease of 67%. The decreases were due to the effects of the graded vesting method of amortization resulting in higher amortization expense during the initial period following the respective option grants.

Interest and other income, net. Interest and other income, net for the three months ended June 30, 2002 was $338,000, compared with $147,000 for the three months ended June 30, 2001, an increase of 130%. Interest and other income, net for the six months ended June 30, 2002 was $697,000, compared with $279,000 for the six months ended June 30, 2001, an increase of 150%. The increases were primarily due to interest earned on higher average cash and cash equivalents balances in 2002 resulting from proceeds received from our initial public offering and concurrent private placement in the third quarter of 2001.

Provision for Taxes. Provision for taxes for the three months ended June 30, 2002 was $551,000 compared with $97,000 for the three months ended June 30, 2001, an increase of 468%. Provision for taxes for the six months ended June 30, 2002 was $1.4 million compared with $282,000 for the six months ended June 30, 2001, an increase of 393%. The increase in both the three-month and six-month periods ended June 30, 2002 was due to increased profitability.

Liquidity and Capital Resources

As of June 30, 2002, working capital was $73.8 million, compared with $70.0 million as of December 31, 2001. Cash and cash equivalents as of June 30, 2002 were $66.6 million, compared to $70.8 million as of December 31, 2001, a decrease of $4.2 million.

Net cash used in operating activities was $4.3 million for the six months ended June 30, 2002 compared to net cash used by operating activities of $546,000 for the six months ended June 30, 2001. Net cash used by operating activities for the six months ended June 30, 2002 resulted from net income of $3.5 million after adjustment for depreciation and amortization, including amortization of deferred stock compensation cost of $1.6 million, and increases in taxes payable of $1.1 million offset by increases in accounts receivable of $5.6 million and prepaid and other assets of $439,000, deferred taxes of $226,000 and decreases in accrued compensation and related benefits of $2.0 million and accrued liabilities of $321,000. The increase in accounts receivable was attributable to performance under an increased number of contracts. The decrease in accrued compensation was primarily the result of the payment of performance incentives for 2001.

Net cash used in investing activities was $1.7 million for the six months ended June 30, 2002 compared to net cash used in investing activities of $738,000 for the six months ended June 30, 2001. Net cash used in investing activities resulted from the purchases of property and equipment, including the investment in characterization vehicle foundry technology for our Design-Based-Yield-improvement product.

Net cash provided by financing activities was $1.7 million for the six months ended June 30, 2002 compared to net cash used in financing activities of $1.0 million for the six months ended June 30, 2001. Net cash provided by financing activities for the six months ended June 30, 2002 was primarily the result of proceeds for stock purchases under the employee stock purchase plan of $889,000, collections of notes receivable from shareholders of $679,000 and the exercise of stock options of $178,000.

We expect to experience growth in our operating expenses, particularly for research and development and additions to our workforce in order to execute our business plan. As a result, we anticipate that our operating expenses, as well as planned capital expenditures, will constitute a material use of our cash resources. In addition, we may use cash resources to fund potential investments in, or acquisitions of, complementary products, technologies or businesses. We believe that our existing cash resources and anticipated funds from operations will satisfy our cash requirements to fund our operating activities, capital expenditures and other obligations for at least the next twelve months. However, in the event that during such period, or thereafter, we are not successful in generating sufficient cash flows from operations we may need to raise additional capital through private or public financings, strategic relationships or other arrangements, which may not be available to us on acceptable terms or at all.

Euro-Currency

The Single European Currency, or Euro, was introduced on January 1, 1999, and we began doing business denominated in Euro on January 1, 2002. We have assessed the situation and believe this adoption will not have a material effect on our business.

Recent Accounting Pronouncements

In June 2001, the FASB issued SFAS No. 141, *Business Combinations* and SFAS No. 142, *Goodwill and Other Intangible Assets.* SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives not be amortized, but will rather be tested at least annually for impairment. We adopted SFAS No. 142 for our fiscal year beginning January 1, 2002. Upon adoption, SFAS No. 142 required that the net book value of employee workforce intangibles, net of related deferred tax liabilities, be reclassified to goodwill and we stopped the amortization of goodwill with a net carrying value of $662,000 at January 1, 2002 and annual amortization of approximately $284,000 that resulted from a business combination completed prior to the adoption of SFAS No. 141. We also performed our transition impairment test of goodwill as of January 1, 2002, which did not indicate any impairment. Had we adopted SFAS No. 142 on January 1, 2001, the net loss for the quarter and six months ended June 30, 2001, would have decreased by $60,000 and $112,000, respectively and net loss per share would have been unchanged.

In June 2001, the FASB issued SFAS No. 143, *Accounting for Asset Retirement Obligations.* SFAS No. 143 addresses the financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. This statement is effective for fiscal years beginning after June 15, 2002, however earlier adoption is permitted. We will adopt SFAS No. 143 on January 1, 2003. We believe the adoption of this statement will not have an effect on our financial position or operating results.

In October 2001, the FASB issued SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets.* SFAS No. 144 supersedes SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of,* and addresses financial accounting and reporting for the impairment or disposal of long-lived assets. This statement is effective for fiscal years beginning after December 15, 2001. We adopted SFAS No. 144 on January 1, 2002. The adoption of this statement did not have an effect on our financial position or operating results.

In November 2001, the FASB issued Emerging Issues Task Force Issue 01-14 (EITF 01-14), *Income Statement Characterization of Reimbursements Received for Out-of-Pocket Expenses Incurred.* EITF 01-14 establishes that reimbursements received for out-of-pocket expenses should be reported as revenue in the statement of operations. We were required to adopt this guidance effective in the first quarter of fiscal 2002. Reclassification required pursuant to our adoption of EITF 01-14 resulted in an increase in Design-to-Silicon-Yield solutions revenue of $399,000 for the three month ending June 30, 2001 and $733,000 for the six months ended June 30, 2001. The adoption of EITF 01-14 will not affect on our net income or loss in any past periods.

In June 2002, the FASB issued SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities,* which addresses accounting for restructuring and similar costs. SFAS 146 supersedes previous accounting guidance, Principally Emerging Issues Task Force Issue No. 94-3. We will adopt the Provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of our commitment to an exit plan. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized. We believe the adoption of this statement will not have an effect on our financial position or operating results.

Factors Which May Affect Future Results

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

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

- our customers' failure to achieve satisfactory yield improvements using our Design-to-Silicon-Yield solutions;
- a decrease in demand for semiconductors generally or the demand for deep submicron semiconductors failing to grow as rapidly as expected;
- the industry may develop alternative methods to enhance the integration between the semiconductor design and manufacturing processes due to a rapidly evolving market and the likely emergence of new technologies;
- our existing and potential customers' reluctance to understand and accept our innovative gain share fee component; and
- our customers' concern about our ability to keep highly competitive information confidential.

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

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

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

Our adoption of a novel and unproven business model makes it difficult to evaluate our future prospects.

Since we adopted our current business model, we do not have a long history of operating results on which you can base your evaluation of our business. In 1998, we began selling software, services and other technologies together as a Design-to-Silicon-Yield solution for the first time. Because we have not demonstrated our ability to generate significant revenue, our business model is unproven, especially with respect to gain share fees, which we expect will constitute a significant portion of our revenue for the foreseeable future. In the past, we generally earned fixed fees for the separate sale of our software, services and other technologies. Under our current business model, we are selling these items together as a package and charging both a fixed fee and a variable fee based on demonstrated improvements in our customers' yields, which we call gain share. Our existing and potential customers may resist this approach and may seek to limit or restrict our gain share fees. As a result, it will be difficult for financial markets analysts and investors to evaluate our future prospects.

Our gain share revenue is largely dependent on the volume of integrated circuits, or IC's, our customers are able to sell to their customers, which is outside of our control.

Our gain share revenue for a particular product is largely determined by the volume of that product our customer is able to sell to its customers, which is outside of our control. We have limited ability to predict the success or failure of our customers' IC products. 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. Since we currently work on a small number of large projects, any product that does not achieve commercial viability could significantly reduce our revenue and results of operations below expectations. In addition, if we work with two directly competitive products, volume in one may offset volume, and any of our related gain share, in the other product. Further, decreased demand for semiconductor products decreases the volume of products our customers are able to sell, which may adversely impact our gain share revenue.

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

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

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

Our success is largely dependent upon our ability to structure our future customer contracts to include a larger gain share component relative to the fixed fee component. If we are successful in increasing the gain share component of our customer contracts, we will experience an adverse impact on our operating results in the short term as we reduce the fixed fee component, which we typically recognize earlier than gain share fees. In addition, by increasing the gain share component, we increase the variability of our revenue, and therefore increase the risk that our total future revenue will be lower than expected and fluctuate significantly from period to period.

We generate virtually all 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 and we expect this to continue in the near term. In the six months ended June 30, 2002, three customers accounted for 60% of our total net

revenue, with Toshiba representing 24%, Matsushita representing 22% and Sony representing 14%, respectively. For the year ended December 31, 2001 Toshiba, Matsushita and Sony represented 34%, 29% and 9% of our total revenue, respectively. The loss of any of these customers or a decrease in the sales volumes of their products could significantly reduce our total revenue below expectations. In particular, such a loss could cause significant fluctuations in results of operations due to our expenses being fixed in the short term, the fact that it takes us a long time to replace customers and because any offsetting gain share revenue from new customers would not begin to be recognized until much later. Due to current economic conditions, some of our customers have recently announced employee layoffs, which may indicate decreased demand for certain of their products. There can be no assurances that such decrease in demand will not ultimately have an impact on our revenues.

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

Because our gain share business model is novel and our Design-to-Silicon-Yield solutions are unfamiliar, our sales cycle is lengthy and requires a significant amount of our senior management's time and effort. Furthermore, we need to target those individuals within a customer's organization who have overall responsibility for the profitability of an IC. These individuals tend to be senior management or executive officers. We may face difficulty identifying and establishing contact with such individuals. We typically send one or more of our senior executives and several engineers to meet with a prospective customer. Even after initial acceptance, due to the complexity of structuring the gain share component, the negotiation and documentation processes can be lengthy. It can take six 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 and we may be unable to maintain recent profitability.

We may not maintain profitability if our revenue increases more slowly than we expect or not at all. In addition, virtually all of our operating expenses are fixed in the short term, so any shortfall in anticipated revenue in a given period could significantly reduce our operating results below expectations. Our accumulated deficit was $14.2 million as of June 30, 2002. We expect to continue to incur significant expenses in connection with:

- increased 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 deferred stock compensation.

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

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

We will need to continue to hire highly talented executives, engineers and research and development personnel to support our planned growth. We have experienced, and we expect to continue to experience, delays and limitations in hiring and retaining highly skilled individuals with appropriate qualifications. We intend to continue to hire foreign nationals, particularly as we expand our operations internationally. We have had, and expect to continue to have, difficulty in obtaining visas permitting entry into the United States, for several of our key personnel, which disrupts our ability to strategically locate our personnel. In addition, we have a number of openings for key executive positions, including a Vice President of Client Services, that we will need to fill in order to successfully execute our business strategy. We may have difficulty recruiting these executives or integrating them into our existing management team. 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 Design-to-Silicon-Yield 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 Design-to-Silicon-Yield 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 Design-to-Silicon-Yield 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 to competitors 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 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 curve as new technologies are introduced. In the past, the absence of an established working relationship with key companies in the industry has meant that we have had to exclude the effect of their component parts from our modeling analysis, which reduces the overall effectiveness of our analysis and limits our ability to improve yield. We may be unable to establish key industry strategic relationships if any of the following occur:

- potential industry partners become concerned about our ability to protect their intellectual property;

- potential industry partners develop their own solutions to address the need for yield improvement;

- our potential competitors establish relationships with industry partners with which we seek to establish a relationship; or

- potential industry partners attempt to restrict our ability to enter into relationships with their competitors.

We face operational and financial risks associated with international operations.

We derive a majority of our revenue from international sales, principally from customers based in Japan. Revenue generated from customers in Japan accounted for 68% of total revenue in the six months ending June 30, 2002. For the year ended December 31, 2001 revenue generated from customers in Japan was 77%. We expect that a significant portion of our total future revenue will continue to be derived from companies based in Japan. We are subject to risks inherent in doing business in international markets. These risks include:

- some of our key engineers and other personnel who are foreign nationals may have difficulty gaining access to the United States and other countries in which our customers or our offices may be located;

- greater difficulty in collecting account receivables resulting in longer collection periods;

- language and other cultural differences may inhibit our sales and marketing efforts and create internal communication problems among our U.S. and foreign research and development teams;

- compliance with, and unexpected changes in, a wide variety of foreign laws and regulatory environments with which we are not familiar;

- currency risk due to the fact that expenses for our international offices are denominated in the local currency, while virtually all of our revenue is denominated in U.S. dollars; and

- economic or political instability.

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

- any recurrence of the recent overall downturn in Asian economies could limit our ability to retain existing customers and attract new ones in Asia;

- if the U.S. dollar increases in value relative to the Japanese Yen, the cost of our solutions will be more expensive to existing and potential Japanese customers and therefore less competitive; and

- if any of these risks materialize, we may be unable to continue to market our Design-to-Silicon-Yield solutions successfully in international markets.

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

Competition in our market may intensify in the future, which could slow our ability to grow or execute our strategy. Our current and potential customers may choose to develop their own solutions internally, particularly if we are slow in deploying our solutions. Many of these companies have the financial and technical capability to develop their own solutions. Currently, we are not aware of any other provider of comprehensive commercial solutions for systematic IC yield and performance enhancement. We face indirect competition from the internal groups at IC companies that use an incomplete set of components that is not optimized to accelerate their process-design integration. 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. Additionally, HPL Technologies, through its acquisition of Test Chip Technologies, has indicated its intent to further utilize test chips in its product offering. 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 integrated device manufacturers, or IDMs, electronic design automation software providers, IC design service companies or semiconductor equipment vendors, may decide to spin-off a business unit that competes with us. Other potential competitors include fabrication facilities that may decide to offer solutions competitive with ours as part of their value proposition to their customers. If these potential competitors are able to attract industry partners or customers faster than we can, we may not be able to grow and execute our strategy as quickly or at all. In addition, customer preferences may shift away from our Design-to-Silicon-Yield solutions as a result of the increase in competition.

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

We will need to continue to grow in all areas of operation and successfully integrate and support our existing and new employees into our operations, or we may be unable to implement our business strategy in the time frame we anticipate, if at all. We will also need to switch to a new accounting system in the near future, which could disrupt our business operations and distract management. In addition, we will need to expand our intranet to support new data centers to enhance our research and development efforts. Our intranet is expensive to expand and must be highly secure due to the sensitive nature of our customers’ information that we transmit. Building and managing the support necessary for our growth places significant demands on our management and resources. These demands may divert these resources from the continued growth of our business and implementation of our business strategy. Further, we must adequately train our new personnel, especially our technical support personnel, to adequately, and accurately, respond to and support our customers. If we fail to do this, it could lead to dissatisfaction among our customers, which could slow our growth.

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

Our solution implementations require a team of engineers to collaborate with our customers to address complex yield loss issues by using our software and other technologies. We must estimate the amount of time needed to complete an existing solution implementation in order to estimate when the engineers will be able to commence a new solution implementation. Given the time pressures involved in bringing IC products to market, targeted customers may proceed without us if we are not able to commence their solution implementation on time. Due to our lengthy sales cycle, we may be unable to replace these targeted implementations in a timely manner, which could cause fluctuations in our operating results.

In addition, our accounting for solution implementation contracts, which generate fixed fees, sometimes require adjustments to profit and loss based on revised estimates during the performance of the contract. These adjustments may have a material effect on our results of operations in the period in which they are made. The estimates giving rise to these risks, which are inherent in fixed-price contracts, include the forecasting of costs and schedules, and contract revenues related to contract performance.

Our chief executive officer and our executive vice president of sales, marketing and business development 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 John Kibarian, our President and Chief Executive Officer, and David Joseph, our Executive Vice President, Sales, Marketing and Business Development. If we lose the services of either of these key executives, it could slow execution of our business plan, hinder our product development processes and impair our sales efforts. Searching for their replacements could divert our other senior management's time and increase our operating expenses. In addition, our industry partners and customers could become concerned about our future operations, which could injure our reputation. We do not have long-term employment agreements with these executives and we do not maintain any key person life insurance policies on their lives.

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

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

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

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

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

Significant litigation regarding intellectual property rights exists in the semiconductor industry. It is possible that a third party may claim that our technologies infringe their intellectual property rights or misappropriate their trade secrets. Any claim, even if without merit, could be time consuming to defend, result in costly litigation or require us to enter into royalty or licensing agreements, which may not be available to us on acceptable terms, or at all. For example, in May 2001 the Company was named as a defendant in a lawsuit claiming, among other things, that it misappropriated trade secrets in connection with hiring an employee. This litigation was settled by all parties in the quarter ended June 30, 2002. In general, however, 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 and software tools could decrease our revenue and our competitive market share.

If the software or proprietary technologies we provide to a customer contain defects that increase our customer’s cost of goods sold and time to market, these defects could significantly decrease the market acceptance of our Design-to-Silicon-Yield solutions. Any actual or perceived defects with our software 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 or proprietary technologies or enhancements to existing software or proprietary technologies. Our software or proprietary technologies may contain errors not discovered until after customer implementation of the silicon design and manufacturing process recommended by us. If our software or proprietary technologies contain errors or defects, it could require us to expend significant resources to alleviate these problems, which could result in the diversion of technical and other resources from our other development efforts.

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

We currently anticipate that our available cash resources will be sufficient to meet our presently anticipated working capital and capital expenditure requirements for at least the next 12 months. However, we may need to raise additional funds in order to:

• support more rapid expansion;

• develop or enhance Design-to-Silicon-Yield solutions;

• respond to competitive pressures; or

• acquire complementary businesses or technologies.

These factors will impact our future capital requirements and the adequacy of our available funds. We may need to raise additional funds through public or private financings, strategic relationships or other arrangements. We cannot guarantee that we will be able to raise any necessary funds on terms favorable to us, or at all.

General economic conditions may reduce our revenues and harm our business.

As our business has grown, we have become increasingly subject to the risks arising from adverse changes in domestic and global economic conditions and in particular, the possible disruption in commercial activities occasioned by terrorist activity and armed conflict. Because of recent events and the worldwide economic slowdown, and in the United States in particular, many industries are delaying or reducing technology purchases. The impact of these events and this slowdown on us is difficult to predict, but it may result in reductions in purchases of our technologies and services by our customers, longer sales cycles and increased price competition. As a result, if terrorist-related events or the current economic slowdown continues or

worsens, we may fall short of our revenue expectations for any given quarter in fiscal 2002 or for the entire year. These conditions would negatively affect our business and results of operations.

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

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

Our stock price is likely to be extremely volatile as the market for technology companies' stock has recently experienced extreme price and volume fluctuations.

Volatility in the market price of our common stock could result in securities class action litigation. Any litigation would likely result in substantial costs and a diversion of management's attention and resources. Despite the strong pattern of operating losses of technology companies, the market demand, valuation and trading prices of these companies have been high. At the same time, the share prices of these companies' stocks have been highly volatile and have recorded lows well below their historical highs. As a result, investors in these companies often buy the stock at very high prices only to see the price drop substantially a short time later, resulting in an extreme drop in value in the stock holdings of these investors. Our stock may not trade at the same levels as other technology stocks. In addition, technology stocks in general may not sustain current market prices.

The semiconductor industry is cyclical in nature.

Our revenue is highly dependent upon the overall condition of the semiconductor industry, especially in light of our gain share revenue component. The semiconductor industry is highly cyclical and subject to rapid technological change and has been subject to significant economic downturns at various times, characterized by diminished product demand, accelerated erosion of average selling prices and production overcapacity. One such downturn commenced during the third quarter of calendar 2000 and is continuing currently. For example, during this downturn one of our largest customers, Toshiba, announced layoffs of some of its employees, which could be indicative of decreased demand for some of its products. 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.

Semiconductor companies are subject to risk of natural disasters.

Semiconductor companies have in the past experienced major reductions in foundry capacity due to earthquakes in Taiwan, Japan and California. In light of our gain share revenue component, our results of operations can be significantly decreased if one of our customers must shut down IC production due to a natural disaster such as earthquake, fire, tornado or flood. Moreover, since semiconductor product life cycles have become relatively short, a significant delay in the production of a product could result in lost revenue, not merely delayed revenue.

Management will have broad discretion as to the use of proceeds from our initial public offering and, as a result, we may not use the proceeds to the satisfaction of our stockholders.

On August 1, 2001, we closed our initial public offering. Our board of directors and management have broad discretion in allocating the net proceeds therefrom. They may choose to allocate such proceeds in ways that do not produce a favorable return or are not supported by our stockholders. We have designated only limited specific uses for the net proceeds from our initial public offering.

The concentration of our capital stock ownership with insiders will likely limit your ability to influence corporate matters.

The concentration of ownership of our outstanding capital stock with our directors and executive officers may limit your ability to influence corporate matters. Our directors, executive officers and their affiliates, beneficially own a significant portion of our outstanding capital stock. As a result, these stockholders, if acting together, will have the ability to control all matters submitted to our stockholders for approval, including the election and removal of directors and the approval of any corporate transactions.

We have anti-takeover defenses that could delay or prevent an acquisition of our company.

Provisions of our certificate of incorporation and bylaws and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders.

A large number of shares becoming eligible for sale could cause our stock price to decline.

Sales of a substantial number of shares of our common stock could cause our stock price to fall. Our current stockholders hold a substantial number of shares, which they are able to sell, from time-to-time, in the public market.

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. We do not use derivative financial or commodity instruments for investment purposes. This discussion contains forward-looking statements that are subject to risks and uncertainties. Our actual results could vary materially as a result of a number of factors.

Interest Rate Risk. As of June 30, 2002 we had cash and cash equivalents of $66.6 million, consisting of cash and highly liquid money market instruments with maturities of less than 90 days. Because of the short maturities of these instruments, a sudden change in market interest rates would not have a material impact on the fair value of the portfolio. We would not expect our operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest on our portfolio. A hypothetical increase in market interest rates of 10% from the market rates in effect at June 30, 2002 would cause the fair value of these investments to decrease by an immaterial amount which would not have significantly impacted our financial position or results of operations. Declines in interest rates over time will result in lower interest income and increased interest expense.

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

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently party to any material legal proceedings. In May 2001 the Company was named as a defendant in a lawsuit claiming, among other things, that it misappropriated trade secrets in connection with hiring an employee. This litigation was settled by all parties in the quarter ending June 30, 2002. All expenses related to the lawsuit have been reflected in the June 2002 quarterly financial statements.

Item 2. Changes in Securities and Use of Proceeds

(d) Use of Proceeds

Our Registration Statement on Form S-1 (File No. 333-43192) related to our initial public offering was declared effective by the SEC on July 26, 2001. The public offering commenced on July 27, 2001. All 4,500,000 shares of common stock offered in the final prospectus, as well as an additional 675,000 shares of common stock subject to the underwriters' over-allotment option, were sold at the closing on August 1, 2001 at a price to the public of $12.00 per share (before deducting underwriting discounts and commissions) through a syndicate of underwriters managed by Credit Suisse First Boston Corporation, Robertson Stephens, Inc. and Dain Rauscher Incorporated. The aggregate gross proceeds of the shares offered and sold was $62.1 million, out of which we paid an aggregate of $4.3 million in underwriting discounts and commissions to the underwriters. In addition, as of December 31, 2001, we had incurred additional expenses of approximately $1.3 million in connection with the offering, which when added to the underwriting discounts and commissions paid by us, amounts to total estimated expenses of $5.6 million. We believe there are no remaining outstanding invoices.

We incurred legal expenses payable to Orrick, Herrington & Sutcliffe LLP in connection with the initial public offering of our common stock. Peter Cohn, our Secretary, is a partner in that law firm. Other than such payments, none of the net proceeds were paid, and none of the initial public offering expenses related to any payments, directly or indirectly, to directors, officers or general partners of PDF or its associates, persons owning 10% or more of any class of securities of PDF, or affiliates of PDF.

We intend to use the net proceeds of the public offering primarily for general corporate purposes, including working capital and capital expenditures. The amounts and timing of these expenditures will vary depending on a number of factors, including the amount of cash generated or used by our operations, competitive and technological developments and the rate of growth, if any, of our business. We may also use a portion of the net proceeds to acquire businesses, services, products or technologies or invest in businesses that we believe will complement our current or future business. As a result, we will retain broad discretion in the allocation of the proceeds of the public offering. Pending the uses described above, we will invest the net proceeds of the public offering in cash, cash equivalents, money market funds or short-term interest-bearing, investment-grade securities to the extent consistent with applicable regulations. We cannot predict whether the proceeds will be invested to yield a favorable return.

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

During the quarter ended June 30, 2002, we submitted the following matters to our stockholders for approval at our Annual Meeting of Stockholders held on May 17, 2002 and the following proposals were adopted by our stockholders by the margins indicated:

Proposals

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

Election of Director	Votes For	Votes Withheld
B.J. Cassin — Class I Director	17,783,921	132,417
Donald L. Lucas — Class I Director	17,783,804	132,300

As a result, Messrs. Cassin and Lucas were re-elected as Class I directors of the Registrant for a three year term expiring upon the Annual Meeting next following the fiscal year ending December 31, 2004, or until their respective successors have been duly qualified and elected. John K. Kibarian, Lucio L. Lanza and Kimon Michaels continued as directors of the Registrant.

2. To ratify the appointment of Deloitte & Touche LLP as the independent auditors of the Company for the Fiscal Year Ending December 31, 2002.

Votes for	Votes Against	Votes Abstained	Broker Non-votes
17,693,866	222,355	0	0

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits:

Exhibit Number	Description
3.1	Third Amended and Restated Certificate of Incorporation of PDF Solutions, Inc.*
3.2	Amended and Restated Bylaws of PDF Solutions, Inc.*
4.1	Specimen Stock Certificate.**
4.2	Second Amended and Restated Rights Agreement dated July 6, 2001.*
99.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.2	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Incorporated by reference to PDF's Registration Statement on Form S-1, as amended (File No. 333-43192).

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

(b) Reports on Form 8-K

No reports on Form 8-K were filed by PDF during the three months ended June 30, 2002.

SIGNATURES

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

Date: August 14, 2002	By: /s/ John K. Kibarian
	John K. Kibarian President and Chief Executive Officer
Date: August 14, 2002	By: /s/ P. Steven Melman
	P. Steven Melman Chief Financial Officer and Vice President, Finance and Administration

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EXHIBIT 99.1

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

In connection with the Quarterly Report of PDF Solutions, Inc. (the "Company") on Form 10-Q for the period ended June 30, 2002 as filed with the Securities and Exchange Commission on the date hereof (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:

(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 present, 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
August 14, 2002

EXHIBIT 99.2

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

In connection with the Quarterly Report of PDF Solutions, Inc. (the "Company") on Form 10-Q for the period ended June 30, 2002 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, P. Steven Melman, Chief Financial 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:

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

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

/s/ P. Steven Melman

P. Steven Melman
Chief Financial Officer
August 14, 2002