PDF SOLUTIONS INC
Form 10-Q
May 10, 2007

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

FORM 10-Q

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

For the Quarterly Period ended March 31, 2007

or

o **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	**25-1701361**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

333 West San Carlos Street, Suite 700 San Jose, California	**95110**
(Address of Principal Executive Offices)	(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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Act (Check one):

Large accelerated filer o Accelerated filer þ Non-accelerated filer o

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

The number of shares outstanding of the Registrant s Common Stock as of May 4, 2007 was 28,043,894.

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Item 1. Financial Statements.

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

	March 31, 2007	December 31, 2006
	(In thousands, except par values)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 32,083	$ 36,451
Short-term investments	18,419	16,402
Accounts receivable, net of allowance of $295 in 2007 and $294 in 2006	35,099	27,575
Prepaid expenses and other current assets	2,720	2,796
Deferred tax assets	3,087	2,581
Total current assets	91,408	85,805
Property and equipment, net	3,742	3,916
Goodwill	60,997	60,034
Intangible assets, net	11,004	13,605
Deferred tax assets	6,603	4,994
Other assets	533	503
Total assets	$ 174,287	$ 168,857
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 289	$ 302
Accounts payable	2,554	3,182
Accrued compensation and related benefits	5,364	3,325
Other accrued liabilities	2,283	3,843
Taxes payable	1,533	4,767
Deferred revenue	6,572	3,705
Billings in excess of recognized revenue	888	95
Total current liabilities	19,483	19,219
Long-term debt	1,173	1,198
Long-term taxes payable	4,757	
Other liabilities	177	221
Total liabilities	25,590	20,638
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 and outstanding 27,991 in 2007 and 27,948 in 2006	4	4

Additional paid-in-capital	169,580	167,323
Treasury stock at cost, 551 shares	(5,549)	(5,549)
Accumulated deficit	(16,783)	(13,890)
Accumulated other comprehensive income	1,445	331
Total stockholders equity	148,697	148,219
Total liabilities and stockholders equity	$ 174,287	$ 168,857

See notes to unaudited condensed consolidated financial statements

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

	Three months Ended March 31,	
	2007	2006
	(In thousands, except per share amounts)	
Revenues:		
Design-to-silicon-yield solutions:		
Integrated solutions	$ 13,764	$ 12,229
Software licenses	3,485	2,612
Gain share	4,893	5,016
Total revenues	22,142	19,857
Cost of design-to-silicon-yield solutions:		
Direct costs of design-to-silicon-yield solutions:		
Integrated solutions	7,708	6,429
Software licenses	59	11
Amortization of acquired core technology	1,575	1,266
Total cost of design-to silicon-yield solutions	9,342	7,706
Gross margin	12,800	12,151
Operating expenses:		
Research and development	8,370	6,256
Selling, general and administrative	5,844	4,956
Amortization of other acquired intangible assets	1,013	235
Total operating expenses	15,227	11,447
Income (loss) from operations	(2,427)	704
Interest and other income, net	496	635
Income (loss) before taxes	(1,931)	1,339
Income tax provision	424	1,071
Net income (loss)	$ (2,355)	$ 268
Net income (loss) per share:		
Basic	$ (0.08)	$ 0.01
Diluted	$ (0.08)	$ 0.01
Weighted average common shares:		
Basic	27,980	26,542

Diluted	27,980	28,223

See notes to unaudited condensed consolidated financial statements

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

	Three Months Ended March 31,	
	2007	2006
	(In thousands)	
Operating activities:		
Net income (loss)	$ (2,355)	$ 268
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	493	570
Stock-based compensation expense	1,838	2,168
Gain on disposal of property, plant and equipment	1	
Amortization of acquired intangible assets	2,604	1,501
Tax benefit related to stock-based compensation expense	(27)	492
Excess tax benefit from stock-based compensation expense		(305)
Deferred taxes	(1,529)	231
Changes in operating assets and liabilities, net of effect of acquisition:		
Accounts receivable, net of allowances	(7,525)	503
Prepaid expenses and other assets	46	269
Accounts payable	(637)	(751)
Accrued compensation and related benefits	607	(1,985)
Other accrued liabilities	368	(229)
Taxes payable	1,833	87
Deferred revenues	2,867	978
Billings in excess of recognized revenue	793	(1,014)
Net cash provided by (used in) operating activities	(623)	2,783
Investing activities:		
Purchases of available-for-sale securities	(9,515)	(27,746)
Maturities and sales of available-for-sale securities	7,671	2,800
Purchases of property and equipment	(476)	(868)
Payments on business acquired in 2006, net of cash acquired	(1,945)	
Net cash used in investing activities	(4,265)	(25,814)
Financing activities:		
Exercise of stock options	447	2,375
Principal payments on long-term obligations	(38)	(27)
Excess tax benefit from stock-based compensation expense		305
Net cash provided by financing activities	409	2,653
Effect of exchange rate changes on cash	111	7
Net decrease in cash and cash equivalents	(4,368)	(20,371)
Cash and cash equivalents, beginning of period	36,451	60,506

Cash and cash equivalents, end of period	$ 32,083	$ 40,135
Non-cash investing and financing activities:		
Purchase price adjustments	$ 4	$
Effect of exchange rate changes on goodwill	$ 992	$
Reversal of deferred stock compensation	$	$ 27
Purchase of property and equipment on account	$ 37	$ 31
Supplemental disclosure of cash flow information:		
Cash paid during the year for:		
Taxes	$ 184	$ 302
Interest	$ 12	$ 2

See notes to unaudited condensed consolidated financial statements

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

1. BASIS OF PRESENTATION

Basis of Presentation

The interim unaudited condensed consolidated financial statements included herein have been prepared by PDF Solutions, Inc. (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC), including the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The interim unaudited condensed consolidated financial statements reflect, in the opinion of management, all adjustments necessary, (consisting only of normal recurring adjustments) to present a fair statement of results for the interim periods presented. The operating results for any interim period are not necessarily indicative of the results that may be expected for other interim periods or the full fiscal year. The accompanying interim unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

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.

Revenue Recognition The Company derives revenue from two sources: Design-to-Silicon-Yield solutions and gain share. The Company recognizes revenue in accordance with the provisions of American Institute of Certified Public Accountants Statement of Position (SOP) No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* and SOP No. 97-2, *Software Revenue Recognition,* as amended.

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

Integrated Solutions The Company generates a significant portion of its revenue from fixed-price contracts delivered over a specific period of time. These contracts require the accurate estimation of the cost to perform obligations and the overall scope of each engagement. Revenue under contracts for solution implementation services is recognized as the services are performed using the cost-to-cost percentage of completion method of contract accounting. Losses on solution implementation contracts are recognized when determined. Revisions in profit estimates are reflected in the period in which the conditions that require the revisions become known and can be estimated.

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

Revenue from support and maintenance services is recognized ratably over the term of the support and maintenance contract, generally one year, while revenue from consulting, installation and training services is recognized as the services are performed. When bundled with software licenses in multiple element arrangements, support and maintenance, consulting (other than for our fixed price solution implementations), installation, and training revenue is allocated to each element of a transaction based upon its fair value as determined by the Company s VSOE. VSOE is generally established for support and maintenance based upon negotiated renewal rates while VSOE for consulting, installation, and training is established based upon the Company s customary pricing for such services

when sold separately. When VSOE does not exist to allocate a portion of the total fee to the undelivered elements, revenue is recognized ratably over the term of the underlying element for which VSOE does not exist.

Software Licenses The Company also licenses its software products separately from its integrated solution implementations. In such cases revenue is recognized under the residual method when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, (iv) collectibility is probable and the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for our fixed price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by the Company s VSOE and such services are recorded as integrated solutions. VSOE is generally established for support and maintenance based upon negotiated renewal rates while VSOE for consulting, installation and training services is established based upon the Company s customary pricing for such services when sold separately. No revenue has been recognized for software licenses with extended payment terms in excess of amounts due.

Gain Share Gain share revenue represents profit sharing and performance incentives earned based upon the Company s customer reaching certain defined operational levels. Upon achieving such operational levels, the Company receives either a fixed fee and/or variable fee based on the units manufactured by the customer. Due to the uncertainties surrounding attainment of such operational levels, the Company recognizes gain share revenue (to the extent of completion of the related solution implementation contract) upon receipt of performance reports or other related information from the customer supporting the determination of amounts and probability of collection.

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004) (SFAS No. 123R), *Share-Based Payment*. Under the provisions of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the award s fair-value as calculated by the Black-Scholes-Merton (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.

2. RECENT ACCOUNTING PRONOUNCEMENTS

Effective January 1, 2007, the Company adopted the provisions of the Financial Accounting Standards Board s (FASB) Emerging Issues Task Force (EITF) No. 06-2, *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43* (EITF No. 06-2). Prior to the issuance of EITF No. 06-2 the Company accounted for sabbatical expense under SFAS No. 43, by expensing the cost of compensated absences for sabbatical programs as incurred. EITF No. 06-2 requires companies to accrue the cost of such compensated absences over the requisite service period. The Task Force allows the use of one of two specified methodologies for adopting the change in accounting principle: i) a cumulative-effect adjustment to retained earnings at the beginning of the year of adoption; or ii) retrospective application to all prior periods. The Company elected to use the cumulative-effect adjustment to the beginning balance of retained earnings resulting in an additional liability of $1.4 million, an additional deferred tax asset of $587,000, and an increase in the accumulated deficit of $845,000. Under this transition method, prior periods will not be restated and accrued expense for the first quarter of fiscal 2007 includes accrued sabbatical expense for all employees who are eligible for sabbatical leave.

In February 2007, the FASB issued SFAS No. 159 (SFAS No. 159), *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115.* SFAS 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. SFAS 159 is effective beginning the first fiscal year that begins after November 15, 2007. The Company is currently evaluating the impact of the adoption of SFAS 159 on its financial statements.

In June, 2006, the FASB issued Financial Interpretation No. 48 (FIN No. 48), *Accounting for Uncertainty in Income Taxes* which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS No. 109. Additionally, the Interpretation provides guidance on measurement, de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition. The Interpretation is effective for fiscal years beginning after December 15, 2006. The Company adopted the provisions of FIN No. 48 on January 1, 2007. See Note 8 *Income Taxes* for a discussion of the effects of adoption.

In September, 2006, the FASB issued SFAS No. 157 (SFAS No. 157), *Fair Value Measurement* that establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America (GAAP), and expands disclosures about fair value measurements. Additionally, the pronouncement provides guidance on definition, measurement, methodology and use of assumptions and inputs in determining fair value. The pronouncement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently evaluating the impact of the adoption of SFAS No. 157 on its financial statements.

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3. INVESTMENTS

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

	March 31, 2007			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Market Value
Commercial paper	$ 16,545	$ 2	$	$ 16,547
Auction rate securities	5,050			5,050
Corporate bonds and notes	1,998			1,998
Money market funds	20,225			20,225
	$ 43,818	$ 2	$	$ 43,820
Included in cash and cash equivalents				$ 25,401
Included in short-term investments				18,419
Total available-for-sale securities				$ 43,820

As of March 31, 2007 all securities held by the Company had a maturity of one year or less.

	December 31, 2006			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Market Value
Commercial paper	$ 13,307	$ 1	$	$ 13,308
Auction rate securities	5,050			5,050
Corporate bonds and notes	1,984		(1)	1,983
Money market funds	23,744			23,744
	$ 44,085	$ 1	$ (1)	$ 44,085
Included in cash and cash equivalents				$ 27,683
Included in short-term investments				16,402
Total available-for-sale securities				$ 44,085

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 $6.0 million and $7.8 million at March 31, 2007 and December 31, 2006, respectively.

5. NET INCOME (LOSS) PER SHARE

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

	Three Months Ended March 31,	
	2007	2006
Net income (loss)	$ (2,355)	$ 268
Denominator for basic calculation:		
Weighted average common shares outstanding	27,980	26,542
Dilutive items		
Stock options outstanding		1,681
Denominator for diluted computation	27,980	28,223
Net income (loss) per share basic	$ (0.08)	$ 0.01
Net income (loss) per share diluted	$ (0.08)	$ 0.01

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

	Three Months Ended March 31,	
	2007	**2006**
Common stock options	6,594	1,402

6. COMPREHENSIVE INCOME (LOSS)

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

	Three Months Ended March 31,	
	2007	**2006**
Net income (loss)	$ (2,355)	$ 268
Unrealized gain (loss) on short-term investments	2	(30)
Foreign currency translation adjustments	1,112	14
Comprehensive income (loss)	$ (1,241)	$ 252

7. GOODWILL AND PURCHASED 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, 2006 and concluded that goodwill was not impaired.

During the three months ended March 31, 2007, the Company recorded adjustments to Goodwill of $29,000 related to assumption of certain liabilities in connection with the Si Automation S.A. acquisition, and of $992,000 related the effect of changes in exchange rates. During the same period, the Company made final net payments of $1.9 million.

The following table provides information relating to the intangible assets and goodwill as of March 31, 2007 and December 31, 2006 (in thousands):

	Amortization Period (Years)	December 31, 2006 Net Carrying Amount	Acquisition	Purchase Price Adjustments	Amortization	Foreign Currency Translation	March 31, 2007 Net Carrying Amount
Goodwill	N/A	$ 60,034	$	$ (29)	$	$ 992	$ 60,997
Acquired identifiable intangibles:							
Acquired core technology	4	$ 7,901	$	$	$ (1,575)	$	$ 6,326
Brand name	4	822			(157)		665
Customer relationships and backlog	1 - 6	4,362			(746)		3,616
Other acquired intangibles	4	520			(126)	3	397
Total		$ 13,605	$	$	$ (2,604)	$ 3	$ 11,004

	Amortization Period (Years)	December 31, 2005 Net Carrying Amount	Acquisitions	Purchase Price Adjustments	Amortization	Foreign Currency Translation	December 31, 2006 Net Carrying Amount
Goodwill	N/A	$ 39,886	$ 21,071	$ (923)	$	$	$ 60,034
Acquired identifiable intangibles:							
Acquired core technology	4	$ 8,221	$ 4,950	$	$ (5,270)	$	$ 7,901
Brand name	4	833	510		(521)		822

Customer relationships and backlog	1 - 6		4,860		(498)		4,362
Other acquired intangibles	4	733	255		(477)	9	520
Total		$ 9,787	$ 10,575	$	$ (6,766)	$ 9	$ 13,605

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

Year Ending December 31,	Amount
2007 (nine-month period)	$ 5,164
2008	1,807
2009	1,807
2010	1,541
2011	375
2012	310
Total	$ 11,004

8. INCOME TAXES

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* (FIN 48) at the beginning of fiscal 2007. FIN 48 provides a comprehensive model for the financial statement recognition, measurement, presentation and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. Unrecognized tax benefits represent tax positions for which reserves have been established. As a result of the implementation of FIN 48, the Company recognized a $308,000 decrease in net liabilities for unrecognized tax benefits. This was accounted for as an adjustment to the beginning balance of the accumulated deficit on the balance sheet. As the Company does not anticipate recognizing these tax benefits over the next twelve months, it has reclassified these liabilities as long term. Prior to the adoption of FIN 48, the Company recorded its tax exposure as short term liabilities.

As of the date of adoption, the Company s unrecognized tax benefits totaled approximately $4.4 million, of which $3.7 million in benefits, if recognized, would favorably affect the effective tax rate in any future period. The Company does not expect the change in unrecognized tax benefits over the next twelve months to materially impact its results of operations and financial position.

The Company conducts business globally and, as a result, files numerous consolidated and separate income tax returns in the U.S. federal, various state and foreign jurisdictions. The Company is not currently under audit by any tax authority. 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 2003 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.

Interest and penalties related to unrecognized tax benefits are recognized in income tax expense in the consolidated statements of operations. At the date of adoption, $309,000 of accrued interest was included in long-term taxes payable on the consolidated balance sheet.

9. STOCKHOLDERS EQUITY

Effective January 1, 2006, the Company adopted the provisions of SFAS No.123 (Revised 2004), *Share-Based Payments*. For the three months ended March 31, 2007 and March 31, 2006, stock-based compensation expenses before taxes related to the Company s ESPP and stock-option plans were $1.8 million and $2.2 million, respectively, and were allocated as follows (in thousands):

	Three Months Ended March 31,	
	2007	2006
Cost of design-to-silicon yield solutions	$ 493	$ 621
Research and development	563	618
Selling, general and administrative	782	929
Stock based compensation before income taxes	$ 1,838	$ 2,168

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 March 31,		Employee Stock Purchase Plans Three Months Ended March 31,	
	2007	2006	2007	2006
Expected life (in years)	6.08	3.82	0.73	1.01
Volatility	60.7%	56.1%	53%	39.3%
Risk-free interest rate	4.76%	4.69%	5.28%	3.1%
Expected dividend				
Weighted average fair value of options granted during the period	$ 7.19	$ 8.01		
Weighted average fair value of employee stock issued during the period			$ 4.14	$ 3.54

On March 31, 2007, the Company has in effect the following stock-based compensation plans:

Stock Plans During 2001, the Company terminated the 1996 and 1997 Stock Plans as to future option grants, and adopted the 2001 Stock Plan. Under the 2001 Stock Plan, on January 1 of each year, starting with year 2002, the number of shares in the reserve will increase by the lesser of (i) 3,000,000 shares, (ii) 5% of the outstanding common

stock on the last day of the immediately preceding year, or (iii) the number of shares determined by the board of directors. Under the 2001 Stock Plan, the Company may grant options to purchase shares of common stock to employees, directors and consultants at prices not less than the fair market value at the date of grant for incentive stock options and not less than 85% of fair market value for nonstatutory stock options. These options generally expire ten years from the date of grant and become vested and exercisable ratably over a four-year period. Certain option grants under the 1996 and 1997 Stock Plans provide for the immediate exercise by the optionee with the resulting shares issued subject to a right of repurchase by the Company which lapses based on the original vesting provisions.

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Stock option activity under the Company plans as of March 31, 2007 and changes during the three months ended March 31, 2007 were as follows:

	Number of Options	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in 000 s)
Outstanding, January 1, 2007	6,664,094	$ 12.11		
Granted	41,500	11.80		
Exercised	(43,551)	10.25		
Forfeited or expired	(67,770)	12.86		
Outstanding at March 31, 2007	6,594,273	12.11	7.39	$ 6,689
Vested and expected to vest	6,155,955	11.98	7.27	$ 6,659
Exercisable at March 31, 2007	3,595,331	$ 10.72	6.11	$ 6,158

The aggregate intrinsic value in the table above represents the total pretax intrinsic value based on the Company s closing stock price of $11.29 as of March 31, 2007, 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 three months ended March 31, 2007 was $146,000.

Nonvested options as of March 31, 2007 and changes during the three months ended March 31, 2007 were as follows:

	Number of Options	Weighted Average Grant Date Fair Value
Nonvested, January 1, 2007	3,244,835	$ 7.84
Granted	41,500	7.19
Vested	(238,474)	6.79
Forfeited	(48,919)	7.26
Nonvested at March 31, 2007	2,998,942	7.89

As of March 31, 2007, there was $14.8 million of total unrecognized compensation cost related to nonvested stock options. That cost is expected to be recognized over a weighted average period of 3.0 years. The total fair value of shares vested during the three months ended March 31, 2007 was $1.6 million.

Employee Stock Purchase Plan In July 2001, the Company adopted an Employee Stock Purchase Plan, (Purchase Plan) under which eligible employees can contribute up to 10% of their compensation, as defined in the Purchase Plan, towards the purchase of shares of PDF common stock at a price of 85% of the lower of the fair market value at the beginning of the offering period or the end of each six-month offering period. For the three months ended March 31, 2007, the purchase plan compensation expense was $175,000.

Stock repurchase program In February 2003, the Board of Directors approved a program to repurchase up to $10.0 million of the Company s common stock in the open market. As of March 31, 2007, the Company has repurchased 550,521 shares at a weighted average price of $10.08 per share for a total cost of $5.5 million. Under this

authorization, the Company may continue to make additional stock repurchases from time to time, depending on market conditions, stock price and other factors. At March 31, 2007, $4.5 million remained available under the program to repurchase additional shares.

10. 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 chief operating decision maker, or group, in deciding how to allocate resources and in assessing performance.

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

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

	Three Months Ended March 31,	
Customer	**2007**	**2006**
A	17%	30%
B	16%	11%
C	5%	10%
D	1%	10%

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

Customer	**March 31, 2007**	**December 31, 2006**
A	16%	12%
B	14%	12%
C	13%	18%
D	11%	10%

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

	Three Months Ended March 31,	
	2007	**2006**
Asia	$ 12,030	$ 9,829
United States	7,475	8,868
Europe	2,637	1,160
Total	$ 22,142	$ 19,857

As of March 31, 2007 and December 31, 2006, long-lived assets related to PDF Solutions GmbH (formerly AISS), located in Germany, totaled $841,000 and $876,000, respectively, of which $659,000 and $659,000, respectively, relates to acquired intangible assets and goodwill. As of March 31, 2007 and December 31, 2006 long-lived assets related to SIA, located in France, totaled $30.3 million and $31.5 million, respectively, of which $29.8 million and $30.9 million, respectively, relate to acquired intangible assets and goodwill. The majority of the Company s remaining long-lived assets are in the United States.

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 , e predict , potential or continue , the negative effect of terms like these or other comparable terminology. These statements are only predictions. These statements involve

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known and unknown risks and uncertainties and other factors that may cause actual events or results to differ materially. All forward-looking statements included in this document are based on information available to us on the date of filing, and we assume no obligation to update any such forward-looking statements. In evaluating these statements, you should specifically consider various factors, including the risk factors set forth in Item 1A and set forth at the end of Item 1A in our Annual Report on Form 10-K for the year ended December 31, 2006. We caution investors that our business and financial performance are subject to substantial risks and uncertainties.

Overview

Our technologies and services enable semiconductor companies to improve the yield and performance of integrated circuits, or ICs, by integrating the design and manufacturing processes and better controlling equipment during mass production. Our solutions are designed to improve a semiconductor company s time-to-market, yield and ultimately product profitability. Our solutions combine proprietary manufacturing process simulation software, yield and performance modeling software, design-for-manufacturability software, test chips, a proprietary electrical wafer test system, yield and performance enhancement methodologies, yield management systems, process control system software, and professional services. We analyze yield loss mechanisms to identify, quantify and correct the issues that cause yield loss, as an integral part of the IC design process. This drives IC design and manufacturing improvements that enable our customers to have higher initial yields and achieve and exceed targeted IC yield and performance throughout product life cycles. Our solution is designed to increase the initial yield when a design first enters a manufacturing line, to increase the rate at which that yield improves, and to allow subsequent product designs to be added to manufacturing lines more quickly and easily.

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

From our incorporation in 1992 through late 1995, we were primarily focused on research and development of our proprietary manufacturing process simulation and yield and performance modeling software. From late 1995 through late 1998, we continued to refine and sell our software, while expanding our offering to include yield and performance improvement consulting services. In late 1998, we began to sell our software and consulting services, together with our newly developed proprietary technologies, as Design-to-Silicon-Yield solutions, reflecting our current business model. In April 2000, we expanded our research and development team and gained additional technology by acquiring AISS, now operating as PDF Solutions, GmbH, which continues to develop software and provide development services to the semiconductor industry. In July 2001, we completed the initial public offering of our common stock. In 2003, we enhanced our product and service offerings through the acquisitions of IDS and WaferYield. In 2006, we further complemented our technology offering by acquiring Si Automation S.A. and adding its FDC software capabilities to our integrated solution.

Industry Trend

Demand for consumer electronics and communications devices continues to drive technological innovation as the need for products which have greater performance, lower power consumption, reduced costs and smaller size continues to grow with each new product generation. To meet this demand, IC manufacturers and designers are constantly challenged to improve the overall performance of ICs by designing and manufacturing ICs with more embedded applications to create greater functionality. As a result, in 2004 and through 2007 more and more companies have expanded or advanced their design and manufacturing processes to develop and produce deep submicron ICs containing component sizes measured at 90 nanometers and below. As this trend continues, companies will continually be challenged to improve process capabilities to optimally produce ICs with minimal random and systematic and yield loss, which is driven by the lack of compatibility between the design and its respective manufacturing process. We believe as volume production of deep submicron ICs continues to grow, the difficulties of integrating IC designs with their respective processes will create a greater need for products and services that address the performance yield loss issues the semiconductor industry is facing today and will face in the future.

Financial Highlights

Financial highlights for the three months ended March 31, 2007 were as follows:

Total revenue for the three months ended March 31, 2007 was $22.1 million, a increase of 12% compared to the three months ended March 31, 2006. Revenue from Design-to-Silicon-Yield solutions for the three months ended March 31, 2007 increased to $17.2 million compared to $14.8 million for the three months ended March 31, 2006. The change was a result of increases in revenues related to both Integrated Solutions and Software Licenses of $1.5 million and $873,000, respectively, over the three months ended March 31, 2006. Gain share revenue for the three months ended March 31, 2007 decreased slightly to $4.9 million from $5.0 million for the three months ended March 31, 2006. Our gain share revenue may continue to fluctuate from quarter to quarter as a result of each customer s contractual performance measures for achieving gain share as well as each customer s production volumes in any given period.

Net loss for the three months ended March 31, 2007 was $2.4 million, compared to net income of $268,000 for the three months ended March 31, 2006. The net loss was primarily attributable to increases in operating expenses and amortization of acquired intangible assets, both as a result of the acquisition of Si Automation S.A. in October 2006.

Net loss per basic and diluted share was $0.08 for the three months ended March 31, 2007 compared to net income per diluted share of $0.01 for the three months ended March 31, 2006, a decrease of $0.09 per diluted share.

Cash, cash equivalents and short-term investments decreased $2.4 million to $50.5 million during the three months ended March 31, 2007. Net cash used in operating activities for the three months ended March 31, 2007 totaled $623,000 reflecting an increase of $7.5 million in accounts receivable, partially offset by the favorable impact in other operating accounts. Net cash used in investing activities for the three months ended March 31, 2007 included $1.9 million as final payments for business acquired and $476,000 to purchase property and equipment. Net cash provided by financing activities for the three months ended March 31, 2007 totaled $409,000 and was primarily related to the exercise of stock options.

Critical Accounting Policies

Financial Reporting Release No. 60 requires all companies to include a discussion of critical accounting policies or methods used in the preparation of financial statements. 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 consolidated financial statements. The following is a brief discussion of the more significant accounting policies and methods that we use.

General

Our discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted 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 and gain share. We recognize revenue in accordance with the provisions of American Institute of Certified Public Accountants Statement of Position (SOP)

No. 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* and SOP No. 97-2, *Software Revenue Recognition,* as amended.

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

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

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

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

Software Licenses We also license our software products separate from our integrated solutions. In such cases revenue is recognized under the residual method when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the fee is fixed or determinable, (iv) collectibility is probable and the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for our fixed price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by our VSOE and such services are recorded as integrated solutions. VSOE is generally established for maintenance based upon negotiated renewal rates while VSOE for consulting, installation and training services is established based upon our customary pricing for such services when sold separately. No revenue has been recognized for software licenses with extended payment terms in excess of amounts due.

Gain Share Gain share revenue represents profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels. Upon achieving such operational levels, we receive either a fixed fee and/or variable fee based on the units sold by the customer. Due to the uncertainties surrounding attainment of such operational levels, we recognize gain share revenue (to the extent of completion of the related solution implementation contract) upon receipt of performance reports or other related information from our customers supporting the determination of amounts and probability of collection. Gain share revenue is dependent on many factors which are outside our control, including among others, continued production of the related ICs by our customers, sustained yield improvements by our customers and our ability to enter into new Design-to-Silicon-Yield solutions contracts containing gain share provisions.

Software Development Costs

Costs for the development of new software products and substantial enhancements to existing software products are expensed as incurred until technological feasibility has been established, at which time any additional costs would

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

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Goodwill and Acquired Intangible Assets

As of March 31, 2007 we had $61.0 million of goodwill and $11.0 million of intangible assets. In valuing our goodwill and intangible assets, we must 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, 2006, we completed our annual testing requirements and determined that the carrying value of goodwill had not been impaired.

We are currently amortizing our acquired intangible assets over estimated useful lives of 1 to 6 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.

Realization of Deferred Tax Assets

Realization of deferred tax assets is dependent on our ability to generate future taxable income and utilize tax planning strategies. We have recorded a deferred tax asset in the amount that is more likely than not to be realized based on current estimations and assumptions. We evaluate the 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

The Company accounts for stock-based compensation in accordance with SFAS No. 123 (revised 2004) (SFAS No. 123R), *Share-Based Payment*. Under the provisions of SFAS No. 123R, stock-based compensation cost is estimated at the grant date based on the award s fair-value as calculated by the Black-Scholes-Merton (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.

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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 March 31,	
	2007	**2006**
Revenues:		
Design-to-silicon-yield solutions:		
Integrated solutions	62%	62%
Software licenses	16	13
Gain share	22	25
Total revenues	100%	100%
Cost of design-to-silicon-yield solutions:		
Direct costs of design-to-silicon-yield solutions:		
Integrated solutions	35	32
Software licenses		
Amortization of acquired core technology	7	6
Total cost of design-to silicon-yield solutions	42	38
Gross margin	58	62
Operating expenses:		
Research and development	38	32
Selling, general and administrative	26	25
Amortization of other acquired intangible assets	5	1
Total operating expenses	69	58
Income (loss) from operations	(11)	4
Interest and other income, net	2	3
Income (loss) before taxes	(9)	7
Income tax provision	2	6
Net income (loss)	(11)%	1%

Comparison of the Three Months Ended March 31, 2007 and 2006

	Three Months Ended March 31,				Three Months Ended March 31,	
					2007	**2006**
Revenue	**2007**	**2006**	**$ Change**	**% Change**	**% of Revenue**	**% of Revenue**

(In thousands, except for % s)						
Design-to-silicon-yield solutions						
Integrated solutions	$ 13,764	$ 12,229	$ 1,535	13%	62%	62%
Software licenses	3,485	2,612	873	33%	16%	13%
Gain share	4,893	5,016	(123)	(2)%	22%	25%
Total	$ 22,142	$ 19,857	$ 2.285	12%	100%	100%

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

Integrated solutions. The increase in integrated solutions revenue of $1.5 million for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 was primarily attributable to an increase in software related integration services and maintenance revenues. Our integrated solutions revenue may fluctuate in the future and is dependent on a number of factors including our ability to obtain new customers at emerging technology nodes and our ability to estimate costs associated with such contracts.

Software licenses. The increase in software licenses revenue of $873,000 for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 was due to greater adoption of our software applications by new and existing customers and the addition of new software offerings a result of the acquisition of Si Automation S.A. in October 2006. Software license revenue may fluctuate in the future and is dependent upon a number of factors including the semiconductor industry s acceptance of our products, our ability to attract new customers and further penetration of our current customer base.

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Gain Share. Gain share revenue represents profit sharing and performance incentives earned based upon our customer reaching certain defined operational levels. Gain share revenue decreased approximately $123,000 for the three months ended March 31, 2007 compared to the three months ended March 31, 2006, primarily as a result of a change in the mix of engagements contributing to gain share. Our gain share revenue may continue to fluctuate from period to period. Our continued receipt of gain share revenue is dependent on many factors that are outside of our control, including among others, continued production of ICs by our customers, sustained yield improvements by our customers and our ability to enter into new Design-to-Silicon-Yield solutions contracts containing gain share provisions.

					Three Months Ended March 31,	
					2007	2006
	Three Months Ended March 31,					
Cost of Design-to-Silicon Yield Solutions	**2007**	**2006**	**$ Change**	**% Change**	**% of Revenue**	**% of Revenue**
(In thousands, except for % s)						
Direct costs of design-to-silicon- yield solutions Integrated solutions	$ 7,708	$ 6,429	$ 1,279	20%	35%	32%
Software licenses	59	11	48	436%		
Amortization of acquired core technology	1,575	1,266	309	24%	7%	6%
Total	$ 9,342	$ 7,706	$ 1,636	21%	42%	38%

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

Integrated solutions. Integrated solutions costs consist of material, labor and overhead costs associated with solution implementations and software support. Costs include purchased materials, employee compensation and benefits, travel and facilities-related costs. The increase in direct costs of Design-to-Silicon-Yield integrated solutions of $1.3 million for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 was primarily attributable to increased distribution of expanded pdFastest products, some underutilization of labor resources, and additional personnel expenses incurred as a result of the acquisition of Si Automation S.A. in October 2006. If we do not accurately estimate the resources required or the scope of work to be performed, or we do not manage the projects properly within the planned period of time or satisfy our obligations under contracts, resulting contract margins could be materially different than those anticipated when the contract was executed. Any such reductions in contract margin could have a material negative impact on our operating results.

Software Licenses. Software license costs consist of costs associated with licensing third-party software sold in conjunction with our software products and expenses incurred to produce and distribute our product documentation. The increase in direct costs of Design-to-Silicon-Yield solutions software licenses of $48,000 for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 was attributable to an increase in third party software license fees and royalties resulting from increased license seat sales. We expect the cost of software licenses to fluctuate in the future as a result of royalties and license fees paid for third party applications incorporated in our software products.

Amortization of Acquired Core Technology. Amortization of acquired core technology consists of the amortization of intangibles acquired as a result of certain business combinations. The amortization of acquired core technology expense increased $309,000 for the three months ended March 31, 2007 compared to the three months ended March 31, 2006, as a result of the acquisition of Si Automation S.A. in October 2006. We anticipate amortization of acquired core technology to be $2.8 million for the remaining nine months in 2007, $1.2 million in 2008, $1.2 million in 2009 and $1.0 million in 2010.

Research and Development	Three Months Ended March 31, 2007	2006	$ Change	% Change	Three Months Ended March 31, 2007 % of Revenue	2006 % of Revenue
(In thousands, except for %s)						
Research and development	$ 8,370	$ 6,256	$ 2,114	34%	38%	32%

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Research and Development. Research and development expenses consist primarily of personnel-related costs to support product development activities, including compensation and benefits, outside development services, travel and facilities cost allocations. The increase in research and development expenses of $2.1 million for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 was primarily the result of the acquisition of Si Automation S.A. in October 2006, coupled with increased personnel-related expenses and third-party developer costs in other locations. We anticipate that we will continue to commit considerable resources to research and development in the future and that these expenses may increase in absolute dollars.

Selling, General and Administrative	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	$ Change	% Change	Three Months Ended March 31, 2007 % of Revenue	Three Months Ended March 31, 2006 % of Revenue
(In thousands, except for % s)						
Selling, general and administrative	$ 5,844	$ 4,956	$ 888	18%	26%	25%

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, fees for legal and accounting services, marketing communications, travel and facilities cost allocations. The increase in selling, general and administrative expenses of $888,000 for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 was primarily due to additional operating costs at Si Automation S.A. which we acquired in October 2006 and to increases in fees for legal and accounting services, and outside commissions. We expect that selling, general and administrative expenses will increase in absolute dollars to support increased selling and administrative efforts in the future.

Amortization of Other Acquired Intangible Assets	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	$ Change	% Change	Three Months Ended March 31, 2007 % of Revenue	Three Months Ended March 31, 2006 % of Revenue
(In thousands, except for % s)						
Amortization of Other Acquired Intangible Assets	$ 1,013	$ 235	$ 778	331%	5%	1%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets consists of the amortization of intangibles acquired as a result of certain business combinations. Amortization of other acquired intangible assets for the three months ended March 31, 2007 increased $778,000 compared to the three months ended March 31, 2006 as a result of the acquisition of Si Automation S.A. We anticipate amortization of these other acquired intangible assets to decrease in future periods.

Interest and Other Income, net	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006	$ Change	% Change	Three Months Ended March 31, 2007 % of Revenue	Three Months Ended March 31, 2006 % of Revenue
(In thousands, except for % s)						

Interest and Other Income, net	$ 496	$ 635	$ (139)	(22)%	2%	3%

Interest and Other Income, net. The decrease in interest and other income, net of $139,000 for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 was primarily due to lower average cash and cash equivalent balances and short term investments during the period as a result of payments made in connection with the acquisition of Si Automation S.A. in October 2006.

	Three Months Ended March 31,				Three Months Ended March 31,	
					2007	2006
Income Tax Provision	**2007**	**2006**	**$ Change**	**% Change**	**% of Revenue**	**% of Revenue**
(In thousands, except for % s)						
Income Tax Provision	$ 424	$ 1,071	$ (647)	(60)%	2%	6%

Income Tax Provision. The income tax provision decreased $647,000 for the three months ended March 31, 2007 compared to the three months ended March 31, 2006 due to the decrease in taxable income and the change in applicable effective tax rates.

Liquidity and Capital Resources

Net cash used in operating activities was $623,000 for the three months ended March 31, 2007 compared to net cash provided by operating activities of $2.8 million for the three months ended March 31, 2006. After adjusting the net loss of $2.4 million by the amortization of acquired intangible assets of $2.6 million, depreciation and amortization of $493,000, stock-based compensation of $1.8 million, the increase in deferred taxes of $1.5 million, and the tax benefit related to stock-based compensation plans of $27,000, our adjusted results provided approximately $1.0 million in cash. Net cash used was the result of an increase in accounts receivable of $7.5 million and a decrease in accounts payable of $637,000, partially offset by a decrease in prepaid expense and other assets of $46,000 and by increases in accrued compensation and related benefits of $607,000, other accrued liabilities of $368,000, taxes payable of $1.8 million, deferred revenue of $2.9 million and billings in excess of revenue recognized of $793,000. The increases in accounts receivable and billings in excess of revenue recognized were due to increased revenues during the period as well as the timing of billing milestones specified in the contract agreements. The decrease in prepaid expenses and other assets was primarily due to the timing of prepaid expense payments. The net decrease in accounts payable and other accrued liabilities was due to the timing of vendor payments, partially offset by increased outside sales commissions. The increase in deferred revenue was primarily due to the billing of certain software contracts with undelivered obligations during the period and increased sales of software support and maintenance contracts. The increase in taxes payable was due to the expected taxable income for the year and the increase in uncertain tax benefits as part of the FIN 48 review.

Net cash used in investing activities decreased to $4.3 million for the three months ended March 31, 2007 from $25.8 million for the three months ended March 31, 2006. The decrease was primarily the result of a decrease in net purchases of securities available- for-sale (purchases less securities sold and held to maturity) to $1.8 million for the three months ended March 31, 2007 from $24.9 million for the three months ended March 31, 2006. The three months ended March 31, 2006 was the first period in which we made such investments. Investing activities for the three months ended March 31, 2007 also included $1.9 million for final net payments associated with the acquisition of Si Automation S.A compared to the three months ended March 31, 2006 when there were no acquisitions . In both periods, investing activities included purchases of property and equipment, principally computer hardware and software, $476,000 and $868,000 during the three months ended March 31, 2007 and March 31, 2006, respectively.

Net cash provided by financing activities was $409,000 for the three months ended March 31, 2007 compared to $2.7 million for the three months ended March 31, 2006. Net cash provided by financing activities during the three months ended March 31, 2007 primarily consisted of $447,000 in proceeds from the exercise of employee stock options. Net cash provided by financing activities during the three months ended March 31, 2006 primarily consisted of proceeds from the exercise of employee stock options of $2.4 million and $305,000 in excess tax benefit derived from stock-based compensation.

As of March 31, 2007, our working capital was $71.9 million, compared with $66.6 million as of December 31, 2006. Cash and cash equivalents, and short term investments as of March 31, 2007 were $50.5 million compared to $52.9 million as of December 31, 2006, a decrease of $2.4 million. Decreases in cash and short term investments were primarily attributable to increases in accounts receivable from increased sales and the timing of billing milestones and final payments associated with the October 2006 acquisition of Si Automation S.A. We expect to experience growth in our overall expenses, as we continue to execute our business plan. As a result, we anticipate that our overall expenses, as well as planned capital expenditures, may constitute a material use of our cash resources. In addition, we may use cash resources to fund potential investments in, or acquisitions of, complementary products, technologies or businesses. We believe that our existing cash resources and anticipated funds from operations will satisfy our cash requirements to fund our operating activities, capital expenditures and other obligations for at least the next twelve months. However, in the event that during such period, or thereafter, we are not successful in generating sufficient cash flows from operations we may need to raise additional capital through private or public financings, strategic relationships or other arrangements, which may not be available to us on acceptable terms or at all.

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt, other than operating leases on our facilities. Additionally, we have not entered into any derivative contracts. As of March 31, 2007, we had no foreign currency contracts outstanding.

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

	Payments due by period					
Contractual obligations	2007 (Nine months remaining)	2008-2009	2010-2011	Thereafter	Other	Total
Debt principal (1)	$ 160	$ 602	$ 481	$	$	$ 1,243
Debt interest	19	36	13			68
Capital lease obligations (including interest)	99	134	11			244
Operating lease obligations	2,089	924	311			3,324
Unrecognized tax benefits (2)					4,757	4,757
Total	$ 2,367	$ 1,696	$ 816	$	$ 4,757	$ 9,636

(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 2011. Capital lease amounts include $26,000 of imputed interest. Capital leases were contracted to purchase computer, software, office equipment, and vehicles in our French subsidiary.

Recent Accounting Pronouncements

Effective January 1, 2007, we adopted the provisions of the Financial Accounting Standards Board s (FASB) Emerging Issues Task Force (EITF) No. 06-2, *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43* (EITF No. 06-2). Prior to the issuance of EITF No. 06-2, we accounted for sabbatical expense under SFAS No. 43 by expensing the cost of compensated absences for sabbatical programs as incurred. EITF No. 06-2 requires companies to accrue the cost of such compensated absences over the requisite service period. The Task Force allows the use of one of two specified methodologies for adopting the change in accounting principle: i) a cumulative-effect adjustment to the beginning balance of retained earnings at the beginning of the year of adoption; or ii) retrospective application to all prior periods. We elected to use the cumulative-effect adjustment to the beginning balance of retained earnings resulting in an additional liability of $1.4 million, an additional deferred tax asset of $587,000, and an increase in the accumulated deficit of $845,000. Under this transition method, prior periods will not be restated and accrued expense for the first quarter of fiscal 2007 includes accrued sabbatical expense for all employees who are eligible for sabbatical leave.

In February 2007, the FASB issued SFAS No. 159 (SFAS No. 159), *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115.* SFAS 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. SFAS 159 is effective beginning the first fiscal year that begins after November 15, 2007. We are currently evaluating the impact of the adoption of SFAS 159 on our financial statements.

In June, 2006, the FASB issued Financial Interpretation No. 48 (FIN No. 48), *Accounting for Uncertainty in Income Taxes* which clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial

statements in accordance with SFAS No. 109. Additionally, the Interpretation provides guidance on measurement, de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition. The Interpretation is effective for fiscal years beginning after December 15, 2006. We adopted the provisions of FIN No. 48 on January 1, 2007. See Note 8 *Income Taxes* in Notes to Unaudited Condensed Consolidated Financial Statements for a discussion of the effects of adoption.

In September, 2006, the FASB issued SFAS No. 157 (SFAS No. 157), *Fair Value Measurement* that establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America (GAAP), and expands disclosures about fair value measurements. Additionally, the pronouncement provides guidance on definition, measurement, methodology and use of assumptions and inputs in determining fair value. The pronouncement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently evaluating the impact of the adoption of SFAS No. 157 on our financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

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

Interest Rate Risk. As of March 31, 2007, we had cash and cash equivalents and short term investments of $50.5 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 March 31, 2007 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. Some foreign sales to date, generated by our German subsidiary since the date of the AISS acquisition and by our French subsidiary since the date of the Si Automation S.A. 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. There can be no assurance that future exchange rate fluctuations will not have a materially negative impact on our business.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures. Our Chief Executive Officer and our Chief Financial Officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by the quarterly report on Form 10-Q, have concluded that our disclosure controls and procedures are effective and designed to ensure that information required to be disclosed by us in the reports we file and submit under the Exchange Act is (i) recorded, processed, summarized and reported within the timeframes specified in the rules and forms of the Securities and Exchange Commission, and (ii) is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Controls Over Financial Reporting. There were no 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.

Currently we are not party to any material legal proceedings.

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 comprised 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 target as

new customers additional integrated device manufacturers (IDM), 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;

our inability to develop, market, or sell effective solutions that are outside of our traditional MPS logic focus;

the industry may develop alternative methods to enhance the integration between the semiconductor design and manufacturing processes due to a rapidly evolving market and the likely emergence of new technologies;

our existing and potential customers reluctance to understand and accept our innovative gain share fee component; and

our customers concern about our ability to keep highly competitive information confidential.

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

Historically, we have had a small number of large customers for our core Design-to-Silicon-Yield solutions and we expect this to continue in the near term. In the three months ended March 31, 2007, two customers accounted for 33% of our total net revenue, with International Business Machines Corporation (IBM) representing 17% and Toshiba Corporation representing 16%. In the three months ended March 31, 2006, four customers accounted for 61% of our total net revenue, with IBM representing 30%, Toshiba Corporation representing 11%, Matsushita representing 10% and Freescale representing 10%, respectively. We could lose a customer due to such customer s 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 (IDMs) of logic integrated circuits (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 our results of operations.

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

We will need to continue to grow in all areas of operation and successfully integrate and support our existing and new employees into our operations, or we may be unable to implement our business strategy in the time frame we anticipate, if at all. We have in the past, and may in the future, experience interruptions in our information systems on which our global operations depend. Further, physical damage to, failure of, or digital damage (such as significant viruses or worms) to, our information systems could disrupt and delay time-sensitive services or computing operations that we perform for our customers, which could negatively impact our business results and reputation. We may need

to switch to a new accounting system in the near future, which could disrupt our business operations and distract management. In addition, we will need to expand our intranet to support new data centers to enhance our research and development efforts. Our intranet is expensive to expand and must be highly secure due to the sensitive nature of our customers information that we transmit. Building and managing the support necessary for our growth places significant demands on our management and resources. These demands may divert these resources from the continued growth of our business and

implementation of our business strategy. Further, we must adequately train our new personnel, especially our client service and technical support personnel, to effectively and accurately, respond to and support our customers. If we fail to do this, it could lead to dissatisfaction among our customers, which could slow our growth.

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

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

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

Competition in our market may intensify in the future, which could slow our ability to grow or execute our strategy and 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 Ponte Solutions, Predictions Software, Syntricity Inc., Spotfire Inc., Synopsys Inc. (through their acquisition of HPL Technologies), and Yield Dynamics, Inc., and process control software, such as Triant Holdings Inc., Straatum Processware Ltd., and MKS Instruments Inc. Some providers of yield management software or inspection equipment may seek to broaden their product offerings and compete with us. For example, KLA-Tencor has announced adding the use of test structures to one of their inspection product lines. In addition, we believe that the demand for solutions that address the need for better integration between the silicon design and manufacturing processes may encourage direct competitors to enter into our market. For example, large integrated organizations, such as IDMs, electronic design automation software providers, IC design service companies or semiconductor equipment vendors, may decide to spin-off a business unit that competes with us. Other potential competitors include fabrication facilities that may decide to offer solutions competitive with ours as part of their value proposition to their customers. In addition, Synopsys, Inc. now appears to offer directly competing DFM capability, while other EDA suppliers provide alternative DFM solutions that may compete for the same budgetary funds. If these potential competitors 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.

We derive a majority of our revenue from international sales, principally from customers based in Asia. Revenue generated from customers in Asia accounted for 54% of total revenue in the three months ended March 31, 2007. During the three months ended March 31, 2006 revenue generated from customers in Asia was 49% of total revenue. We expect that a significant portion of our total future revenue will continue to be derived from companies based in Asia. In addition, we have expanded our non-U.S. operations recently and plan to continue such expansion by establishing overseas subsidiaries, offices, or contractor relationships in locations, and when, deemed appropriate by our management. The success of our business is subject to risks inherent in doing business internationally, including

third-party vendors that provide certain software quality assurance and other services having operations in the Middle East. These risks include:

- some of our key engineers and other personnel who are foreign nationals may have difficulty gaining access to the United States and other countries in which our customers or our offices may be located and it may be difficult for us to recruit and retain qualified technical and managerial employees in foreign offices;

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

- language and other cultural differences may inhibit our sales and marketing efforts and create internal communication problems among our U.S. and foreign research and development teams, increasing the difficulty of managing multiple, remote locations performing various development, quality assurance, and yield ramp analysis projects;

- compliance with, and unexpected changes in, a wide variety of foreign laws and regulatory environments with which we are not familiar, including, among other issues, with respect to protection of our intellectual property, and a wide variety of trade and export controls under domestic, foreign, and international law;

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

- quarantine, private travel limitation, or business disruption in regions affecting our operations, stemming from actual, imminent or perceived outbreak of human pandemic or contagious disease;

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

- economic or political instability, including but not limited to armed conflict, terrorism, and the resulting disruption to economic activity and business operations.

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

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

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

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

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

- the size and timing of sales volumes achieved by our customers products;

- the loss of any of our large customers or an adverse change in any of our large customers businesses;

- the size of improvements in our customers yield and the timing of agreement as to those improvements;

- our long and variable sales cycle;

- changes in the mix of our revenue;

changes in the level of our operating expenses needed to support our projected growth; and

delays in completing solution implementations for our customers.

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

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

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

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

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

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

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

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

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

While we have been profitable in some prior quarters and certain fiscal years, we have experienced losses in the past and in the three months ended March 31, 2007 and the fiscal year ended December 31, 2006. 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 $16.8 million as of March 31, 2007. 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 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 in light of our gain share revenue component. The semiconductor industry is highly cyclical and subject to rapid technological change and has been subject to significant economic downturns at various times, characterized by diminished product demand, accelerated erosion of average selling prices, and production overcapacity. The semiconductor industry also periodically experiences increased demand and production capacity constraints. As a result, we may experience significant fluctuations in operating results due to general semiconductor industry conditions and overall economic conditions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Significant litigation regarding intellectual property rights exists in the semiconductor industry. It is possible that a third party may claim that our technologies infringe their intellectual property rights or misappropriate their trade secrets. Any claim, even if without merit, could be time consuming to defend, result in costly litigation, or require us

to enter into royalty or licensing agreements, which may not be available to us on acceptable terms, or at all. A successful claim of infringement against us in connection with the use of our technologies could adversely affect our business.

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

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

We may have difficulty maintaining the effectiveness of our internal control over financial reporting.

Pursuant to Section 404 of the Sarbanes-Oxley Act, we are required to furnish a report on our management s assessment of the design and effectiveness of our system of internal control over financial reporting as part of our Annual Report on Form 10-K. Our auditors are also required to attest to, and report on, our management s assessment. In order to issue their report, our management is required to document both the design of our system of internal controls and our testing processes that support our management s evaluation and conclusion. While our management has been able to conclude that our internal control over financial reporting has been effective in each of the last three years, during the course of future testing, we may identify deficiencies, including those arising from turnover of qualified personnel or arising as a result of acquisitions, which we may not be able to remediate in time to meet the continuing reporting deadlines imposed by Section 404 and the costs of which may harm our results of operations. In addition, if we fail to maintain the adequacy of our internal controls, as such standards are modified, supplemented or amended from time to time, we may not be able to ensure that our management can conclude on an ongoing basis that we have effective internal controls. We also may not be able to retain independent auditors with sufficient resources to attest to and report on our internal controls in a timely manner. Moreover, our auditors may not agree with our management s future assessments and may 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.

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

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

On October 31, 2006, we completed our acquisition of Si Automation S.A. Our success in realizing the strategic benefits and growth opportunities to be gained from incorporating the operations of Si Automation S.A. into PDF and the timing of this realization depend upon our successful integration of Si Automation S.A. The integration of Si Automation S.A. is a complex, costly and time-consuming process. The difficulties of combining our operations associated with this acquisition 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.

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

(b) *Use of Proceeds*. Our first registration statement, filed on Form S-1 (Registration No. 333-43192) related to our initial public offering was declared effective by the SEC on July 26, 2001. There has been no change to the disclosure contained in our report on Form 10-K for the year ended December 31, 2006, as amended, with respect to the use of proceeds generated by our initial public offering.

(c) *Stock Repurchases*. The table below sets forth the information with respect to purchases made by or on behalf of the Company or any affiliated purchaser (as the term is defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934) of our common stock during the three months ended March 31, 2007:

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 (January 1, 2007 through January 31, 2007)				$ 4,451,236
Month #2 (February 1, 2007 through February 28, 2007)				$ 4,451,236
Month #3 (March 1, 2007 through March 31, 2007)				$ 4,451,236
Total				

(1) On March 26, 2003, we announced that our Board of Directors had approved a share repurchase program, pursuant to which up to $10.0 million of our outstanding common stock may be repurchased; the repurchase program has no set expiration or termination date. As of March 31, 2007,

550,521 shares had been repurchased under this program at a weighted average per share price of $10.08 and approximately $4.5 million remained available for repurchases.

Item 3. Defaults Upon Senior Securities.

Not Applicable.

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

None

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibit Number	Description
3.01	Third Amended and Restated Certificate of Incorporation of PDF Solutions, Inc. *
3.02	Amended and Restated Bylaws of PDF Solutions, Inc.
4.01	Specimen Stock Certificate**
4.02	Second Amended and Restated Rights Agreement dated July 6, 2001*
10.01	2001 Stock Plan and related agreements
31.01	Certification of the President and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.02	Certification of the Chief Financial Officer and Vice President of Finance and Administration pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.01	Certification of the President and Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002***
32.02	Certification the Chief Financial Officer and Vice President of Finance and Administration pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002***

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

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

** Incorporated by reference to PDF s Report on Form 10-Q filed

September 6, 2001 (File No. 000-31311).

*** As contemplated by SEC Release No. 33-8212, these exhibits are furnished with this Quarterly Report on Form 10-Q/A 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.

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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: May 10, 2007

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

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