

FORM 10-Q

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

For the Quarterly Period ended September 30, 2012

or

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

For the transition period from _____ to _____

Commission File Number 000-31311

PDF SOLUTIONS, INC.

(Exact name of Registrant as Specified in its Charter)

Delaware

(State or Other Jurisdiction of
Incorporation or Organization)

25-1701361

(I.R.S. Employer
Identification No.)

333 West San Carlos Street, Suite 1000

San Jose, California

(Address of Principal Executive Offices)

95110

(Zip Code)

(408) 280-7900

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes R No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R No £

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

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

The number of shares outstanding of the Registrant's Common Stock as of November 6, 2012 was 29,090,206.

TABLE OF CONTENTS

	<u>Page</u>
PART I FINANCIAL INFORMATION	
Item 1. Financial Statements (Unaudited)	
Condensed Consolidated Balance Sheets	3
Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)	4
Condensed Consolidated Statements of Cash Flows	5
Notes to Condensed Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	17
Item 3. Quantitative and Qualitative Disclosures About Market Risk	27
Item 4. Controls and Procedures	28
PART II OTHER INFORMATION	
Item 1. Legal Proceedings	29
Item 1A. Risk Factors	29
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	30
Item 3. Defaults Upon Senior Securities	30
Item 4. Mine Safety Disclosure	30
Item 5. Other Information	30
Item 6. Exhibits	31
SIGNATURES	32
INDEX TO EXHIBITS	33

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

PDF SOLUTIONS, INC.
 CONDENSED CONSOLIDATED BALANCE SHEETS
 (unaudited)
 (in thousands, except par value)

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 50,932	\$ 46,041
Short-term investments	500	—
Accounts receivable, net of allowance of \$351 and \$254, respectively	34,213	20,863
Prepaid expenses and other current assets	3,234	3,717
Total current assets	88,879	70,621
Non-current investments	—	784
Property and equipment, net	3,577	777
Intangible assets, net	126	539
Other non-current assets	1,161	1,663
Total assets	\$ 93,743	\$ 74,384
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 818	\$ 974
Accrued compensation and related benefits	8,414	5,026
Accrued and other current liabilities	2,539	2,335
Deferred revenues	2,445	2,961
Billings in excess of recognized revenues	783	2,089
Total current liabilities	14,999	13,385
Long-term income taxes payable	3,092	3,489
Other non-current liabilities	162	667
Total liabilities	18,253	17,541
Commitments and contingencies (Note 13)		
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 33,793 and 32,635, respectively; shares outstanding 29,052 and 28,304, respectively	4	4
Additional paid-in-capital	218,034	208,826
Treasury stock at cost, 4,741 and 4,331 shares, respectively	(26,977)	(22,899)
Accumulated deficit	(115,477)	(128,789)
Accumulated other comprehensive income (loss)	(94)	(299)
Total stockholders' equity	75,490	56,843
Total liabilities and stockholders' equity	\$ 93,743	\$ 74,384

See accompanying Notes to Condensed Consolidated Financial Statements (unaudited).

PDF SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(unaudited)
(in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
Design-to-silicon-yield solutions	\$ 15,305	\$ 13,903	\$ 42,484	\$ 37,473
Gainshare performance incentives	7,246	3,036	23,241	11,643
Total revenues	<u>22,551</u>	<u>16,939</u>	<u>65,725</u>	<u>49,116</u>
Costs of design-to-silicon-yield solutions:				
Direct costs of design-to-silicon-yield solutions	9,457	7,650	26,830	21,350
Amortization of acquired technology	—	156	261	468
Total costs of design-to-silicon-yield solutions	<u>9,457</u>	<u>7,806</u>	<u>27,091</u>	<u>21,818</u>
Gross profit	13,094	9,133	38,634	27,298
Operating expenses:				
Research and development	3,203	3,366	9,651	10,912
Selling, general and administrative	4,498	4,158	14,122	14,239
Amortization of other acquired intangible assets	51	51	153	153
Restructuring charges (credits)	—	4	83	(129)
Total operating expenses	<u>7,752</u>	<u>7,579</u>	<u>24,009</u>	<u>25,175</u>
Income from operations	5,342	1,554	14,625	2,123
Interest and other income (expense), net	(179)	201	(166)	(209)
Income before income taxes	5,163	1,755	14,459	1,914
Income tax provision	170	1,129	1,147	2,147
Net income (loss)	<u>\$ 4,993</u>	<u>\$ 626</u>	<u>\$ 13,312</u>	<u>\$ (233)</u>
Net income (loss) per share:				
Basic	<u>\$ 0.17</u>	<u>\$ 0.02</u>	<u>\$ 0.47</u>	<u>\$ (0.01)</u>
Diluted	<u>\$ 0.17</u>	<u>\$ 0.02</u>	<u>\$ 0.45</u>	<u>\$ (0.01)</u>
Weighted average common shares:				
Basic	<u>28,720</u>	<u>28,124</u>	<u>28,555</u>	<u>28,015</u>
Diluted	<u>30,180</u>	<u>28,348</u>	<u>29,596</u>	<u>28,015</u>
Net income (loss)	\$ 4,993	\$ 626	\$ 13,312	\$ (233)
Other comprehensive income:				
Foreign currency translation adjustments, net of tax	257	(369)	(10)	(7)
Reclassification adjustment for other-than-temporary impairment on auction-rate-securities recognized in earnings, net of tax	—	—	216	—
Unrealized gain on investments	—	66	—	66
Comprehensive income (loss)	<u>\$ 5,250</u>	<u>\$ 323</u>	<u>\$ 13,518</u>	<u>\$ (174)</u>

See accompanying Notes to Condensed Consolidated Financial Statements (unaudited).

PDF SOLUTIONS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Nine Months Ended	
	September 30,	
	2012	2011
Operating activities:		
Net income (loss)	\$ 13,312	\$ (233)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	316	355
Stock-based compensation expense	3,476	3,787
Amortization of acquired intangible assets	413	621
Deferred taxes	(32)	(87)
Losses on disposal of assets	8	—
Purchases of treasury stock in connection with tax withholdings on restricted stock grants	(187)	(536)
Provision for doubtful accounts	97	—
Gain on sale of investments	(50)	—
Net impairment of investments	75	—
Changes in operating assets and liabilities:		
Accounts receivable	(12,692)	1,854
Prepaid expenses and other assets	(811)	(219)
Accounts payable	(281)	(131)
Accrued compensation and related benefits	3,393	182
Accrued and other liabilities	(532)	2
Deferred revenues	(555)	(357)
Billings in excess of recognized revenues	(1,306)	788
Net cash provided by operating activities	<u>4,644</u>	<u>6,026</u>
Investing activities:		
Proceeds from the sale of short-term investments	475	—
Purchases of property and equipment	(2,066)	(353)
Net cash used in investing activities	<u>(1,591)</u>	<u>(353)</u>
Financing activities:		
Proceeds from exercise of stock options	4,753	2,063
Proceeds from employee stock purchase plan	977	865
Purchases of treasury stock	(3,891)	(2,510)
Principal payments on debt obligations	—	(84)
Net cash provided by financing activities	<u>1,839</u>	<u>334</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(1)</u>	<u>26</u>
Net change in cash and cash equivalents	4,891	6,033
Cash and cash equivalents, beginning of period	46,041	38,154
Cash and cash equivalents, end of period	<u>\$ 50,932</u>	<u>\$ 44,187</u>
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Income taxes	\$ 1,807	\$ 1,695
Interest	\$ —	\$ 4

See accompanying Notes to Condensed Consolidated Financial Statements (unaudited).

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

1. BASIS OF PRESENTATION

Basis of Presentation

The interim unaudited condensed consolidated financial statements included herein have been prepared by PDF Solutions, Inc. (“the Company”) pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”), including the instructions to the Quarterly Report on 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 and notes thereto in the Company’s Annual Report on Form 10-K for the year ended December 31, 2011.

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

The condensed consolidated balance sheet at December 31, 2011 has been derived from the audited consolidated financial statements but does not include all disclosures required by accounting principles generally accepted in the United States of America.

Use of Estimates — The preparation of financial statements in conformity with generally accepted accounting principles in the United States (“U.S. GAAP”) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates in these financial statements include stock-based compensation expense, allowances for doubtful accounts receivable, estimates for useful lives associated with long-lived assets, restructuring charges, fair value of investment and income taxes and tax valuation allowances. Actual results could differ from those estimates.

Revenue Recognition — The Company derives revenue from two sources: Design-to-silicon-yield solutions and Gainshare performance incentives.

Design-to-Silicon-Yield Solutions — Revenue that is derived from Design-to-silicon-yield solutions comes from services and software licenses. The Company recognizes revenue for each element of Design-to-silicon-yield solutions as follows:

The Company generates a significant portion of its Design-to-silicon-yield solutions revenue from fixed-price solution implementation service contracts delivered over a specific period of time. These contracts require reliable estimation of costs to perform obligations and the overall scope of each engagement. Revenue under project-based contracts for solution implementation services is recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting. Revenue under time-based contracts for solution implementation services are recognized under the proportional performance method. Losses on solution implementation contracts are recognized in the period when they become probable. 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 licenses its software products as a component of its fixed-price service contracts. In such instances, the software products are licensed to customers over a specified term of the agreement with support and maintenance to be provided at each customer's option over the license term. The amount of product and service revenue recognized in a given period is affected by the Company’s judgment as to whether an arrangement includes multiple deliverables and, if so, the Company’s determination of the fair value of each deliverable. In general, vendor-specific objective evidence of selling price (“VSOE”) does not exist for the Company’s solution implementation services and software products and because the Company’s services and products include our unique technology, the Company is not able to determine third-party evidence of selling price (“TPE”). Therefore, in such circumstances the Company uses best estimated selling prices (“BESP”) in the allocation of arrangement consideration. In determining BESP, the Company applies significant judgment as the Company’s weighs a variety of factors, based on the facts and circumstances of the arrangement. The Company typically arrives at BESP for a product or service that is not sold separately by considering company-specific factors such as geographies, internal costs, gross margin objectives, pricing practices used to establish bundled pricing, and existing portfolio pricing and discounting. After fair value is established for each deliverable, the total transaction amount is allocated to each deliverable based upon its relative fair value. Fees allocated to solution implementation services are recognized using the cost-to-cost percentage of completion method of contract accounting. Fees allocated to software and related support and maintenance are recognized under software revenue recognition guidance.

The Company also licenses its software products separately from its solution implementations. For software license arrangements that do not require significant modification or customization of the underlying software, software license revenue is recognized under the residual method when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, (4) collectability is probable, and (5) the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for its fixed price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by the Company's VSOE and such services are recorded as services revenue. VSOE for maintenance is generally established 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. Revenue for software licenses with extended payment terms is not recognized in excess of amounts due. For software license arrangements that require significant modification or customization of the underlying software, the software license revenue is recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting, and such revenue is recorded as services revenue.

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

2. RECENT ACCOUNTING PRONOUNCEMENTS

In December 2011, the Financial Accounting Standards Board ("FASB") amended its guidance related to the disclosures about offsetting assets and liabilities. The standard requires the Company to disclose information about offsetting and related arrangements to enable users of its financial statements to understand the effect of those arrangements on its financial position. The guidance is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. The disclosures are to be applied retrospectively for all comparative periods presented. The Company does not expect that this guidance will have an impact on the Company's consolidated financial statements as it is disclosure-only in nature.

In June 2011, the FASB amended its guidance related to the presentation of comprehensive income to increase comparability between U.S. GAAP and International Financial Reporting Standards ("IFRS"). This amended guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity and instead requires presenting in one continuous statement or two separate but consecutive statements. Additionally, the amendment requires entities to present reclassification adjustments to show the effect of reclassifications on both the components of other comprehensive income and the components of net income in interim and annual financial statements. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 with early adoption permitted. The guidance is effective for the Company's fiscal year beginning January 1, 2012. In October 2011, the FASB decided that the specific requirement to present items that are reclassified from other comprehensive income to net income alongside their respective components of net income and other comprehensive income will be deferred. Therefore, those requirements will not be effective for public entities for fiscal years and interim periods within those years beginning after December 15, 2011. The adoption of this guidance did not have a material impact on our consolidated financial statements, as it only requires a change in the format of presentation.

In May 2011, the FASB issued a new standard amending U.S. GAAP fair value measurements and disclosures for the purpose of ensuring that fair value measurement and disclosure requirements are the same across both U.S. GAAP and IFRS. The standard contains amendments changing the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements, clarifying the application of existing fair value measurement requirements and changing a particular principle for measuring fair value or for disclosing information about fair value measurements. Additionally, the standard expands certain disclosure requirements, including qualitative disclosures selected to level 3 fair value measurements. Early adoption is not permitted. This guidance is effective for the Company's fiscal year beginning January 1, 2012. The adoption of this new standard did not have material impact the Company's consolidated financial statements.

3. INVESTMENTS

The following table summarizes the Company's investments at September 30, 2012 and December 31, 2011 (in thousands):

	September 30, 2012			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Fair Value
Auction-rate securities	\$ 500	\$ —	\$ —	\$ 500

	December 31, 2011			
	Amortized Cost	Unrealized Holding Gains	Unrealized Holding Losses	Fair Value
Auction-rate securities	\$ 1,000	\$ —	\$ (216)	\$ 784

As of September 30, 2012 and December 31, 2011, the Company's investments consisted entirely of auction-rate securities. Please refer to Note 12 "Fair Value Measurements" for further discussion of auction-rate securities.

4. ACCOUNTS RECEIVABLE

Accounts receivable include amounts that are unbilled at the end of the period. Unbilled accounts receivable are determined on an individual contract basis and were approximately \$9.5 million and \$11.0 million as of September 30, 2012 and December 31, 2011, respectively.

5. PROPERTY AND EQUIPMENT

Property and equipment consists of (in thousands):

	September 30, 2012	December 31, 2011
Property and equipment, net:		
Computer equipment	11,996	12,642
Software	3,534	3,543
Furniture, fixtures and equipment	924	1,060
Leasehold improvements	986	926
Test equipment	468	—
Construction-in-progress	2,049	—
	<u>19,957</u>	<u>18,171</u>
Less: accumulated depreciation	(16,380)	(17,394)
Total	<u>3,577</u>	<u>777</u>

The construction-in-progress relates to the construction of test equipment. As of December 31, 2011, the Company had incurred a total of \$1.4 million for the construction of test equipment and the amounts were classified as prepaid expense and other current assets. During the quarter ended March 31, 2012, it was determined that the useful life of the test equipment is more than one year. Therefore, the Company reclassified this amount from prepaid expense and other current assets to property and equipment. The Company depreciates the test equipment over the estimated useful life of 5 years as the assets are put in use.

6. INTANGIBLE ASSETS

The following table provides information relating to the intangible assets as of September 30, 2012 and December 31, 2011 (in thousands):

Acquired Identifiable Intangible	September 30, 2012			
	Amortization Period (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Acquired technology	4 - 5	\$ 11,800	\$ (11,800)	\$ —
Brand name	4	510	(510)	—
Customer relationships and backlog	1 - 6	3,420	(3,417)	3
Patents and applications	7	1,400	(1,277)	123
Other acquired intangibles	4	255	(255)	—
Total		<u>\$ 17,385</u>	<u>\$ (17,259)</u>	<u>\$ 126</u>

Acquired Identifiable Intangible	December 31, 2011			
	Amortization Period (Years)	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Acquired technology	4 - 5	\$ 11,800	\$ (11,539)	\$ 261
Brand name	4	510	(510)	—
Customer relationships and backlog	1 - 6	3,420	(3,320)	100
Patents and applications	7	1,400	(1,222)	178
Other acquired intangibles	4	255	(255)	—
Total		<u>\$ 17,385</u>	<u>\$ (16,846)</u>	<u>\$ 539</u>

For the three months ended September 30, 2012 and 2011, intangible asset amortization expense was \$51,000 and \$207,000, respectively. For the nine months ended September 30, 2012 and 2011, intangible asset amortization expense was \$413,000 and \$621,000, respectively.

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

Year Ending December 31,	Amount
2012 (remaining three-month period)	\$ 22
2013	74
2014	30
Total	<u>\$ 126</u>

Intangible assets are amortized over their useful lives unless these lives are determined to be indefinite. Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable. During the three months and nine months ended September 30, 2012 and 2011, there were no indicators of impairment related to the Company's intangible assets.

7. STOCKHOLDERS' EQUITY

Stock-based compensation is estimated at the grant date based on the award's fair value and is recognized on a straight-line basis over the vesting periods of the applicable stock purchase rights and stock options, generally four years. Stock-based compensation expenses before taxes related to the Company's stock plans and employee stock purchase plan were allocated as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Cost of design-to-silicon-yield solutions	\$ 513	\$ 521	\$ 1,264	\$ 1,511
Research and development	288	356	726	1,036
Selling, general and administrative	452	316	1,486	1,240
Stock-based compensation expenses	<u>\$ 1,253</u>	<u>\$ 1,193</u>	<u>\$ 3,476</u>	<u>\$ 3,787</u>

The Company estimated the fair value of share-based awards granted during the period using the Black-Scholes-Merton option-pricing model with the following weighted average assumptions, resulting in the following weighted average fair values:

Stock Plans:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Expected life (in years)	4.58	—	4.82	4.94
Volatility	57.42%	—	59.41%	61.02%
Risk-free interest rate	0.66%	—	0.77%	1.66%
Expected dividend	—	—	—	—
Weighted average fair value per share of share-based awards granted during the period	\$ 4.77	\$ —	\$ 4.26	\$ 3.17

The Company granted no share-based awards during the three months ended September 30, 2011.

Employee Stock Purchase Plan:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Expected life (in years)	1.25	1.25	1.25	1.25
Volatility	51.92%	43.75%	51.59%	46.66%
Risk-free interest rate	0.19%	0.27%	0.18%	0.36%
Expected dividend	—	—	—	—
Weighted average fair value of purchase rights granted during the period	\$ 3.46	\$ 2.03	\$ 2.99	\$ 2.06

On September 30, 2012, the Company has in effect the following stock-based compensation plans:

Stock Plans — At the annual meeting of stockholders on November 16, 2011, the Company's stockholders approved the 2011 Stock Incentive Plan (the "2011 Plan"). Under the 2011 Plan, the Company may award stock options, stock appreciation rights, stock grants or stock units covering shares of the Company's common stock to employees, directors, non-employee directors and contractors. The aggregate number of shares reserved for awards under this plan is 3,200,000 shares, plus up to 3,500,000 shares previously issued under the 2001 Plan that are forfeited or repurchased by the Company or shares subject to awards previously issued under the 2001 Plan that expire or that terminate without having been exercised or settled in full. In case of awards other than options or stock appreciation rights, the aggregate number of shares reserved under the plan will be decreased at a rate of 1.33 shares issued pursuant to such awards. The exercise price for stock options must generally be at prices no less than the fair market value at the date of grant. Stock options generally expire ten years from the date of grant and become vested and exercisable over a four-year period.

In 2001, the Company adopted a 2001 Stock Plan (the "2001 Plan"). In 2003, in connection with its acquisition of IDS Systems Inc., the Company assumed IDS' 2001 Stock Option / Stock Issuance Plan (the "IDS Plan"). Both of the 2001 and the IDS Plans expired in 2011. Stock options granted under the 2001 and IDS Plans generally expire ten years from the date of grant and become vested and exercisable over a four-year period. Although no new awards may be granted under the 2001 or IDS Plans, awards made under the 2001 and IDS Plans that are currently outstanding remain subject to the terms of each such plan.

As of September 30, 2012, 3.4 million shares of common stock were reserved to cover stock-based awards under the 2011 Plan, of which 1.7 million shares were available for future grant. The number of shares reserved and available under the 2011 Plan includes 0.2 million shares that were subject to awards previously made under the 2001 Plan and were forfeited or expired after adoption of the 2011 Plan through September 30, 2012. As of September 30, 2012, there were no outstanding awards that had been granted outside of the 2011, 2001 or the IDS Plans (collectively, the "Stock Plans").

Stock option activity under the Company's Stock Plans during the nine months ended September 30, 2012 was as follows:

	Number of Options (in thousands)	Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value (in thousands)
Outstanding, January 1, 2012	3,872	\$ 5.91		
Granted	1,180	8.66		
Exercised	(874)	5.44		
Canceled	(140)	6.04		
Expired	(44)	9.78		
Outstanding, September 30, 2012	<u>3,994</u>	6.79	<u>7.62</u>	<u>\$ 27,608</u>
Vested and expected to vest, September 30, 2012	<u>3,658</u>	6.73	<u>7.49</u>	<u>\$ 25,499</u>
Exercisable, September 30, 2012	<u>1,742</u>	6.71	<u>6.08</u>	<u>\$ 12,209</u>

The aggregate intrinsic value in the table above represents the total intrinsic value based on the Company's closing stock price of \$13.66 per share as of September 30, 2012, which would have been received by the option holders had all "in-the-money" option holders exercised their options as of that date. The total intrinsic value of options exercised during the nine months ended September 30, 2012 was \$4.6 million.

As of September 30, 2012, there was \$6.6 million of total unrecognized compensation cost related to unvested 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 and nine months ended September 30, 2012 was \$0.8 million and \$1.9 million, respectively.

Nonvested restricted stock units activity during the nine months ended September 30, 2012 was as follows:

	Shares (in thousands)	Weighted Average Grant Date Fair Value Per Share
Nonvested, January 1, 2012	303	\$ 7.82
Granted	339	8.71
Vested	(82)	9.66
Forfeited	(22)	7.70
Nonvested, September 30, 2012	<u>538</u>	<u>8.10</u>

As of September 30, 2012, there was \$3.2 million of total unrecognized compensation cost related to nonvested restricted stock units. That cost is expected to be recognized over a weighted average period of 3.1 years.

Employee Stock Purchase Plan — In July 2001, the Company adopted a ten-year 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 the purchase period. The Purchase Plan consists of twenty-four-month offering periods with four six-month purchase periods in each offering period. Under the Purchase Plan, on January 1 of each year, starting with 2002, the number of shares reserved for issuance will automatically increase by the lesser of (1) 675,000 shares, (2) 2% of the Company's outstanding common stock on the last day of the immediately preceding year, or (3) the number of shares determined by the board of directors. At the annual meeting of stockholders on May 18, 2010, the Company's stockholders approved an amendment to the Purchase Plan to extend it through May 17, 2020. During the three months and the nine months ended September 30, 2012, a total of 104,000 and 202,000 shares, respectively, were issued at a weighted-average purchase price of \$4.89 and \$4.85 per share, respectively, under the Purchase Plan. During the three months and the nine months ended September 30, 2011, a total of 103,000 and 414,000 shares, respectively, were issued at a weighted-average purchase price of \$4.23 and \$2.05 per share, respectively, under the Purchase Plan. As of September 30, 2012, there was \$0.3 million of unrecognized compensation cost related to the Purchase Plan. That cost is expected to be recognized over a weighted average period of 1.3 years. As of September 30, 2012, 1.5 million shares were available for future issuance under the Purchase Plan.

Stock Repurchase Program — On October 29, 2007, the Board of Directors adopted a program to repurchase up to \$10.0 million of the Company's common stock on the open market. The initial program was for three years, but on October 19, 2010, the Board of Directors authorized an extension of, and an increase in, the program and the aggregate amount available to repurchase between October 19, 2010 and October 29, 2012 was reset to \$10.0 million of the Company's common stock, meaning a total of \$19.3 million was available. As of September 30, 2012, 3.8 million shares had been repurchased at the average price of \$4.52 per share, a total purchase price of \$17.0 million, under this program. The program expired on October 29, 2012. On November 8, 2012, the Board of Directors adopted a new program to repurchase up to \$20.0 million of the Company's common stock on the open market over the next two years.

8. RESTRUCTURING

On October 28, 2008, the Company announced a restructuring plan to better allocate its resources to improve its operational results in light of the market conditions. Under this plan, the Company has recorded cumulative restructuring charges of \$7.8 million, primarily consisting of employee severance costs of \$4.8 million and facility exit costs of \$2.7 million. The facility exit cost consists primarily of the cost of future obligations related to the locations. Discounted liabilities for future lease costs and the fair value of the related subleases of closed locations that are recorded is subject to adjustments as liabilities are settled. In assessing the discounted liabilities for future costs of obligations related to the locations, the Company made assumptions regarding the amounts of future subleases. If these assumptions or their related estimates change in the future, the Company may be required to record additional exit costs or reduce exit costs previously recorded. Exit costs recorded for each period presented include the effect of such changes in estimates.

The following table summarizes the activities of these restructuring liabilities (in thousands) for the periods covered below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Beginning balance	\$ 697	\$ 943	\$ 728	\$ 1,379
Restructuring charges (credits)	—	4	83	(129)
Adjustments	4	11	170	28
Cash payments	(134)	(131)	(414)	(451)
Ending balance	\$ 567	\$ 827	\$ 567	\$ 827

The balance as of September 30, 2012 consists of \$0.5 million of facility exit costs and \$0.1 million of severance costs. The balance as of December 31, 2011 consists of \$0.6 million of facility exit costs and \$0.1 million of severance costs. The adjustments primarily represent deferred rent balances recognized at the cease-use-date during the period.

As of September 30, 2012, the remaining accrual of \$0.6 million was included in accrued liabilities and other current. As of December 31, 2011, of the remaining accrual of \$0.7 million, \$0.5 million was included in accrued and other current liabilities and \$0.2 million was included in other non-current liabilities. Accrued facility exit expenses will be paid in accordance with the lease payment schedule through 2013.

9. INCOME TAXES

The Company accounts for temporary differences between the book and tax basis of assets and liabilities by recording deferred tax assets and liabilities. The Company must assess the likelihood that its deferred tax assets will be recovered from future taxable income and, to the extent the Company believes that recovery is not likely, the Company must establish a valuation allowance. Changes in the Company's net deferred tax assets and valuation allowance in a period are recorded through the income tax provision in the condensed consolidated statements of operations.

The Company classifies its liabilities related to unrecognized tax benefits as long-term. The Company includes interest and penalties related to unrecognized tax benefits within the Company's income tax provision. As of September 30, 2012 and December 31, 2011, the Company had accrued for payment of interest and penalties related to unrecognized tax benefits of \$381,000 and \$442,000, respectively.

Income tax provision decreased \$1 million for the nine months ended September 30, 2012 to \$1.1 million as compared to an income tax provision of \$2.1 million for the nine months ended September 30, 2011 due primarily to a \$0.5 million refund of previous paid withholding tax and a reduction in current year withholding tax estimate. The income tax provision for both the nine months ended September 30, 2012 and the nine months ended September 30, 2011 primarily consisted of foreign withholding taxes, statutory taxes and changes in unrecognized tax benefits. The difference in effective tax rate of 7.9% for the nine months ended September 30, 2012 and 56.5% for the year ended December 31, 2011 is primarily due to the impact of the valuation allowance on its U.S. deferred tax assets.

The Company's total amount of unrecognized tax benefits as of September 30, 2012 was \$9.5 million, of which \$2.7 million, if recognized, would affect the Company's effective tax rate. The Company's total amount of unrecognized tax benefits as of December 31, 2011 was \$9.6 million, of which \$3.0 million, if recognized, would affect the Company's effective tax rate. As of September 30, 2012, the Company has recognized a net amount of \$3.1 million as long-term taxes payable for unrecognized tax benefits in its condensed consolidated balance sheet.

The Company reviewed its conclusions about the appropriate amount of its deferred income tax asset valuation allowance in light of circumstances existing in current periods and considering the expected future period results. If in the future, we determine based on our future profitability that these deferred tax assets are more likely than not to be realized, a release of all, or part, of the related valuation allowance could result in an immediate material income tax benefit in the period of decrease and material income tax provisions in future periods. A continued improvement in the Company's financial performance and expected future period results could result in a reversal of the valuation allowance in the near future.

The Company conducts business globally and, as a result, files numerous consolidated and separate income tax returns in the U.S. federal, various state and foreign jurisdictions. Because the Company used some of the tax attributes carried forward from previous years to tax years that are still open, statutes of limitation remain open for all tax years to the extent of the attributes carried forward into tax year 2002 for federal and California tax purposes. The Company's France income tax examinations for 2009 were closed during the three months ended March 31, 2012, with immaterial adjustments. The Company is not subject to income tax examinations in any other of its major foreign subsidiaries' jurisdictions.

10. NET INCOME (LOSS) PER SHARE

Basic net income (loss) per share is computed by dividing net income (loss) by weighted average number of common shares outstanding for the period (excluding outstanding stock options and shares subject to repurchase). Diluted net income (loss) per share is computed using the weighted-average number of common shares outstanding for the period plus the potential effect of dilutive securities which are convertible into common shares (using the treasury stock method), except in cases in which the effect would be anti-dilutive. There are no dilutive shares included during the nine months ended September 30, 2011 due to the net loss for the period. Under the treasury stock method, the amount that the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of the tax benefits that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares. 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 amount):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Numerator:				
Net income (loss)	\$ 4,993	\$ 626	\$ 13,312	\$ (233)
Denominator:				
Basic weighted average common shares outstanding	28,720	28,124	28,555	28,015
Dilutive effect of equity incentive plans	1,460	224	1,041	—
Diluted weighted average common shares outstanding	30,180	28,348	29,596	28,015
Net income (loss) per share:				
Basic	\$ 0.17	\$ 0.02	\$ 0.47	\$ (0.01)
Diluted	\$ 0.17	\$ 0.02	\$ 0.45	\$ (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		Nine Months	
	Ended September 30,		Ended September 30,	
	2012	2011	2012	2011
Outstanding options	1,229	3,553	1,633	2,198
Nonvested restricted stock units	9	332	24	245
Employee Stock Purchase Plan	—	—	—	21
Total	1,238	3,885	1,657	2,464

11. CUSTOMER AND GEOGRAPHIC INFORMATION

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 regularly 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 companies designing and/or manufacturing integrated circuits.

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

Customer	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2012	2011	2012	2011
A	35%	22%	39%	22%
B	25%	16%	21%	18%
C	11%	14%	12%	15%

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

Customer	September 30,	December 31,
	2012	2011
A	43%	34%
B	28%	23%
C	*%	10%

* represents less than 10%

Revenues from customers by geographic area based on the location of the customers' work sites are as follows (in thousands):

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2012	2011	2012	2011
United States	10,877	5,514	26,437	15,407
Europe	6,365	4,868	22,646	11,334
Asia	5,309	6,557	16,642	22,375
Total	\$ 22,551	\$ 16,939	\$ 65,725	\$ 49,116

Long-lived assets, net by geographic area are as follows (in thousands):

	September 30, 2012	December 31, 2011
United States	\$ 3,192	\$ 595
Asia	304	100
Europe	81	82
Total	<u>\$ 3,577</u>	<u>\$ 777</u>

12. FAIR VALUE MEASUREMENTS

Fair value is the exit price, or the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants as of the measurement date. The multiple assumptions used to value financial instruments are referred to as inputs, and a hierarchy for inputs used in measuring fair value is established, that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon its own market assumptions. These inputs are ranked according to a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels.

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

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

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

The following table represents the Company's assets measured at fair value on a recurring basis as of September 30, 2012 and the basis for that measurement (in thousands):

Assets	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market mutual funds	\$ 25,834	\$ 25,834	\$ —	\$ —
Auction-rate securities	500	—	500	—
Total	<u>\$ 26,334</u>	<u>\$ 25,834</u>	<u>\$ 500</u>	<u>\$ —</u>

The following table represents the Company's assets measured at fair value on a recurring basis as of December 31, 2011 and the basis for that measurement (in thousands):

Assets	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Money market mutual funds	\$ 25,339	\$ 25,339	\$ —	\$ —
Auction-rate securities	784	—	—	784
Total	<u>\$ 26,123</u>	<u>\$ 25,339</u>	<u>\$ —</u>	<u>\$ 784</u>

The Company holds investments in auction-rate securities (“ARS”), which are variable rate debt instruments whose interest rates are reset through a “Dutch” auction process at regular intervals, typically every 28 days. All ARS are backed by pools of student loans guaranteed by governmental agencies and private entities, and were rated AAA/Aaa at the date of acquisition. Rating of MBIA (bond insurer on one of the Company’s ARS) was downgraded from Aaa to A2, by Moody’s Investor Services on June 19, 2008, due to uncertainty in the credit markets and the exposure of these securities to the financial condition of bond insurance companies. All ARS have failed to sell at auction since February 2008, and as a result, their interest rates were reset to the maximum LIBOR + 150 basis points. As a result of these auction failures, there was limited active market with observable prices for these securities. Therefore, the Company computed the fair value of these securities based on a discounted cash flow model, using significant level 3 inputs, to take into account the lack of liquidity. The Company’s valuation analysis considers, among other items, assumptions that market participants would use in their estimates of fair value, such as the collateral underlying the security, the creditworthiness of the issuer and any associated guarantees, credit ratings of the security by the major securities rating agencies, the ability or inability to sell the investment in an active market or to the issuer, the timing of expected future cash flows, and the expectation of the next time the security will have a successful auction or when call features may be exercised by the issuer. Based on the methodology and the analysis above, the Company estimated the fair value of its ARS to be \$784,000 as of December 31, 2011.

During the three months ended September 30, 2012, the Company finalized the sale of certain ARS. The Company received \$475,000 proceeds from the sale of these investments and recorded a realized gain of \$50,000 from the sale of these investments, which was the difference between the proceeds received and the recorded fair value of these investments at the date of sale. In addition, during the period, the Company received redemption notices for its remaining ARS by the issuers. As a result, as of September 30, 2012, the Company valued these ARS at par value of \$500,000, which represents the fair value of these securities. The Company also classified the ARS from Level 3 to Level 2 since the amount is valued based upon a redemption notice for an inactive market. The redemption occurred in October, 2012 and the securities were settled at par.

The following table provides a reconciliation of the beginning and ending balances for the assets measured at fair value using significant unobservable inputs (Level 3) during the nine months ended September 30, 2012 (in thousands):

Auction-rate securities	Amount
Beginning balance at January 1, 2012	\$ 784
Sale of ARS	(475)
Realized gain on sale of ARS	50
Reversal of loss on ARS based on redemption fair value	141
Transfer out of Level 3	(500)
Ending balance at September 30, 2012	<u>\$ —</u>

13. COMMITMENTS AND CONTINGENCIES

Leases

The Company leases administrative and sales offices and certain equipment under noncancelable operating leases, which contain various renewal options and, in some cases, require payment of common area costs, taxes and utilities. These operating leases expire at various times through 2018. Rent expense was \$0.5 million and \$0.6 million for the three months ended September 30, 2012 and 2011, respectively. Rent expense was \$1.7 million and \$1.8 million for the nine months ended September 30, 2012 and 2011, respectively.

Future minimum lease payments under noncancelable operating leases at September 30, 2012 are as follows (in thousands):

Year Ending September 30,	Amount
2012 (remaining three months)	\$ 656
2013	1,610
2014	1,651
2015	1,548
2016	1,556
Thereafter	1,980
Total future minimum lease payments	<u>\$ 9,001</u>

The operating lease obligations have been reduced by future minimum sublease rental income of \$0.1 million in the remaining three months of 2012 and \$0.4 million in 2013, respectively.

Litigation — From time to time, the Company is subject to various claims and legal proceedings that arise in the ordinary course of business. Although the Company currently believes that the ultimate outcome of the claim described below will not have a material adverse effect on its financial position or overall trends in results of operations and cash flows, litigation is subject to inherent uncertainty. If an unfavorable ruling occurs in the legal proceeding described below, our financial position and results of operations and cash flows could be negatively affected. The Company accrues for losses related to litigation when a potential loss is probable and the loss can be reasonably estimated in accordance with FASB requirements. With respect to the matter below, the Company has determined a potential loss is not probable at this time and, accordingly, no amount has been accrued at September 30, 2012. As the Company continues to monitor this matter, however, the Company's determination could change and the Company may decide a different reserve is appropriate in the future.

Philip Steven Melman filed a complaint against the Company and the Company's Chief Executive Officer on December 7, 2009 in the Superior Court for Santa Clara County. In the complaint, Mr. Melman alleges wrongful discharge based on discrimination, fraud, breach of contract and similar theories, in connection with the termination of Mr. Melman's employment with the Company. The complaint seeks compensatory and punitive damages, any other available remedies, as well as attorney's fees and costs. Summary judgment in the favor of both the Company and Dr. Kibarian was entered by the court on October 27, 2011 and November 15, 2011, respectively. Mr. Melman is appealing both orders in the Court of Appeals for Santa Clara County. The Company believes the appeal is without merit and intends to vigorously oppose it.

14 – SUBSEQUENT EVENTS

On October 24, 2012, the Company announced a restructuring plan as part of the Company's continuing efforts to simplify the organization, leverage cross-training and learning, and reduce annual operations expenses. During the first week of October, 2012, the Company notified the employees in the United States whose employment was terminated as part of the overall plan. Notifications in France are expected to occur at a later date in compliance with local laws and regulations. In connection with this plan, the Company estimates that it will incur pre-tax cash charges of \$1.6 million to \$2.0 million for severance pay expenses and related cash expenditures in connection with this action. The Company expects that majority of these charges will be recognized during the quarter ended December 31, 2012, with the remaining costs to be recognized during fiscal year 2013. The pre-tax cash charges estimate does not include facilities, lease or other charges the Company may incur as part of the overall plan.

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

Forward-Looking Statements

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

Overview

We analyze our customers' IC design and manufacturing processes to identify, quantify, and correct the issues that cause yield loss to improve our customers' profitability by improving time-to-market, increasing yield and reducing total design and manufacturing costs. We package our solutions in various ways to meet our customers' specific business and budgetary needs, each of which provides us various revenue streams. We receive a mix of fixed fees and variable, performance-based fees for the vast majority of our yield improvement solutions. The fixed fees are typically reflective of the length of time and the resources needed to characterize a customer's manufacturing process and receive preliminary results of proposed yield improvement suggestions. The variable fee, or what we call gainshare, usually depends on our achieving certain yield targets by a deadline. Variable fees are currently typically tied to wafer volume on the node and size of the manufacturing facility where we performed the yield improvement solutions. We receive license fees and service fees for related installation, integration, training, and maintenance and support services for our software that we license on a stand-alone basis.

Industry Trend

We believe that logic foundries invested in leading edge nodes and capacity in 2010 and 2011, even though utilization rates fluctuated in both 2011 and 2012. This investment trend resulted in an increase in our business and improved results of operations in 2011 and 2012 to date. We may experience fluctuations in our results of operations in the future if there is continued consolidation of foundries and fabless companies around the world, any major new foundries enter the market or any of our manufacturing customers experience a decrease in orders.

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

Financial Highlights

Financial highlights for the three months ended September 30, 2012 were as follows:

- Total revenues for the three months ended September 30, 2012 were \$22.6 million, an increase of \$5.6 million, or 33%, compared to \$16.9 million for the three months ended September 30, 2011. Design-to-silicon-yield solutions revenue for the three months ended September 30, 2012 was \$15.3 million, an increase of \$1.4 million, or 10%, compared to \$13.9 million for the three months ended September 30, 2011. The increase in Design-to-silicon-yield solutions revenue was primarily due to more services performed on revenue-generating projects during the period. Gainshare performance incentives revenue for the three months ended September 30, 2012 was \$7.2 million, an increase of \$4.2 million, or 139%, compared to \$3.0 million for the three months ended September 30, 2011. The increase in revenue from Gainshare performance incentives was primarily the result of a higher number of projects reaching performance measures for achieving gainshare and higher wafer volumes at customers' manufacturing facilities.
- Net income for the three months ended September 30, 2012 was \$5.0 million, compared to net income of \$0.6 million for the three months ended September 30, 2011. The increase in net income was primarily attributable to an increase in revenues and a more favorable product mix with relatively flat operating expenses, lower foreign withholding taxes and a foreign withholding tax refund benefit recognized in the period.
- Net income per basic and diluted share was \$0.17 and \$0.17, respectively, for the three months ended September 30, 2012 compared to net income per basic and diluted share of \$0.02 for the three months ended September 30, 2011, an increase of \$0.15 and \$0.15 per basic and diluted share, respectively.
- Cash, cash equivalents and investments increased \$4.6 million from \$46.8 million at December 31, 2011 to \$51.4 million at September 30, 2012, primarily due to an increase in cash from operating activities during the period.

Financial highlights for the nine months ended September 30, 2012 were as follows:

- Total revenues for the nine months ended September 30, 2012 were \$65.7 million, an increase of \$16.6 million, or 34%, compared to total revenues of \$49.1 million for the nine months ended September 30, 2011. Design-to-silicon-yield solutions revenue for the nine months ended September 30, 2012 was 42.5 million, an increase of \$5.0 million, or 13%, compared to \$37.5 million for the nine months ended September 30, 2011. The increase in Design-to-silicon-yield solutions revenue was primarily due to more services performed on revenue-generating projects during the period. Gainshare performance incentives revenue for the nine months ended September 30, 2012 was \$23.2 million, an increase of \$11.6 million, or 100%, compared to Gainshare performance incentive revenue of \$11.6 million for the nine months ended September 30, 2011. The increase in Gainshare performance incentives was primarily the result of higher number of projects reaching performance measures for achieving gainshare and higher wafer volumes at customer manufacturing facilities.
- Net income for the nine months ended September 30, 2012 was \$13.3 million, compared to net loss of \$(0.2) million for the nine months ended September 30, 2011. The increase in net income was primarily attributable to an increase in revenues and a more favorable product mix, a decrease in operating expenses, lower foreign tax withholding taxes, and a foreign withholding tax refund benefit recognized in the period.
- Net income per basic and diluted share was \$0.47 and \$0.45, respectively, for the nine months ended September 30, 2012 compared to net loss per basic and diluted share of \$(0.01) for the nine months ended September 30, 2011, an increase of \$0.48 and \$0.46 per basic and diluted share, respectively.

Critical Accounting Policies

There were no significant changes in our critical accounting policies. Please refer to Management's Discussion and Analysis of Financial Condition and Results of Operations contained in Part II, Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2011. 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 conditions, results of operations and cash flows are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Our preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We based our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. The most significant estimates and assumptions relate to revenue recognition, stock-based compensation and the realization of deferred tax assets. Actual amounts may differ from such estimates under different assumptions or conditions.

Revenue Recognition

We derive revenue from two sources: Design-to-silicon-yield solutions, which include services and software licenses, and Gainshare performance incentives.

Design-to-Silicon-Yield Solutions — Revenue that is derived from Design-to-silicon-yield solutions comes from services and software licenses. We recognize revenue for each element of Design-to-silicon-yield solutions as follows:

We generate a significant portion of our Design-to-silicon-yield solutions revenue from fixed-price solution implementation service contracts delivered over a specific period of time. These contracts require reliable estimation of costs to perform obligations and the overall scope of each engagement. Revenue under project-based contracts for solution implementation services is recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting. Revenue under certain time-based contracts for solution implementation services is recognized under the proportional performance method. Losses on solution implementation contracts are recognized in the period when they become evident. 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 contracts were executed. Any such reductions in contract margin could have a material negative impact on our operating results. On occasion, we license our software products as a component of our fixed price service contracts. In such instances, the software products are licensed to customers over a specified term of the agreement with support and maintenance to be provided at each customer's option over the license term. The amount of product and service revenue recognized in a given period is affected by our judgment as to whether an arrangement includes multiple deliverables and, if so, our determination of the fair value of each deliverable. In general, vendor-specific objective evidence of selling price ("VSOE") does not exist for our solution implementation services and software products and because our services and products include our unique technology, we are not able to determine third-party evidence of selling price ("TPE"). Therefore, in such circumstances, we use best estimated selling prices ("BESP") in our allocation of arrangement consideration. In determining BESP, we apply significant judgment as we weigh a variety of factors, based on the facts and circumstances of the arrangement. We typically arrive at BESP for a product or service that is not sold separately by considering company-specific factors such as geographies, internal costs, gross margin objectives, pricing practices used to establish bundled pricing, and existing portfolio pricing and discounting. After fair value is established for each deliverable, the total transaction amount is allocated to each deliverable based upon its relative fair value. Fees allocated to solution implementation services are recognized using the cost-to-cost percentage of completion method of contract accounting. Fees allocated to software and related support and maintenance are recognized under software revenue recognition guidance.

We also license our software products separately from our solution implementation services. For software license arrangements that do not require significant modification or customization of the underlying software, software license revenue is recognized under the residual method when (1) persuasive evidence of an arrangement exists, (2) delivery has occurred, (3) the fee is fixed or determinable, (4) collectability is probable, and (5) the arrangement does not require services that are essential to the functionality of the software. When arrangements include multiple elements such as support and maintenance, consulting (other than for our fixed price solution implementations), installation, and training, revenue is allocated to each element of a transaction based upon its fair value as determined by our VSOE and such services are recorded as services revenues. VSOE for maintenance is generally established 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. Revenues for software licenses with extended payment terms are not recognized in excess of amounts due. For software license arrangements that require significant modification or customization of the underlying software, the software license revenues are recognized as services are performed using the cost-to-cost percentage of completion method of contract accounting, and such revenues are recorded as services revenue.

Gainshare Performance Incentives — When we enter into a contract to provide yield improvement services, the contract usually includes two components: (1) a fixed fee for performance by us of services delivered over a specific period of time; and (2) a Gainshare performance incentives component where the customer may pay a variable fee, usually after the fixed fee period has ended. Revenues derived from Gainshare performance incentives represent profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels established in related solution implementation service contracts. Gainshare performance incentives periods are usually subsequent to the delivery of all contractual services and therefore have no cost to us. Due to the uncertainties surrounding attainment of such operational levels, we recognize Gainshare performance incentives revenues (to the extent of completion of the related solution implementation services) upon receipt of performance reports or other related information from our customers supporting the determination of amounts and probability of collection. Gainshare performance incentives revenue is dependent on many factors which are outside our control, which can include among others, continued production of the related ICs by our customers, sustained yield improvements by our customers, and our ability to enter into new Design-to-silicon-yield solutions contracts containing provisions for Gainshare performance incentives.

Stock-Based Compensation

Stock-based compensation is estimated at the grant date based on the award's fair value and is recognized on a straight-line basis over the vesting periods of the applicable stock purchase rights and stock options, generally four years. As stock-based compensation expense recognized is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates.

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

Income Taxes

We must assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. Changes in the net deferred tax assets, less offsetting valuation allowance, in a period are recorded through the income tax provision in the consolidated statements of operations. During the year ended December 31, 2008, we concluded that a valuation allowance was required based on our evaluation and weighting of the positive and negative evidence. We continued to carry a valuation allowance against our U.S. and certain foreign deferred tax assets as of September 30, 2012 and December 31, 2011. See Note 9 to the condensed consolidated financial statements for further discussion. If in the future, we determine based on our future profitability that these deferred tax assets are more likely than not to be realized, a release of all, or part, of the related valuation allowance could result in an immediate material income tax benefit in the period of decrease and material income tax provisions in future periods. A continued improvement in the Company's financial performance and expected future results could result in a reversal of the valuation allowance in the near future.

Our income tax calculations are based on application of the respective U.S. federal, state or foreign tax law. Our tax filings, however, are subject to audit by the respective tax authorities. Accordingly, we recognize tax liabilities based upon our estimate of whether, and the extent to which, additional taxes will be due when such estimates are more-likely-than-not to be sustained. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. To the extent the final tax liabilities are different than the amounts originally accrued, the increases or decreases are recorded as income tax expense or benefit in the consolidated statements of operations.

Recent Accounting Pronouncements and Accounting Changes

See Note 2 of "Notes to Condensed Consolidated Financial Statements (Unaudited)" of this Quarterly Report on Form 10-Q for a description of recent accounting pronouncements and accounting changes, including the expected dates of adoption and estimated effects, if any, on our consolidated financial statements.

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
Design-to-silicon-yield solutions	68%	82%	65%	76%
Gainshare performance incentives	32	18	35	24
Total revenues	100%	100%	100%	100%
Costs of design-to-silicon-yield solutions:				
Direct costs of design-to-silicon-yield solutions	42	45	41	44
Amortization of acquired technology	—	1	—	1
Total costs of design-to-silicon-yield solutions	42	46	41	45
Gross Profit	58	54	59	55
Operating expenses:				
Research and development	14	20	15	22
Selling, general and administrative	20	25	22	29
Amortization of other acquired intangible assets	—	—	—	—
Restructuring charges (credits)	—	—	—	—
Total operating expenses	34	45	37	51
Income from operations	24	9	22	4
Interest and other income (expense), net	(1)	1	—	—
Income before taxes	23	10	22	4
Income tax provision	1	6	2	4
Net income (loss)	22%	4%	20%	(0)%

Comparison of the Three Months Ended September 30, 2012 and 2011

	Three Months Ended September 30,		\$ Change	% Change
	2012	2011		
Revenues				
(In thousands, except for percentages)				
Design-to-silicon-yield solutions	\$ 15,305	\$ 13,903	\$ 1,402	10%
Gainshare performance incentives	7,246	3,036	4,210	139%
Total	\$ 22,551	\$ 16,939	\$ 5,612	33%

Design-to-Silicon-Yield Solutions. Design-to-silicon-yield solutions revenue is derived from services (including solution implementations, software support and maintenance, consulting, and training) and software licenses, provided during our customer yield improvement engagements as well as during solution product sales. Design-to-silicon-yield solutions revenue increased \$1.4 million for the three months ended September 30, 2012 compared to the three months ended September 30, 2011, primarily due to an increase in fixed fee integrated solutions, the result of higher field utilization in the period due to increased business activity. Our Design-to-silicon-yield solutions revenues may fluctuate in the future and are dependent on a number of factors, including the semiconductor industry's acceptance of our products, the timing of purchases by existing customers, and our ability to attract new customers and penetrate new markets including photovoltaic and LED, and further penetration of our current customer base. Fluctuations in future results may also occur if any of our significant customers renegotiate pre-existing contractual commitments due to adverse changes in their own businesses or, in some cases, take advantage of contractual provisions that permit the suspension of contracted work for a period if their business experiences a financial hardship.

Gainshare Performance Incentives. Gainshare performance incentives revenue represents profit sharing and performance incentives earned based upon our customers reaching certain defined operational levels. Revenue derived from Gainshare performance incentives increased \$4.2 million for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. The increase was primarily the result of a higher number of projects reaching performance measures for achieving gainshare and higher wafer volumes at customers' manufacturing facilities. The revenue from Gainshare performance incentives was generated from eight customers and ten engagements for the three months ended September 30, 2012 and seven customers and seven engagements for the three months ended September 30, 2011. Our Gainshare performance incentives revenue may continue to fluctuate from period to period. Gainshare performance incentives revenue is dependent on many factors that are outside our control, including among others, continued production of ICs by our customers at facilities at which we generate gainshare, sustained yield improvements by our customers, and our ability to enter into new Design-to-silicon-yield solutions contracts containing provisions for Gainshare performance incentives.

Cost of Design-to-Silicon-Yield Solutions	Three Months Ended		\$	%
	September 30,			
(In thousands, except for percentages)	2012	2011	Change	Change
Direct costs of design-to-silicon-yield solutions	\$ 9,457	\$ 7,650	\$ 1,807	24%
Amortization of acquired technology	—	156	(156)	(100)%
Total	\$ 9,457	\$ 7,806	\$ 1,651	21%

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

Direct Costs of Design-to-Silicon-Yield Solutions. Direct costs of Design-to-silicon-yield solutions consist of services costs and software license costs. Services costs consist of material, labor, overhead costs, and stock-based compensation charges associated with solution implementations. Costs include purchased materials, employee compensation and related benefits, travel and facilities-related costs. Software license costs consist of costs associated with licensing third-party software sold in conjunction with our software products and expenses incurred to produce and distribute our product documentation. Direct costs of Design-to-silicon-yield solutions increased \$1.8 million for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. The increase was primarily due to an increase of \$1.7 million in personnel expense, which was the result of additional headcount needed to support the growth in revenue-generating engagements and higher variable compensation, an increase of \$0.2 million in travel expense and an increase of \$0.1 million in outside services, which were related to increased project activity, and an increase of \$0.2 million in facility expenses, only slightly offset by a decrease of \$0.2 million in equipment cost and a decrease of \$0.2 in third-party software royalty expense.

Amortization of Acquired Technology. Amortization of acquired technology consists of amortization of intangible assets acquired as a result of certain business combinations. Amortization of acquired technology expense was zero for the three months ended September 30, 2012 and \$156,000 for the three months ended September 30, 2011. All acquired technology intangible assets was fully amortized as of June 30, 2012, resulting in no amortization expense for the three months ended September 30, 2012.

Research and Development	Three Months Ended		\$	%
	September 30,			
(In thousands, except for percentages)	2012	2011	Change	Change
Research and development	\$ 3,203	\$ 3,366	\$ (163)	(5)%

Research and Development. Research and development expenses consist primarily of personnel-related costs to support product development activities, including compensation and benefits, outside development services, travel and facilities cost allocations, and stock-based compensation charges. Research and development expenses decreased \$0.2 million for the three months ended September 30, 2012 compared to the three months ended September 30, 2011, primarily due to the decrease in facility expenses. We anticipate our expenses in research and development will fluctuate in absolute dollars from period to period as a result of the size and the timing of product development projects and revenue generating activity requirements.

Selling, General and Administrative	Three Months Ended		\$	%
	September 30,			
(In thousands, except for percentages)	2012	2011	Change	Change
Selling, general and administrative	\$ 4,498	\$ 4,158	\$ 340	8%

Selling, General and Administrative. Selling, general and administrative expenses consist primarily of compensation and benefits for sales, marketing and general and administrative personnel in addition to outside sales commissions, legal and accounting services, marketing communications, travel and facilities cost allocations, and stock-based compensation charges. Selling, general and administrative expenses increased \$0.3 million for the three months ended September 30, 2012 compared to the three months ended September 30, 2011, primarily due to an increase of \$0.2 million in personnel-related expense as a result of higher variable compensation and an increase of \$0.1 million in stock-based compensation expense, which was mainly due to the impact of awards granted to our non-employee directors. We anticipate our selling, general and administrative expenses will fluctuate in absolute dollars from period to period as a result of cost control initiatives and to support increased selling efforts in the future.

	Three Months Ended September 30,		\$ Change	% Change
	2012	2011		
Amortization of Other Acquired Intangible Assets (In thousands, except for percentages)				
Amortization of other acquired intangible assets	\$ 51	\$ 51	\$ —	—%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets consists of amortization of intangibles acquired as a result of certain business combinations. Amortization of other acquired intangible assets remained flat for the three months ended September 30, 2012 compared to the three months ended September 30, 2011. We anticipate amortization of other acquired intangible assets to be \$22,000 in the remaining three months in 2012, \$74,000 in 2013, and \$30,000 in 2014.

	Three Months Ended September 30,		\$ Change	% Change
	2012	2011		
Restructuring Charges (Credits) (In thousands, except for percentages)				
Restructuring charges (credits)	\$ —	\$ 4	\$ (4)	(100)%

Restructuring Charges (Credits). For the three months ended September 30, 2012, we incurred no restructuring charges (credits). Restructuring charges for the three months ended September 30, 2011 is not material and is due to the change in previous estimate.

	Three Months Ended September 30,		\$ Change	% Change
	2012	2011		
Interest and Other Income (Expense), net (In thousands, except for percentages)				
Interest and other income (expense), net	\$ (179)	\$ 201	\$ (380)	(189)%

Interest and Other Income (Expense), Net. For the three months ended September 30, 2012, we recorded interest and other expense, net of \$0.2 million as compared to interest and other income, net of \$0.2 million for the three months ended September 30, 2011. The interest and other expense, net for the three months ended September 30, 2012 was primarily related to \$0.4 million of losses related to the Euro to U.S. Dollar exchange rate, offset by gains on auction-rate securities of \$0.2 million. The interest and other income, net for the three months ended September 30, 2011 was primarily due to foreign currency exchange gains related to the Euro to U.S. Dollar exchange rate. We anticipate interest and other income (expense), net will fluctuate in future periods as a result of our projected use of cash and fluctuations of foreign exchange rates.

	Three Months Ended September 30,		\$ Change	% Change
	2012	2011		
Income Tax Provision (In thousands, except for percentages)				
Income tax provision	\$ 170	\$ 1,129	\$ (959)	(85)%

Income Tax Provision. Our income tax provision primarily consists of foreign withholding taxes, statutory taxes associated with our foreign subsidiaries, and changes in unrecognized tax benefits. On a quarterly basis, we evaluate our expected income tax provision based on our year-to-date operations, and record an adjustment in the current quarter. Income tax provision decreased \$0.9 million for the three months ended September 30, 2012 compared to three months ended September 30, 2011, primarily due to a \$0.2 million decrease in foreign withholding taxes and \$0.5 million of foreign withholding tax refund benefits recognized during the three months ended September 30, 2012. Income tax provision for the three months ended September 30, 2012 and 2011 primarily consisted of foreign withholding taxes, statutory taxes and changes in unrecognized tax benefits.

As of September 30, 2012, a valuation allowance remains on U.S. deferred tax assets that are not more-likely-than-not to be realized. We evaluate our deferred tax asset valuation allowance position on a regular basis. As a result, management believes a reversal of a substantial portion of the Company's valuation allowance is possible in the near future. Such reversal, if and when it occurs, may have material impact to the tax provision in the future.

Comparison of the Nine Months Ended September 30, 2012 and 2011

Revenues	Nine Months Ended September 30,		\$ Change	% Change
	2012	2011		
(In thousands, except for percentages)				
Design-to-silicon-yield solutions	\$ 42,484	\$ 37,473	\$ 5,011	13%
Gainshare performance incentives	23,241	11,643	11,598	100%
Total	\$ 65,725	\$ 49,116	\$ 16,609	34%

Design-to-Silicon-Yield Solutions. Design-to-silicon-yield solutions revenue increased \$5.0 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, primarily due to an increase in fixed fee integrated solutions, the result of higher field utilization in the period due to increased business activity. Our Design-to-silicon-yield revenues may fluctuate in the future and are dependent on a number of factors, including the semiconductor industry's acceptance of our products, the timing of purchases by existing customers, and our ability to attract new customers and penetrate new markets including photovoltaic and LED, and further penetration of our current customer base. Fluctuations in future results may also occur if any of our significant customers renegotiate pre-existing contractual commitments due to adverse changes in their own businesses or, in some cases, take advantage of contractual provisions that permit the suspension of contracted work for a period if their business experiences a financial hardship.

Gainshare Performance Incentives. Revenue derived from Gainshare performance incentives increased \$11.6 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. The increase was primarily the result of a higher number of projects reaching performance measures for achieving gainshare and higher wafer volumes at customers' manufacturing facilities. The revenue from Gainshare performance incentives was generated from nine customers and eleven engagements for the nine months ended September 30, 2012 and seven customers and seven engagements for the nine months ended September 30, 2011. Our Gainshare performance incentives revenue may continue to fluctuate from period to period. Gainshare performance incentives revenue is dependent on many factors that are outside our control, including among others, continued production of ICs by our customers at facilities at which we generate gainshare, sustained yield improvements by our customers, and our ability to enter into new Design-to-silicon-yield solutions contracts containing provisions for Gainshare performance incentives.

Cost of Design-to-Silicon-Yield Solutions	Nine Months Ended September 30,		\$ Change	% Change
	2012	2011		
(In thousands, except for percentages)				
Direct costs of design-to-silicon-yield solutions	\$ 26,830	\$ 21,350	\$ 5,480	26%
Amortization of acquired technology	261	468	(207)	(44)%
Total	\$ 27,091	\$ 21,818	\$ 5,273	24%

Direct Costs of Design-to-Silicon-Yield Solutions. Direct costs of Design-to-silicon-yield solutions increased \$5.5 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. The increase was primarily due to an increase of \$5.5 million in personnel expense, which was the result of additional headcount needed to support the growth in revenue-generating engagements and higher variable compensation, an increase of \$0.6 million in travel expense and an increase of \$0.3 million in outside services, which were related to increased project activity, only slightly offset by a decrease of \$0.4 million in third-party software royalty expense, a decrease of \$0.3 million in equipment cost and a decrease of \$0.2 million in stock-based compensation expense due to certain awards related to the tender offer in 2009 that became fully vested in fiscal year 2011.

Amortization of Acquired Technology. Amortization of acquired technology expense was \$261,000 for the nine months ended September 30, 2012 and \$468,000 for the nine months ended September 30, 2011. All acquired technology intangible assets was fully amortized as of June 30, 2012, resulting in no amortization expense for the three months ended September 30, 2012.

	Nine Months Ended September 30,		\$ Change	% Change
	2012	2011		
Research and Development				
(In thousands, except for percentages)				
Research and development	\$ 9,651	\$ 10,912	\$ (1,261)	(12)%

Research and Development. Research and development expenses decreased \$1.3 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, primarily due to the decrease in personnel-related and outside service expenses, a result of the decrease in research and development activities due to the timing of research and development projects. We anticipate our expenses in research and development will fluctuate in absolute dollars from period to period as a result of cost control initiatives and the timing of when we hire personnel as a result of the size and the timing of product development projects and revenue generating activity requirements.

	Nine Months Ended September 30,		\$ Change	% Change
	2012	2011		
Selling, General and Administrative				
(In thousands, except for percentages)				
Selling, general and administrative	\$ 14,122	\$ 14,239	\$ (117)	(1)%

Selling, General and Administrative. Selling, general and administrative expenses decreased \$0.1 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, primarily due to \$1.0 million in lower accounting fees and decreased legal-related activities and \$0.1 million in lower recruiting expense related to the search of the Chief Financial Officer in fiscal year 2011, offset by an increase of \$0.7 million in personnel-related expense due to increase in variable compensation, an increase of \$0.1 million in travel expense and an increase of \$0.2 million on stock-based compensation expense, which was mainly due to the impact of awards granted to our non-employee directors.

	Nine Months Ended September 30,		\$ Change	% Change
	2012	2011		
Amortization of Other Acquired Intangible Assets				
(In thousands, except for percentages)				
Amortization of other acquired intangible assets	\$ 153	\$ 153	\$ —	—%

Amortization of Other Acquired Intangible Assets. Amortization of other acquired intangible assets remains flat for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011. We anticipate amortization of other acquired intangible assets to be \$22,000 in the remaining nine months in 2012, \$74,000 in 2013, and \$30,000 in 2014.

	Nine Months Ended September 30,		\$ Change	% Change
	2012	2011		
Restructuring Charges (Credits)				
(In thousands, except for percentages)				
Restructuring charges (credits)	\$ 83	\$ (129)	\$ 212	(164)%

Restructuring Charges (Credits). For the nine months ended September 30, 2012, we incurred restructuring charges of \$0.1 million, which is primarily related to a decision to restructure additional square footage of office facilities. For the nine months ended September 30, 2011, the Company reversed \$0.1 million of restructuring charges due to the sublease of certain previously restructured facilities earlier than previously estimated.

	Nine Months Ended September 30,		\$ Change	% Change
	2012	2011		
Interest and Other Income (Expense), Net				
(In thousands, except for percentages)				
Interest and other income (expense), net	\$ (166)	\$ (209)	\$ 43	(21)%

Interest and Other Income (Expense), Net. The interest and other expense, net for the nine months ended September 30, 2012 and 2011 was primarily attributable to gains related to the Euro to U.S. Dollar exchange rate. We anticipate interest and other income (expense), net will fluctuate in future periods as a result of our projected use of cash and fluctuations of foreign exchange rates.

Income Tax Provision	Nine Months Ended		\$	%
	September 30,			
(In thousands, except for percentages)	2012	2011	Change	Change
Income tax provision	\$ 1,147	\$ 2,147	\$ (1,000)	(47)%

Income Tax Provision. Income tax provision decreased \$1.0 million for the nine months ended September 30, 2012 compared to the nine months ended September 30, 2011, primarily due to a \$0.5 million decrease in foreign withholding taxes and foreign withholding tax refunds benefits of \$0.5 million recognized in fiscal 2012. Income tax provision for the nine months ended September 30, 2012 and 2011 primarily consisted of foreign withholding taxes, statutory taxes and changes in unrecognized tax benefits.

As of September 30, 2012, a valuation allowance remains on U.S. deferred tax assets that are not more-likely-than-not to be realized. We evaluate our deferred tax asset valuation allowance position on a regular basis. As a result, management believes a reversal of a substantial portion of the Company's valuation allowance is possible in the near future. Such reversal, if and when it occurs, may have material impact to the tax provision in the future.

Liquidity and Capital Resources

Operating Activities

Cash flows from operating activities of \$4.6 million for the nine months ended September 30, 2012 consisted primarily of net income of \$13.3 million and non-cash charges of \$4.1 million that was offset by \$12.8 million of cash flow decreases reflected in the net change of operating assets and liabilities. Non-cash charges consisted primarily of stock-based compensation of \$3.5 million, amortization of acquired intangible assets of \$0.4 million, depreciation of \$0.3 million, provision for doubtful accounts of \$0.1 million, partially offset by purchases of treasury stock of \$0.2 million for employee income tax withholdings due upon vesting of restricted stock units. Cash flow decreases resulting from the net change in operating assets and liabilities primarily consisted of a \$12.7 million increase in accounts receivable, a \$0.8 million increase in prepaid expense and other assets, a \$0.3 million decrease in accounts payable, a \$0.5 million decrease in accrued and other liabilities, a \$0.5 million decrease in deferred revenues, and a \$1.3 million decrease in billings in excess of recognized revenue, partially offset by a \$3.4 million increase in accrued compensation and related benefits. The \$14.6 million combined cash flow decrease resulted from the increase in accounts receivable and decrease in combined billings in excess of recognized revenues and deferred revenue due to the timing of billing milestones and payments received.

Cash flows from operating activities of \$6.0 million for the nine months ended September 30, 2011 consisted primarily of net loss of \$0.2 million that was offset by \$4.1 million of non-cash charges and \$2.1 million of cash flow increases reflected in the net change of operating assets and liabilities. Non-cash charges consisted primarily of stock-based compensation of \$3.8 million, amortization of acquired intangible assets of \$0.6 million and depreciation of \$0.4 million, partially offset by purchases of treasury stock of \$0.5 million for employee income tax withholdings due upon vesting of restricted stock units. Cash flow increases resulting from the net change in assets and liabilities primarily consisted of a decrease of \$1.9 million of accounts receivable, a \$0.2 million increase in accrued compensation, and a \$0.8 million increase in billings in excess of recognized revenue, partially offset by a \$0.2 million increase in prepaid expenses and other assets, a \$0.1 million decrease in accounts payable, and a combined \$0.4 million decrease in accrued and other liabilities and deferred revenue. The \$2.6 million combined cash flow increase resulted from the decrease in accounts receivable and increase in billings in excess of recognized revenues due to the timing of billing milestones and payments received.

Investing Activities

Cash flows used in investing activities for the nine months ended September 30, 2012 was attributable to \$2.1 million payment for capital expenditures, offset by \$0.5 million proceeds from the sale of auction-rate-securities. Cash flows used in investing activities of \$0.4 million for the nine months ended September 30, 2011 consisted of payments for capital expenditures.

Financing Activities

Cash flows provided from financing activities of \$1.8 million for the nine months ended September 30, 2012 consisted of \$4.7 million of proceeds from the exercise of stock options and \$1.0 million of proceeds from our Employee Stock Purchase Plan, partially offset by \$3.9 million of cash used to repurchase 389,000 shares of our common stock on the open market during the period.

Cash flows provided by financing activities of \$0.3 million for the nine months ended September 30, 2011 consisted of \$2.1 million of proceeds from the exercise of stock options and \$0.9 million of proceeds from our Employee Stock Purchase Plan, partially offset by \$2.5 million of cash used to repurchase 472,000 shares of our common stock on the open market during the period and \$0.1 million of principal payments on debt obligations.

Liquidity

As of September 30, 2012, our working capital, defined as total current assets less total current liabilities, was \$73.9 million, compared with \$57.2 million as of December 31, 2011. Cash and cash equivalents were \$50.9 million as of September 30, 2012, compared to \$46.0 million as of December 31, 2011. As of September 30, 2012 and December 31, 2011, cash and cash equivalents held by our foreign subsidiaries were not material. We anticipate that our overall expenses, as well as planned capital expenditures, may constitute a material use of our cash resources. In addition, we may use cash resources to repurchase common stock or fund potential investments in, or acquisitions of complementary products, technologies or businesses. We believe that our existing cash resources and anticipated funds from operations will satisfy our cash requirements to fund our operating activities, capital expenditures and other obligations for at least the next twelve months. However, in the event that during such period, or thereafter, we are not successful in generating sufficient cash flows from operations we may need to raise additional capital through private or public financings, strategic relationships or other arrangements, which may not be available to us on acceptable terms or at all.

As of September 30, 2012, our short-term investments included auction-rate securities with a fair value of \$500,000. The auction-rate securities are measured at fair value based upon a redemption notice for an inactive market and accounted for approximately 2% of total assets that are measured at fair value on a recurring basis. See Note 12 to "Notes to Condensed Consolidated Financial Statements (Unaudited)" in Part I for further discussion.

Off-Balance Sheet Agreements

We do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt.

We indemnify certain customers from third-party claims of intellectual property infringement relating to the use of our products. Historically, costs related to these guarantees of indemnification have not been significant. We are unable to estimate the maximum potential impact of these guarantees on our future results of operations.

Contractual Obligations

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

Contractual Obligations (1)	Payments Due by Period						Total
	2012 (remaining three months)	2013	2014	2015	2016	Thereafter	
Operating lease obligations (2)	656	1,610	1,651	1,548	1,556	1,980	\$ 9,001

(1) The contractual obligation table above excludes liabilities for uncertain tax positions of \$2.7 million, which are not practicable to assign to any particular years, due to the inherent uncertainty of the tax positions. See Note 9 of "Notes to Consolidated Financial Statements" for further discussion.

(2) The operating lease obligations have been reduced by future minimum sublease rental income of \$0.1 million in 2012 and \$0.4 million in 2013, respectively.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

Interest Rate Risk. As of September 30, 2012, we had cash and cash equivalents of \$50.9 million. Cash and cash equivalents consisted of cash and highly liquid money market instruments. We would not expect our operating results or cash flows to be affected to any significant degree by the effect of a sudden change in market interest on our portfolio. A hypothetical increase in market interest rates of 100 basis points from the market rates in effect at September 30, 2012 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 interest expense.

Foreign Currency and Exchange Risk. Certain of our payables for our international offices are denominated in the local currency, including the Euro, Yen and RMB. Therefore, a portion of our operating expenditures is subject to foreign currency risks. The effect of an immediate 10% adverse change in exchange rates on foreign denominated payables as of September 30, 2012 would result in a loss of approximately \$0.6 million. As of September 30, 2012, we did not have outstanding hedging contracts, although we may enter into such contracts in the future. We intend to monitor our foreign currency exposure. Future exchange rate fluctuations may have a material negative impact on our business.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial and accounting officer, evaluated the effectiveness of our "disclosure controls and procedures" as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) as of September 30, 2012 in connection with the filing of this Quarterly Report on Form 10-Q. Based on that evaluation as of September 30, 2012, our principal executive officer and principal financial and accounting officer concluded that our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in rules and forms of the SEC and accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting during the three months ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

From time to time, we are subject to various claims and legal proceedings that arise in the ordinary course of business. Although we currently believe that the ultimate outcome of the claim described below will not have a material adverse effect on our financial position or overall trends in results of operations, litigation is subject to inherent uncertainty. If an unfavorable ruling occurs in the legal proceeding described below, our financial position and results of operations and cash flows could be negatively affected. We accrue for losses related to litigation when a potential loss is probable and the loss can be reasonably estimated in accordance with FASB requirements. With respect to the matter below, we have determined a potential loss is not probable at this time and, accordingly, no amount has been accrued at September 30, 2012. As we continue to monitor this matter, however, our determination could change and we may decide a different reserve is appropriate in the future.

Philip Steven Melman filed a complaint against us and our Chief Executive Officer on December 7, 2009 in the Superior Court for Santa Clara County. In the complaint, Mr. Melman alleges wrongful discharge based on discrimination, fraud, breach of contract and similar theories, in connection with the termination of Mr. Melman's employment with us. The complaint seeks compensatory and punitive damages, any other available remedies, as well as attorney's fees and costs. Summary judgment in the favor of both the Company and Dr. Kibarian was entered by the court on October 27, 2011 and November 15, 2011, respectively. Mr. Melman is appealing both orders in the Court of Appeals for Santa Clara County. We believe the appeal is without merit and intend to continue to vigorously oppose it.

Item 1A. Risk Factors

Item 1A, "Risk Factors," on pages 28 through 34 of the Company's Quarterly Report on Form 10-Q for the second fiscal quarter ended June 30, 2012, provides information on the significant risks associated with our business. There have been no subsequent material changes to these risks.

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

The table below sets forth the information with respect to purchases made by or on behalf of the Company or any “affiliated purchaser” (as the term is defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934) of our common stock during the three months ended September 30, 2012 (in thousands except per share amounts):

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased (2)	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs(1)
Month #7 (July 1, 2012 through July 31, 2012)	—	\$ 10.19	—	\$ 4,188
Month #8 (August 1, 2012 through August 31, 2012)	53	10.40	53	\$ 3,634
Month #9 (September 1, 2012 through September 30, 2012)	109	12.42	109	\$ 2,276
Total	<u>162</u>	\$ 11.76	<u>162</u>	

- (1) On October 29, 2007, the Board of Directors adopted a program to repurchase up to \$10.0 million of the Company’s common stock on the open market. The initial program was for three years, but on October 19, 2010, the Board of Directors authorized an extension of, and an increase in, the program and the aggregate amount available to repurchase between October 19, 2010 and October 29, 2012 was reset to an additional \$10.0 million of the Company’s common stock, meaning a total of \$19.3 million was available. As of September 30, 2012, 3.8 million shares had been repurchased at the average price of \$4.52 per share, a total purchase price of \$17.0 million, under this program. The program expired on October 29, 2012. On November 8, 2012, the Board of Directors adopted a new program to repurchase up to \$20.0 million of the Company’s common stock on the open market over the next two years.
- (2) Included in the shares indicated in the table above are shares that the Company withheld through net share settlements to cover tax withholding obligations upon the vesting of restricted stock unit awards under the Company’s equity compensation plans.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

None

Item 5. Other Information

None

Item 6. Exhibits

Exhibit Number	Description
10.9	First Amendment to Office Lease dated June 1, 2012 (incorporated herein by reference to registrar's Quarterly Report on Form 10-Q filed August 22, 2012).
10.10	Form of Stock Appreciation Right Agreement under PDF Solutions, Inc. 2011 Stock Incentive Plan. **
31.01	Certification of the principal executive officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.02	Certification of the principal financial and accounting officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.01*	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *
32.02*	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *
101.INS	XBRL Instance Document. ††
101.SCH	XBRL Taxonomy Extension Schema Document. ††
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document. ††
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document. ††
101.LAB	XBRL Taxonomy Extension Label Linkbase Document. ††
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document. ††

* As contemplated by SEC Release No. 33-8212, these exhibits are furnished with this Quarterly Report on Form 10-Q and are not deemed filed with the Securities and Exchange Commission and are not incorporated by reference in any filing of PDF Solutions, Inc. under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

** Indicates management contract or compensatory plan or arrangement.

†† In accordance with Rule 406T of Regulation S-T, the interactive data files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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.

PDF SOLUTIONS, INC.

Date: November 9, 2012

By: /s/ JOHN K. KIBARIAN
John K. Kibarian
President and Chief Executive Officer
(principal executive officer)

Date: November 9, 2012

By: /s/ GREGORY WALKER
Gregory Walker
Vice President, Finance and Chief Financial Officer
(principal financial and accounting officer)

INDEX TO EXHIBITS

Exhibit Number	Description
10.9	First Amendment to Office Lease dated June 1, 2012 (incorporated herein by reference to registrar's Quarterly Report on Form 10-Q filed August 22, 2012).
10.10	Form of Stock Appreciation Right Agreement under PDF Solutions, Inc. 2011 Stock Incentive Plan. **
31.01	Certification of the principal executive officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.02	Certification of the principal financial and accounting officer pursuant to Exchange Act Rules 13a-14(a) and 15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.01*	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *
32.02*	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. *
101.INS	XBRL Instance Document. ††
101.SCH	XBRL Taxonomy Extension Schema Document. ††
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document. ††
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document. ††
101.LAB	XBRL Taxonomy Extension Label Linkbase Document. ††
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document. ††

* As contemplated by SEC Release No. 33-8212, these exhibits are furnished with this Quarterly Report on Form 10-Q and are not deemed filed with the Securities and Exchange Commission and are not incorporated by reference in any filing of PDF Solutions, Inc. under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

** Indicates management contract or compensatory plan or arrangement.

†† In accordance with Rule 406T of Regulation S-T, the interactive data files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.



2011 Stock Incentive Plan – Stock Appreciation Right Agreement

1. **Grant of Stock Appreciation Right.** PDF Solutions, Inc., a Delaware corporation (the “Company”), has authorized the grant to the person (“Participant”) to whom this Agreement is delivered and who is named in the Notice of Grant of Stock Appreciation Right or online Grant Summary, as applicable (the “Notice”), a stock appreciation right (“SAR”) relating to the total number of shares of Common Stock (the “Shares”) set forth in such Notice, at the exercise price per Share set forth in the Notice (the “Exercise Price”) subject to the terms, definitions and provisions of the 2011 Stock Incentive Plan (the “Plan”), which is incorporated in this SAR Agreement (the “Agreement”) by reference. Unless otherwise defined in this Agreement or the Notice, the terms used in this Agreement shall have the meanings defined in the Plan.

(a) **Vesting.** This SAR is only exercisable before it expires and then only with respect to the vested portion of the SAR. This SAR will vest according to the vesting schedule in the Notice (the “Vesting Schedule”). If Participant takes a leave of absence, the Company may, at its discretion, suspend vesting during the period of leave to the extent permitted under applicable local laws, rules and regulations.

(b) **Acceptance; Cancellation.** Participant acknowledges that by electronically accepting the SAR (or instructing the Company in writing to record such acceptance with its designated third-party broker), Participant agrees to be bound by all terms applicable to the SAR, as set forth in this Agreement and the Plan. **Participant must expressly accept the terms and conditions of the SAR as set forth in the Notice, the Agreement and the Plan by electronically accepting the Agreement within ninety (90) calendar days after the Company first makes the Notice available to Participant.** If Participant does not accept this SAR in the manner instructed by the Company, this SAR may be cancelled by the Company in its discretion.

2. **Exercise of SAR.** This SAR shall be exercisable during its term in accordance with the Vesting Schedule set forth in the Notice and with the applicable provisions of the Plan as follows:

(a) **Right to Exercise.**

(i) In the event of Participant’s termination of Service, Participant may exercise this SAR as set forth in Section 4 below, and subject to the limitations contained in this Section 2. Participant is responsible for keeping track of these exercise periods following the termination of Service for any reason. The Company will not provide further notice of such periods.

(ii) In no event may this SAR be exercised after the Expiration Date set forth in the Notice.

(b) **Method of Exercise.**

(i) This SAR shall be exercisable by (A) completing the proper “Notice of Exercise” form provided by the Company or its designated broker, which shall state Participant’s election to exercise this SAR, the number of Shares in respect of which this SAR is being exercised, and such other representations and agreements as may be required by the Company pursuant to the provisions of the Plan, or (B) following the policies and procedures of the Company’s designated broker, as applicable. Such notice shall be delivered to the Company or its designated broker by such means as are determined by the Company, in its discretion, or its designated broker, as applicable, to constitute adequate delivery.

(ii) As a condition to the exercise of this SAR and as further set forth in Section 6 of this Agreement and Section 13 of the Plan, Participant agrees to make adequate provision for all local, state, federal, foreign or other applicable tax, withholding, required deductions or other payments, including any income tax, social taxes or social insurance contributions, fringe benefit tax, payroll tax, payment on account or other tax items related to Participant’s participation in the Plan and legally applicable to Participant (“Tax-Related Items”).

(iii) The Company is not obligated, and will have no liability for failure, to deliver any payment of cash upon exercise of this SAR unless such delivery would comply with all applicable laws, rules and regulations, with such compliance determined by the Company in consultation with its legal counsel.

(iv) Subject to compliance with all applicable laws, rules and regulations, this SAR shall be deemed to be exercised upon receipt by the Company of the appropriate notice of exercise and the satisfaction of any applicable obligations for Tax-Related Items.

(c) **No Automatic Exercise.** Notwithstanding Section 7(e) of the Plan, this SAR shall not automatically be deemed to be exercised in any circumstance.

3. **Payment upon Exercise.** Upon exercise of all or a portion of this SAR, Participant shall receive from the Company cash equal to the amount by which the Fair Market Value of the Shares subject to the exercised portion of the SAR on the date of exercise exceeds the Exercise Price of the Shares.

4. **Termination of Relationship.** Following the date of termination of Participant's active Service for any reason (the "Termination Date") (whether or not later found to be invalid or in breach of employment laws in the jurisdiction where Participant is employed or the terms of Participant's employment agreement, if any), Participant may exercise this SAR only as set forth in this Agreement, including Section 2 and this Section 4 and vesting will not be extended by any notice period (e.g., active Service would not include any contractual notice period or any period of "garden leave" or similar period mandated under employment laws in the jurisdiction where Participant is employed or the terms of Participant's employment agreement, if any). The Company shall have the exclusive discretion to determine when Participant is no longer in active Service for purposes of this SAR (including whether Participant may still be considered to be in active Service while on a leave of absence). If Participant does not exercise this SAR within the termination periods set forth below, this SAR shall terminate in its entirety. In no event, may this SAR be exercised after the Expiration Date as set forth in the Notice.

(a) **General Termination.** In the event of termination of Participant's active Service other than as a result of Participant's Disability or death or Participant's termination for Cause, Participant may, to the extent Participant is vested in the SAR, exercise this SAR within 90 days after the Termination Date.

(b) **Termination upon Disability of Participant.** In the event of termination of Participant's Service as a result of Participant's Disability, Participant may, but only within 6 months following the Termination Date, exercise this SAR to the extent Participant is vested in the SAR.

(c) **Death of Participant.** In the event of termination of Participant's Service as a result of Participant's death, or in the event of Participant's death within 30 days following Participant's Termination Date unless for Cause, this SAR may be exercised at any time within 6 months following the Termination Date or, if later, 6 months following the date of death by Participant's estate, or by a person who acquired the right to exercise this SAR by bequest or inheritance, but only to the extent Participant is vested in the SAR.

(d) **Termination for Cause.** In the event of termination of Participant's Service for Cause, this SAR shall immediately terminate in its entirety upon first notification to Participant of such termination for Cause. If Participant's Service is suspended pending an investigation of whether Participant's Service will be terminated for Cause, all Participant's rights under this SAR, including the right to exercise this SAR, shall be suspended during the investigation period.

5. **Non-Transferability of SAR.** This SAR shall not be anticipated, assigned, attached, garnished, optioned, transferred or made subject to any creditor's process, whether voluntarily or involuntarily or by operation of law. Notwithstanding the foregoing, should Participant die while holding this SAR, then this SAR shall be transferred in accordance with Participant's will or the laws of descent and distribution.

6. **Responsibility for Taxes.**

(a) Regardless of any action the Company or Participant's employer (the "**Employer**") takes with respect to any or all Tax-Related Items, Participant acknowledges that the ultimate liability for all Tax-Related Items is and remains Participant's responsibility and may exceed the amount actually withheld by the Company or the Employer. Participant further acknowledges that the Company and/or the Employer (i) make no representations or undertakings regarding the treatment of any Tax-Related Items in connection with any aspect of the SAR, including the grant, vesting or exercise of the SAR and the receipt of any cash payment pursuant to exercise of the SAR; and (ii) do not commit to and are under no obligation to structure the terms of the grant or any aspect of the SAR to reduce or eliminate Participant's liability for Tax-Related Items or achieve any particular tax result. Further, if Participant is subject to Tax-Related Items in more than one jurisdiction, Participant acknowledges that the Company and/or the Employer (or former employer, as applicable) may be required to withhold or account for Tax-Related Items in more than one jurisdiction.

(b) Prior to the relevant taxable or tax withholding event, as applicable, Participant agrees to make appropriate arrangements with the Company and/or the Employer or their respective agents for the satisfaction of all Tax-Related Items. In this regard, Participant authorizes the Company and/or the Employer to withhold all applicable Tax-Related Items from any cash payment made pursuant to this Agreement or from any wages or other cash compensation payable to Participant by the Company and/or the Employer. Participant must pay to the Company or the Employer any amount of Tax-Related Items that the Company or the Employer may be required to withhold or account for as a result of Participant's participation in the Plan or Participant's exercise of the SAR that cannot be satisfied by the means previously described. The Company may refuse to honor the exercise and refuse to deliver the cash if Participant fails to comply with Participant's obligations in connection with the Tax-Related Items.

7. **Data Privacy.**

(a) Participant hereby explicitly and unambiguously consents to the collection, use and transfer, in electronic or other form, of Participant's personal data as described in this Agreement and any other SAR materials by and among, as applicable, the Employer, the Company, its Parent, Subsidiaries and Affiliates for the exclusive purpose of implementing, administering and managing Participant's participation in the Plan.

(b) Participant understands that the Company and the Employer may hold certain personal information about Participant, including, but not limited to, Participant's name, home address and telephone number, date of birth, social insurance number (or any other social or national identification number), salary, nationality, job title, residency status, any shares or directorships held in the Company, details of all awards or any other entitlement to shares or cash awarded, canceled, exercised, vested, unvested or outstanding, in Participant's favor, for the exclusive purpose of implementing, administering and managing Participant's participation in the Plan ("Data").

(c) Participant understands that Data may be transferred to E*Trade or such other service provider as may be selected by the Company in the future, which is assisting the Company with the implementation, administration and management of the Plan. Participant understands that the recipients of Data may be located in the United States or elsewhere, and that the recipients' country (e.g., the United States) may have different data privacy laws and protections than Participant's country. Participant understands that Participant may request a list with the names and addresses of any potential recipients of Data by contacting Participant's local human resources representative. Participant authorizes the Company, E*Trade and any other possible recipients which may assist the Company (presently or in the future) with implementing, administering and managing the Plan to receive, possess, use, retain and transfer the Data, in electronic or other form, for the sole purpose of implementing, administering and managing Participant's participation in the Plan.

(d) Participant understands that Data will be held only as long as is necessary to implement, administer and manage Participant's participation in the Plan. Participant understands that Participant may, at any time, view Data, request additional information about the storage and processing of Data, require any necessary amendments to Data or refuse or withdraw the consents herein, in any case without cost, by contacting Participant's local human resources representative in writing. Further, Participant understands that Participant is providing the consents herein on a purely voluntary basis. If Participant does not consent, or if Participant later seeks to revoke his or her consent, Participant's Service relationship and career with the Employer will not be adversely affected; the only adverse consequence of refusing or withdrawing Participant's consent is that the Company would not be able to grant the SAR to Participant or administer or maintain the SAR. Therefore, Participant understands and acknowledges that refusing or withdrawing his or her consent may affect Participant's ability to participate in the Plan. For more information on the consequences of Participant's refusal to consent or withdrawal of consent, Participant understands that Participant may contact Participant's local human resources representative.

8. **Nature of Grant.**

(a) Participant's rights, if any, in respect of or in connection with this SAR or any other Award are derived solely from the discretionary decision of the Company to permit Participant to participate in the Plan and to benefit from a discretionary Award. The Plan may be amended, suspended or terminated by the Company at any time, unless otherwise provided in the Plan, the Notice and this Agreement. By accepting this SAR, Participant expressly acknowledges that there is no obligation on the part of the Company to continue the Plan and/or grant any additional Awards to Participant or benefits in lieu of SARs or any other Awards even if SARs or other Awards have been granted in the past. All decisions with respect to future SAR grants, if any, will be at the sole discretion of the Company.

(b) This SAR, the Shares subject to the SAR and any cash paid upon exercise of the SAR are not intended to replace any pension rights or compensation.

(c) This SAR, the Shares subject to the SAR and any cash paid upon exercise of the SAR and the income and value of the same are not part of normal or expected compensation for purposes of calculating any severance, resignation, termination, redundancy, dismissal, end-of-service payments, bonuses, long-service awards, pension or retirement or welfare benefits or similar payments.

(d) Participant acknowledges that he or she is voluntarily participating in the Plan.

(e) This SAR, the Shares subject to the SAR, any cash paid upon exercise of the SAR and Participant's participation in the Plan shall not create a right to employment or be interpreted to form an employment contract or relationship with the Company, the Employer or any Parent, Subsidiary or Affiliate and shall not interfere with the ability of the Company, the Employer or any Parent, Subsidiary or Affiliate, as applicable, to terminate Participant's employment relationship (if any).

(f) The future value of the underlying Shares is unknown, indeterminable and cannot be predicted with certainty. If the underlying Shares do not increase in value, the SAR will have no value.

(g) In consideration of the grant of the SAR, no claim or entitlement to compensation or damages shall arise from forfeiture of the SAR resulting from the termination of Participant's Service by the Company or the Employer (for any reason whatsoever whether or not later found to be invalid or in breach of employment laws in the jurisdiction where Participant is employed or the terms of Participant's employment agreement, if any) and, in consideration of the grant of the SAR to which Participant is otherwise not entitled, Participant irrevocably agrees never to institute any claim against the Company, the Employer or any Parent or Subsidiary or Affiliate, waives his or her ability, if any, to bring any such claim, and releases the Company, the Employer and any Parent, Subsidiary and Affiliate from any such claim; if, notwithstanding the foregoing, any such claim is allowed by a court of competent jurisdiction, then, by participating in the Plan, Participant shall be deemed irrevocably to have agreed not to pursue such claim and agrees to execute any and all documents necessary to request dismissal or withdrawal of such claim.

(h) Participant agrees that unless otherwise provided in the Plan or by the Company in its discretion, the SAR and the benefits evidenced by this Agreement do not create any entitlement to have the SAR or any such benefits transferred to, or assumed by, another company nor to be exchanged, cashed out or substituted for, in connection with any corporate transaction affecting the Shares.

(i) Participant acknowledges and agrees that neither the Company, the Employer nor any Parent, Subsidiary or Affiliate shall be liable for any foreign exchange rate fluctuation between Participant's local currency and the United States Dollar that may affect the value of the SAR or amounts due to Participant pursuant to the SAR.

9. **No Advice Regarding Grant.** The Company is not providing any tax, legal or financial advice, nor is the Company making any recommendations regarding Participant's participation in the Plan or Participant's exercise of the SAR. Participant is advised to consult with Participant's own personal tax, legal and financial advisors regarding Participant's participation in the Plan before taking any action related to the SAR.

10. **Effect of Agreement.** Participant acknowledges receipt of a copy of the Plan and represents that he or she is familiar with the terms and provisions thereof (and has had an opportunity to consult counsel regarding the SAR terms), and hereby accepts this SAR and agrees to be bound by its contractual terms as set forth herein and in the Plan. Participant hereby agrees to accept as binding, conclusive and final all decisions and interpretations of the Company regarding any questions relating to this SAR. In the event of a conflict between the terms and provisions of the Plan and the terms and provisions of the Notice and this Agreement, the Plan terms and provisions shall prevail (except as set forth in Section 2(c) above).

11. **Electronic Delivery and Participation.** The Company may, in its sole discretion, decide to deliver any documents related to Participant's current or future participation in the Plan by electronic means or to request Participant's consent to participate in the Plan by electronic means. Participant hereby consents to receive such documents by electronic delivery and agrees to participate in the Plan through an on-line or electronic system established and maintained by the Company or a third party designated by the Company.

12. **Miscellaneous.**

(a) **Governing Law and Forum.** This Agreement and all acts and transactions pursuant hereto and the rights and obligations of the parties hereto shall be governed, construed and interpreted in accordance with the laws of the State of California, without giving effect to such state's conflict of laws principles. For purposes of any action, lawsuit or other proceedings that may arise directly or indirectly from this Agreement, the parties hereby submit and consent to litigation in the exclusive jurisdiction of the State of California and agree that any such litigation shall be conducted only in the courts of Santa Clara County, California or the federal courts for the United States for the Northern District of California and no other courts.

(b) **Entire Agreement; Enforcement of Rights.** This Agreement, together with the Notice and the Plan, sets forth the entire agreement and understanding of the parties relating to the subject matter herein and therein and merges all prior or contemporaneous discussions between the parties. Except as contemplated under the Plan, no modification of, or amendment to, this Agreement, nor any waiver of any rights under this Agreement, shall be effective unless in writing signed by the parties to this Agreement. The failure by either party to enforce any rights under this Agreement shall not be construed as a waiver of any rights of such party.

(c) **Severability.** If one or more provisions of this Agreement are held to be unenforceable under applicable law, the parties agree to renegotiate such provision in good faith. In the event that the parties cannot reach a mutually agreeable and enforceable replacement for such provision, then (i) such provision shall be excluded from this Agreement, (ii) the balance of this Agreement shall be interpreted as if such provision were so excluded and (iii) the balance of this Agreement shall be enforceable in accordance with its terms.

(d) **Notices.** Any notice required or permitted under the terms of this Agreement shall be in writing and shall be deemed sufficient when delivered personally or sent by confirmed email, telegram, or fax or forty-eight (48) hours after being deposited in the mail, as certified or registered mail, with postage prepaid, and addressed to the Company at the Company's principal corporate offices or to Participant at the address maintained for Participant in the Company's records or, in either case, as subsequently modified by written notice to the other party.

(e) **Language.** If this Agreement or any other document related to the Plan is translated into a language other than English and the meaning of the translated version is different from the English version, the English version will take precedence.

(f) **Appendix A.** This SAR shall be subject to any special terms and conditions set forth in Appendix A to this Agreement for Participant's country. Moreover, if Participant relocates to one of the countries included in the Appendix, the special terms and conditions for such country will apply to Participant, to the extent the Company determines that the application of such terms and conditions is necessary or advisable for legal or administrative reasons. Appendix A constitutes part of this Agreement.

(g) **Imposition of Other Requirements.** The Company reserves the right to impose other requirements on Participant's participation in the Plan, on the SAR, or on any cash paid upon exercise of the SAR, to the extent the Company determines it is necessary or advisable for legal or administrative reasons. Participant agrees to sign and/or accept any additional agreements or undertakings that may be necessary to accomplish the foregoing. Furthermore, Participant acknowledges that the laws of the country in which Participant is working or residing at the time of grant, vesting and exercise of the SAR or the receipt of any cash payment pursuant to exercise of the SAR (including any rules or regulations governing securities, foreign exchange, tax, labor, or other matters) may subject Participant to additional procedural or regulatory requirements that Participant is and will be solely responsible for and must fulfill.

(h) **Successors and Assigns.** The rights and benefits of this Agreement shall inure to the benefit of, and be enforceable by the Company's successors and assigns. The rights and obligations of Participant under this Agreement may not be assigned without the prior written consent of the Company.

* * * *

PLEASE PRINT AND KEEP A COPY OF THIS AGREEMENT (INCLUDING APPENDIX A) FOR YOUR RECORDS



2011 Stock Incentive Plan – Stock Appreciation Right Agreement – Appendix A

This Appendix A includes additional terms and conditions that govern the SAR granted to Participant under the Plan if Participant resides in one of the countries listed in this Appendix A. This Appendix A, including any documents incorporated herein, is part of the Stock Appreciation Right Agreement to which it is attached (the "Agreement") and contains terms and conditions material to participation in the Plan. Unless otherwise provided below, capitalized terms used but not defined herein shall have the same meanings assigned to them in the Plan and the Agreement.

This Appendix A also includes information regarding exchange controls and certain other issues of which Participant should be aware with respect to participation in the Plan. The information is based on the securities, exchange control, and other laws in effect in the respective countries as of October 2012. Such laws are often complex and change frequently. As a result, the Company strongly recommends that Participant not rely on the information in this Appendix A as the only source of information relating to the consequences of his or her participation in the Plan because the information may be out of date at the time that Participant exercises the SAR or receives cash pursuant to exercise of the SAR.

In addition, the information contained herein is general in nature and may not apply to Participant's particular situation, and the Company is not in a position to assure Participant of a particular result. Accordingly, Participant is advised to seek appropriate professional advice as to how the relevant laws in his or her country may apply to Participant's situation.

Finally, if Participant is a citizen or resident, or is considered a resident, of a country other than the one in which he or she is currently working, or if Participant transfers to another country after the SAR is granted to him or her, the information contained herein may not be applicable. The Company will determine to what extent the terms and conditions included herein will apply in such situations.

CANADA

Termination of Relationship. The following provision replaces Section 4 of the Agreement:

Following the date of termination of Participant's active Service for any reason (the "Termination Date") (whether or not later found to be invalid or in breach of employment laws in the jurisdiction where Participant is employed or the terms of Participant's employment agreement, if any), Participant's right to exercise this SAR (if any) will terminate effective as of the earlier of (i) the date on which Participant's Service is terminated or (ii) the date on which Participant receives a notice of termination. Participant's right to exercise this SAR will not be extended by any notice period (e.g., active Service would not include any contractual notice period or any period of "garden leave" or similar period mandated under employment laws in the jurisdiction where Participant is employed or the terms of Participant's employment agreement, if any). The Company shall have the exclusive discretion to determine when Participant is no longer in active Service for purposes of this SAR (including whether Participant may still be considered to be in active Service while on a leave of absence). If Participant does not exercise this SAR within the termination periods set forth in the Agreement, this SAR shall terminate in its entirety. In no event, may this SAR be exercised after the Expiration Date as set forth in the Notice.

CHINA

Vesting and Exercise of SAR. This provision supplements Section 1(a) and Section 2 of the Agreement:

If Participant is subject to exchange control laws in China, then the SAR shall not vest and be exercisable with respect to any of the Shares unless and until the Company (or a Subsidiary or Affiliate) has received all necessary approvals from the PRC State Administration of Foreign Exchange to permit the exercise of the SAR and the issuance of cash pursuant to the SAR in China, as determined by the Company in its sole discretion.

Exchange Control Restrictions. If Participant is subject to exchange control laws in China, Participant will be required to immediately repatriate to China any cash received upon exercise of the SAR. Participant further understands that such repatriation of the cash may need to be effectuated through a special exchange control account established by the Company or a Subsidiary or Affiliate, and Participant hereby consents and agrees that any cash from the exercise of the SARs may be transferred to such account by the Company (or its designated broker) on Participant's behalf prior to being delivered to Participant. Participant also agrees to sign any agreements, forms and/or consents that may be reasonably requested by the Company (or the Company's designated broker) to effectuate such transfers.

Participant understands that the cash may be paid to Participant in U.S. dollars or local currency at the Company's discretion. If the cash is paid to Participant in U.S. dollars, Participant understands that he or she will be required to set up a U.S. dollar bank account in China so that the cash may be deposited into this account. If the cash is paid to Participant in local currency, Participant understands that the Company is under no obligation to secure any particular exchange rate and that the Company may face delays in converting the U.S. dollars to local currency due to exchange control restrictions.

Participant agrees to comply with any other requirements that may be imposed by the Company in the future in order to facilitate compliance with exchange control requirements in China.

FRANCE

Language Consent. By executing and submitting the Agreement, Participant confirms that he or she has read and understood the documents relating to the SAR (the Plan, the Notice, the Agreement and this Appendix) which were provided to Participant in the English language. Participant accepts the terms of these documents accordingly.

Consentement Relatif à la Langue Utilisée. *En signant et renvoyant le présent Contrat, le Participant confirme avoir lu et compris les documents relatifs à cette Attribution de Droits sur l'augmentation de la valeur des Actions ("Stock Appreciation Right ") qui lui ont été remis en langue anglaise (le Plan, le Formulaire d'Attribution, le Contrat ainsi que la présente Annexe). Le Participant accepte les termes et conditions afférentes à ces documents en connaissance de cause.*

GERMANY

Exchange Control Notification. Cross-border payments in excess of €12,500 must be reported monthly to the State Central Bank. Participant will be responsible for obtaining the appropriate form from the bank and complying with the applicable reporting obligations.

ITALY

Data Privacy. This provision replaces Section 7 of the Agreement:

Participant understands that the Company, the Employer and any Parent, Subsidiary or Affiliate may hold certain personal information about Participant, including, but not limited to, Participant's name, home address and telephone number, date of birth, social insurance number or other identification number, salary, nationality, job title, any shares of stock or directorships held in the Company or any Parent, Subsidiary or Affiliate, details of all SARs, or any other entitlement to shares of stock or cash awarded, canceled, exercised, vested, unvested or outstanding in Participant's favor ("Data") and will process such Data for the exclusive purpose of implementing, managing and administering the Plan and in compliance with applicable laws and regulations.

Participant also understand that providing the Company with Data is mandatory for compliance with local law and necessary for the performance of the Plan and that Participant's refusal to provide such Data would make it impossible for the Company to perform its contractual obligations and may affect Participant's ability to participate in the Plan. The Controllers of personal data processing are PDF Solutions, Inc., with registered offices at 333 West San Carlos Street, Suite 1000, San Jose, California U.S.A., and PDF Solutions, Inc. Sede Secondaria with registered offices at Piazza Meda 3, Milano 20100, Italy, which is also the Company's Representative in Italy for privacy purposes pursuant to Legislative Decree no. 196/2003.

Participant understands that Data will not be publicized, but it may be accessible by the Employer and its internal and external personnel in charge of processing of such Data and by the data processor (the "Processor"), if any. An updated list of Processors and other transferees of Data is available upon request from the Employer. Furthermore, Data may be transferred to any brokers, banks or other financial institutions involved in the management and administration of the Plan. Participant further understands that the Company and/or any Parent, Subsidiary or Affiliate will transfer Data among themselves as necessary for the purpose of implementing, administering and managing Participant's participation in the Plan, and that the Company and/or any Parent, Subsidiary or Affiliate may each further transfer Data to third parties assisting the Company in the implementation, administration, and management of the Plan, including any requisite transfer of Data to E*Trade or other broker or third party with whom Participant may elect to deposit any cash acquired at exercise of the SARs. Such recipients may receive, possess, use, retain, and transfer Data in electronic or other form, for the purposes of implementing, administering, and managing Participant's participation in the Plan. Participant understands that these recipients may be acting as Controllers, Processors or persons in charge of processing, as the case may be, in accordance with local law and may be located in or outside the European Economic Area in countries such as in the United States that might not provide the same level of protection as intended under Italian data privacy laws. Should the Company exercise its discretion in suspending all necessary legal obligations connected with the management and administration of the Plan, it will delete Data as soon as it has completed all the necessary legal obligations connected with the management and administration of the Plan.

Participant understands that Data processing related to the purposes specified above shall take place under automated or non-automated conditions, anonymously when possible, that comply with the purposes for which Data is collected and with confidentiality and security provisions as set forth by applicable laws and regulations, with specific reference to Legislative Decree no. 196/2003.

The processing activity, including communication, the transfer of Data abroad, including outside of the European Economic Area, as herein specified and pursuant to applicable laws and regulations, does not require Participant's consent thereto as the processing is necessary to performance of contractual obligations related to implementation, administration and management of the Plan. Participant understands that, pursuant to Section 7 of the Legislative Decree no. 196/2003, Participant has the right to, including but not limited to, access, delete, update, correct, or terminate, for legitimate reason, the Data processing. Participant should contact the Employer in this regard.

Furthermore, Participant is aware that Data will not be used for direct marketing purposes. In addition, Data provided can be reviewed and questions or complaints can be addressed by contacting Participant's human resources department.

Plan Document Acknowledgment. By accepting the SAR, Participant acknowledges that he or she has received a copy of the Plan, has reviewed the Plan, the Notice and the Agreement in their entirety and fully understands and accepts all provisions of the Plan, the Notice and the Agreement. Participant further acknowledges that he or she has read and expressly approves the following sections in the Agreement: Section 2: Exercise of SAR; Section 4: Termination of Relationship; Section 6: Responsibility for Taxes; Section 8: Nature of Grant; Section 12(a): Governing Law and Forum; Section 12(f): Appendix A; Section 12(g): Imposition of Other Requirements; and the Data Privacy provision above.

Exchange Control Notification. Participant is required to report on his or her annual tax return: (a) any transfers of cash to or from Italy exceeding €10,000 or the equivalent amount in U.S. dollars; (b) any foreign investments or investments (including cash proceeds from the exercise of SARs) held outside of Italy exceeding €10,000 or the equivalent amount in U.S. dollars, if the investment may give rise to income in Italy; and (c) the amount of transfers to and from Italy which have had an impact during the calendar year on Participant's foreign investments or investments held outside of Italy. Participant is exempt from the formalities in (a) if the investments are made through an authorized broker resident in Italy, as the broker will comply with the reporting obligation on behalf of Participant.

JAPAN

There are no country-specific terms and conditions or notifications.

KOREA

Exchange Control Notification. Exchange control laws require Korean residents who realize US\$500,000 or more from any cash payment made pursuant to the SARs to repatriate the proceeds to Korea within eighteen (18) months of the receipt.

TAIWAN

Securities Notification. The offer of the SAR is available only for employees of the Company or its Parent or any Subsidiary or Affiliate. This is not a public offer by a Taiwanese company; therefore, it is exempt from registration in Taiwan.

Exchange Control Notification. Participant may acquire and remit foreign currency (including any cash payments received pursuant to the SAR) up to US\$5,000,000 per year without justification. If the transaction amount is TWD500,000 or more in a single transaction, Participant must submit a Foreign Exchange Transaction Form. If the transaction amount is US\$500,000 or more in a single transaction, Participant must also provide any supporting documentation to the satisfaction of the remitting bank.

CERTIFICATIONS

I, John K. Kibarian, certify that:

1. I have reviewed this quarterly report on Form 10-Q of PDF Solutions, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ JOHN K. KIBARIAN

John K. Kibarian
President and Chief Executive Officer
(principal executive officer)

Date: November 9, 2012

CERTIFICATIONS

I, Gregory Walker, certify that:

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

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

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

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

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

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

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

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

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

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

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

By: /s/ GREGORY WALKER

Gregory Walker

*Vice President, Finance and Chief Financial Officer
(principal financial and accounting officer)*

Date: November 9, 2012

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

In connection with the Quarterly Report of PDF Solutions, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2012 as filed with the Securities and Exchange Commission on November 9, 2012 (the "Report"), I, Gregory Walker, Vice President, Finance and Chief Financial Officer, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

By: /s/ GREGORY WALKER
Gregory Walker
Vice President, Finance and Chief Financial Officer
(principal financial and accounting officer)

Date: November 9, 2012

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

In connection with the Quarterly Report of PDF Solutions, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2012 as filed with the Securities and Exchange Commission on November 9, 2012 (the "Report"), I, John K. Kibarian, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

/s/ JOHN K. KIBARIAN

John K. Kibarian
President and Chief Executive Officer
(principal executive officer)

Date: November 9, 2012

