PDF SOLUTIONS INC
Form 10-Q
August 06, 2014

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the Quarterly Period ended June 30, 2014

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

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

The number of shares outstanding of the Registrant's Common Stock as of August 1, 2014 was 30,854,866.

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PART I — FINANCIAL INFORMATION

Item 1. Financial Statements

PDF SOLUTIONS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(unaudited)

(in thousands, except par value)

	June 30, 2014	**December 31, 2013**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 106,909	$ 89,371
Accounts receivable, net of allowance of $327 and $354, respectively	30,705	34,860
Deferred tax assets - current portion	4,181	5,920
Prepaid expenses and other current assets	5,321	3,632
Total current assets	147,116	133,783
Property and equipment, net	8,497	7,064
Deferred tax assets - non-current portion	8,196	8,599
Other non-current assets	1,597	1,718
Total assets	$ 165,406	$ 151,164
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 933	$ 1,129
Accrued compensation and related benefits	6,024	7,707
Accrued and other current liabilities	1,668	1,593
Deferred revenues	3,442	2,096
Billings in excess of recognized revenues	128	343
Total current liabilities	12,195	12,868
Non-current liabilities	3,409	3,584
Total liabilities	15,604	16,452
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, $0.00015 par value, 5,000 shares authorized, no shares issued and outstanding	—	—
	5	5

Common stock, $0.00015 par value, 70,000 shares authorized: shares issued 35,873 and 35,285, respectively; shares outstanding 30,786 and 30,437, respectively		
Additional paid-in-capital	242,514	233,813
Treasury stock at cost, 5,087 and 4,848 shares, respectively	(33,326)	(28,905)
Accumulated deficit	(59,698)	(70,649)
Accumulated other comprehensive income	307	448
Total stockholders' equity	149,802	134,712
Total liabilities and stockholders' equity	$ 165,406	$ 151,164

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

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PDF SOLUTIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(unaudited)

(in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenues:				
Design-to-silicon-yield solutions	$13,091	$14,950	$28,010	$29,798
Gainshare performance incentives	11,519	9,826	23,686	19,088
Total revenues	24,610	24,776	51,696	48,886
Cost of design-to-silicon-yield solutions	8,847	9,741	18,552	19,398
Gross profit	15,763	15,035	33,144	29,488
Operating expenses:				
Research and development	3,337	3,184	6,933	6,548
Selling, general and administrative	4,661	4,404	8,990	9,198
Amortization of other acquired intangible assets	12	19	30	37
Restructuring charges (credits)	—	9	57	(43)
Total operating expenses	8,010	7,616	16,010	15,740
Income from operations	7,753	7,419	17,134	13,748
Interest and other income (expense), net	(27)	(76)	(114)	174
Income before income taxes	7,726	7,343	17,020	13,922
Income tax provision	3,030	2,791	6,069	4,639
Net income	$4,696	$4,552	$10,951	$9,283
Net income per share:				
Basic	$0.15	$0.15	$0.36	$0.31
Diluted	$0.15	$0.15	$0.34	$0.30
Weighted average common shares:				
Basic	30,590	29,650	30,533	29,501
Diluted	31,882	31,154	31,923	30,985
Net income	$4,696	$4,552	$10,951	$9,283
Other comprehensive income:				
Foreign currency translation adjustments, net of tax	(89)	182	(141)	13

Comprehensive income	$4,607	$4,734	$10,810	$9,296

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

PDF SOLUTIONS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

(in thousands)

	Six Months Ended June 30, 2014	2013
Operating activities:		
Net income	$10,951	$9,283
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	940	575
Stock-based compensation expense	4,034	3,018
Amortization of acquired intangible assets	30	37
Deferred taxes	2,224	2,494
Loss (gain) on disposal of property and equipment	(93)	3
Purchases of treasury stock in connection with tax withholdings on restricted stock grants	(855)	(385)
Reversal of allowance for doubtful accounts	(28)	(82)
Unrealized gain on foreign currency forward contract	(23)	—
Tax benefit related to stock-based compensation expense	1,657	141
Excess tax benefit from stock-based compensation	(1,543)	(79)
Changes in operating assets and liabilities:		
Accounts receivable	4,183	7,707
Prepaid expenses and other assets	(1,658)	(2,027)
Accounts payable	(321)	(1,079)
Accrued compensation and related benefits	(1,660)	(3,622)
Accrued and other liabilities	(649)	(1,170)
Deferred revenues	1,380	(219)
Billings in excess of recognized revenues	(215)	(291)
Net cash provided by operating activities	18,354	14,304
Investing activities:		
Purchases of property and equipment	(1,946)	(2,537)
Proceeds from the sales of property and equipment	135	—
Net cash used in investing activities	(1,811)	(2,537)
Financing activities:		
Proceeds from exercise of stock options	2,398	2,810
Proceeds from employee stock purchase plan	632	546
Excess tax benefit from stock-based compensation	1,543	79
Purchases of treasury stock	(3,566)	—
Net cash provided by financing activities	1,007	3,435
Effect of exchange rate changes on cash and cash equivalents	(12)	(72)
Net change in cash and cash equivalents	17,538	15,130

Cash and cash equivalents, beginning of period	89,371	61,637
Cash and cash equivalents, end of period	$106,909	$76,767
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Taxes	$2,702	$2,303
Property and equipment received and accrued in accounts payable and accrued and other liabilities	$788	$350

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, 2013.

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, 2013, 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 revenue recognition for fixed-price solution implementation service contracts, stock-based compensation expense and accounting for income taxes. 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 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. Losses on fixed-price 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. Revenue under time and materials contracts for solution implementation services are recognized as the services are performed. 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 contingent variable fee, usually after the fixed fee period has ended. Revenue derived from Gainshare performance incentives represents profit sharing and performance incentives earned contingent 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 May 2014, the Financial Accounting Standards Board ("FASB") issued new accounting guidance related to revenue recognition. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration for which the entity expects to be entitled in exchange for those goods or services. The updated standard will replace most existing revenue recognition guidance under GAAP when it becomes effective and permits the use of either the retrospective or cumulative effect transition method. Early adoption is not permitted. The updated standard will be effective for the Company beginning January 1, 2017 and can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. The Company has not yet selected a transition method and is currently evaluating the impact of adopting this new accounting standard on its financial statements.

3. BALANCE SHEET COMPONENTS

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 $10.2 million and $8.0 million as of June 30, 2014, and December 31, 2013, respectively.

Property and equipment consists of (in thousands):

	June 30, 2014	**December 31, 2013**
Property and equipment, net:		
Computer equipment	$10,044	$9,969
Software	3,428	3,441
Furniture, fixtures and equipment	739	734
Leasehold improvements	1,129	1,052
Test equipment	5,682	4,928
Construction-in-progress	2,171	1,421
	23,193	21,545
Less: accumulated depreciation	(14,496)	(14,481)
Total	$8,497	$7,064

Depreciation and amortization expense was $0.5 million and $0.3 million for the three months ended June 30, 2014 and 2013, respectively. Depreciation and amortization expense was $0.9 million and $0.6 million for the six months ended June 30, 2014 and 2013, respectively.

Intangible assets balance was zero and $31,000 as of June 30, 2014, and December 31, 2013, respectively. The balance was included in other non-current assets in the accompanying condensed consolidated balance sheets. For the three-months ended June 30, 2014 and 2013, intangible asset amortization expense was $12,000 and $19,000, respectively. For the six months ended June 30, 2014 and 2013, intangible asset amortization expense was $30,000 and $37,000, respectively.

4. 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, 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 June 30,		**Six Months Ended June 30,**	
	2014	**2013**	**2014**	**2013**
Cost of design-to-silicon yield-solutions	$797	$649	$1,520	$1,183
Research and development	434	337	805	659
Selling, general and administrative	1,143	723	1,709	1,176
Stock-based compensation expenses	$2,374	$1,709	$4,034	$3,018

On June 30, 2014, 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, which was first amended and restated at the 2013 annual meeting of stockholders on May 28, 2013, when the Company's stockholders approved the First Amended and Restated 2011 Stock Incentive Plan and then subsequently amended at the 2014 annual meeting of stockholders on May 27, 2014, when the Company's stockholders approved the Second Amended and Restated 2011 Incentive Plan (as amended, 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 6,550,000 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 on or after November 16, 2011. 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.

The Company estimated the fair value of share-based awards granted under the Stock Plan 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:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Expected life (in years)	4.58	4.78	4.58	4.78
Volatility	42.3%	55.0%	42.7%	56.1%
Risk-free interest rate	1.47%	1.33%	1.50%	0.93%
Expected dividend	—	—	—	—
Weighted average fair value per share of options granted during the period	$7.15	$8.50	$7.39	$7.77

As of June 30, 2014, 7.0 million shares of common stock were reserved to cover stock-based awards under the 2011 Plan, of which 3.9 million shares were available for future grant. The number of shares reserved and available under the 2011 Plan includes 0.4 million shares that were subject to awards previously made under the 2001 Plan and were forfeited, expired or repurchased by the Company after adoption of the 2011 Plan through June 30, 2014. As of June 30, 2014, 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 six months ended June 30, 2014, 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, 2014	2,880	$ 7.35		
Granted (weighted average fair value of $7.39 per share)	12	$ 19.72		
Exercised	(371)	$ 6.46		
Canceled	(16)	$ 9.87		
Expired	(6)	$ 5.91		
Outstanding, June 30, 2014	2,499	$ 7.53	6.22	$ 34,219

Vested and expected to vest, June 30, 2014	2,455	$ 7.50	6.19	$ 33,704
Exercisable, June 30, 2014	1,751	$ 7.01	5.58	$ 24,871

The aggregate intrinsic value in the table above represents the total intrinsic value based on the Company's closing stock price of $21.22 per share as of June 30, 2014. The total intrinsic value of options exercised during the six months ended June 30, 2014, was $5.0 million.

As of June 30, 2014, there was $3.1 million of total unrecognized compensation cost related to unvested stock options. That cost is expected to be recognized over a weighted average period of 1.7 years. The total fair value of shares vested during the six months ended June 30, 2014, was $1.2 million.

Nonvested restricted stock units activity during the six months ended June 30, 2014, was as follows:

	Shares (in thousands)	**Weighted Average Grant Date Fair Value Per Share**
Nonvested, January 1, 2014	759	$ 14.44
Granted	551	$ 19.53
Vested	(164)	$ 13.81
Forfeited	(7)	$ 17.86
Nonvested, June 30, 2014	1,139	$ 17.02

As of June 30, 2014, there was $16.7 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 (as amended, "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.

The Company estimated the fair value of purchase rights granted under the Purchase Plan 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:

	Six Months Ended June 30,	
	2014	**2013**
Expected life (in years)	1.25	1.25
Volatility	34.6%	46.1%
Risk-free interest rate	0.18%	0.19%
Expected dividend	—	—
Weighted average fair value of purchase rights granted under the Purchase Plan	$7.18	$5.28

During the three months ended June 30, 2014 and 2013, the Company did not issue any shares under the Purchase Plan. During the six months ended June 30, 2014 and 2013, a total of 52,000 and 104,000 shares, respectively, were issued at a weighted-average purchase price of $12.10 and $5.24 per share, respectively, under the Purchase Plan. For the three-month periods ended June 30, 2014 and 2013, the Purchase Plan compensation expense was $0.1 million and $0.2 million, respectively. For the six months ended June 30, 2014 and 2013, the Purchase Plan compensation expense was $0.3 million and $0.4 million, respectively. As of June 30, 2014, there was $0.4 million of unrecognized compensation cost related to the Purchase Plan. That cost is expected to be recognized over a weighted average period of 1.0 years. As of June 30, 2014, 1.2 million shares were available for future issuance under the Purchase Plan.

Stock Repurchase Program — On November 8, 2012, the Board of Directors adopted a program to repurchase up to $20.0 million of the Company's common stock on the open market over the next two years. As of June 30, 2014, 230,311 shares had been repurchased at the average price of $17.56 per share under this new program, at a total purchase of $4.0 million, and $16.0 million remained available for future repurchases.

5. RESTRUCTURING

The Company implemented restructuring plans during fiscal years 2012 and 2008, and recorded total restructuring charges of zero and $9,000 for the three months ended on June 30, 2014 and 2013, respectively. The Company recorded total restructuring charges of $57,000 for the six months ended June 30, 2014 and restructuring credits of $43,000 for the six months ended June 30, 2013. As of June 30, 2014, the Company had no outstanding restructuring accrual balance.

October 2012 Plan

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. Under this plan, the Company has recorded restructuring charges of $2.2 million, which primarily consisted of employee severance costs of $2.1 million. All outstanding accrual balance under this plan had been paid out as of June 30, 2014. The following table summarizes the activities of restructuring liabilities (in thousands) under this plan for the periods covered below:

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2014	**2013**	**2014**	**2013**
Beginning balance	$62	$210	$13	$896
Restructuring charges (credits)	—	9	57	59
Cash payments	(62)	(153)	(70)	(889)
Ending balance	$—	$66	$—	$66

October 2008 Plan

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 restructuring charges of $7.4 million, primarily consisting of employee severance costs of $4.7 million and facility exit costs of $2.7 million. All remaining accrual balance under this plan had been paid out as of December 31, 2013. There were no restructuring activities incurred under this plan during the three and six months ended June 30, 2014. The following table summarizes the activities of restructuring liabilities (in thousands) under this plan for the periods covered below:

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Beginning balance	$—	$224	$—	$448
Restructuring charges (credits)	—	—	—	(102)
Adjustments	—	3	—	3
Cash payments	—	(122)	—	(244)
Ending balance	$—	$105	$—	$105

6. INCOME TAXES

Income tax provision increased $1.4 million for the six months ended June 30, 2014, to $6.1 million as compared to an income tax provision of $4.6 million for the six months ended June 30, 2013. The Company's effective tax rate was 35.66% and 33.32% for the six months ended June 30, 2014, and June 30, 2013, respectively. The income tax provision for the six months ended June 30, 2014, was less than the provision at the statutory rate primarily due to changes in unrecognized tax benefits. The income tax provision for the six months ended June 30, 2013, was less than the provision at the statutory rate primarily due to the utilization of U.S. tax credits, offset by foreign withholding taxes, statutory taxes, and changes in unrecognized tax benefits.

On January 2, 2013, the President signed into law the American Taxpayer Relief Act which reinstated the U.S. Federal Research and Development tax credit retroactive to January 1, 2012, and extended the tax credit through December 31, 2013. As a result of the new legislation, the Company recognized a benefit in the six months ended June 30, 2013 related to 12 months of fiscal 2012 as well as a benefit to the annual effective tax rate for the full year research tax credit for fiscal 2013, which amounted to $0.4 million. The expiration of the U.S Federal research tax credit resulted in zero tax credit for the six months ended June 30, 2014.

The Company’s total amount of unrecognized tax benefits, excluding interest and penalties, as of June 30, 2014, was $10.2 million, of which $6.2 million, if recognized, would affect the Company’s effective tax rate. The Company’s total amount of unrecognized tax benefits, excluding interest and penalties, as of December 31, 2013, was $10.2 million, of which $6.3 million, if recognized, would affect the Company's effective tax rate. As of June 30, 2014, the Company has recorded unrecognized tax benefits of $2.8 million, including interest and penalties, as long-term taxes payable in its condensed consolidated balance sheet. The remaining $7.8 million has been recorded net of our deferred tax assets, of which $4.0 million is subject to a full valuation allowance.

As of June 30, 2014, the Company believes that most of its deferred tax assets are “more likely than not” to be realized with the exception of California R&D tax credits that have not met the “more likely than not” realization threshold criteria because on an annual basis and pursuant to current law, the Company generates more California credits than California tax. As a result, at June 30, 2014, the excess California R&D tax credits continue to be subject to a full valuation allowance. In the event the Company concludes at a future financial reporting period that there has been a change in its ability to realize the California R&D credit deferred tax assets, and it is at such time no longer “more likely than not” that the Company will realize the tax credits before applicable expiration dates, the Company’s tax provision will increase in the period in which the Company makes such determination.

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 is not subject to income tax examinations in any other of its major foreign subsidiaries’ jurisdictions.

7. NET INCOME PER SHARE

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2014	**2013**	**2014**	**2013**
Numerator:				
Net income	$4,696	$4,552	$10,951	$9,283
Denominator:				
Basic weighted average common shares outstanding	30,590	29,650	30,533	29,501
Dilutive effect of equity incentive plans	1,292	1,504	1,390	1,484
Diluted weighted average common shares outstanding	31,882	31,154	31,923	30,985
Net income per share:				
Basic	$0.15	$0.15	$0.36	$0.31
Diluted	$0.15	$0.15	$0.34	$0.30

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

	Three Months Ended June 30,		**Six Months Ended June 30,**	
	2014	**2013**	**2014**	**2013**
Outstanding options	52	112	22	110
Nonvested restricted stock units	173	174	2	88
Employee Stock Purchase Plan	43	—	46	—
Total	268	286	70	198

8. 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 Ended June 30, 2014	2013	Six Months Ended June 30, 2014	2013
A	50%	32 %	48%	32 %
B	14%	23 %	16%	19 %
C	11%	18 %	12%	21 %

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

Customer	June 30, 2014	December 31, 2013
A	45 %	36 %
B	21 %	17 %
C	11 %	23 %

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

	Three Months Ended June 30, 2014		2013	
	Revenues	Percentage of Revenues	Revenues	Percentage of Revenues
North America	$10,158	41 %	$10,816	44 %
Germany	9,034	37	5,241	21
South Korea	1,242	5	3,631	15
Japan	1,216	5	1,961	8
Rest of Asia	1,223	5	2,098	8
Rest of Europe	1,737	7	1,029	4
Total revenue	$24,610	100 %	$24,776	100 %

	Six Months Ended June 30,				
	2014			2013		
	Revenues	Percentage of Revenues		Revenues	Percentage of Revenues	
North America	$21,558	42	%	$20,682	42	%
Germany	18,134	35		9,866	20	
South Korea	3,502	7		8,544	18	
Japan	2,929	6		4,222	9	
Rest of Asia	2,717	5		3,642	7	
Rest of Europe	2,856	5		1,930	4	
Total revenue	$51,696	100	%	$48,886	100	%

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

	June 30, 2014	December 31, 2013
North America	$7,962	$ 6,578
Asia	415	364
Europe	120	122
Total long-lived assets, net	$8,497	$ 7,064

9. 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 June 30, 2014, and the basis for that measurement (in thousands):

<u>Assets</u>	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	$26,354	$26,354	$ —	$ —

The following table represents the Company's assets measured at fair value on a recurring basis as of December 31, 2013, and the basis for that measurement (in thousands):

<u>Assets</u>	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	$26,353	$26,353	$ —	$ —

The Company enters into foreign currency forward contracts to reduce the exposure to foreign currency exchange rate fluctuations on certain foreign currency denominated monetary assets and liabilities, primarily on third-party accounts payables and intercompany balances. The primary objective of the Company's hedging program is to reduce volatility of earnings related to foreign currency exchange rate fluctuations. The counterparty to these foreign currency forward contracts is a large global financial institution that the Company believes is creditworthy, and therefore, the Company believes the credit risk of counterparty nonperformance is not significant. These foreign currency forward contracts are not designated for hedge accounting treatment. Therefore, the change in fair value of these contracts is recorded into earnings as a component of other income (expense), net, and offsets the change in fair value of the foreign currency denominated assets and liabilities, which is also recorded in other income (expense), net. For both the three months and six months ended June 30, 2014, the Company recognized a realized loss on the contracts of $0.1 million, which is recorded in other income (expense), net in the Company's Statement of Operations and Comprehensive Income.

The Company carries these derivatives financial instruments on its Consolidated Balance Sheets at their fair values. The Company's foreign currency forward contracts are classified as Level 2 because it is not actively traded and the valuation inputs are based on quoted prices and market observable data of similar instruments. As of June 30, 2014, the Company had one outstanding forward contract with a notional amount of $7.2 million and recorded $23,000 other current assets associated with this outstanding forward contract.

10. 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 2019. Rent expense was both $0.5 million for the three months ended June 30, 2014 and 2013. Rent expense was $1.0 million for both the six months ended June 30, 2014 and 2013.

Future minimum lease payments under noncancelable operating leases at June 30, 2014, are as follows (in thousands):

Year Ending December 31,	**Amount**
2014 (remaining six months)	$ 947
2015	1,787
2016	1,717
2017	1,408
2018	801
Thereafter	66
Total future minimum lease payments	$ 6,726

Litigation — From time to time, the Company is subject to various claims and legal proceedings that arise in the ordinary course of business. 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. During the reported period, the Company was not party to any material legal proceedings, thus no loss was probable and no amount was accrued at June 30, 2014.

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 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 in our Annual Report on Form 10-K for the year ended December 31, 2013 filed with the Securities and Exchange Commission on March 14, 2014. All references to “we”, “us”, “our”, “PDF”, “PD Solutions” or “the Company” refer to PDF Solutions, Inc.

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 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

Consistent with the trend since 2010, we believe that the largest logic foundries will continue to increase their investment in leading edge nodes and capacity in 2014. Leading foundries are also investing in new technologies such as multi-patterned lithography and 3-D transistor architecture, which has resulted in an increase in our business, and improved results of operations in the past few years and to date in 2014.

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

Customer Contracts

Although a substantial portion of our total revenues are concentrated in a small number of customers, the total revenues for each of these customers in any period is the result of Design-to-silicon-yield solutions and Gainshare performance incentives revenues recognized in the period under multiple, separate contracts, with no interdependent performance obligations. These contracts were all entered into in the ordinary course of our business and contain general terms and conditions that are standard across most of our yield improvement solutions customers, including providing services typically targeted to one manufacturing process node, for example the 28 or 20 nanometer node. Fluctuations in future results may occur if any of these customers renegotiate pre-existing contractual commitments due to adverse changes in their own business or, in the case of one time and materials contract, if the customer takes advantage of contractual provisions that permit the suspension of contracted work for a period if their business experiences a financial hardship. See the additional discussion in Part I, Item 1, "Customers," on page 8 of our Annual Report on Form 10-K for the year ended December 31, 2013, and in Item 1A, "Risk Factors," on pages 11 through 17 of the Annual Report on Form 10-K for the year ended December 31, 2013 for related information on the risks associated with customer concentration and Gainshare performance incentives revenue.

Financial Highlights

Financial highlights for the three months ended June 30, 2014, were as follows:

- Total revenues for the three months ended June 30, 2014, were $24.6 million, a decrease of $0.2 million, or 1%, compared to $24.8 million for the three months ended June 30, 2013. Design-to-silicon-yield solutions revenue for the three months ended June 30, 2014, was $13.1 million, a decrease of $1.9 million, or 12%, when compared to Design-to-silicon yield solutions revenue of $15.0 million for the three months ended June 30, 2013. Gainshare performance incentives revenue for the three months ended June 30, 2014, was $11.5 million, an increase of $1.7 million, or 17%, compared to $9.8 million for the three months ended June 30, 2013. The increase in revenue from Gainshare performance incentives was primarily the result of higher wafer volumes at customers' manufacturing facilities.

- Net income for the three months ended June 30, 2014, was $4.7 million, compared to $4.6 million for the three months ended June 30, 2013. The increase in net income was primarily attributable to an increase in gross margin of $0.7 million, offset by an increase of total operating expenses of $0.4 million and an increase in income tax provision of $0.2 million. The increase in gross margin is reflective of the mix shift between Design-to-silicon yield solutions and Gainshare performance incentive revenue.

- Net income per basic and diluted share was $0.15 for the three months ended June 30, 2014, which was the same as the net income per basic and diluted share for the three months ended June 30, 2013.

- Cash and cash equivalents increased $17.5 million from $89.4 million at December 31, 2013, to $106.9 million at June 30, 2014, primarily due to an increase in cash from operating and financing activities during the period.

Financial highlights for the six months ended June 30, 2014, were as follows:

- Total revenues for the six months ended June 30, 2014, were $51.7 million, an increase of $2.8 million, or 6%, compared to $48.9 million for the three months ended June 30, 2013. Design-to-silicon-yield solutions revenue for the six months ended June 30, 2014, was $28.0 million, a decrease of $1.8 million, or 6%, when compared to Design-to-silicon yield solutions revenue of $29.8 million for the six months ended June 30, 2013. Gainshare performance incentives revenue for the six months ended June 30, 2014, was $23.7 million, an increase of $4.6 million, or 24%, compared to $19.1 million for the six months ended June 30, 2013. The increase in revenue from Gainshare performance incentives was primarily the result of higher wafer volumes at customers' manufacturing facilities.

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Net income for the six months ended June 30, 2014, was $11.0 million, compared to $9.3 million for the six months ended June 30, 2013. The increase in net income was primarily attributable to an increase in gross margin of $3.7 million, offset by an increase in total operating expenses of $0.3 million, a higher interest and other expense of $0.3 million and an increase in income tax provision of $1.4 million. The increase in gross margin is reflective of the mix shift between Design-to-silicon yield solutions and Gainshare performance incentive revenue.

- Net income per basic and diluted share was $0.36 and $0.34, respectively, for the six months ended June 30, 2014 compared to net income per basic and diluted share of $0.31 and $0.30, respectively, for the six months ended June 30, 2013, an increase of $0.05 and $0.04 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, 2013. 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 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. 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. 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. Revenue under certain time and materials contracts for solution implementation services is recognized as the services are performed. 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 contingent variable fee, usually after the fixed fee period has ended. Revenues derived from Gainshare performance incentives represent profit sharing and performance incentives earned contingent 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, 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 are required to assess the likelihood that our deferred tax assets will be recovered from future taxable income and if we believe that they are not likely to be realizable before the expiration dates applicable to such assets then, to the extent we believe that recovery is not likely, 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 condensed consolidated statements of operations. As of June 30, 2014, we believe that most of our deferred tax assets are "more likely than not" to be realized with the exception of California R&D tax credits that have not met the "more likely than not" realization threshold criteria because on an annual basis and pursuant to current law, we generate more California credits than California tax. As a result, at June 30, 2014, the excess California R&D tax credits continue to be subject to a full valuation allowance. See Note 6 to the condensed consolidated financial statements for further disclosures regarding our income taxes. In the event we conclude at a future financial reporting period that there has been a change in our ability to realize our California R&D credit deferred tax assets, and it is at such time no longer "more likely than not" that we will realize the tax credits before applicable expiration dates, our tax provision will increase in the period in which we make such determination.

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 June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Revenues:				
Design-to-silicon-yield solutions	53 %	60 %	54 %	61 %
Gainshare performance incentives	47	40	46	39
Total revenues	100 %	100 %	100 %	100 %
Costs of design-to-silicon-yield solutions	36	39	36	40
Gross profit	64	61	64	60
Operating expenses:				
Research and development	14	13	13	13
Selling, general and administrative	19	18	18	19
Amortization of other acquired intangible assets	—	—	—	—
Restructuring charges (credits)	—	—	—	—
Total operating expenses	33	31	31	32
Income from operations	31	30	33	28
Interest and other income (expense), net	—	(1)	—	1
Income before taxes	31	29	33	29
Income tax provision	12	11	12	10
Net income	19 %	18 %	21 %	19 %

Comparison of the Three Months Ended* June 30*, 2014 and 2013

Revenues	Three Months Ended June 30, 2014	2013	$ Change	% Change
(in thousands, except for percentages)				
Design-to-silicon-yield solutions	$13,091	$14,950	$(1,859)	(12)%
Gainshare performance incentives	11,519	9,826	1,693	17 %

Total	$24,610	$24,776	$(166)	(1)%

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 decreased $1.9 million for the three months ended June 30, 2014, compared to the three months ended June 30, 2013, primarily due to a decrease in fixed fee integrated solutions, the result of lower billable hours to revenue-generating projects in the period due the completion of certain engagements during the quarter and timing of signing new engagements. Our Design-to-silicon-yield solutions revenue may fluctuate in the future and is dependent on a number of factors, including the semiconductor industry's continued acceptance of our solutions, 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 business or, in the case of a time and materials contract, may 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 revenues represent profit sharing and performance incentives earned contingent upon our customers reaching certain defined operational levels. Revenue derived from Gainshare performance incentives increased $1.7 million for the three months ended June 30, 2014, compared to the three months ended June 30, 2013. The increase was primarily the result of higher wafer volumes at customers' manufacturing facilities. 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 June 30, 2014**	**2013**	**$ Change**	**% Change**
(in thousands, except for percentages)				
Costs of Design-to-silicon-yield solutions	$8,847	$9,741	$ (894)	(9)%

Costs of Design-to-Silicon-Yield Solutions. Costs of Design-to-silicon-yield solutions consist of costs incurred to provide and support our services and costs recognized in connection with licensing our software. Services costs consist of material, employee compensation and related benefits, overhead costs, travel and facilities-related costs. Software license costs consist of costs associated with licensing third-party software sold in conjunction with our software products. Costs of Design-to-silicon-yield solutions for the three months ended June 30, 2014, decreased $0.9 million compared to the three months ended June 30, 2013. The decrease is primarily due to a $0.5 million decrease in personnel-related expense, a result of lower variable compensation, a $0.1 million decrease in allocated facility expense, a $0.1 million decrease in equipment shipping cost and a $0.4 million increase in deferred cost due to timing of completion of the contract signature process, offset by a $0.1 million increase in travel expense and a $0.1 million increase in depreciation expense related to our test equipment.

	Three Months Ended		**$**	**%**
	June 30**,**			
Research and Development	**2014**	**2013**	**Change**	**Change**
(in thousands, except for percentages)				
Research and development	$3,337	$3,184	$ 153	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 increased $0.2 million for the three months ended June 30, 2014, compared to the three months ended June 30, 2013, primarily due to a $0.1 million increase in subcontractor expense and a $0.1 million increase in allocated facility expense. 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.

	Three Months Ended		**$**	**%**
	June 30,			
Selling, General and Administrative	**2014**	**2013**	**Change**	**Change**
(in thousands, except for percentages)				