

FORMFACTOR INC  
Form 10-Q  
November 05, 2009  
[Table of Contents](#)

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark one)

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

For the quarterly period ended September 26, 2009

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: 000-50307

# FormFactor, Inc.

(Exact name of registrant as specified in its charter)

**DELAWARE**  
(State or other jurisdiction of  
incorporation or organization)

**13-3711155**  
(I.R.S. Employer  
Identification No.)

**705 Southfront Road, Livermore, California 94551**

(Address of principal executive offices, including zip code)

**(925) 290-4000**

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

Large Accelerated filer <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

As of October 30, 2009, 49,752,726 shares of the registrant's common stock, par value \$0.001 per share, were outstanding.



Table of Contents

**FORMFACTOR, INC.**

**FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 26, 2009**

**INDEX**

<b><u>Part I.</u></b>	<b><u>Financial Information</u></b>	3
<u>Item 1.</u>	<u>Financial Statements:</u>	3
	<u>Unaudited Condensed Consolidated Statements of Operations for the three and nine months ended September 26, 2009 and September 27, 2008</u>	3
	<u>Unaudited Condensed Consolidated Balance Sheets as of September 26, 2009 and December 27, 2008</u>	4
	<u>Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 26, 2009 and September 27, 2008</u>	5
	<u>Notes to Unaudited Condensed Consolidated Financial Statements</u>	6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	23
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	33
<u>Item 4.</u>	<u>Controls and Procedures</u>	33
<b><u>Part II.</u></b>	<b><u>Other Information</u></b>	34
<u>Item 1.</u>	<u>Legal Proceedings</u>	34
<u>Item 1A.</u>	<u>Risk Factors</u>	34
<u>Item 5.</u>	<u>Other Matters</u>	39
<u>Item 6.</u>	<u>Exhibits</u>	39
<u>Signature</u>		40
<u>Exhibit Index</u>		41

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****FORMFACTOR, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
Revenues	\$ 43,773	\$ 52,584	\$ 102,340	\$ 170,300
Cost of revenues	36,435	40,583	100,007	134,626
Gross profit	7,338	12,001	2,333	35,674
Operating expenses:				
Research and development	13,775	17,079	41,823	49,288
Selling, general and administrative	17,366	23,675	61,939	69,038
Restructuring		141	7,943	8,684
Total operating expenses	31,141	40,895	111,705	127,010
Operating loss	(23,803)	(28,894)	(109,372)	(91,336)
Interest income	694	2,805	2,571	10,808
Other income (expense), net	(415)	263	(920)	404
Loss before income taxes	(23,524)	(25,826)	(107,721)	(80,124)
Provision for (benefit from) income taxes	377	(11,785)	19,969	(29,463)
Net loss	\$ (23,901)	\$ (14,041)	\$ (127,690)	\$ (50,661)
Net loss per share:				
Basic	\$ (0.48)	\$ (0.29)	\$ (2.59)	\$ (1.04)
Diluted	\$ (0.48)	\$ (0.29)	\$ (2.59)	\$ (1.04)
Weighted-average number of shares used in per share calculations:				
Basic	49,582	48,988	49,392	48,855
Diluted	49,582	48,988	49,392	48,855

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents**FORMFACTOR, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except share and per share amounts)****(Unaudited)**

	<b>September 26, 2009</b>	<b>December 27, 2008</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 149,920	\$ 337,926
Marketable securities	312,687	184,968
Accounts receivable, net of allowances for doubtful accounts of \$9,260 at September 26, 2009 and \$4,220 at December 27, 2008	48,233	34,127
Inventories	21,166	18,788
Deferred tax assets	3,768	23,039
Refundable income taxes	18,130	29,413
Prepaid expenses and other current assets	11,462	14,702
Total current assets	565,366	642,963
Restricted cash	680	680
Property and equipment, net	96,998	113,813
Deferred tax assets	1,928	20,580
Other assets	3,599	7,674
Total assets	\$ 668,571	\$ 785,710
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 27,450	\$ 33,214
Accrued liabilities	16,718	25,693
Income taxes payable	105	1,904
Deferred revenue	10,001	4,946
Deferred rent	458	452
Total current liabilities	54,732	66,209
Long-term income taxes payable	6,334	7,732
Deferred rent and other liabilities	5,416	5,705
Total liabilities	66,482	79,646
Commitments and contingencies (Note 16)		
Stockholders' equity		
Preferred stock, \$0.001 par value:		
10,000,000 shares authorized; no shares issued and outstanding at September 26, 2009 and December 27, 2008, respectively		
Common stock, \$0.001 par value:		
250,000,000 shares authorized; 49,752,366 and 49,062,308 shares issued and outstanding at September 26, 2009 and December 27, 2008, respectively		
	50	49
Additional paid-in capital	626,211	602,295
Accumulated other comprehensive income	1,720	1,922
Retained earnings (accumulated deficit)	(25,892)	101,798
Total stockholders' equity	602,089	706,064
Total liabilities and stockholders' equity	\$ 668,571	\$ 785,710

Edgar Filing: FORMFACTOR INC - Form 10-Q

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

## FORMFACTOR, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	September 26, 2009	September 27, 2008
<b>Cash flows from operating activities:</b>		
Net loss	\$ (127,690)	\$ (50,661)
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	24,204	24,063
Stock-based compensation expense	16,412	17,905
Deferred income tax provision (benefit)	37,952	(9,727)
Excess tax benefits from equity based compensation plans	(508)	(266)
Provision for doubtful accounts receivable	5,040	489
Provision for excess and obsolete inventories	5,639	12,307
Loss on disposal of property and equipment	743	982
Non-cash restructuring	366	
Foreign currency transaction gains	(845)	
Changes in assets and liabilities:		
Accounts receivable	(18,236)	28,900
Inventories	(7,971)	(5,302)
Prepays and other current assets	3,487	510
Refundable income taxes	11,582	(22,942)
Other assets	6,374	830
Accounts payable	(1,475)	(3,779)
Accrued liabilities	(9,038)	(7,811)
Income tax payable	(3,198)	1,046
Deferred rent	(392)	(302)
Deferred revenues	5,050	(99)
Net cash used in operating activities	(52,504)	(13,857)
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment	(13,078)	(26,418)
Purchases of marketable securities	(419,600)	(181,004)
Proceeds from maturities of marketable securities	259,999	49,015
Proceeds from sales of marketable securities	31,198	277,331
Release of restricted cash		1,570
Advance payment for acquisition of assets (Refer to Note 19)	(1,731)	
Net cash provided by (used in) investing activities	(143,212)	120,494
<b>Cash flows from financing activities:</b>		
Proceeds from issuances of common stock and awards, net	7,119	5,678
Excess tax benefits from equity based compensation plans	508	266
Net cash provided by financing activities	7,627	5,944
Effect of exchange rate changes on cash and cash equivalents	83	(199)
Net increase (decrease) in cash and cash equivalents	(188,006)	112,382
Cash and cash equivalents, beginning of period	337,926	315,232
Cash and cash equivalents, end of period	\$ 149,920	\$ 427,614



Edgar Filing: FORMFACTOR INC - Form 10-Q

**Supplemental cash flow disclosures:**

Purchases of property and equipment through accounts payable and accruals	\$	(4,897)	\$	(11,400)
Income taxes paid (refunded), net	\$	(25,991)	\$	

The accompanying notes are an integral part of these condensed consolidated financial statements.

Table of Contents

**FORMFACTOR, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)**

**Note 1 Basis of Presentation**

**Basis of presentation.** The accompanying unaudited condensed consolidated interim financial statements of FormFactor, Inc. and its subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America and pursuant to the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities and Exchange Commission (the SEC). The Company's interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for annual financial statements. In the opinion of management, all adjustments considered necessary to fairly present the Company's financial position, results of operations and cash flows have been included. Operating results for the three and nine months ended September 26, 2009 are not necessarily indicative of the results that may be expected for the year ending December 26, 2009, or for any other period. The balance sheet at December 27, 2008 has been derived from the audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These financial statements and notes should be read with the consolidated financial statements and notes thereto for the year ended December 27, 2008 included in the Company's Annual Report on Form 10-K filed with the SEC on February 27, 2009.

**Fiscal Year.** The Company operates on a 52/53 week fiscal year, whereby the year ends on the last Saturday of December. Fiscal 2009 will end on December 26, 2009, and will consist of 52 weeks.

**Reclassifications.** Certain prior period balances have been reclassified to conform to the current financial statement presentation. None of these reclassifications had an impact on reported net loss for any periods presented.

**Codification.** In June 2009 the Financial Accounting Standards Board, or FASB, established the Accounting Standards Codification, or Codification, as the source of authoritative GAAP recognized by the FASB. The Codification is effective in the first interim and annual periods ending after September 15, 2009 and had no effect on the Company's unaudited condensed consolidated financial statements.

**Subsequent Events.** The Company has performed an evaluation of subsequent events through November 5, 2009, which is the date the financial statements were issued.

**Note 2 Recent Accounting Pronouncements and Other Reporting Considerations**

## Edgar Filing: FORMFACTOR INC - Form 10-Q

In August 2009, the FASB issued Accounting Standards Update titled "Fair Value Measurements and Disclosures - Measuring Liabilities at Fair Value" which provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value of such liability using one or more of the techniques prescribed by the update. The Company will adopt this guidance in the fourth quarter of fiscal 2009. The adoption of this standard is not expected to have a material impact on the Company's consolidated financial statements.

In June 2009, the FASB issued an accounting standard intended to improve financial reporting by providing additional guidance to companies involved with variable interest entities and by requiring additional disclosures about a company's involvement in variable interest entities. This standard is effective for interim and annual periods ending after November 15, 2009. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In June 2009, the FASB issued accounting guidance related to accounting for transfers and servicing of financial assets and extinguishments of liabilities. This accounting guidance requires more information about transfers of financial assets where companies have continuing exposure to the risk related to transferred financial assets. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosure. This standard is effective for interim and annual periods ending after November 15, 2009. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

For the quarter beginning March 29, 2009, the Company adopted the FASB accounting guidance related to recognition and presentation of other-than-temporary impairments. This accounting guidance amends the prior other-than-temporary impairment ( OTTI ) guidance in U.S. GAAP to make the guidance more operational and to improve the presentation of other-than-temporary impairments in a company's financial statements. Prior to its issuance, if OTTI was determined to exist, the Company recognized an OTTI charge into earnings in an amount equal to the difference between the investment's amortized cost basis and its fair value as of the balance sheet date of the reporting period. Under this accounting guidance, if OTTI has been incurred, and it is more-likely-than-not that the Company will not sell the investment security before the recovery of its amortized cost basis, then the OTTI is separated into (a) the amount representing the credit loss and (b) the amount related to all other factors. The amount of the total OTTI related to

Table of Contents

the credit loss is recognized in earnings. The amount of the total OTTI related to other factors is recognized in accumulated other comprehensive income ( AOCI ). There was no initial effect of adoption on March 28, 2009.

For the quarter beginning March 29, 2009, the Company adopted new accounting guidance issued by the FASB related to determination of fair value when the volume and level of activity for an asset or liability have significantly decreased and identification of transactions that are not orderly. This accounting guidance provides additional guidance for estimating fair value in accordance with the accounting standard on fair value measurements. The adoption of this accounting guidance did not have an impact on the Company's consolidated results of operations or financial condition.

For the quarter beginning March 29, 2009, the Company adopted accounting guidance issued by the FASB related to interim disclosures about fair value of financial instruments. This accounting guidance amends the previously issued accounting standard that related to financial instruments, to require disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements. The adoption of this accounting guidance did not have an impact on the Company's consolidated results of operations or financial condition. See Note 5 for additional disclosures included in accordance with this accounting guidance.

For the quarter beginning March 29, 2009, the Company adopted FASB's newly issued accounting standard related to subsequent events. This accounting standard establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date—that is, whether that date represents the date the financial statements were issued or were available to be issued. This disclosure should alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented. Adoption of accounting standard did not have an impact on the Company's consolidated results of operations or financial condition.

In September 2009, the Financial Accounting Standards Board ratified accounting guidance regarding revenue arrangements with multiple deliverables. In absence of vendor-specific objective evidence (VSOE) or other third party evidence (TPE) of the selling price for the deliverables in a multiple-element arrangement, this accounting guidance requires companies to use an estimated selling price (ESP) for the individual deliverables. Companies shall apply the relative-selling price model for allocating an arrangement's total consideration to its individual elements. Under this model, the ESP is used for both the delivered and undelivered elements that do not have VSOE or TPE of the selling price. This accounting guidance will be applied on a prospective basis for revenue arrangements entered into or materially modified beginning in fiscal 2011, with earlier application permitted. Since the Company will apply this accounting guidance on a prospective basis, it is currently unable to evaluate its effect on its consolidated financial statements.

**Note 3 Concentration of Credit and Other Risks**

Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents, investments and trade receivables. The Company's cash equivalents and marketable securities are held in safekeeping by large, creditworthy financial institutions. The Company invests its excess cash primarily in U.S. banks, government and agency bonds, money market funds and corporate obligations. The Company has established guidelines relative to credit ratings, diversification and maturities that seek to maintain safety and liquidity.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

The Company sells its products to large multinational semiconductor manufacturers primarily located in Asia and North America. During the three months ended September 26, 2009 and September 27, 2008 one customer represented 53.0% and 15.5%, respectively, of total revenues. No other customer represented greater than 10% of total revenues for these fiscal periods. One customer represented 55.0% of total revenues during the nine months ended September 26, 2009, and three customers represented 23.4%, 13.1%, and 13.0% of total revenues for the nine months ended September 27, 2008. No other customer accounted for more than 10% of total revenues in either of these fiscal periods.

The Company has significant accounts receivables concentrated with a few customers in the semiconductor industry. While the Company's allowance for doubtful accounts balance is based on historical loss experience along with anticipated economic trends, unanticipated financial instability in the semiconductor industry could lead to higher than anticipated losses. As of September 26, 2009, three customers accounted for greater than 10% of gross accounts receivable. As of December 27, 2008, four of the Company's customers accounted for greater than 10% of gross accounts receivable.

### **Note 4 Restructuring Charges**

Restructuring charges include costs related to one-time employee termination benefits, cost of long-lived assets abandoned, as well as contract termination costs. The Company recognizes a liability for employee termination benefits when a plan of termination, approved by management and establishing the terms of the benefit arrangement, has been communicated to employees.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

### Table of Contents

The timing of the recognition of one-time employee termination benefits is dependant upon the period of time the employees are required to render service after communication. If employees are not required to render service in order to receive the termination benefits or if employees will not be retained to render service beyond the minimum legal notification period, a liability for the termination benefits is recognized at the communication date. In instances where employees will be retained to render service beyond the minimum legal notification period, the liability for employee termination benefits is measured initially at the communication date based on the fair value of the liability as of the termination date and is recognized ratably over the future service period. The Company records charges related to long-lived assets to be abandoned when the assets cease to be used. The Company records a liability for contract termination costs that will continue to be incurred under a contract for its remaining term without economic benefit to the Company at the cease-use date.

The Company recorded restructuring charges of \$0.1 million for the three months ended September 27, 2008 and \$7.9 million and \$8.7 million for the nine months ended September 26, 2009 and September 27, 2008, respectively. There were no restructuring charges incurred in the three months ended September 26, 2009. The restructuring plan implemented in the first quarter of 2009 is discussed in detail below. For a complete discussion of all restructuring actions that were implemented prior to fiscal 2009, please refer to the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K filed on February 27, 2009.

In the first quarter of fiscal 2009, the Company implemented a global reorganization and cost reduction plan (the Q1 2009 Restructuring Plan) designed to lower the Company's cash breakeven level in the current market environment. The Q1 2009 Restructuring Plan extended the global cost reduction plans implemented during fiscal 2008 and included workforce reductions of 178 employees spread across all functions of the organization. The Q1 2009 Restructuring Plan also included other actions such as the elimination of 24 contractor positions as well as non-replacement of certain voluntary employee terminations. The Company recorded \$7.7 million in charges for this restructuring plan in the first quarter of fiscal 2009 of which \$7.3 million related to severance and related benefits and \$0.4 million related to write-down of certain assets taken out of service. The Company incurred approximately \$0.3 million in connection with this restructuring plan in the second quarter of fiscal 2009 related to severance and related benefits. The following table summarizes the activity related to the Q1 2009 Restructuring Plan as of September 26, 2009 (in thousands):

	Employee Severance and Benefits	Property and Equipment Write-down	Contract Termination and Other	Total
Accrual at December 27, 2008	\$ 77	\$	\$ 71	\$ 148
Q1 09 Restructuring charges	7,332	366	(19)	7,679
Cash payments	(5,287)		19	(5,268)
Non-cash settlements	(217)	(366)		(583)
Accrual at March 28, 2009	1,905		71	1,976
Q2 09 Restructuring charges	250		14	264
Cash payments	(776)			(776)
Accrual at June 27, 2009	1,379		85	1,464
Q3 09 Restructuring charges				
Cash payments	(1,120)			(1,120)
Accrual at September 26, 2009	\$ 259	\$	\$ 85	\$ 344

Restructuring charges are reflected separately as Restructuring in the accompanying Condensed Consolidated Statements of Operations. The remaining accrual as of September 26, 2009 relates primarily to severance benefits which will be paid within the next six months. As such, the restructuring accrual is recorded as a current liability within Accrued Liabilities in the Condensed Consolidated Balance Sheets.

### **Note 5 Fair Value**

## Edgar Filing: FORMFACTOR INC - Form 10-Q

The Company uses fair value measurements to record fair value adjustments to certain financial and non-financial assets and to determine fair value disclosures. Our marketable securities are financial assets recorded at fair value on a recurring basis. The Company also has a building held for sale in Livermore, CA as well as certain manufacturing equipment held for sale, which are measured at fair value on a non-recurring basis and included within Prepaid expenses and other current assets in the accompanying Condensed Consolidated Balance Sheet.

Table of Contents

The accounting standard for fair value defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires disclosures about fair value measurements. Fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and consider assumptions that market participants would use when pricing the asset or liability, such as inherent risk, transfer restrictions, and risk of nonperformance. The accounting standard for fair value establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The standard describes a fair value hierarchy based on three levels of inputs, the first two of which are considered observable and the last unobservable, that may be used to measure fair value:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.
  
- Level 2 - Inputs, other than the quoted prices in active markets, that are observable either directly or indirectly.
  
- Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company adopted accounting standard for fair value as of the beginning of its fiscal 2008 year for its financial assets and financial liabilities, and as of the beginning of its 2009 fiscal year as it relates to nonrecurring fair value measurement requirements for non-financial assets and liabilities.

*Assets Measured at Fair Value on a Recurring Basis*

The Company measures and reports certain assets and liabilities at fair value on a recurring basis, including money market funds, U. S. government securities, municipal bonds, agency securities and foreign currency derivatives. The following tables represent the Company's fair value hierarchy for its financial assets (cash equivalents and marketable securities):

Fair value measured on a recurring basis as of September 26, 2009 (in thousands):

	Level 1	Level 2	Total
<b>Assets:</b>			
<b>Cash equivalents</b>			
Money market funds	\$ 128,275	\$	\$ 128,275
Commercial paper		5,000	5,000
<b>Marketable securities</b>			



Edgar Filing: FORMFACTOR INC - Form 10-Q

U. S. Treasury		91,444		91,444
Municipal bonds		7,379		7,379
Agency securities		208,867		208,867
Commercial paper		4,997		4,997
<b>Total</b>	\$	128,275	\$	317,687
				\$ 445,962

Fair value measured on a recurring basis as of December 27, 2008 (in thousands):

	Level 1	Level 2	Total
<b>Assets:</b>			
<b>Cash equivalents</b>			
Money market funds	\$ 183,765	\$	\$ 183,765
U. S. Treasury		20,000	20,000
Agency securities		79,977	79,977
<b>Marketable securities</b>			
U. S. Treasury		105,285	105,285
Municipal bonds		17,928	17,928
Agency securities		61,755	61,755
<b>Total</b>	\$ 183,765	\$ 284,945	\$ 468,710

Table of Contents

The Level 1 assets consist of the Company's money market fund deposits. The Level 2 assets consist of the Company's available-for-sale debt investment portfolio. The Company's investments are priced by pricing vendors who provided observable inputs for their pricing without applying significant judgments. Broker's pricing is used mainly when a quoted price is not available, the investment is not priced by the Company's pricing vendors or when a broker price is more reflective of fair values in the market in which the investment trades. The Company's investments are labeled as Level 2 investments because fair values for these investments are based on similar assets without applying significant judgments. In addition, all of the Company's investments have a sufficient level of trading volume to demonstrate that the fair values used are appropriate for these investments.

*Assets Measured at Fair Value on a Nonrecurring Basis*

The building held for sale is classified as Level 3 as the Company used unobservable inputs in its valuation reflecting the Company's assumptions that market participants would use in pricing this asset due to the absence of recent comparable market transactions and inherent lack of liquidity. The building held for sale was valued at \$900,000 as of September 26, 2009. The Company also classified certain manufacturing equipment as held for sale as of September 26, 2009. The equipment was classified as Level 3 as the Company used unobservable inputs in its valuation reflecting the Company's assumptions that market participants would use in pricing this asset due to the absence of observable market data on pricing and inherent lack of liquidity. The manufacturing equipment held for sale was valued at \$250,000 at September 26, 2009.

The Company's fair value processes include controls that are designed to ensure appropriate fair values are recorded. Such controls include model validation, review of key model inputs, and analysis of period-over-period fluctuations and independent recalculation of prices.

**Note 6 Marketable Securities**

The Company classifies its marketable debt securities as available-for-sale. All marketable securities represent the investment of funds available for current operations, notwithstanding their contractual maturities. Such marketable securities are recorded at fair value and unrealized gains and losses are recorded to accumulated other comprehensive income (loss) until realized.

Marketable securities at September 26, 2009 consisted of the following (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Market Value
U. S. Treasury	\$ 91,142	\$ 316	\$ (14)	\$ 91,444
Agency Securities	208,353	526	(12)	208,867
Obligations of states and political subdivisions	7,340	38		7,379
Commercial Paper	4,997			4,997
	\$ 311,832	\$ 880	\$ (26)	\$ 312,687

## Edgar Filing: FORMFACTOR INC - Form 10-Q

Marketable securities at December 27, 2008 consisted of the following (in thousands):

	Amortized Cost		Gross Unrealized Gains		Gross Unrealized Losses		Market Value
U. S. Treasury	\$ 104,817	\$	468	\$		\$	105,285
Agency Securities	60,943		836		(24)		61,755
Obligations of states and political subdivisions	17,862		126		(60)		17,928
	\$ 183,622	\$	1,430	\$	(84)	\$	184,968

The Company typically invests in highly-rated securities with low probabilities of default. The Company's investment policy requires investments to be rated single-A or better, limits the types of acceptable investments, concentration as to security holder and duration of the investment. The net unrealized losses on the Company's investments during the three and nine months ended September 26, 2009 were caused primarily by changes in interest rates. When evaluating the investments for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below the amortized cost basis, review of current market liquidity, interest rate risk, the financial condition of the issuer, as well as credit rating downgrades.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

### Table of Contents

The Company believes that the unrealized losses are not other-than-temporary. The Company does not have a foreseeable need to liquidate the portfolio and anticipates recovering the full cost of the securities either as market conditions improve, or as the securities mature.

Contractual maturities of marketable securities as of September 26, 2009 were as follows (in thousands):

	Amortized Cost	Market Value
Due in one year or less	\$ 221,350	\$ 221,731
Due after one year to three years	90,483	90,956
	\$ 311,833	\$ 312,687

Realized gains on sales and maturities of marketable securities were immaterial for the three and nine months ended September 26, 2009. Realized losses on sales and maturities of marketable securities were immaterial for the three months ended September 27, 2008 and were \$0.5 million for the nine months ended September 27, 2008.

### **Note 7 Allowance for Doubtful Accounts**

A majority of the Company's trade receivables are derived from sales to large multinational semiconductor manufacturers throughout the world. In order to monitor potential credit losses, the Company performs ongoing credit evaluations of its customers' financial condition. An allowance for doubtful accounts is maintained for probable credit losses based upon the Company's assessment of the expected collectibility of all accounts receivable. The allowance for doubtful accounts is reviewed on a quarterly basis to assess the adequacy of the allowance. The Company takes into consideration (1) any circumstances of which the Company is aware of a customer's inability to meet its financial obligations; and (2) its judgments as to prevailing economic conditions in the industry and their impact on its customers. If circumstances change, and the financial condition of its customers are adversely affected and they are unable to meet their financial obligations to the Company, the Company may need to take additional allowances, which would result in an increase in the Company's net loss.

The Company recorded a provision for doubtful accounts of \$5.2 million in the first quarter of fiscal 2009 primarily due to the heightened risk of non-payment of accounts receivable by certain customers facing financial difficulty. The Company recorded a reduction to provision for doubtful accounts of \$0.3 million in the second quarter of fiscal 2009 and a provision for doubtful accounts of \$0.1 million in the third quarter of fiscal 2009. The allowance for doubtful accounts consisted of the following activity for the three and nine months ended September 26, 2009 (in thousands):

	Allowance for Doubtful Accounts Receivable
Balance at December 27, 2008	\$ 4,220
Net additions/(reductions) to provision	5,246
Deductions	
Balance at March 28, 2009	9,466
Net additions/(reductions) to provision	(315)
Deductions	

Edgar Filing: FORMFACTOR INC - Form 10-Q

Balance at June 27, 2009		9,151
Net additions/(reductions) to provision		109
Deductions		
Balance at September 26, 2009	\$	9,260

**Note 8 Inventories**

Inventories are stated at the lower of cost (principally standard cost which approximates actual cost on a first-in, first-out basis) or market value. Provisions for estimated excess and obsolete inventories are made based on management's analysis of inventory levels and future sales forecasts. Once the value is adjusted, the original cost of the Company's inventory less the related inventory write-down represents the new cost basis of such products. Reversal of these write-downs is recognized only when the related inventory has been scrapped or sold.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

### Table of Contents

The Company designs, manufactures and sells a fully custom product into a market that is subject to cyclical and significant demand fluctuations. Probe cards are complex products, custom to a specific chip design and must be delivered on short lead-times. Probe cards are manufactured in low volumes; therefore, material purchases are often subject to minimum purchase order quantities in excess of the actual demand. It is not uncommon for the Company to acquire production materials and start certain production activities based on estimated production yields and forecasted demand prior to or in excess of actual demand for the Company's wafer probe cards. These factors make inventory valuation adjustments part of the Company's normal recurring cost of revenue. Excess and obsolete inventory write downs were \$5.6 million, and \$12.3 million for the nine months ended September 26, 2009, and September 27, 2008, respectively. The Company retains a portion of the excess inventory until the customer's design is discontinued. The inventory may be used to satisfy customer warranty obligations.

When the Company's products have been delivered, but the revenue associated with that product is deferred because the related revenue recognition criteria have not been met, the Company defers the related inventory costs. The deferred inventory costs do not exceed the deferred revenue amounts.

Inventories consisted of the following (in thousands):

	September 26, 2009	December 27, 2008
Raw materials	\$ 1,841	\$ 2,147
Work-in-progress	8,131	7,120
Finished goods:		
Deferred cost of revenue	5,591	1,765
Manufactured finished goods	5,603	7,756
	\$ 21,166	\$ 18,788

### **Note 9 Warranty**

The Company offers warranties on its products and records a liability for the estimated future costs associated with customer warranty claims, which is based upon historical experience and the Company's estimate of the level of future costs. Warranty costs are reflected in the Condensed Consolidated Statements of Operations as a cost of revenues.

A reconciliation of the changes in the Company's warranty liability (included in accrued liabilities in the Condensed Consolidated Balance Sheets) is as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
Warranty accrual beginning balance	\$ 634	\$ 1,480	\$ 1,098	\$ 1,383
Accrual for warranties issued during the period	41	1,398	13	3,886
Settlements made during the period	(79)	(985)	(515)	(3,376)
Warranty accrual ending balance	\$ 596	\$ 1,893	\$ 596	\$ 1,893



Table of Contents**Note 10 Property and Equipment**

Property and equipment consisted of the following (in thousands):

	Useful Life (in years)	September 26, 2009	December 27, 2008
Machinery and equipment	5 to 7	\$ 112,278	\$ 109,808
Computer equipment and software	3 to 5	34,833	28,378
Furniture and fixtures	5	7,088	6,860
Leasehold improvements	1 to 15	70,726	70,699
		224,925	215,745
Less: Accumulated depreciation and amortization		(139,761)	(116,900)
		85,164	98,845
Construction-in-progress		11,834	14,968
		\$ 96,998	\$ 113,813

In fiscal 2007, as part of its global manufacturing plan, the Company entered into a land lease offer agreement to establish a manufacturing facility in Singapore. During fiscal 2008, the Company decided not to proceed with the construction of the new manufacturing facility at this proposed site in Singapore. Accordingly in the first quarter of fiscal 2009, the Company entered into a contract for the early termination of the land lease offer agreement in Singapore and received \$6.7 million in exchange for surrendering to the lessor the lease offer and related land.

**Note 11 Comprehensive loss**

Comprehensive loss includes foreign currency translation adjustments and unrealized gains (losses) on available-for-sale securities, the impact of which has been excluded from net income and reflected as components of stockholders' equity.

Components of comprehensive loss were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
Net loss	\$ (23,901)	\$ (14,041)	\$ (127,690)	\$ (50,661)
Unrealized gain (loss) on investments, net of taxes	6	116	(557)	(719)
Cumulative translation adjustments	655	(273)	355	(47)
Other Comprehensive income (loss)	661	(157)	(202)	(766)
Comprehensive Loss	\$ (23,240)	\$ (14,198)	\$ (127,892)	\$ (51,427)

Components of accumulated other comprehensive income were as follows (in thousands):



	September 26, 2009		December 27, 2008
Unrealized gains and losses on investments, net of tax	\$ 523	\$	1,080
Foreign currency translation adjustments	1,197		842
Accumulated other comprehensive income	\$ 1,720	\$	1,922

**Note 12 Stockholders Equity**

*Stock Option Plans*

The Company has three equity incentive plans: Incentive Option Plan and Management Incentive Option Plan (together, the Prior Plans ), and 2002 Equity Incentive Plan ( 2002 Plan ), which became effective in June 2002. Upon the effectiveness of the 2002 Plan, the Company ceased granting any equity awards under the Prior Plans, although forfeited, repurchased, cancelled or terminated Prior Plan shares are transferred to the 2002 Plan.

Edgar Filing: FORMFACTOR INC - Form 10-Q

Table of Contents

Stock option activity under the Prior Plans and the 2002 Plan during the nine months ended September 26, 2009 is set forth below:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Balance at December 27, 2008	6,686,820	\$ 27.36		
Options granted	12,500	15.25		
Options exercised	(42,498)	8.76		
Options cancelled:				
Forfeited	(220,130)	32.86		
Expired	(25,434)	38.42		
Balance at March 28, 2009	6,411,258	27.23	4.65	\$ 9,061,934
Options granted	327,500	17.11		
Options exercised	(104,794)	7.85		
Options cancelled:				
Forfeited	(243,520)	37.71		
Expired	(233,705)	30.39		
Balance at June 27, 2009	6,156,739	\$ 26.49	4.66	\$ 7,180,708
Options granted				
Options exercised	(166,409)	18.22		
Options cancelled:				
Forfeited	(11,758)	32.96		
Expired	(198,040)	38.61		
Balance at September 26, 2009	5,780,532	\$ 26.30	4.63	\$ 21,343,845
Vested and expected to vest at September 26, 2009	5,475,368	\$ 26.38	4.58	\$ 20,030,980
Exercisable at September 26, 2009	4,178,862	\$ 25.69	4.37	\$ 16,069,154

The intrinsic value of option grants during the nine months ended September 26, 2009 was \$7.81 per share. The intrinsic value of option exercises during the three and nine months ended September 26, 2009 was \$0.9 million and \$2.4 million, respectively. Cash received from stock option exercises during the three and nine months ended September 26, 2009 was \$3.0 million and \$4.2 million, respectively. Gross tax benefits from the exercises of stock options and other equity based awards was approximately \$1.3 million and \$5.0 million for the three and nine months ended September 26, 2009.

Table of Contents

*Restricted Stock Units*

Activity of the restricted stock units under the 2002 Plan during the nine months ended September 26, 2009 is set forth below:

	Units	Weighted Average Grant Date Fair Value
Restricted stock units at December 27, 2008	583,865	\$ 19.92
Awards granted	25,300	14.90
Awards released	(117,307)	20.10
Awards cancelled	(35,923)	18.87
Restricted stock units at March 28, 2009	455,935	19.65
Awards granted	686,190	17.13
Awards released	(31,730)	20.87
Awards cancelled	(13,432)	19.18
Restricted stock units at June 27, 2009	1,096,963	18.05
Awards granted	12,560	21.82
Awards released	(5,170)	18.48
Awards cancelled	(11,267)	17.72
Restricted stock units at September 26, 2009	1,093,086	\$ 18.09

**Note 13 Stock-Based Compensation**

The Company accounts for all stock-based compensation to employees and directors, including grants of stock options, as stock-based compensation costs in the Condensed Consolidated Financial Statements based on the fair value measured as of the date of grant. These costs are recognized as an expense in the Condensed Consolidated Statements of Operations over the requisite service period and increase additional paid-in capital.

The table below shows the stock-based compensation expense included in the Condensed Consolidated Statement of Operations (in thousands):

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
Stock-based compensation expense included in:				
Cost of revenues	\$ 978	\$ 1,099	\$ 2,787	\$ 3,645
Research and development	910	1,087	3,385	3,842
Selling, general and administrative	2,615	2,908	10,240	9,795
Restructuring				623
Total stock-based compensation	\$ 4,503	\$ 5,094	\$ 16,412	\$ 17,905
Tax effect on stock-based compensation		(1,751)	(4,018)	(5,581)
Total stock-based compensation, net of tax	\$ 4,503	\$ 3,343	\$ 12,394	\$ 12,324

## Edgar Filing: FORMFACTOR INC - Form 10-Q

Stock-based compensation expense for the nine months ended September 26, 2009 includes \$2.5 million resulting from the modification and acceleration of the vesting of a portion of the options awarded to the Company's founder and former Executive Chairman of the Board of Directors in conjunction with his separation agreement and general release. Stock-based compensation expense for the nine months ended September 27, 2008 includes approximately \$0.3 million in stock-based compensation expense resulting from the modification and acceleration of the vesting of a portion of the Company's former Chief Financial Officer's stock options in conjunction with his separation agreement and general release and approximately \$0.3 million in stock-based compensation expense resulting from the acceleration of the vesting of a portion of the Company's former Senior Vice President, Product Business Group's restricted stock units in conjunction with his separation agreement and general release.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

### Table of Contents

The fair value of restricted stock units is equal to the closing market price of the underlying common stock as of the date of grant. The fair value of stock option grants is estimated as of the date of grant using a Black-Scholes option pricing model. The weighted average grant-date fair value of options granted during the nine months ended September 26, 2009 was \$7.81 per share. The weighted-average assumptions used for valuation under the Black-Scholes model were as follows:

	Three Months Ended September 27, 2008	September 26, 2009	Nine Months Ended September 27, 2008
<b>Stock Options:</b>			
Dividend yield			
Expected volatility	52.7%	53.4%	53.1%
Risk-free interest rate	3.27%	1.68%	3.06%
Expected term (in years)	4.75	4.67	4.75

Risk-free interest rates are yields for zero-coupon U.S. Treasury notes maturing approximately at the end of the expected option life. The expected volatility is based on a blend of historical volatility of our common stock using daily stock prices and implied market volatility, both over a period equal to the expected option life. The expected term is based on historical exercise behavior. In fiscal 2008, the Company applied the simplified method approach for deriving expected term. The simplified method is based on the vesting period and the contractual term for each grant, or for each vesting-tranche for awards with graded vesting. The mid-point between the vesting date and the expiration date is used as the expected term under this method.

### *Employee Stock Purchase Plan*

	Three Months Ended September 26, 2009	September 27, 2008	Nine Months Ended September 26, 2009	September 27, 2008
<b>ESPP:</b>				
Dividend yield				
Expected volatility	58.21%	56.2%	57.19%	52.2%
Risk-free interest rate	0.38%	1.88%	1.03%	2.1%
Expected term (in years)	0.5 - 1.0 year	0.5 - 1.0 year	0.5 - 1.0 year	0.5 - 1.0 year

During the three months ended September 26, 2009 and September 27, 2008, 115,011 shares and 150,410 shares, respectively, were issued under the 2002 Employee Stock Purchase Plan ( ESPP ). During the nine months ended September 26, 2009 and September 27, 2008, 269,156 shares and 286,349 shares, respectively, were issued under the 2002 Employee Stock Purchase Plan ( ESPP ).

### *Unrecognized Compensation Costs*

At September 26, 2009, the unrecognized stock-based compensation, adjusted for estimated forfeitures, was as follows (in thousands):

Edgar Filing: FORMFACTOR INC - Form 10-Q

	Unrecognized Expense	Weighted Average Expected Recognition Period in years
Stock options	\$ 16,604	1.35
Restricted stock units	11,950	3.01
Employee Stock Purchase Plan	308	0.35
Total unrecognized share-based compensation expense	\$ 28,862	

**Note 14 Net Loss per Share**

Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding for the period. Diluted net loss per share is computed giving effect to all potential dilutive common stock, including stock options, restricted stock units and common stock subject to repurchase. Diluted loss per share for the three and nine months ended September 26, 2009 and September 27, 2008 were based only on the weighted-average number of shares outstanding during that period as the inclusion of any common stock equivalents would have been anti-dilutive.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

### Table of Contents

A reconciliation of the numerator and denominator used in the calculation of basic and diluted net loss per share follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
(In thousands)				
<b>Basic net loss per share</b>				
Numerator:				
Net loss	\$ (23,901)	\$ (14,041)	\$ (127,690)	\$ (50,661)
Denominator:				
Weighted average common stock outstanding	49,582	48,988	49,392	48,855
<b>Diluted net loss per share</b>				
Numerator:				
Net loss	\$ (23,901)	\$ (14,041)	\$ (127,690)	\$ (50,661)
Denominator:				
Weighted-average shares used in computing basic net loss per share	49,582	48,988	49,392	48,855
Add stock options, restricted stock, ESPP, warrants and common stock subject to repurchase				
Weighted average shares used in computing diluted net loss per share	49,582	48,988	49,392	48,855

The following table sets forth the weighted-average of all potentially dilutive securities excluded from the computation in the table above because their effect would have been antidilutive:

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
Options to purchase common stock	4,465	6,788	5,362	6,865
Restricted stock units		43	2	39
Employee Stock Purchase Plan	51	16	51	5
Total potentially dilutive securities	4,516	6,847	5,415	6,909

### **Note 15 Income Taxes**

During the three months ended September 26, 2009 and September 27, 2008, the Company recorded an income tax provision of \$0.4 million and an income tax benefit of \$11.8 million, respectively. During the nine months ended September 26, 2009 and September 27, 2008, the Company recorded an income tax provision of \$20.0 million and an income tax benefit of \$29.5 million, respectively. The Company's income tax provision for the three months ended September 26, 2009 is primarily related to income taxes of the Company's non U.S. operations. The income tax provision for the nine months ended September 26, 2009 is primarily related to the Company recording a valuation allowance covering substantially all of the Company's U.S. deferred tax assets at the end of the second quarter of fiscal 2009 of \$44.7 million.

The Company utilizes the asset and liability method of accounting for income taxes, under which deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, the Company considered available positive and negative evidence giving greater weight to its recent cumulative losses and its ability to carryback losses against prior taxable income and lesser weight to its projected financial results due to the challenges of forecasting future periods. The Company also considered, commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. At the end of the second quarter of fiscal 2009, changes in previously anticipated expectations necessitated a valuation allowance against the excess tax benefits to be recognized in that quarter and prior quarters since they are no longer more likely than not realizable. Under current tax laws, this valuation allowance will not limit the Company's ability to utilize Federal and state deferred tax assets provided it can generate sufficient future taxable income.

The Company classifies interest and penalties related to uncertain tax positions as part of income tax provision. The Company recognized interest expense of \$40,000 and \$56,000 for the three months ended September 26, 2009 and September 27, 2008, respectively, and \$170,000 and \$305,000 for the nine months ended September 26, 2009 and September 27, 2008, respectively. As of September 26, 2009, the Company had approximately \$483,000 of interest and zero penalties related to uncertain tax positions.



Table of Contents

The amount of income taxes the Company pays is subject to ongoing audits by Federal, state and non-U.S. tax authorities which might result in proposed assessments. The Company's estimate for the potential outcome for any uncertain tax issue is judgmental in nature. However, the Company believes that it has adequately provided for any reasonably foreseeable outcome related to those matters. The Company's future results may include favorable or unfavorable adjustments to its estimated tax liabilities in the period the assessments are made or resolved or when statutes of limitation on potential assessments expire. As of September 26, 2009, changes to the Company's uncertain tax positions in the next 12 months, that are reasonably possible, are not expected to have a significant impact on its financial position or results of operations.

The Company and its subsidiaries file income tax returns in the U.S. Federal jurisdiction, various U.S. states and non-U.S. jurisdictions. The Company is currently under examination by the State of California Franchise Tax Board for fiscal years 2004 and 2005.

The Company's effective tax rate may vary from period to period based on changes in estimated taxable income or loss by jurisdiction, changes to the valuation allowance, changes to federal, state or foreign tax laws, future expansion into areas with varying country, state, and local income tax rates, deductibility of certain costs and expenses by jurisdiction.

**Note 16 Commitments and Contingencies**

*Environmental Matters*

The Company is subject to U.S. federal, state and local, and foreign governmental laws and regulations relating to the protection of the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes, the clean-up of contaminated sites and the maintenance of a safe workplace. The Company believes that it complies in all material respects with the environmental laws and regulations that apply to it, including those of the California Department of Toxic Substances Control, the Bay Area Air Quality Management District, the City of Livermore Water Resources Division and the California Division of Occupational Safety and Health. No provision has been made for loss from environmental remediation liabilities associated with the Company's Livermore facility because the Company believes that it is not probable that a liability has been incurred as of September 26, 2009.

While the Company believes that it is in compliance in all material respects with the environmental laws and regulations that apply to it, in the future, the Company may receive environmental violation notices, and if received, final resolution of the violations identified by these notices could harm the Company's operations, which may adversely impact its operating results and cash flows. New laws and regulations, stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination at Company or others' sites or the imposition of new cleanup requirements could also harm the Company's operations, thereby adversely impacting its operating results and cash flows.

*Legal Matters*

From time to time, the Company may be subject to legal proceedings and claims in the ordinary course of business. For the fiscal quarter ended September 26, 2009, the Company was not involved in any material legal proceedings, other than the proceedings summarized below. In the future the Company may become a party to additional legal proceedings, including proceedings designed to protect its intellectual property

rights that require the Company to spend significant resources.

### **Patent Litigation**

The Company initiated patent infringement litigation in the United States against Phicom Corporation, a Korea corporation, and its U.S. subsidiary, both collectively "Phicom", and against Micronics Japan Co., Ltd., a Japan corporation, and its U.S. subsidiary, both collectively "Micronics Japan". In 2005, the Company filed a patent infringement lawsuit in the United States District Court for the District of Oregon against Phicom charging that it is willfully infringing four U.S. patents that cover key aspects of the Company's wafer probe cards: U.S. Patent Nos. 5,974,662, entitled "Method of Planarizing Tips of Probe Elements of a Probe Card Assembly", 6,246,247, entitled "Probe Card Assembly and Kit, and Methods of Using Same", 6,624,648, entitled "Probe Card Assembly" and 5,994,152, entitled "Fabricating Interconnects and Tips Using Sacrificial Substrates". In 2006, the Company also filed an amended complaint in the same Oregon district court adding two additional patents to the litigation: U.S. Patent Nos. 7,073,254, entitled "Method for Mounting a Plurality of Spring Contact Elements" and 6,615,485, entitled "Probe Card Assembly and Kit, And Methods of Making Same". Phicom answered the complaint and the amended complaint by denying infringement, alleging defenses and asserting counterclaims seeking adjudications on the validity, infringement and enforceability of the Company's patents. Also in 2006, the Company filed a patent infringement lawsuit in the United States District Court for the Northern District of California against Micronics Japan charging that it is willfully infringing four U.S. patents that cover key aspects of the Company's wafer probe cards: U.S. Patent Nos. 6,246,247, entitled "Probe Card Assembly and Kit, and Methods of Using Same", 6,509,751, entitled "Planarizer for a Semiconductor Contactor", 6,624,648, entitled "Probe Card Assembly" and 7,073,254, entitled "Method for

## Edgar Filing: FORMFACTOR INC - Form 10-Q

### Table of Contents

Mounting a Plurality of Spring Contact Elements. Micronics Japan answered the complaint by denying infringement, alleging defenses and asserting counterclaims seeking adjudications on the validity, infringement and enforceability of the Company's patents. The complaints in these actions seek both injunctive relief and monetary damages. These two district court actions have been stayed pending resolution of the complaint that the Company filed with the United States International Trade Commission, or ITC, which is described below.

On or about November 13, 2007, the Company filed a complaint with the ITC seeking institution of a formal investigation by the ITC into the activities of Micronics Japan and Phicom. The requested investigation as filed encompassed U.S. Patent Nos. 5,994,152, entitled "Fabricating Interconnects and Tips Using Sacrificial Substrates," 6,509,751, entitled "Planarizer for a Semiconductor Contactor," 6,615,485, entitled "Probe Card Assembly and Kit, And Methods of Making Same," 6,624,648, entitled "Probe Card Assembly," 7,168,162, entitled "Method of Manufacturing a Probe Card" and 7,225,538, entitled "Resilient Contact Structures Formed and Then Attached to a Substrate," and alleges that infringement by each of Micronics Japan and Phicom of certain of the identified patents constitute unfair acts in violation of 19 U.S.C. Section 1337. The ITC complaint alleges violations of Section 337 of the Tariff Act of 1930 in the importation into the United States of certain probe card assemblies, components thereof, and certain tested DRAM and NAND flash memory devices and products containing such devices that infringe patents owned by the Company, and requests a permanent exclusion order banning importation into the United States of infringing products and certain downstream products. The asserted patents currently in the investigation are U.S. Patent Nos. 5,994,152, 6,509,751, 6,615,485, 6,624,648 and 7,225,538.

On or about December 13, 2007, the ITC provided public notice that it voted to institute an investigation of certain probe card assemblies, components thereof and certain tested DRAM and NAND flash memory devices and products containing such devices. The products at issue in this investigation are probe card assemblies, which are used to test semiconductor devices that have been fabricated on silicon wafers, memory chips that have been so tested, and products containing such chips.

The investigation (337-TA-621) was originally referred to the Honorable Theodore R. Essex, an ITC Administrative Law Judge (ALJ), and in July 2008 was reassigned to the Honorable Charles E. Bullock, a ALJ, who will make an initial determination as to whether there is a violation of Section 337; that initial determination is subject to review by the full ITC Commission (the Commission). On or about January 23, 2009, the ALJ, after a September 2008 hearing, issued a claim construction ruling interpreting and defining terms of certain of the claims of the patents-in-suit. On or about January 28, 2009, the Company voluntarily withdrew its allegations to the extent that they encompassed its U.S. Patent No. 7,168,162, and on or about February 13, 2009, the ALJ issued an initial determination holding invalid the asserted claims of the Company's U.S. Patent No. 6,624,648, after finding as part of the claim construction ruling that one of the terms in the asserted claims of that patent is indefinite. The Company appealed that initial determination of invalidity to the Commission on or about February 18, 2009. The Commission agreed to review the initial determination and a ruling, termed the "Final Determination" is expected on, or about November 12, 2009.

The scheduled hearing relating to the Company's U.S. Patent Nos. 5,994,152, 6,509,751, 6,615,485, and 7,225,538 was conducted from February 23, 2009 through March 6, 2009. The ALJ issued a decision, termed an "Initial Determination," on June 29, 2009. The Initial Determination is directed to four FormFactor patents: U.S. Patent Nos. 5,994,152, entitled "Fabricating Interconnects and Tips Using Sacrificial Substrates," 6,509,751, entitled "Planarizer for a Semiconductor Contactor," 6,615,485, entitled "Probe Card Assembly and Kit, And Methods of Making Same," and 7,225,538, entitled "Resilient Contact Structures Formed and Then Attached to a Substrate." The Initial Determination found all of the asserted claims of U.S. Patent Nos. 6,509,751, 6,615,485 and 7,225,538 valid and enforceable, and all but one of the asserted claims of U.S. Patent No. 5,994,152 valid and all of the asserted claims enforceable. The Initial Determination did not find infringement of any of the asserted claims, and therefore did not find a violation of Section 337.

The Company, Micronics Japan and Phicom filed additional briefing to the Commission seeking review of parts of the ALJ's Initial Determination. The Commission can accept, reject or modify any of the ALJ's recommendations. The Commission issued a Notice on

## Edgar Filing: FORMFACTOR INC - Form 10-Q

September 14, 2009 in which it stated it would review only certain parts of the Initial Determination. The only non-infringement finding the Commission will review is whether Phicom's products infringe U.S. Patent No. 6,509,751. After review by the Commission is completed, the Final Determination is scheduled to be issued on or about November 12, 2009. The Final Determination, which is an ITC remedial order in Section 337 cases, is effective when issued and becomes final 60 days after issuance, subject to Presidential review. The Company will evaluate whether it will file an appeal with the Court of Appeals for the Federal Circuit, and if so on what issues, after issuance of the Final Determination.

In addition to the United States litigations, the Company also initiated actions in Seoul, South Korea against Phicom. In 2004 the Company filed two actions in Seoul Southern District Court, located in Seoul, South Korea, against Phicom alleging infringement of the Company's Korean Patent Nos. 252,457, entitled Method of Fabricating Interconnections Using Cantilever Elements and Sacrificial Substrates, 324,064, entitled Contact Tip Structures for Microelectronic Interconnection Elements and Methods of Making Same, 278,342, entitled Method of Altering the Orientation of Probe Elements in a Probe Card Assembly and 399,210,

Table of Contents

entitled Probe Card Assembly; as well as two actions the Company filed in 2006 in Seoul Central District Court against Phicom alleging infringement of certain claims of its Korean Patent No. 252,457 and seeking injunctive relief. These actions are all pending, on appeal to the High Court in Seoul as (i) on April 18, 2008, the Seoul Southern District Court issued a ruling that dismissed the Company's complaint as it related to Korean Patent Nos. 252,457 and 324,064, finding certain claims of Patent Nos. 252,457 and 324,064 were invalid, and that one of the claims of each of the patents was not infringed by Phicom, (ii) in July 2008, the Seoul Central District Court dismissed the Company's complaint related to Korean Patent No. 252,457, and (iii) on November 27, 2008, the Seoul Southern District Court dismissed the Company's complaint related to Korean Patent Nos. 278,342 and 399,210. The Company did not appeal the judgment on the injunctive relief request related to Korean Patent No. 252,457 filed in the Seoul Central District.

In response to the Company's initiation of the infringement actions in Korea, Phicom filed in the Korean Intellectual Property Office, or KIPO, invalidity actions challenging the validity of some or all of the claims of each of the Company's four patents at issue in the Seoul Southern District Court infringement actions. KIPO dismissed Phicom's challenges against all four of the patents-at-issue. Phicom appealed the dismissals of the challenges to the Korea Patent Court. In 2005 the Korea Patent Court issued rulings holding invalid certain claims of the Company's Korean Patent Nos. 278,342 and 399,210. In 2006, the Korea Patent Court issued a ruling holding invalid certain claims of the Company's Korean Patent No. 324,064, and also issued a ruling upholding the validity of the Company's Korean Patent No. 252,457. The Company appealed the Patent Court invalidity rulings to the Korea Supreme Court. Phicom appealed the Patent Court ruling on Korean Patent No. 252,457 to the Korea Supreme Court. In September 2007, the Korea Supreme Court affirmed the Patent Court rulings holding invalid certain claims of the Company's Korean Patent Nos. 278,342 and 399,210. In April 2008, the Korea Supreme Court affirmed the Patent Court ruling holding invalid certain claims of the Company's Korean Patent No. 324,064. In June 2008, the Korea Supreme Court reversed the Patent Court ruling and finding invalid certain claims of the Company's Korean Patent No. 252,457 and remanding the case for further trial to the Patent Court.

Additionally, one or more third parties have initiated challenges in the U.S. and foreign patent offices against certain of the above and other of the Company's patents. These actions include re-examination proceedings filed in the U.S. Patent and Trademark Office against certain of the Company's U.S. Patents that are at issue in the ITC investigation, proceedings in Korea against two of the Company's Korean patents, and proceedings filed in Taiwan against four of the Company's Taiwan patents.

No provision has been made for patent-related litigation because the Company believes that it is not probable that a liability had been incurred as of September 26, 2009. The Company will incur material attorneys' fees in prosecuting and defending the various identified actions.

**Securities Litigation**

On October 31, 2007, a plaintiff filed a purported stockholder class action in the United States District Court for the Northern District of California in which the Company and certain of its then officers, including one former officer who was a director at the time of filing, are named as defendants under the caption Danny McCasland, Individually and on Behalf of All Others Similarly Situated v. FormFactor, Inc., Igor Y. Khandros, Ronald C. Foster and Richard M. Freeman. Subsequently, plaintiffs filed two other purported stockholder class actions in the United States District Court for the Northern District of California under the captions Yuk Ling Lui, on Behalf of Herself and All Others Similarly Situated v. FormFactor, Inc., Igor Y. Khandros, Ronald C. Foster and Richard M. Freeman, and Victor Albertazzi, Individually and on Behalf of All Others Similarly Situated v. FormFactor, Inc., Igor Y. Khandros, Ronald C. Foster and Richard M. Freeman. The three actions have been consolidated. The plaintiffs filed these actions following the Company's restatement of its financial statements for the fiscal year ended December 30, 2006, for each of the fiscal quarters for that year, and for the fiscal quarters ended March 31 and June 30, 2007. In April 2008, the designated lead plaintiffs filed a Consolidated Amended Complaint. The plaintiffs claimed violations of Sections 10(b) and 20(a), and Rule 10b-5 of the Securities Exchange Act of 1934, alleging that the defendants knowingly issued materially false and misleading statements regarding the Company's business and financial results prior to the restatements. On July 25, 2008, the court granted the defendants' motion to dismiss the Consolidated Amended Complaint with leave to amend. On August 22, 2008 the designated lead plaintiffs filed a Second Amended

## Edgar Filing: FORMFACTOR INC - Form 10-Q

Complaint. The Second Amended Complaint also alleged violations of Sections 10(b) and 20(a), and Rule 10b-5 of the Securities Exchange Act of 1934. The plaintiffs again claimed that defendants knowingly issued materially false and misleading statements regarding the Company's business and financial results prior to the restatement, as well as regarding the development of the Harmony product line. Plaintiffs sought to recover unspecified monetary damages, equitable relief and attorneys' fees and costs. Defendants filed a motion to dismiss the Second Amended Complaint on October 6, 2008, and a hearing on the motion was held on February 6, 2009. On July 14, 2009, the court issued a ruling granting the Company's and the other defendants' motion to dismiss the second amended complaint without leave to amend. On July 28, 2009, plaintiffs filed a Motion to Alter or Amend the Judgment and to Uphold a Revised, Narrowed Second Amended Complaint. The revised complaint does not contain the accounting and restatement allegations that were included in the Second Amended Complaint but asks the Court to uphold only the Harmony-related allegations. On September 14, 2009, the court issued a ruling denying plaintiffs' Motion to Alter or Amend the Judgment and to Uphold a Revised, Narrowed Second Amended Complaint. Plaintiffs appealed to the Court of Appeals for the Ninth Circuit the Judgment dismissing the case and the Court's ruling denying their Motion to Alter or Amend the Judgment.

Table of Contents

No provision has been made for the securities litigation because the Company believes that it is not probable that a liability had been incurred as of September 26, 2009.

**Stockholder Derivative Litigation**

On November 19, 2007, a plaintiff filed a purported stockholder derivative action in the Superior Court of the State of California for the County of Alameda in which the Company is named as a nominal defendant and certain of its then directors and officers are named as defendants under the caption John King, Derivatively on Behalf of Nominal Defendant FormFactor, Inc. v. Dr. Igor Y. Khandros, Dr. Homa Bahrami, Dr. Thomas J. Campbell, G. Carl Everett, Jr., Lothar Maier, James A. Prestridge, Harvey A. Wagner, Ronald C. Foster and Richard M. Freeman, and FormFactor, Inc. Subsequently, another plaintiff filed a second purported stockholder class action in the Superior Court of the State of California for the County of Alameda under the caption Joseph Priestley, Derivatively on Behalf of FormFactor, Inc. v. Igor Y. Khandros, Mario Ruscev, James A. Prestridge, Thomas J. Campbell, Harvey A. Wagner, G. Carl Everett, Jr., Homa Bahrami, Lothar Maier, William H. Davidow and Joseph R. Bronson, and FormFactor, Inc. The plaintiffs filed these two later actions following the Company's restatement of its financial statements for the fiscal year ended December 30, 2006, for each of the fiscal quarters for that year, and for the fiscal quarters ended March 31 and June 30, 2007. The plaintiffs allege that the defendants breached their fiduciary duties and violated applicable law by issuing, and permitting the Company to issue, materially false and misleading statements regarding the Company's business and financial results prior to the restatements. The plaintiffs seek to recover monetary damages, and attorneys' fees and costs. The two derivative actions which were consolidated have been dismissed without prejudice, though the plaintiffs will have the right to refile the actions at some point in the future.

No provision has been made for the stockholder derivative litigation because the Company believes that it is not probable that a liability had been incurred as of September 26, 2009.

The Company believes that the factual allegations and circumstances underlying the legal proceedings described above that have been filed against the Company are without merit. The Company also believes that it does not have a material monetary damages exposure in these legal proceedings that would individually or in the aggregate have a material adverse effect on its financial condition, liquidity or results of operations; however, these legal proceedings have been costly and it is possible the Company will incur significant, and possibly material, attorneys' fees, which may not be covered by its insurance policies. These legal proceedings may also divert the Company's management's time and attention away from business operations, which could prove to be disruptive to the Company's business operations. In addition, an unfavorable outcome or settlement of these proceedings, particularly if it is not covered by or exceeds the Company's insurance coverage, could individually or in the aggregate adversely impact the Company's financial condition, liquidity or results of operations.

**Commercial Litigation**

On February 20, 2009, the Company filed a complaint for breach of contract, common counts, account stated and injunctive relief against Spansion, LLC, a Delaware limited liability company (Spansion), in the state superior court located in Santa Clara County, California. The complaint alleges that Spansion, in breach of Spansion's obligations under a purchase agreement entered into by the Company and Spansion, has failed to pay the Company for probe cards that the Company designed, developed and manufactured pursuant to several purchase orders placed by Spansion with the Company pursuant to the agreement. The complaint states that as of February 13, 2009, Spansion owed the Company \$8,094,533 for probe cards delivered by the Company and not paid for by Spansion. In the complaint, the Company is seeking (i) payment of at least \$8,094,533, (ii) a temporary protective order and an injunction enjoining Spansion from assigning or in any way divesting itself of any monies that the Company believes Spansion received from a certain third party entity, (iii) a prejudgment writ of attachment in favor of the Company over Spansion's corporate assets and property, (iv) costs and (v) attorney's fees. Prior to making any appearance or filing any answer in

the action, Spansion filed for protection under Chapter 11 of the Bankruptcy Laws of the United States, which served to stay the Company's complaint against Spansion. The Company has not recognized \$1.4 million of revenue related to shipments to Spansion and has reserved the remaining \$6.7 million of the outstanding receivable from Spansion.

### **Indemnification Arrangements**

The Company from time to time in the ordinary course of its business enters into contractual arrangements with third parties that include indemnification obligations. Under these contractual arrangements, the Company has agreed to defend, indemnify and/or hold the third party harmless from and against certain liabilities. These arrangements include indemnities in favor of customers in the event that the Company's wafer probe cards infringe a third party's intellectual property and the Company's lessors in connection with facility leasehold liabilities that the Company may cause. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers, and its bylaws contain indemnification obligations in favor of its directors, officers and agents. These indemnity arrangements may limit the type of the claim, the total amount that the Company can be required to pay in connection with the indemnification obligation and the time within which an indemnification claim can be made. The duration of the



Table of Contents

indemnification obligation may vary, and for most arrangements, survives the agreement term and is indefinite. The Company believes that substantially all of its indemnity arrangements provide for limitations on the maximum potential future payments it could be obligated to make. However, it is not possible to determine or reasonably estimate the maximum potential amount of future payments under these indemnification obligations due to the varying terms of such obligations, the history of prior indemnification claims, the unique facts and circumstances involved in each particular contractual arrangement and in each potential future claim for indemnification, and the contingency of any potential liabilities upon the occurrence of events that are not reasonably determinable. The Company has not had any requests for indemnification under these arrangements. The Company's management believes that any liability for these indemnity arrangements would not be material to its accompanying consolidated financial statements. The Company has not recorded any liabilities for these indemnification arrangements on its condensed consolidated balance sheet as of September 26, 2009.

**Note 17 Derivative Financial Instruments**

The Company operates and sells its products in various global markets. As a result, the Company is exposed to changes in foreign currency exchange rates. The Company utilizes foreign currency forward contracts to hedge against future movements in foreign exchange rates that affect certain existing foreign currency denominated assets and liabilities. Under this program, our strategy is to have increases or decreases in our foreign currency exposures offset by gains or losses on the foreign currency forward contracts to mitigate the risks and volatility associated with foreign currency transaction gains or losses. The Company does not use derivative financial instruments for speculative or trading purposes. The Company's derivative instruments, which are generally settled in the same quarter, are not designated as hedging instruments. The Company records the fair value of these contracts as of the end of its reporting period to its consolidated balance sheet with changes in fair value recorded in its consolidated statement of operations. The statement of operations classification for the fair values of these forward contracts is to non-operating income, net, for both realized and unrealized gains and losses.

As of September 26, 2009, there were three outstanding foreign exchange forward contracts to sell Japanese Yen, Korean Won and Taiwan Dollars. The following table provides information about the Company's foreign currency forward contracts outstanding as of September 26, 2009 (in thousands):

	<b>Contract Amount (Local Currency)</b>	<b>\$</b>	<b>Contract Amount (U.S. Dollars)</b>
Japanese Yen	3,057,387	\$	33,990
Taiwan Dollar	27,763		857
Korean Won	2,654,422		2,219
Total USD notional amount of outstanding foreign exchange contracts		\$	37,066

The contracts were entered into on September 25, 2009 and matured on September 29, 2009. Accordingly, there were no amounts reported in the Company's Condensed Consolidated Balance Sheets as of September 26, 2009 related to these contracts. Additionally, no gains or losses relating to the outstanding derivative contracts were recorded in the fiscal quarter ended September 26, 2009.

Table of Contents

The location and amount of gains and losses related to non-designated derivative instruments that matured in the fiscal quarter ended September 26, 2009 in the Condensed Consolidated Statement of Operations are as follows (in thousands):

Derivatives Not Designated as Hedging Instruments Under ASC 815	Location of Gain or (loss) Recognized in Loss on Derivative	Amount of Gain or (Loss) Recognized in Loss on Derivative
Foreign exchange forward contracts	Other Income (expense), net	\$ (2,327)

**Note 18 Departure of Executive Officer**

The Company entered into a Separation Agreement and Mutual Release as of May 1, 2009 (the Separation Agreement) with its founder and former Executive Chairman Dr. Igor Khandros, who retired from the Company and the board of directors. Under the terms of the Separation Agreement, the Company accelerated vesting of options to acquire 75,000 shares and permitted certain vested stock options to be exercisable until the earlier of (i) May 1, 2014 or (ii) the original expiration date of the applicable stock option (Refer to Note 12). The Company and Dr. Khandros also entered into a consulting agreement effective as of May 1, 2009 under which Dr. Khandros would continue to serve as a key advisor to the Company for a term of one-year for a quarterly consulting fee of \$75,000. The consulting agreement was terminated by Dr. Khandros effective July 1, 2009.

**Note 19 Subsequent Events**

In October 2009, the Company completed the acquisition of certain assets from Electroglas Inc., a company under Chapter 11 bankruptcy protection in Delaware ( Electroglas ). Prior to the acquisition, Electroglas was engaged in the supply of semiconductor manufacturing equipment and software to the semiconductor industry. The assets acquired consisted of manufacturing and testing equipment, spare parts and components related to the purchased equipment and other technology assets related to precision motion control automation and all of the intellectual property rights of Electroglas, with the exception of certain trademark rights. The Company believes that the acquisition of these assets will enable it to continue to improve its manufacturing efficiency and provide its customers with high quality end products. The purchase price for the assets, including transaction costs, of approximately \$10.5 million will be capitalized in the fourth quarter of fiscal 2009. Approximately \$2.3 million of the purchase price for these assets was paid or accrued in the third quarter of fiscal 2009 and has been included in Other Assets in the condensed consolidated balance sheet.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Cautionary Statement Regarding Forward-Looking Statements**

## Edgar Filing: FORMFACTOR INC - Form 10-Q

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Securities Exchange Act of 1934 and the Securities Act of 1933, which are subject to risks, uncertainties and assumptions that are difficult to predict. The forward-looking statements include statements concerning, among other things, our business strategy, including anticipated trends and developments in and management plans for our business and the markets in which we operate, financial results, operating results, revenues, gross margin, operating expenses, products, projected costs and capital expenditures, research and development programs, sales and marketing initiatives, and competition. In some cases, you can identify these statements by forward-looking words such as may, might, will, could, should, expect, plan, anticipate, believe, estimate, predict, intend and continue, the negative or plural of these words and other comparable terminology.

The forward-looking statements are only predictions based on our current expectations and our projections about future events. All forward-looking statements included in this Quarterly Report are based upon information available to us as of the filing date of this Quarterly Report. You should not place undue reliance on these forward-looking statements. We undertake no obligation to update any of these statements for any reason. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to differ materially from those expressed or implied by these statements. These factors include the matters discussed in the section titled "Risk Factors" in our Annual Report on Form 10-K for the year ended December 27, 2008, and in the section titled "Risk Factors" elsewhere in this Quarterly Report. You should carefully consider the numerous risks and uncertainties described under these sections.

The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and the accompanying notes contained in this Quarterly Report. Unless expressly stated or the context otherwise requires, the terms "we," "our," "us" and "FormFactor" refer to FormFactor, Inc. and its subsidiaries.

Table of Contents

**Overview**

We design, develop, manufacture, sell and support precision, high performance advanced semiconductor wafer probe card products and solutions. Semiconductor manufacturers use our wafer probe cards to perform wafer sort and test on the semiconductor die, or chips, or the whole semiconductor wafer, which is prior to singulation of the wafer into individual separate chips. We work closely with our customers on product design, as each wafer probe card is a custom product that is specific to the chip and wafer designs of the customer. We operate in a single industry segment and have derived substantially all of our revenues from the sale of wafer probe cards incorporating our proprietary technology, including our MicroSpring® interconnect technology.

The oversupply of memory devices coupled with the overall global economic downturn and uncertainty in fiscal 2008 had a significant impact on global semiconductor device manufacturing. In the first half of fiscal 2009, we saw our markets continue to be affected by the continuing global macroeconomic downturn which resulted in a significant decrease in demand and continuing market challenges for our advanced wafer probe cards. In the third quarter of fiscal 2009, we saw improvement across all of our business segments. In the DRAM market, demand and supply conditions tightened, as PC and memory module makers along with digital consumer electronics makers increased their DRAM procurement in anticipation of future demand trends. Given these conditions, DRAM device pricing took an upward turn in the third quarter of fiscal 2009. Additionally, we also experienced market share gains in DRAM, acceleration in DDR III, positive mobile DRAM activity and improved results in both Flash and Logic markets. As a result, revenue was up 40.3% sequentially from the three months ended June 27, 2009. Compared to the third quarter of fiscal 2008, revenue was down 16.8%, an improvement from the 40.0% year over year decline we saw in the second quarter of fiscal 2009. While this may signal increased market confidence, we believe the global economic environment remains volatile, creating an uncertain demand environment.

We incurred a net loss of \$23.9 million in the third quarter of fiscal 2009 as compared to net loss of \$14.0 million for the third quarter of fiscal 2008 primarily due to lower revenues. We incurred a net loss of \$127.7 million in the first nine months of fiscal 2009 as compared to net loss of \$50.7 million for the first nine months of fiscal 2008 primarily due to lower revenues, the recognition of a valuation allowance of \$44.7 million for our deferred tax assets as well as the \$5.0 million provision for bad debts due to the heightened risk of non-payment of certain accounts receivable. Net loss for the first nine months of fiscal 2008 included \$0.5 million in provision for doubtful debts. In the first quarter of fiscal 2009, we initiated a global reorganization and cost reduction plan designed to lower our cash breakeven level in the current market environment. As part of the plan, we reduced our workforce by approximately 22% and implemented certain non-severance measures that we expect to result in future cost savings.

In addition, we are restructuring our operations through our global regionalization strategy by, for example, placing more decision-making in regions close to our semiconductor customers to enhance customer relationships, strengthening our local design, application and service capabilities to improve customer responsiveness, changing our manufacturing structure for shorter cycle time and improved product delivery capabilities, and realigning our research and development efforts. We have accelerated our regionalization efforts by bringing up back-end manufacturing in Asia. We qualified our back-end manufacturing in Korea during our first quarter of fiscal 2009 and plan to do so in Japan in the fourth quarter of fiscal 2009, followed by Singapore in fiscal 2010. The combination of these initiatives is intended to result in a lower manufacturing cost, a simplified manufacturing process and decreased cycle times for our customers.

We established a valuation allowance of \$44.7 million in the second quarter of fiscal 2009 against the excess tax benefits recognized in prior quarters. This charge resulted in an income tax provision, rather than an income tax benefit, for the nine months ended September 26, 2009. This valuation allowance was based on our quarterly assessment of the realizability of our deferred tax assets. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, we considered available positive and negative evidence giving greater weight to our recent cumulative losses, ability to carryback losses against prior taxable income and lesser weight to our projected financial results due to the challenges of forecasting future periods. We also considered,

## Edgar Filing: FORMFACTOR INC - Form 10-Q

commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. The necessity for this valuation allowance and any future adjustments will be based on the available positive and negative evidence at that time, commensurate with its objective verifiability. Under current tax law, this valuation allowance will not limit our ability to utilize Federal and state deferred tax assets provided we can generate sufficient future taxable income. Our tax provisions in future periods will primarily consist of income taxes on our profits in certain jurisdictions outside of the US in the event they materialize.

Our cash, cash equivalents and marketable securities totaled approximately \$462.6 million as of September 26, 2009 as compared to \$522.9 million at December 27, 2008. We believe that we will be able to satisfy our working capital requirements for the next twelve months with the liquidity provided by our existing cash, cash equivalents and marketable securities. If demand for our products does not increase or if we are unsuccessful in improving our operating efficiency, reducing our cash outlays or increasing our available cash through financing, our cash, cash equivalents and marketable securities will further decline in the fourth quarter of fiscal 2009.

Table of Contents

We believe it is likely that the global economic and semiconductor industry downturns will persist; however, we cannot predict their severity or duration. Given the overall weakness of the United States and global economy, and the ongoing downturn in the semiconductor industry and its effects on demand for our products, we are unable to precisely forecast when or if revenues and profitability will return to previous levels.

*Revenues.* We derive substantially all of our revenues from product sales of wafer probe cards. Revenues from our customers are subject to fluctuations due to factors including, but not limited to, design cycles, technology adoption rates, competitive pressure to reduce prices, cyclicality of the different end markets into which our customers' products are sold and market conditions in the semiconductor industry. Historically, increases in revenues have resulted from increased demand for our existing products, the introduction of new, more complex products and the penetration of new markets. We expect that revenues from the sale of wafer probe cards will continue to account for substantially all of our revenues for the foreseeable future.

*Cost of Revenues.* Cost of revenues consists primarily of manufacturing materials, payroll and manufacturing-related overhead. Our manufacturing operations rely upon a limited number of suppliers to provide key components and materials for our products, some of which are a sole source. We order materials and supplies based on backlog and forecasted customer orders. Tooling and setup costs related to changing manufacturing lots at our suppliers are also included in the cost of revenues. We expense all warranty costs and inventory provisions as cost of revenues.

We design, manufacture and sell a fully custom product into the semiconductor test market, which is subject to significant variability and demand fluctuations. Our wafer probe cards are complex products that are custom to a specific chip design and must be delivered on relatively short lead-times as compared to our overall manufacturing process. As our advanced wafer probe cards are manufactured in low volumes and must be delivered on relatively short lead-times, it is not uncommon for us to acquire production materials and start certain production activities based on estimated production yields and forecasted demand prior to or in excess of actual demand for our wafer probe cards. We record an adjustment to our inventory valuation for estimated obsolete and non-saleable inventories equal to the difference between the cost of inventories and the estimated market value based upon assumptions about future demand and market conditions.

*Research and Development.* Research and development expenses include expenses related to product development, engineering and material costs. Almost all research and development costs are expensed as incurred. We plan to continue to invest in research and development activities to improve and enhance existing technologies and to develop new technologies for current and new markets and for new applications.

*Selling, General and Administrative.* Selling, general and administrative expenses include expenses related to sales, marketing, and administrative personnel, provision for doubtful accounts, internal and outside sales representatives' commissions, market research and consulting, and other sales, marketing, and administrative activities. These expenses also include costs for protecting and enforcing our patent rights and regulatory compliance costs.

*Restructuring Charges.* Restructuring charges include expenses related to employee termination severance pay and benefits, and property and equipment impairment charges incurred as part of our global cost reduction plans.

*Use of Estimates.* Our discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements. The preparation of consolidated financial statements in conformity with generally accepted accounting

## Edgar Filing: FORMFACTOR INC - Form 10-Q

principles in the United States of America ( 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. Actual results could differ from those estimates. Estimates may change as new information is obtained. Significant items that are subject to such estimates include the fair value of revenue elements, fair value of marketable securities, allowance for doubtful accounts, reserves for product warranty, valuation of obsolete and slow moving inventory, valuation and recognition of stock-based compensation, provision for income taxes and valuation allowance for deferred tax assets and, tax liabilities and accruals for other liabilities.

Table of Contents**Results of Operations**

The following table sets forth our operating results as a percentage of revenues for the periods indicated:

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	83.2	77.2	97.7	79.1
Gross profit	16.8	22.8	2.3	20.9
Operating expenses:				
Research and development	31.5	32.4	40.9	28.9
Selling, general and administrative	39.7	45.0	60.5	40.5
Restructuring charge		0.3	7.8	5.1
Total operating expenses	71.1	77.7	109.2	74.5
Operating loss	(54.4)	(54.9)	(106.9)	(53.6)
Interest income, net	1.6	5.3	2.5	6.4
Other income (expense)	(0.9)	0.5	(0.9)	0.2
Loss before income taxes	(53.7)	(49.1)	(105.3)	(47.0)
Provision for (benefit from) income taxes	0.9	(22.4)	19.5	(17.3)
Net loss	(54.6)%	(26.7)%	(124.8)%	(29.7)%



Table of Contents*Three and Nine Months Ended September 26, 2009 and September 27, 2008:***Revenues**

	Three Months Ended			Nine Months Ended		
	September 26, 2009	September 27, 2008	% Change	September 26, 2009	September 27, 2008	% Change
	(In thousands, except percentages)					
<b>Revenues by Market:</b>						
DRAM	\$ 36,430	\$ 36,525	(0.3)%	\$ 85,243	\$ 108,421	(21.4)%
Flash	2,096	8,470	(75.3)	4,567	36,207	(87.4)
Logic	5,247	7,589	(30.9)	12,530	25,672	(51.2)
Total revenues	\$ 43,773	\$ 52,584	(16.8)%	\$ 102,340	\$ 170,300	(39.9)%

The decrease in revenue for the three and nine months ended September 26, 2009 was primarily due to weak demand for our advanced wafer probe cards caused by the ongoing downturn in the semiconductor market. For certain of our products we also experienced pricing pressure due to the availability of competitive products, which also contributed to the decrease in revenues.

Our revenues for the three and nine months ended September 26, 2009 were primarily generated by sales of wafer probe cards to manufacturers of DRAM devices. Revenues for our products that address the DRAM segment declined slightly in the three and nine months ended September 26, 2009 as compared to the comparable periods in the prior year, primarily due to a number of factors including the relative supply and demand of various semiconductor devices and end products incorporating those devices, semiconductor manufacturers' efforts to curtail spending and conserve cash by taking capacity offline, reducing production, delaying the transition to new technology nodes and postponing the implementation of tooling cycles. We also experienced pricing pressure on certain DRAM test products due to the competitive environment.

Revenues from sales to Flash memory device manufacturers also decreased significantly in the three and nine months ended September 26, 2009 compared to the comparable periods in the prior year, with the decrease driven by sales decline in both NOR and NAND Flash wafer probe cards. The weakness in NOR Flash can be attributed to a decline in purchases by certain key customers. The decrease was primarily driven by a decline in revenues from NOR Flash wafer probe cards resulting from our largest NOR customer filing for bankruptcy protection in the first quarter of fiscal 2009. Additionally, revenues from NAND Flash wafer probe cards declined as NAND Flash memory device manufacturers significantly reduced their output in the first quarter of fiscal 2009, in an attempt to promote industry absorption of excess inventories.

Revenues from manufacturers of Logic devices decreased in the three and nine months ended September 26, 2009 compared to the comparable periods in the prior year, primarily due to the overall downturn in the semiconductor industry which negatively impacted the revenues from sales of our wafer probe cards.

Current global economic and semiconductor market conditions have adversely impacted the profitability of our customers and their capital spending and are likely to result in product revenues in the near term that are lower than our revenue levels in comparable periods during prior fiscal years.

Edgar Filing: FORMFACTOR INC - Form 10-Q

*Revenue by Geographic Region*

The following table sets forth our revenues by geographic region for the periods indicated:

	September 26, 2009		Three Months Ended September 27, 2008		September 26, 2009		Nine Months Ended September 27, 2008					
		% of Revenues		% of Revenues		% of Revenues		% of Revenues		% of Revenues		
(In thousands except percentages)												
Japan	\$	22,895	52.0%	\$	14,371	27.3%	\$	56,780	55.0%	\$	55,036	32.3%
North America		7,046	16.0		9,959	18.9		16,226	16.0		34,440	20.2
Asia Pacific		11,400	26.0		22,855	43.5		24,434	24.0		65,387	38.4
Europe		2,432	6.0		5,399	10.3		4,900	5.0		15,437	9.1
Total revenues	\$	43,773	100%	\$	52,584	100%	\$	102,340	100%	\$	170,300	100%

Geographic revenue information is based on the location to which we ship the customer product. For example, certain South Korean customers purchase through their North American subsidiaries and accordingly, if the product is shipped to an address in South Korea it is reflected in the revenue for Asia Pacific.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

### Table of Contents

The increase in Japan for the three and nine months ended September 26, 2009 as compared to the same period in the prior year was primarily due to the increase in our DRAM product sales in the region. The decrease in revenues in Asia Pacific for the three and nine months ended September 26, 2009 as compared to the same period in the prior year was primarily due to the decrease in our DRAM product sales in the region. The decrease in revenues in North America for the three and nine months ended September 26, 2009 compared to the same period in the prior year was primarily driven by decreased demand for all our products in this region. Revenue in Europe increased for the three months ended September 26, 2009 primarily due to the increased demand for our Logic products in this region.

The following customers accounted for more than 10% of our revenues:

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
Elpida Memory (1)	53.0%	15.5%	55.0%	23.4%
Spansion	*	*	*	13.1
Intel Corporation	*	*	*	13.0

(1) Includes Elpida Memory and its consolidated subsidiaries, Rexchip and Tera Probe

\* Less than 10% of revenues.

### **Gross Profit**

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
	(In thousands except percentages)			
Gross profit	\$ 7,338	\$ 12,001	\$ 2,333	\$ 35,674
Gross margin	16.8%	22.8%	2.3%	20.9%

Gross margin fluctuates with revenue levels, product mix, selling prices, factory loading, and material costs. For the three and nine months ended September 26, 2009, gross margin declined compared to the same period in the prior year, primarily due to the significant decline in revenue driving lower factory utilization, thereby increasing unit manufacturing costs, combined with declines in average selling prices as well as unfavorable change in product mix from higher margin to lower margin products. This decline was partially mitigated by lower personnel costs as a result of our fiscal 2008 and 2009 global cost reduction plans as well as a decline in inventory write-downs. Inventory provision decreased from \$12.3 million or 7.2% of revenues in the first nine months of fiscal 2008 to \$5.6 million, or 5.5% of revenues, in the first nine months of fiscal 2009. The higher inventory write-downs in first nine months of fiscal 2008 were associated with deterioration in the DRAM memory segment in that period. Excess custom inventories are not uncommon for us as our advanced wafer probe cards are custom designs manufactured in low volumes and must be delivered on relatively short lead times, which requires us to acquire production materials and start certain production activities based on estimated production yields and forecasted demand prior to or in excess of actual demand for our wafer probe cards. Stock-based compensation included in gross margin was \$1.0 million or 2.2% of revenues, and \$1.1million, or 2.1% of revenues, in the three months ended September 26, 2009 and September 27, 2008, respectively, and \$2.8 million, or 2.7% of revenues and \$3.6 million, or 2.1% of revenues for the nine months ended September 26, 2009 and September 27, 2008, respectively. The decline of stock-based

compensation, in absolute dollars, was primarily as a result of reductions in headcount as a result of our 2008 and 2009 global cost reduction plans.

Table of Contents

In the near future, our gross margins will likely continue to be adversely affected by lower levels of product revenues in comparison to the same periods in the prior fiscal year, even though we have taken significant steps to reduce our production levels and operating cost structure. Additionally, we may be required to record additional inventory write-downs if estimated average selling prices of products held in finished goods and work in process inventories at a quarter-end date are below the manufacturing cost of those products. Also, as part of our global regionalization strategy, we continued our efforts to transition back-end manufacturing to Asia in the third quarter of fiscal 2009. We qualified our back-end manufacturing in Korea during our first quarter of fiscal 2009 and plan to do so in Japan in the fourth quarter of fiscal 2009, followed by Singapore in fiscal 2010. This initiative is intended, in part, to reduce manufacturing cost. However, as we go through our ramp up of new technologies over the coming quarters, we will see associated costs related to the transition before we more fully experience the benefits of lower manufacturing costs by the second half of fiscal 2010.

**Research and Development**

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
	(In thousands except percentages)			
Research and development	\$ 13,775	\$ 17,079	\$ 41,823	\$ 49,288
% of revenues	31.5%	32.4%	40.9%	28.9%

Research and development expenses decreased in absolute dollars for the three and nine months ended September 26, 2009 compared to the same period in the prior year primarily due to a decrease in certain new technology product development related costs, personnel costs and depreciation, facilities and information technology allocations. For the three and nine months ended September 26, 2009, personnel costs decreased \$2.3 million and \$5.4 million, respectively, primarily due to reductions in headcount as a result of our global reorganization plans, expenses related to new technology and product development decreased \$0.6 million in both periods, and depreciation and facilities and information technology allocations decreased \$0.2 million and \$1.0 million, respectively, primarily due to the implementation of corporate cost reduction initiatives. Stock-based compensation included within research and development was \$0.9 million for the three months ended September 26, 2009 compared to \$1.1 million for the three months ended September 27, 2008, and \$3.3 million for the first nine months of fiscal 2009 as compared to \$3.8 million for the nine months of fiscal 2008. The decline in stock-based compensation in absolute dollars was primarily due to reductions in headcount resulting from the 2008 and 2009 global cost reduction plans.

As a percent of revenues, research and development expenses declined slightly during the three months ended September 26, 2009 as compared to the comparable period in the prior year. This was because the decline in research and development expenses in absolute dollars was slightly more than the decline in revenues in absolute dollars for the comparable period. As a percent of revenues, research and development expenses increased during the nine months ended September 26, 2009 as compared to the comparable periods in the prior year, primarily due to the declining revenue base.

We are continuing our strategic investments in research and development, including the development of our next generation parallelism architecture and products, fine pitch memory and Logic products, advanced MicroSpring interconnect technology and new process technologies. We remain committed to product development in new and emerging technologies.

**Selling, General and Administrative**

## Edgar Filing: FORMFACTOR INC - Form 10-Q

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
	(In thousands except percentages)			
Selling, general and administrative	\$ 17,366	\$ 23,675	\$ 61,939	\$ 69,038
% of revenues	39.7%	45.0%	60.5%	40.5%

Selling, general and administrative expenses decreased in absolute dollars for the three and nine months ended September 26, 2009 compared to the same period in the prior year primarily due to a decrease in personnel-related costs and other discretionary spending. For the three and nine months ended September 26, 2009, personnel related costs decreased by approximately \$3.2 million and \$7.9 million, respectively, primarily due to the work force reductions. Other discretionary spending decreased by \$0.3 million and \$1.3 million, respectively, due to the newly implemented corporate cost reduction initiatives. Outside legal and other professional fees

Table of Contents

decreased by \$2.6 million in the three months ended September 26, 2009 and by \$2.3 million in the nine months ended September 26, 2009, as compared to the comparable periods in the prior year. The decrease in legal fees for the three and nine months ended September 26, 2009 was primarily due to the scheduling of the International Trade Commission hearing on the investigation (337-TA-621) of two of our competitors which arose out of our complaint filed in late 2007. The decrease for the three and nine months ended September 26, 2009 reflects that the majority of the fees and costs related to the hearing and post hearing activities were completed by the end of the first quarter of fiscal 2009. In comparison, in the third quarter of fiscal 2008, we were engaged in active discovery activities.

Additionally, we recorded a provision for doubtful accounts of \$109,000 in the three months ended September 26, 2009. There was no provision for doubtful accounts in the three months ended September 27, 2008. Provision for doubtful accounts was \$5.0 million in the nine months ended September 26, 2009 compared to \$0.5 million in the comparable period in the prior year. We recorded a provision for doubtful debts primarily due to the heightened risk of non-payment of accounts receivable by certain customers facing financial difficulty. In addition, stock-based compensation included within selling, general and administrative expense was \$2.6 million and \$10.2 million for the three and nine months ended September 26, 2009, compared to \$2.9 million and \$9.8 million for the three and nine months ended September 27, 2008. The decrease in stock-based compensation for the three months ended September 26, 2009 was due to reductions in headcount as a result of our 2008 and 2009 global cost reduction plans. The increase in stock-based compensation for the nine months ended September 26, 2009 was due to an option modification compensation expense of \$2.5 million in connection with the retirement of Dr. Igor Y. Khandros, our founder and former executive chairman of our board of directors in May 2009, offset in part by a decrease due to reductions in headcount as a result of our 2008 and 2009 global cost reduction plans.

As a percent of revenues, selling, general and administrative expenses declined during the three months ended September 26, 2009 as compared to the comparable period in the prior year. This was primarily because the decline in selling, general and administrative expenses in absolute dollars was more than the decline in revenues in absolute dollars for the comparable period. As a percent of revenue, selling, general and administrative expenses increased in nine months ended September 26, 2009 as compared to the comparable period in the prior year, primarily due to the declining revenue base.

**Restructuring Charges**

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
	(In thousands except percentages)			
Restructuring charges	\$	\$ 141	\$ 7,943	\$ 8,684
% of revenues	%	0.3%	7.8%	5.1%

In the first quarter of fiscal 2009, we implemented the Q1 2009 Restructuring Plan that included reducing our global workforce by 22%. The Q1 2009 Restructuring Plan extended the cost reduction plans implemented during fiscal 2008 and impacted employees across all functions of the organization. We recorded \$7.7 million in relation to the Q1 2009 Restructuring Plan in the first quarter of fiscal 2009 and \$0.3 million in relation to the Q1 2009 Restructuring Plan in the second quarter of fiscal 2009. The plan consisted primarily of involuntary employee terminations and benefit costs and write-down of certain assets taken out of service. During the three and nine months ended September 26, 2009, we paid \$1.1 million and \$7.2 million of severance and benefits related to the Q1 Restructuring 2009 Plan. We anticipate that the remainder of the employee-related charges resulting from the cost reduction plan implemented in the first quarter of fiscal 2009 will be paid within the next six months. We expect to realize a quarterly cost savings of approximately \$3.4 million as a result of the actions taken in the first quarter of fiscal 2009 related to this plan.





Table of Contents

In both the first and second quarters of fiscal 2008, we implemented global cost reduction plans that included reducing our global workforce. We recorded \$0.1 million and \$8.7 million in restructuring charges in the three and nine months ended September 27, 2008, respectively. Both plans consisted primarily of involuntary employee termination and benefit costs and facility impairment charges related to vacating buildings in Livermore, California. Substantially all of the employee related charges related to the first quarter of fiscal 2008 and second quarter of fiscal 2008 cost reduction plans were paid by the end of fiscal 2008.

*Interest Income and Other Income (Expense), Net*

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
	(In thousands except percentages)			
Interest income	\$ 694	\$ 2,805	\$ 2,571	\$ 10,808
% of revenue	1.6%	5.3%	2.5%	6.4%
Other income (expense)	\$ (415)	\$ 263	\$ (920)	\$ 404
% of revenues	(0.9)%	0.5%	(0.9)%	0.2%

The decrease in interest income on cash, cash equivalents and marketable securities for the three and nine months ended September 26, 2009 was primarily a result of lower interest yields as compared to the comparable periods in the prior year as well as lower average balances. Weighted average yields for the three months ended September 26, 2009 and September 27, 2008 were 0.69% and 2.12%, respectively and weighted average yields for the nine months ended September 26, 2009 and September 27, 2008 were 0.73% and 2.58%, respectively. Cash, cash equivalents, restricted cash and marketable securities were \$463.3 million at September 26, 2009 compared to \$536.1 million at September 27, 2008. Other income (expense) for the three and nine months ended September 26, 2009 was mainly comprised of bank fees and foreign currency losses primarily related to Japanese Yen offset by net realized gains related to the sale of investments.

*Provision for (Benefit from) Income Taxes*

	Three Months Ended		Nine Months Ended	
	September 26, 2009	September 27, 2008	September 26, 2009	September 27, 2008
	(In thousands, except percentages)			
Provision for (benefit from) income taxes	\$ 377	\$ (11,785)	\$ 19,969	\$ (29,463)
Effective tax rate	1.6%	(45.6)%	18.5%	(36.8)%

During the three months ended September 26, 2009 and September 27, 2008, the Company recorded an income tax provision of \$0.4 million and an income tax benefit of \$11.8 million, respectively. During the nine months ended September 26, 2009 and September 27, 2008, the Company recorded an income tax provision of \$20.0 million and an income tax benefit of \$29.5 million, respectively. The Company's income tax provision for the three months ended September 26, 2009 is primarily related to income taxes of the Company's non U.S. operations. The income tax provision for the nine months ended September 26, 2009 is primarily related to the Company recording a valuation allowance covering substantially all of the Company's U.S. deferred tax assets at the end of the second quarter of fiscal 2009 of \$44.7 million.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

The Company utilizes the asset and liability method of accounting for income taxes, under which deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, we considered available positive and negative evidence giving greater weight to our recent cumulative losses and our ability to carryback losses against prior taxable income and lesser weight to our projected financial results due to the challenges of forecasting future periods. We also considered, commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. At the end of the second quarter of fiscal 2009, changes in previously anticipated expectations necessitated a valuation allowance against the excess tax benefits to be recognized in that quarter and prior quarters since they are no longer more likely than not realizable. Under current tax laws, this valuation allowance will not limit our ability to utilize Federal and state deferred tax assets provided it can generate sufficient future taxable income.

Table of Contents

We anticipate we will continue to record a valuation allowance against the losses of certain jurisdictions, primarily Federal and state, until such time as we are able to determine it is more likely than not the deferred tax asset will be realized. Such position is dependent on whether there will be sufficient future taxable income to realize such deferred tax assets. We expect our future tax provisions, during the time such valuation allowances are recorded, will consist primarily of the tax expense of our non-US jurisdictions that are profitable.

We classify interest and penalties related to uncertain tax positions as part of the income tax provision. We recognized interest expense of \$40,000 and \$56,000 and for the three months ended September 26, 2009 and September 27, 2008, respectively, and \$170,000 and \$305,000 for the nine months ended September 26, 2009 and September 27, 2008, respectively. As of September 26, 2009, the Company had approximately \$483,000 of interest and zero penalties related to uncertain tax positions.

The amount of income taxes we pay is subject to ongoing audits by Federal, state and non-U.S. tax authorities which might result in proposed assessments. Our estimate for the potential outcome for any uncertain tax issue is judgmental in nature. However, we believe that we have adequately provided for any reasonably foreseeable outcome related to those matters. Our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved or when statutes of limitation on potential assessments expire. As of September 26, 2009, changes to our uncertain tax positions in the next 12 months, that are reasonably possible, are not expected to have a significant impact on our financial position or results of operations.

We and our subsidiaries file income tax returns in the U.S. Federal jurisdiction, various U.S. states and non-U.S. jurisdictions. We are currently under examination by the State of California Franchise Tax Board for fiscal years 2004 and 2005.

**Liquidity and Capital Resources**

(Dollars in thousands)	September 26, 2009	Change	December 27, 2008
Working capital	\$ 510,634	(11.5)%	\$ 576,754
Cash and cash equivalents and marketable securities	462,607	(11.5)	522,894

**Working capital:** The decrease in working capital in the nine months ended September 26, 2009 was primarily due to a decrease in our cash, cash equivalents and marketable securities balances due to use of cash for operating and investing activities, a decrease in deferred tax assets due to the establishment of a valuation allowance in the second quarter of fiscal 2009, and an increase in deferred revenue due to lengthening of payment terms for certain customers. This was offset in part by decreases in accounts payable and accrued liabilities and an increase in accounts receivable due to lengthening of payment terms for certain customers.

**Cash, cash equivalents and marketable securities:** Cash and cash equivalents consist of deposits held at major banks, money market funds, U.S. government securities and commercial paper that at the time of purchase had maturities of 90 days or less. Marketable securities consist of U.S. government and agency securities and municipal bonds. Cash, cash equivalents and marketable securities include \$14.1 million held by our foreign subsidiaries as of September 26, 2009.

## Edgar Filing: FORMFACTOR INC - Form 10-Q

**Day Sales Outstanding:** Days sales outstanding from receivables, or DSO, was 116 days at September 26, 2009 compared with 87 days at December 27, 2008. Our DSO calculation is based on gross accounts receivable, including accounts receivable for amounts in deferred revenue, net of allowance for doubtful accounts. The increase in DSO is primarily due to the shift to longer payment terms for several customers. Additionally, with the continuing challenges in the semiconductor market, one customer which is in cash preservation mode is extending payments past original due dates.

(Dollars in thousands)	Nine Months Ended		
	September 26, 2009	Change	September 27, 2008
Cash used in operating activities	\$ (52,504)	279%	\$ (13,857)
Cash provided by (used in) investing activities	(143,212)	(219)	120,494
Cash provided by financing activities	7,627	28	5,944

**Cash flows from operating activities:** Net cash used in operating activities for the nine months ended September 26, 2009 was primarily driven by the operating loss offset in part by non-cash charges.

Table of Contents

The net change in operating assets and liabilities for the nine months ended September 26, 2009 consisted primarily of the increase in gross accounts receivable due to a shift to longer payment terms for certain customers and a one of our customers extending payments past its original due date, decrease in refundable income taxes due to the receipt of a federal income tax refund of \$29.0 million in March 2009, a decrease in prepaid expenses due to the receipt of a consumption tax refund of \$3.4 million and a decrease in other assets due to the receipt of \$6.7 million related to the termination of a prepaid land lease agreement in Singapore, offset by the decrease in accounts payable and accrued liabilities.

**Cash flows from investing activities:** The cash flows used in investing activities for the nine months ended September 26, 2009 primarily relate to the purchase of marketable securities, net of receipts from the sales and maturities thereof as well as cash used for capital expenditures in support of information technology system upgrades and new product technology. Cash flows used in investing activities for the nine months ended September 26, 2009 also included \$1.7 million of consideration paid for the purchase of manufacturing and testing equipment and technology assets from Electroglas (See Note 19 Subsequent Events).

We carefully monitor our investments to minimize risks and have not experienced other-than-temporary investment losses. Except for experiencing declining yields, our investment portfolio has not been negatively impacted by the ongoing economic turmoil in the credit markets.

**Cash flows from financing activities:** The cash flows provided by financing activities for the nine months ended September 26, 2009 are primarily due to \$3.6 million received from the January 2009 and July 2009 purchases under our 2002 Employee Stock Purchase Plan, or ESPP and net proceeds from the exercise of stock options offset by stock withheld in lieu of payment of employee taxes related to the release of restricted stock units of \$3.5 million.

Our cash, cash equivalents and marketable securities declined in the third quarter of fiscal 2009. Given the uncertainty in the global economy and the downturn in the semiconductor industry coupled with the decrease in demand for our products, we are focusing on improving our operating efficiency to achieve break even operating cash flow. Our actions have included operational expense reduction initiatives, re-timing or eliminating certain capital spending and research and development projects and re-negotiating longer payment terms with our vendors. We believe that we will be able to satisfy our cash requirements for the next twelve months with the liquidity provided by our existing cash, cash equivalents and marketable securities. We are also considering establishing manufacturing and technology partnerships, or to seek short and long-term debt obligations, or to obtain new financing facilities which may not be available on terms favorable to us or at all. Our future capital requirements may vary materially from those now planned. However, if we are unsuccessful in improving our operating efficiency, reducing our cash outlays or increasing our available cash through financing, our cash, cash equivalents and marketable securities will further decline in the fourth quarter of fiscal 2009.

**Off-Balance Sheet Arrangements**

Historically, we have not participated in transactions that have generated relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of September 26, 2009, we were not involved in any such off-balance sheet arrangements.

**Recent Accounting Pronouncements**

For a discussion on the impact of recently issued accounting pronouncements, please refer to Note 2 of the Notes to the Unaudited Condensed Consolidated Financial Statements in this Quarterly Report on Form 10-Q.

**Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

For financial market risks related to changes in interest rates and foreign currency exchange rates, reference is made to Item 7A: Quantitative and Qualitative Disclosures about Market Risk contained in Part II of our Annual Report on Form 10-K for the fiscal year ended December 27, 2008. Our exposure to market risk has not changed materially since December 27, 2008.

**Item 4. *Controls and Procedures***

**Evaluation of Disclosure Controls and Procedures**

Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the Exchange Act)) are effective to ensure that information required to be disclosed by us in reports that we

Table of Contents

file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

**Changes in Internal Control over Financial Reporting**

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during our third quarter of fiscal 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Limitations on the Effectiveness of Controls**

Control systems, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control systems objectives are being met. Further, the design of any control systems must reflect the fact that there are resource constraints, and the benefits of all controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within our company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Control systems can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based, in part, on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

**CEO and CFO Certifications**

We have attached as exhibits to this Form 10-Q the certifications of our Chief Executive Officer and Chief Financial Officer, which are required in accordance with the Exchange Act. We recommend that this Item 4 be read in conjunction with the certifications for a more complete understanding of the subject matter presented.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information relating to Legal Matters set forth under Note 16 - Commitments and Contingencies of the Notes to Condensed Consolidated Financial Statements of this Form 10-Q is incorporated herein by reference.

**Item 1A. Risk Factors**

In addition to the other information in this Form 10-Q, you should carefully consider the risk factors discussed in our Annual Report on Form 10-K for the year ended December 27, 2008, and the updated risk factors set forth below in evaluating FormFactor and our business. If any of the identified risks actually occur, our business, financial condition and results of operations could suffer. The trading price of our common stock could decline and you may lose all or part of your investment in our common stock. The risks and uncertainties described in our Annual Report on Form 10-K and below are not the only ones we face. Additional risks that we currently do not know about or that we currently believe to be immaterial may also impair our business operations.

*The ongoing global economic and semiconductor industry downturns could continue to negatively affect our business, results of operations, and financial condition.*

The ongoing financial crisis and resulting global economic downturn could continue to adversely affect our business. Our customers could continue to curtail capital expenditures and to defer adoption of emerging technologies in response to slow demand for consumer and other products incorporating devices tested with our wafer probe cards. A protracted downturn could cause customers to file for bankruptcy protection or insolvency proceeding, as occurred in 2009 with our customers Spansion and Qimonda, resulting in our loss of revenue. In the current economic environment, many customers are seeking extended payment terms, which could impact their payment histories and result in our deferring of revenue. We have also, on a one time basis agreed to further extended payment terms on a material purchase order, which could increase our potential bad debt exposure.



Table of Contents

We may experience the insolvency of key suppliers, leading to delays in the development and shipment of our products, increased expense and loss of revenue. We may also experience increased impairment charges due to decline in the fair values of marketable debt securities.

***We derive a substantial portion of our revenues from a small number of customers, and we could continue to experience significant declines in our revenues if any major customer does not place, cancels, reduces or delays a purchase of our products, or does not pay us, or delays or extends payment for our products past their original due dates.***

A relatively small number of customers have accounted for a significant portion of our revenues in any particular period. One customer accounted for 53.0% of our revenues in the quarter ended September 26, 2009, and our ten largest customers accounted for 90.7% of our revenues. In the first quarter of fiscal 2009, fewer than ten customers accounted for all of our revenues. We anticipate that sales of our products to a relatively small number of customers will continue to account for a significant portion of our revenues. As a result of the ongoing global economic and semiconductor industry downturns, we have experienced significant declines in our revenues. In the future, the cancellation, reduction or deferral of even a small number of purchases of our products could significantly reduce our revenues in any particular quarter. Cancellations, reductions or deferrals could result from a prolonged or another downturn in the semiconductor industry, manufacturing delays, quality or reliability issues with our products, or interruptions to our customers' operations due to fire, natural disasters or other events. Furthermore, because our probe cards are custom products designed for our customers' unique wafer designs, any cancellations, reductions or delays can result in significant, non-recoverable costs. In some situations, our customers might be able to cancel or reduce orders without a significant penalty. Our customers could also fail to pay all or part of an invoice for our products. In the current global economic and semiconductor industry downturns, we are more exposed to this non-payment risk because of concerns regarding the financial viability of certain semiconductor manufacturers. For example, in the first quarter of fiscal 2009, we recorded a \$5.2 million pre-tax expense to increase our allowance for doubtful accounts as a result of the heightened non-payment risk of accounts receivable primarily related to three customers. Additionally, on February 20, 2009, we filed a complaint in a California state superior court against Spansion, LLC in which we are seeking, among other things, payment of approximately \$8.1 million for probe cards purchased by and delivered to Spansion; the action was stayed by Spansion LLC's filing for bankruptcy protection in the United States. In addition, our customers could delay payment for our products past their original due dates, or in light of a customer's financial condition, we may agree to extend the customer's payment terms for our products. In the current global economic and semiconductor industry downturns, we are more exposed to our customers delaying or extending payment for our products past their original due dates. For example, days sales outstanding from receivables, or DSO, was 116 days at September 26, 2009 compared with 87 days at December 27, 2008. If a customer fails to pay us or delays payment for our products, we may be unable to recognize revenue for such products and defer recognizing revenue for other sales of product to the same customer in the future. We may be unable to recognize revenue, our financial condition and liquidity could be impacted, and we may incur additional charges for bad debt reserve to the extent certain of our customers continue to face financial difficulties during this down turn. It is also possible that if we make the decision to file one or more additional actions against customers to seek payment of outstanding receivables that it will negatively impact a customer relationship and result in lost revenues in the future. Customers with financial difficulties may be forced to materially reduce or discontinue operations, file for bankruptcy or other relief, or may be acquired by one of our other customers, any of which would further reduce our customer base.

***The markets in which we participate are competitive, and if we do not compete effectively, our operating results could be harmed.***

We are experiencing increased competition in the wafer probe card market and we expect competition to intensify in the future. Increased competition has resulted and in the future is likely to result in price reductions, reduced gross margins or loss of market share. Competitors might introduce new competitive products for the same markets that our products currently serve. These products may have better performance, lower prices and/or broader acceptance than our products. In addition, for products such as wafer probe cards, semiconductor manufacturers typically qualify more than one source, to avoid dependence on a single source of supply. As a result, our customers would likely purchase products from our competitors. Current and potential competitors include AMST Co., Ltd., Feinmetall GmbH, Japan Electronic Materials Corporation, Korea Instrument Co., Ltd., SV Probe Inc., Micronics Japan Co., Ltd., Microfriend Inc., MicroProbe Inc., Phicom Corporation, Technoprobe Asia Pte. Ltd., Tokyo Cathode Laboratory Co., Ltd., TSE Co., Ltd., Verigy Ltd., and Wentworth Laboratories, Inc., among others. Many of our current and potential competitors have greater name recognition, larger customer bases, more established customer relationships or

## Edgar Filing: FORMFACTOR INC - Form 10-Q

greater financial, technical, manufacturing, marketing and other resources than we do. As a result, they might be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion, sale and support of their products, and reduce prices to increase market share. Some of our competitors also supply other types of test equipment, or offer both advanced wafer probe cards and needle probe cards. Those competitors that offer both advanced wafer probe cards and needle probe cards might have strong, existing relationships with our existing customers or with potential customers. Because we do not offer a needle probe card or other conventional technology wafer probe card for less advanced applications, it may be difficult for us to introduce our advanced wafer probe cards to these customers and potential customers for certain wafer test applications. It is also possible that one or more of our competitors may be able to increase their relative revenue with mutual customers, resulting in a loss of revenue share to us. It is further possible that existing or new competitors, including test equipment manufacturers, may offer new technologies that reduce the value of our wafer probe cards.

Table of Contents

***If we fail to protect our proprietary rights, our competitors might gain access to our technology, which could adversely affect our ability to compete successfully in our markets and harm our operating results.***

If we chose not to protect our proprietary rights adequately or fail in our efforts to protect our proprietary rights, our competitors might gain access to our technology. Unauthorized parties might attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. Others might independently develop similar or competing technologies or methods or design around our patents. In addition, the laws of many foreign countries in which we or our customers do business do not protect our intellectual property rights to the same extent as the laws of the United States. To date, we have not been successful in our efforts to enforce our proprietary rights in South Korea. As a result, our proprietary rights could be compromised, our competitors might offer products similar to ours and we might not be able to compete successfully. We also cannot assure that:

- our means of protecting our proprietary rights will be adequate;
  
- patents will be issued from our pending or future applications;
  
- our existing or future patents will be sufficient in scope or strength to provide any meaningful protection or commercial advantage to us;
  
- our patents or other intellectual property will not be invalidated, circumvented or successfully challenged in the United States or foreign countries; or
  
- others will not misappropriate our proprietary technologies or independently develop similar technologies, duplicate our products or design around any of our patents or other intellectual property, or attempt to manufacture and sell infringing products in countries that do not strongly enforce intellectual property rights.

We have spent in the past and may be required to spend in the future significant resources to monitor and protect our intellectual property rights. We presently believe that it is likely that two or more of our competitors are using methodologies or have implemented structures into certain of their products that are covered by one or more of our intellectual property rights. We have in the past brought claims to protect our rights, and we are currently involved in patent infringement litigation, including an ongoing proceeding against two competitors before the International Trade Commission, or ITC. The ITC administrative law judge issued a decision, or initial determination, on June 29, 2009, which did not find infringement of our asserted claims under the four U.S. patents at issue and therefore, did not find a violation of Section 337 of the Tariff Act of 1930. On September 14, 2009, the ITC issued a notice providing that it would review part of the Initial Determination, but the only infringement finding to be reviewed is Phicom's infringement of one of the asserted patents. We may not obtain a favorable ruling from the ITC. In certain cases, our competitors have initiated re-examination proceedings in the U.S. Patent and Trademark Office and invalidity proceedings in foreign patent offices against certain of our patents. Any litigation, whether or not resolved in our favor, and whether initiated by us or by a third party, could result in significant and possibly material expense to us and divert the efforts of our management and technical personnel. In addition, while patents are territorial and a ruling on a certain given patent does not necessarily impact the validity or enforceability of a corresponding or related patent in a different country, an adverse ruling in one country might negatively impact our ability to enforce the corresponding or related

## Edgar Filing: FORMFACTOR INC - Form 10-Q

patent in other countries. Finally, certain of our customer contracts contain provisions that require us to defend and/or indemnify our customers for third party intellectual property infringement claims, which would increase the cost to us of an adverse ruling in such a claim. An adverse determination could also negatively impact our ability to license certain of our technologies and methods to others, and result in our competitors being allowed to sell products with, or add to their products, features and benefits contained in our products, thereby reducing our competitive advantages over these competing products.

*If we do not innovate and keep pace with technological developments in the semiconductor industry, our products might not be competitive and our revenues and operating results could suffer.*

We must continue to innovate and to invest in research and development to improve our competitive position and to meet the testing requirements of our customers. Our future growth depends, in significant part, upon our ability to work effectively with and anticipate the testing needs of our customers and to develop and support new products and product enhancements to meet these needs on a timely and cost-effective basis. Our customers' testing needs are becoming more challenging as the semiconductor industry continues to experience rapid technological change driven by the demand for complex circuits that are shrinking in size and at the same time are increasing in speed and functionality and becoming less expensive to produce. Examples of trends driving demand for technological research and development include semiconductor manufacturers' transitions to 70 and below nanometer technology nodes, to one gigabit density devices, to Double Data Rate II, or DDR II, architecture devices, and to Double Data Rate III, or DDR III, architecture devices. Our customers expect that they will be able to integrate our wafer probe cards into any manufacturing process as soon as it is deployed. Therefore, to meet these expectations and remain competitive, we must continually design, develop and introduce on a timely basis new products and product enhancements with improved features. For example, in October 2009, we acquired certain intellectual property rights and other technology assets related to precision motion control automation from Electroglas, a company under Chapter 11 bankruptcy protection, which had been an important technology partner in the development of certain manufacturing equipment for future products. However, it is unclear whether we will be able to proceed with the development effort on the same timeline and any delay in the timeline could negatively impact our financial results. It is possible that

Table of Contents

our internal development efforts and engagements with third parties regarding the development of manufacturing equipment having similar functionality may have a lengthy bring-up time and negatively impact our ability to complete new products and realize revenue from those products.

Successful product design, development and introduction on a timely basis require that we:

- design innovative and performance-enhancing product architectures, technologies and features that differentiate our products from those of our competitors;
- in some cases engage with third parties who have particular expertise in order to complete one or more aspects of the design and manufacturing process;
- transition our products to new manufacturing technologies;
- identify emerging technological trends in our target markets;
- maintain effective marketing strategies;
- respond effectively to technological changes or product announcements by others; and
- adjust to changing market conditions quickly and cost-effectively.

Not only do we need the technical expertise to implement the changes necessary to keep our technologies current, but we must also rely heavily on the judgment of our management to anticipate future market trends. If we are unable to timely predict industry changes, or if we are unable to modify our products or design, manufacture and deliver new products on a timely basis, or if a third party with which we engage does not timely deliver a component or service for one of our product modifications or new products, we might lose customers or market share. In addition, we might not be able to recover our research and development expenditures, which could harm our operating results.

*If semiconductor manufacturers do not migrate elements of final test to wafer probe test, market acceptance of other applications of our technology could be delayed.*

We are working with some existing and new customers as they evolve the focus of their semiconductor test efforts from the individual device level to the wafer level. This evolution is typically a long-term process in which the outcome and the affect on our business is not clear. Semiconductor manufacturers might not adopt wafer-level final test in a way that uses our technology. Our technology to perform elements of final test on the wafer may not scale with the needs of semiconductor manufacturers. Further, the pace and manner in which wafer-level testing is adopted will also vary by manufacturer and will be affected by factors like capital tooling cycles and end market growth in different application segments. We believe, for example, that testing in stacked packaging or 3-D packaging applications is more likely to migrate to wafer level test than other applications. If the migration of elements of final test to wafer probe test does not grow as we anticipate, or if semiconductor manufacturers do not adopt our technology for their wafer probe test requirements, market acceptance of other applications for our technology could be delayed. In addition, to the extent manufacturers do not invest in wafer test technology enabling the identification of known good die, or KGD, or if the projected or anticipated investment in such technology is delayed or reduced, it could delay the introduction of certain of our technologies and negatively affect our business.

*Changes in test strategies, equipment and processes could cause us to lose revenues.*

The demand for wafer probe cards depends in large part upon the number of semiconductor designs, the pace of technology and architecture transitions in chip designs, and overall semiconductor unit volume. The time it takes to test a wafer depends upon the number of devices being tested, the complexity of these devices, the test software program and the test equipment itself. As test programs become increasingly effective and test throughput increases, the number of wafer probe cards required to test a given volume of devices declines. Therefore, advances in the test process could cause us to lose sales. Further, most semiconductor manufacturers are implementing chip designs featuring built-in self-test (BIST) capabilities or similar design for testability (DFT) functions or methodologies that increase test throughput and reduce the cost of test. These efforts include strategies to reduce the technical requirements on test equipment, or to improve gather data about device performance early in the manufacturing process, or to test the device later in the life of the product for quality assurance purposes. In some cases, BIST or DFT can create opportunities for our technologies. In other cases BIST or DFT can reduce requirements for wafer level test and therefore reduce our opportunities. Although we seek to work with our customers to show ways that our technologies can be applied together with BIST and DFT approaches to create opportunities to further reduce the cost of test, the overall impact of BIST and DFT technologies, as they exist today and as they may be developed in the future, could slow the migration to wafer level testing and adversely affect our revenues. Similar results could occur if new chip designs are implemented which we are unable to test efficiently, or if semiconductor manufacturers reduce generally the amount or degree of wafer test they perform. We incur significant research and development expenses in conjunction with the introduction of new product architectures and platforms. Often, we time our product introductions to

Table of Contents

the introduction of new test equipment platforms or the declination of manufacturers to adopt a new test platform. Because our customers require both test equipment and wafer probe cards, any delay or disruption in the introduction of new test equipment platforms would negatively affect our growth.

***If the Company does not execute planned cost reduction measures timely and successfully, the Company may not meet certain operational goals and it could result in the Company incurring total costs and expenses that are greater than expected.***

The Company has implemented cost reduction measures over the last few years and is continuing to implement such measures in an effort to improve the Company's expense structure. Such actions have included workforce reductions, the movement of certain manufacturing activities to geographic areas that are closer to the Company's customers, the bring-up of a shared service center, the consolidation of manufacturing capacity, and the centralization of support functions to regional and global shared service centers. The Company expects to realize cost savings in the future through these actions and may announce future actions to further improve its operating expenses. The risks associated with these actions include potential delays in their implementation, increased shorter term costs associated with such actions, such as the need to provide internal training and resources as certain activities are moved from one location to a different location and the need to retain duplicative capabilities; the failure to meet operational targets due to, for example, unplanned departures of employees and excessive training requirements, which could result in the Company incurring greater than anticipated operating expenses and, consequently, overall lower operating results.

***We have recorded significant restructuring, inventory write-off and asset impairment charges in the past and may do so again in the future, which could have a material negative impact on our business.***

We recorded material restructuring charges related to our global workforce reductions and impairment charges related to our long-lived assets in the first and second quarters of fiscal 2008 and the first quarter of fiscal 2009. If the current challenging economic conditions persist, we may implement additional cost-reduction actions, which would require us to take additional, potentially material, restructuring charges related to, among other things, employee terminations or asset disposal or exit costs. We may also be required to write off additional inventory if our product build plans or usage of inventory experience further declines, and such additional write-offs could constitute material charges. In addition, a further decline in our stock price or significant adverse change in market conditions could require us to take additional material impairment charges related to our long-lived assets. Our long-lived assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment annually, or whenever events or changes in circumstances indicate that their carrying amount may not be recoverable. The valuation of our long-lived assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. Declines in our stock price, or any other adverse change in market conditions, particularly if such change has the effect of changing one of the critical assumptions or estimates we used to calculate the amount of impairment charge, could result in a change to the estimation of fair value that could result in future impairment charges. Any such additional material charges, whether related to restructuring or asset impairment, may have a material negative impact on our operating results and related financial statements.

***Changes in our tax rates, inability to realize our deferred tax assets or exposure to additional tax liabilities could adversely affect our operating results.***

We are subject to income taxes in both the United States and various foreign jurisdictions, and our domestic and international tax liabilities are subject to the allocation of expenses in different jurisdictions. Our effective tax rate could be adversely affected by changes in the mix of earnings in countries with different statutory tax rates, the inability to realize our deferred tax assets, as a result of recurring losses, changes in

## Edgar Filing: FORMFACTOR INC - Form 10-Q

tax laws such as reducing the export sales and research and development tax credits, changes in our operational activities in connection with implementation of our global regionalization strategy, and material audit assessments. For example, realization of our deferred tax assets, which are predominantly in the United States, is dependent on our ability to generate sufficient future taxable income in the United States. If we determine that we may not be able to realize some portion of our deferred tax assets in the future, we would record a valuation allowance against the deferred tax assets that could result in additional income tax expense. For example, in the second quarter of fiscal 2009, we recorded a non-cash charge of \$44.7 million to establish a valuation allowance against the excess tax benefits recognized in prior quarters since they are no longer more likely than not realizable. This valuation allowance will not limit our ability to utilize our federal and state deferred tax assets to offset future U.S. profits. In addition, the amount of income taxes we pay could be subject to ongoing audits in various jurisdictions and a material assessment by a governing tax authority could adversely affect our operating results.



Table of Contents

*Our equity plans have evergreen provisions that automatically increase the number of shares available for issuance each year without stockholder approval, and as a result of this annual increase in shares, you may experience dilution and we may not seek your approval for further additions to our existing plans or for new plans.*

Our 2002 Equity Incentive Plan and 2002 Employee Stock Purchase Plan have evergreen provisions that automatically increase the number of shares available for issuance under these plans each year without stockholder approval. Specifically, our 2002 Equity Incentive Plan's evergreen provision increases the number of shares available for issuance on each January 1st by an amount equal to 5% of the total amount of the company's outstanding common stock as of December 31st of the prior year, and our 2002 Employee Stock Purchase Plan's evergreen provision increases the number of shares available for issuance on each January 1st by an amount equal to 1% of the total amount of the company's outstanding common stock as of December 31st of the prior year. These evergreen provisions, which have a compounding effect, have been in place since the adoption of the plans in 2003. In 2009, these evergreen provisions added 2,453,115 shares to the 2002 Equity Incentive Plan and 490,623 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2009. In 2008, these evergreen provisions added 2,432,112 shares to the 2002 Equity Incentive Plan and 486,422 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2008, and we had 49,062,308 shares of common stock outstanding on December 27, 2008. In 2007, these evergreen provisions added 2,343,067 shares to the 2002 Equity Incentive Plan and 468,613 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2007, and we had 48,642,258 shares of common stock outstanding on December 29, 2007. In 2006, these evergreen provisions added 2,011,834 shares to the 2002 Equity Incentive Plan and 402,366 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2006, and we had 46,861,334 shares of common stock outstanding on December 30, 2006. In 2005, these evergreen provisions added 1,944,281 shares to the 2002 Equity Incentive Plan and 388,856 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2005, and we had 40,236,686 shares of common stock outstanding on December 31, 2005. In 2004, these evergreen provisions added 1,840,502 shares to the 2002 Equity Incentive Plan and 368,100 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2004, and we had 38,885,637 shares of common stock outstanding on December 25, 2004. Since the adoption of the plans, we have added 13,024,911 shares to the 2002 Equity Incentive Plan and 2,604,980 shares under the 2002 Employee Stock Purchase Plan. Due to the annual increase in the amount of shares available for issuance under these equity plans and to the extent that we issue these shares and they become outstanding, you will continue to experience dilution. While the equity plans are in effect, it is more likely that due to the plans' evergreen provision, we will not ask our stockholders to approve or disapprove further additions to the plans. In addition, while the equity plans are in effect, it is more likely that due to the plans' evergreen provisions, we will not ask our stockholders to approve or disapprove the adoption of any new equity plans.

**Item 5. Other Matters**

In our third quarter earning release, included in our Form 8-K filed on October 28, 2009, we disclosed non-GAAP net loss of \$20.9 million, or \$0.42 per share, for the three months ended September 26, 2009. The non-GAAP net loss figures excluded the effect of stock-based compensation, including the tax benefit of such expense, but did not reflect that a corresponding valuation allowance was established for the tax benefit. As a result, non-GAAP net loss should have been reported as \$19.4 million, or \$0.39 per share.

**Item 6. Exhibits**

The following exhibits are filed herewith:

Exhibit Number	Exhibit Description	Incorporated by Reference			Filed Herewith
		Form	Date	Number	

Edgar Filing: FORMFACTOR INC - Form 10-Q

31.01	Certification of Chief Executive Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X
31.02	Certification of Chief Financial Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X
32.01*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X

---

\* This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing 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.

Table of Contents

**SIGNATURE**

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.

FORMFACTOR, INC.

By:

/s/ JEAN B. VERNET  
Jean B. Vernet  
Chief Financial Officer  
*(Principal Financial Officer and Principal Accounting  
Officer)*

Date: November 5, 2009

Table of Contents

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Exhibit Description</b>	<b>Incorporated by Reference</b>			<b>Filed Herewith</b>
		<b>Form</b>	<b>Date</b>	<b>Number</b>	
31.01	Certification of Chief Executive Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
31.02	Certification of Chief Financial Officer pursuant to 15 U.S.C. Section 7241, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002				X
32.01*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002				X

---

\* This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing 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.