

FORMFACTOR INC  
Form 10-Q  
November 13, 2007

**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 29, 2007

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.)

**7005 Southfront Road, Livermore, California 94551**

(Address of principal executive offices, including zip code)

**(925) 290-4000**

(Registrant's telephone number, including area code)

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

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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 26, 2007, 48,595,941 shares of the registrant's common stock, par value \$0.001 per share, were outstanding.

---

FORMFACTOR, INC.

FORM 10-Q FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 29, 2007

INDEX

<b>Part I.</b>	<b><u>Financial Information</u></b>	3
<u>Item 1.</u>	<u>Financial Statements:</u>	3
	<u>Unaudited Condensed Consolidated Statements of Income for the three and nine months ended September 29, 2007 and September 30, 2006 (As Restated)</u>	3
	<u>Unaudited Condensed Consolidated Balance Sheets as of September 29, 2007 and December 30, 2006 (As Restated)</u>	4
	<u>Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 29, 2007 and September 30, 2006 (As Restated)</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>	16
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	24
<u>Item 4.</u>	<u>Controls and Procedures</u>	24
<b>Part II.</b>	<b><u>Other Information</u></b>	25
<u>Item 1.</u>	<u>Legal Proceedings</u>	25
<u>Item 1A.</u>	<u>Risk Factors</u>	25
<u>Item 6.</u>	<u>Exhibits</u>	28
<u>Signature</u>		29
<u>Exhibit Index</u>		30

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## FORMFACTOR, INC.

**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(In thousands, except per share amounts)  
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006 As Restated	September 29, 2007	September 30, 2006 As Restated
Revenues	\$ 125,291	\$ 96,757	\$ 341,686	\$ 270,520
Cost of revenues	58,609	47,578	156,563	133,956
Gross margin	66,682	49,179	185,123	136,564
Operating expenses:				
Research and development	16,219	11,994	44,704	33,397
Selling, general and administrative	23,365	19,321	69,349	53,034
Total operating expenses	39,584	31,315	114,053	86,431
Operating income	27,098	17,864	71,070	50,133
Interest income	5,766	4,485	16,767	10,196
Other income	415	59	234	45
Income before income taxes	33,279	22,408	88,071	60,374
Provision for income taxes	11,056	7,282	29,532	20,613
Net income	\$ 22,223	\$ 15,126	\$ 58,539	\$ 39,761
Net income per share:				
Basic	\$ 0.46	\$ 0.33	\$ 1.23	\$ 0.89
Diluted	\$ 0.45	\$ 0.31	\$ 1.19	\$ 0.85
Weighted-average number of shares used in per share calculations:				
Basic	48,291	46,417	47,757	44,625
Diluted	49,729	48,494	49,335	46,690

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

## FORMFACTOR, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share and per share amounts)

(Unaudited)

	September 29, 2007	December 30, 2006 As Restated
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 283,391	\$ 284,131
Marketable securities	253,802	208,263
Accounts receivable	86,191	54,571
Inventories	32,568	18,926
Deferred tax assets	14,551	14,496
Prepaid expenses and other current assets	15,338	12,138
Total current assets	685,841	592,525
Restricted cash	2,250	2,250
Property and equipment, net	118,975	94,064
Deferred tax assets	7,610	4,689
Other assets	10,108	945
Total assets	\$ 824,784	\$ 694,473
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 43,883	\$ 31,273
Accrued liabilities	21,749	28,334
Income taxes payable	40	7,979
Deferred revenue and customer advances	6,674	7,273
Deferred rent	471	448
Total current liabilities	72,817	75,307
Long term income taxes payable	10,991	
Deferred rent and other long term liabilities	5,934	5,125
Total liabilities	89,742	80,432
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred Stock, \$0.001 par value:		
10,000,000 shares authorized; no shares issued and outstanding at September 29, 2007 and December 30, 2006, respectively		
Common stock, \$0.001 par value:		
250,000,000 shares authorized; 48,589,467 and 46,861,334 shares issued and outstanding at September 29, 2007 and December 30, 2006, respectively		
	49	47
Additional paid-in capital	566,348	504,709
Accumulated other comprehensive income (loss)	577	(244)
Retained earnings	168,068	109,529
Total stockholders' equity	735,042	614,041
Total liabilities and stockholders' equity	\$ 824,784	\$ 694,473

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

## FORMFACTOR, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	September 29, 2007	September 30, 2006 As Restated
<b>Cash flows from operating activities:</b>		
Net income	\$ 58,539	\$ 39,761
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	19,570	15,919
Stock-based compensation expense	19,960	15,316
Deferred income taxes	(2,950)	(1,650)
Excess tax benefits from equity based compensation plans	(7,486)	(13,448)
Provision for excess and obsolete inventories	9,540	12,017
Loss on disposal of equipment	576	378
Changes in assets and liabilities:		
Accounts receivable	(31,619)	(10,122)
Inventories	(23,094)	(16,222)
Prepaid expenses and other current assets	(2,555)	(5,472)
Other assets	(8,950)	(599)
Accounts payable	7,612	4,867
Accrued liabilities	(8,833)	16,853
Income taxes payable	11,745	(3,187)
Deferred rent	484	1,464
Deferred revenues and customer advances	(538)	2,968
Net cash provided by operating activities	42,001	58,843
<b>Cash flows from investing activities:</b>		
Acquisition of property and equipment	(37,107)	(26,862)
Purchase of marketable securities	(164,397)	(202,929)
Proceeds from maturities and sales of marketable securities	118,491	201,340
Net cash used in investing activities	(83,013)	(28,451)
<b>Cash flows from financing activities:</b>		
Proceeds from issuance of common stock	32,906	201,289
Excess tax benefits from equity based compensation plans	7,486	13,448
Net cash provided by financing activities	40,392	214,737
Effect of exchange rate changes on cash and cash equivalents	(120)	19
Net increase (decrease) in cash and cash equivalents	(740)	245,148
Cash and cash equivalents, beginning of the period	284,131	31,217
Cash and cash equivalents, end of the period	\$ 283,391	\$ 276,365
<b>Supplemental disclosure of significant non-cash investing activities:</b>		
Purchases of property and equipment through accounts payable and accrued liabilities	\$ 7,130	\$ 2,671

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

**FORMFACTOR, INC.**

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

**Note 1 Basis of Presentation**

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

**Basis of presentation.** The accompanying unaudited condensed consolidated 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 ). Accordingly, the 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 (consisting only of normal recurring adjustments) considered necessary for a fair statement have been included. Operating results for the three and nine months ended September 29, 2007 are not necessarily indicative of the results that may be expected for the year ending December 29, 2007, or for any other period. The balance sheet at December 30, 2006 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 30, 2006 included in the Company s Annual Report on Form 10-K/A filed with the SEC.

**Fiscal Year.** The Company operates on a 52/53 week fiscal year, whereby the year ends on the Saturday nearest December 31. Fiscal year 2007 will end on December 29, 2007, and will consist of 52 weeks.

### **Note 2 Restatement of Financial Statements**



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

The Company completed a review of its historical practices with respect to inventory valuation. That review indicated that during fiscal 2006 and the first half of fiscal 2007 the Company did not consistently follow its accounting policies for valuing inventory resulting in a material misstatement of inventory and cost of revenue. The change in inventory valuation impacted the amount of stock based compensation capitalized into inventory due to the change in inventory turns. As a result, the Board of Directors determined on November 8, 2007 that the Company would restate 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 impacts of these adjustments including the related tax impact are described below in the following tables.

Edgar Filing: FORMFACTOR INC - Form 10-Q

The following table presents the impact of the restatement adjustments on the Company's Condensed Consolidated Balance Sheet as of September 30, 2006:

	As Previously Reported	September 30, 2006 Effect of Restatement (In thousands, except share)		Restated
<b>ASSETS</b>				
Current assets:				
Cash and cash equivalents	\$ 276,365			\$ 276,365
Marketable securities	181,128			181,128
Accounts receivable,	54,097			54,097
Inventories	26,317	\$ (3,257)		23,060
Deferred tax assets	11,233			11,233
Prepaid expenses and other current assets	12,674			12,674
Total current assets	561,814	(3,257)		558,557
Restricted cash	2,250			2,250
Property and equipment, net	87,398			87,398
Deferred tax assets	6,270			6,270
Other assets	994			994
Total assets	\$ 658,726	(3,257)		\$ 655,469
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>				
Current liabilities:				
Accounts payable	\$ 27,346			\$ 27,346
Accrued liabilities	21,850			21,850
Income tax payable	7,653	\$ (1,150)		6,503
Deferred revenue and customer advances	353			353
Deferred rent	6,556			6,556
Total current liabilities	63,758	(1,150)		62,608
Deferred rent and other liabilities	4,559			4,559
Total liabilities	68,317	(1,150)		67,167
Stockholders' equity				
Preferred stock, \$0.001 par value:				
Common stock, \$0.001 par value:	47			47
Additional paid-in capital	496,296			496,296
Deferred stock-based compensation				
Accumulated other comprehensive loss	(114)			(114)
Retained earnings	94,180	(2,107)		92,073
Total stockholders' equity:	590,409	(2,107)		588,302
Total liabilities and stockholders' equity	\$ 658,726	\$ (3,257)		\$ 655,469

Edgar Filing: FORMFACTOR INC - Form 10-Q

The following table presents the impact of the restatement adjustments on the Company's Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2006:

	Three Months Ended September 30, 2006			Nine Months Ended September 30, 2006		
	As Previously Reported	Effect of Restatement (In thousands except per share data)	Restated	As Previously Reported	Effect of Restatement (In thousands except per share data)	Restated
Revenues	\$ 96,757		\$ 96,757	\$ 270,520		\$ 270,520
Cost of revenues	46,492	\$ 1,086	47,578	130,699	\$ 3,257	133,956
Gross margin	50,265	(1,086)	49,179	139,821	(3,257)	136,564
Operating expenses:						
Research and development	11,994		11,994	33,397		33,397
Selling, general and administrative	19,321		19,321	53,034		53,034
Total operating expenses	31,315		31,315	86,431		86,431
Operating income	18,950	(1,086)	17,864	53,390	(3,257)	50,133
Interest income	4,485		4,485	10,196		10,196
Other income	59		59	45		45
Income before income taxes	23,494	(1,086)	22,408	63,631	(3,257)	60,374
Provision for income taxes	7,675	(393)	7,282	21,763	(1,150)	20,613
Net income	\$ 15,819	\$ (693)	\$ 15,126	\$ 41,868	\$ (2,107)	\$ 39,761
Net income per share:						
Basic	\$ 0.34	\$ (0.01)	\$ 0.33	\$ 0.94	\$ (0.05)	\$ 0.89
Diluted	\$ 0.33	\$ (0.02)	\$ 0.31	\$ 0.90	\$ (0.05)	\$ 0.85
Weighted-average number of shares used in per share calculations:						
Basic	46,417	46,417	46,417	44,625	44,625	44,625
Diluted	48,494	48,494	48,494	46,690	46,690	46,690

The following table presents the impact of the restatement adjustments on the Company's Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2006:

	Three Months Ended September 30, 2006			Nine Months Ended September 30, 2006		
	As Previously Reported	Effect of Restatement (In thousands)	Restated	As Previously Reported	Effect of Restatement (In thousands)	Restated
Components of other comprehensive income:						
Change in unrealized loss on marketable securities, net of tax	\$ 722		\$ 722	\$ 199		\$ 199
Translation adjustments	(29)		(29)	46		46
Net income	15,819	(693)	15,126	41,868	(2,107)	39,761
Comprehensive income	\$ 16,512	\$ (693)	\$ 15,819	\$ 42,113	\$ (2,107)	\$ 40,006

The restatement adjustments did not impact the total net cash flows from total operating, financing, or investing activities in the condensed consolidated statements of cash flows for the three and nine months ended September 30, 2006. Additionally, all notes to the consolidated financial statements affected by the restatements have been labeled as restated.

**Note 3 Significant Accounting Policies**

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

The Company's significant accounting policies are disclosed in the Company's Annual Report on Form 10-K/A for the year ended December 30, 2006. The Company adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109, ( FIN 48 ) as of the first day of the first quarter of fiscal 2007. The Company has not otherwise materially changed its significant accounting policies.

**Income Taxes**

The Company adopted FIN 48 on December 31, 2006, the first day of the first quarter of fiscal 2007. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN 48 provides guidance on derecognition, statement of operations classification of interest and penalties, accounting in interim periods, disclosure, and transition. As a result of the implementation of FIN 48, the Company's tax assets and liabilities did not differ from the assets and liabilities before adoption. Therefore, the Company did not record any cumulative effect adjustment as of the adoption date. See Note 9 - Income Taxes for additional information.

**Note 4 Departure of Executive Officer**

On January 30, 2007, the Company entered into a Separation Agreement and General Release (the Separation Agreement) with its former President and member of Office of Chief Executive, Joseph R. Bronson, who resigned from the Company effective January 5, 2007. Mr. Bronson also resigned from the Board of Directors of the Company effective January 5, 2007.

In the first quarter of fiscal 2007, in conjunction with the Separation Agreement, the Company recorded a charge of approximately \$1.8 million consisting primarily of a \$400,000 severance payment and approximately \$1.4 million in stock-based compensation resulting from the accelerated vesting of a portion of his unvested stock options and all of his remaining unvested restricted stock units.

**Note 5 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. Adjustments for potential excess and obsolete inventory 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.

Inventories consisted of the following:

	September 29, 2007	December 30, 2006 As Restated
	(In thousands)	
Raw materials	\$ 13,300	\$ 7,354
Work-in-progress	12,827	9,566
Finished goods	6,441	2,006
	\$ 32,568	\$ 18,926

**Note 6 Warranty**

The Company offers warranties on its products, other than certain evaluation and early adopter products that are sold without warranty, 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 consolidated income statement as a cost of revenues. A reconciliation of the changes in the Company's warranty liability (included in accrued liabilities) for the three and nine months ended September 29, 2007 and September 30, 2006, respectively, follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
Warranty accrual beginning balance	\$ 1,140	\$ 1,012	\$ 778	\$ 511
Accrual for warranties issued during the period	1,867	227	4,500	1,051
Settlements made during the period	(1,294)	(533)	(3,565)	(856)
Warranty accrual ending balance	\$ 1,713	\$ 706	\$ 1,713	\$ 706



**Note 7 Stock-Based Compensation**

The Company recorded stock-based compensation for the three and nine months ended September 29, 2007 and September 30, 2006 as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006 As Restated	September 29, 2007	September 30, 2006 As Restated
(In thousands)				
Stock-based compensation expense by type of award:				
Employee stock options (1)	\$ 5,501	\$ 5,195	\$ 16,940	\$ 13,672
Employee stock purchase plan	623	880	2,225	1,820
Restricted stock units (2)	32	92	880	276
Net change in amounts capitalized as inventory	(36)	(94)	(85)	(452)
Total stock-based compensation	\$ 6,120	\$ 6,073	\$ 19,960	\$ 15,316

(1) The nine months ended September 29, 2007 includes approximately \$575,000 in stock-based compensation resulting from the acceleration of the vesting of a portion of the Company's former President's stock options in conjunction with his Separation Agreement (See Note 4 - Departure of Executive Officer).

(2) The nine months ended September 29, 2007 includes approximately \$798,000 in stock-based compensation resulting from the acceleration of the Company's former President's remaining unvested restricted stock units in conjunction with his Separation Agreement (See Note 4 - Departure of Executive Officer).

*Equity Incentive Plans*

The Company has four incentive plans: 1996 Stock Option Plan, Incentive Option Plan and Management Incentive Option Plan (collectively, the Plans) and 2002 Equity Incentive Plan (2002 Plan), which became effective in June 2002. As a result of the effectiveness of the 2002 Plan, the Company ceased granting any options under the Plans.

*Stock Options*

The following weighted average assumptions were used in the estimated grant-date fair value calculations using the Black-Scholes option pricing model for stock options for the three and nine months ended September 29, 2007 and September 30, 2006, respectively:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
<b>Stock Options:</b>				
Dividend yield				
Expected volatility	45.0%	52.9%	44.4%	50.2%
Risk-free interest rate	4.44%	4.93%	4.62%	4.92%
Expected life (in years)	4.75	4.75	4.71	4.82

Stock option activity under the Plans and the 2002 Plan is set forth below:

	Shares Available	Options Outstanding	Weighted- Average Exercise Price
Balances, December 30, 2006	3,390,293	7,118,946	\$ 24.39
Additional shares reserved	2,342,743		
Options granted	(1,468,668)	1,468,668	41.86
Options exercised		(1,450,542)	18.16
Options forfeited	634,452	(634,452)	33.31
Balances, September 29, 2007	4,898,820	6,502,620	\$ 28.86





*Restricted Stock Units*

Restricted stock units are converted into shares of the Company's common stock upon vesting on a one-for-one basis. The vesting of restricted stock units is subject to the employee's continuing service to the Company. The cost of these awards is determined using the fair value of the Company's common stock on the date of the grant, and compensation cost is recognized over the vesting period. Restricted stock units generally vest over four years.

Activity of the restricted stock units under the 2002 Plan during the nine months ended September 29, 2007 is set forth below:

	Units	Weighted Average Grant Date Fair Value
Restricted stock units at December 30, 2006	37,324	\$ 25.46
Vested (1)	(28,824)	26.02
Restricted stock units at September 29, 2007	8,500	\$ 23.56

(1) In January 2007, 9,608 shares of the former President's restricted stock units vested. The remaining 19,216 shares of restricted stock units vested on an accelerated basis under the Separation Agreement with the former President (See Note 4 - Departure of Executive Officer).

*Employee Stock Purchase Plan*

The 2002 Employee Stock Purchase Plan (the "ESPP") provides that eligible employees may contribute up to 15% of their eligible earnings toward the semi-annual purchase of the Company's common stock. Under the ESPP, employees may purchase the Company's common stock through payroll deductions at a price equal to 85% of the lower of the fair market value at the beginning of the applicable offering period or at the end of each applicable purchase period. Each offering period has generally been two years in length, consisting of four six month purchase periods. Effective from February 1, 2007, the new offering periods under the ESPP are a 12 month fixed offering period commencing on February 1 of each calendar year and ending on January 31 of the subsequent calendar year, and a six month fixed offering period commencing on August 1 of each calendar year and ending on January 31 of the subsequent calendar year. The 12 month offering period consists of two six month purchase periods and the six month offering period consists of one six month purchase period. During the nine months ended September 29, 2007 and September 30, 2006, 253,253 shares and 209,789 shares, respectively, were issued under the ESPP. As of September 29, 2007, the Company had \$0.8 million of total unrecognized deferred stock-based compensation related to ESPP grants, which will be recognized over the weighted average period of 0.5 years. Compensation expense is calculated using the fair value of the employees' purchase rights under the Black-Scholes model.

The following assumptions were used in the estimated fair value calculations for the employees' purchase rights:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
<b>ESPP:</b>				
Dividend yield				
Expected volatility	37.9%	49.1%	41.1%	48.0%
Risk-free interest rate	4.96%	4.34%	5.02%	4.19%
Expected life (in years)	0.5	1.43	.73	1.39

**Note 8 Net Income per Share**

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted net income per share is computed giving effect to all potential dilutive common stock, including stock options, restricted stock units and common stock subject to repurchase.

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

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

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006 As Restated	September 29, 2007	September 30, 2006 As Restated
<b>Basic net income per share</b>				
Numerator:				
Net income	\$ 22,223	\$ 15,126	\$ 58,539	\$ 39,761
Denominator:				
Weighted-average common stock outstanding	48,291	46,417	47,757	44,625
<b>Diluted net income per share</b>				
Numerator:				
Net income	\$ 22,223	\$ 15,126	\$ 58,539	\$ 39,761
Denominator:				
Weighted-average shares used in computing basic net income per share	48,291	46,417	47,757	44,625
Add: Dilutive potential common shares used in computing diluted net income per share	1,438	2,077	1,578	2,065
Weighted-average number of shares used in computing diluted net income per share	49,729	48,494	49,335	46,690

The following outstanding options to purchase common stock were excluded from the computation of diluted net income per share as they had an antidilutive effect (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
Options to purchase common stock	2,947	1,932	2,635	1,986

### Note 9 Income Taxes

On December 31, 2006, the Company adopted FIN 48. As a result of the implementation of FIN 48, the Company's tax assets and liabilities did not differ from the assets and liabilities before adoption, therefore, the Company did not record any adjustments as of the adoption date. In addition, consistent with the provisions of FIN 48, the Company reclassified \$9.8 million of income tax liabilities from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date and the Company is unable to make a reasonably reliable estimate when cash settlement with a taxing authority will occur. At the adoption date of December 31, 2006, the Company had \$16.7 million of total gross unrecognized tax benefits. Of this total, \$14.0 million (net of the federal benefit on state issues) of unrecognized tax benefits would impact our effective tax rate if recognized and the remaining \$2.7 million would impact the valuation allowance. At September 29, 2007, we added an additional \$2.7 million gross unrecognized tax benefit of which \$2.3 million of unrecognized tax benefits would impact our effective tax rate if recognized. During the quarter ended September 29, 2007 we released \$1.9 million liability due to the expiration of the statute of limitations.

The Company continues to recognize interest and penalties related to uncertain tax positions in income tax expense. Upon adoption the Company had approximately \$545,000 of accrued interest and \$0 of penalties related to uncertain tax positions. As of September 29, 2007 the Company had approximately \$729,000 of accrued interest and \$0 of penalties related to uncertain tax positions.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, various states and non-U.S. jurisdictions. The Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years prior to 2001.

The Company does not expect that the amounts of unrecognized tax benefits will change significantly within the next 12 months. Changes to the estimate would be the result of audits or statute of limitation expirations, which are due to expire but not anticipated to occur because we are scheduled for or currently under audit by the relevant tax authorities in the U.S. and California.



**Note 10 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 the Company. In fiscal 2006 and January 2007, the Company received a total of three notices from the City of Livermore regarding violation of certain applicable discharge limits. For each notice received, the Company promptly took appropriate steps to address the violations noted. The Company is also implementing certain corrective measures in consultation with the City of Livermore. In addition, the Company and the City of Livermore are discussing the Company's purchase of additional waste water discharge capacity, which the Company requires as a result of its increased manufacturing capacity. No provision has been made for loss from environmental remediation liabilities associated with the Livermore sites, because the Company believes that it is not probable that a liability has been incurred as of September 29, 2007.

While the Company believes it is in compliance in all material respects with the environmental laws and regulations that apply to the Company, in the future the Company may receive additional environmental violation notices, and if received, final resolution of the violations identified by these notices could impact the Company's operations, which may adversely impact the Company's operating results and cash flows. New laws and regulations, stricter enforcement of existing laws and regulations, the discovery of previously unknown contamination at the Company's or others' sites or the imposition of new cleanup requirements could also adversely impact the Company's operations, which may adversely impact 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. The Company was not involved in any material legal proceedings, other than the patent litigation 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.

The Company is currently involved in certain patent-related litigation as part of its ongoing efforts to protect the intellectual property embodied in its proprietary technology, including its MicroSpring interconnect technology. These litigations include two actions the Company filed in 2004 in Seoul Southern District Court, located in Seoul, South Korea, against Phicom Corporation, a Korean corporation, 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, 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 the Company's Korean Patent No. 252,457, entitled "Method of Fabricating Interconnections Using Cantilever Elements and Sacrificial Substrates." These actions are all pending, except that the Seoul Central District Court has denied the Company's request for the issuance of preliminary injunctive relief in the Company's 2006 injunction action.

In response to the Company's infringement actions 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 infringement actions. KIPO dismissed Phicom's challenges against all four of the patents-at-issue. Phicom appealed the dismissals of the challenges to the Korean Patent Court. The Korean Patent Court has issued rulings holding invalid certain claims of the Company's Korean Patent Nos. 278,342, 399,210, and 324,064, and also issued a ruling upholding the validity of the Company's Korean Patent No. 252,457. The Company has appealed the Patent Court invalidity rulings to the Korea Supreme Court. Phicom has 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 Korean Patent Court rulings holding invalid certain claims of the Company's Korean Patent Nos. 278,342 and 399,210. The Korea Supreme Court has not ruled on the Company's appeal of the Patent Court invalidity ruling regarding the Company's Korean Patent No. 324,064 and Phicom's appeal of the Patent Court ruling upholding the Company's Korean Patent No. 252,457.

The Company has also initiated patent infringement litigation in the United States against certain third parties. 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 action that adds two additional patents to the litigation against Phicom 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 has answered the complaint and the amended complaint by denying infringement, alleging defenses and asserting counterclaims seeking adjudications on the validity and enforceability of the Company's patents and whether Phicom is infringing the patents-in-issue. 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 Co., Ltd. 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 Mounting a Plurality of Spring Contact Elements. Micronics Japan has answered the complaint by denying infringement, alleging defenses and asserting counterclaims seeking adjudications on the validity and enforceability of the Company's patents and whether Micronics Japan is infringing those patents.

Additionally, one or more third parties have initiated challenges in foreign patent offices against other of the Company's patents. These actions include proceedings filed in Korea against two of the Company's Korean patents and proceedings filed in Taiwan against four of the Company's Taiwan patents.

While the Company believes that it does not have a material monetary damages exposure in these various proceedings, it is possible the Company will incur material attorneys' fees in defending its intellectual property at issue in these challenges.

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 29, 2007.

The Company and certain current officers of the Company, including one officer who is a director, have been named as defendants in a shareholder class action filed in the United States District Court for the Northern District of California. The action was filed on October 31, 2007, 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 (the Action). Plaintiffs in the Action allege violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), and Section 20(a) of the Exchange Act. The Action seeks to recover unspecified money damages, equitable relief and attorneys' fees and costs. The deadline by which the Company has to respond to the Action has yet to occur as of the filing of this Quarterly Report.

No provision has been made for the class action related litigation because the Company believes that it is not probable that a liability had been incurred as of September 29, 2007.

#### ***Indemnification Obligations***

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 hold the third party harmless from and against certain losses. These arrangements may limit the time within which an indemnification claim can be made, the type of the claim and the total amount that the Company can be required to pay in connection with the indemnification obligation. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers, and the Company's bylaws contain indemnification obligations in favor of the Company's directors, officers and agents. 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 and the unique facts and circumstances involved in each particular contractual arrangement and in each potential future claim for indemnification. The Company has not had any requests for indemnification under these arrangements. The Company has not recorded any liabilities for these indemnification arrangements on the Company's condensed consolidated balance sheet as of September 29, 2007.

**Note 11 Stockholders Equity****Comprehensive Income (Loss)**

Comprehensive income (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 income were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006 As Restated	September 29, 2007	September 30, 2006 As Restated
	(In thousands)			
Net income	\$ 22,223	\$ 15,126	\$ 58,539	\$ 39,761
Change in unrealized gain on marketable securities	1,209	722	772	199
Cumulative translation adjustments	112	(29)	49	46
Comprehensive income	\$ 23,544	\$ 15,819	\$ 59,360	\$ 40,006

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

	September 29, 2007	December 30, 2006
	(In thousands)	
Unrealized gain (loss) on marketable securities	\$ 490	\$ (282)
Foreign currency translation adjustments	87	38
Accumulated other comprehensive income (loss)	\$ 577	\$ (244)

**Note 12 Derivative Financial Instruments**

The Company purchases forward exchange contracts to hedge certain existing foreign currency exposures. These hedges do not qualify for hedge accounting treatment in accordance with the provisions of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The Company recognized losses of \$2.2 million and \$1.0 million for the three and nine months ended September 29, 2007, respectively, from the fluctuation in foreign exchange rates and the valuation of these hedge contracts in other expense. The Company does not use derivative financial instruments for trading or speculative purposes. As of September 29, 2007, the Company had one outstanding foreign exchange forward contract to sell 3,146,000,000 Japanese Yen on October 26, 2007, for \$27,463,990 with a contract rate of 114.55. There were no unrealized gains or losses recorded at September 29, 2007.

**Note 13 Recent Accounting Pronouncements**

In May 2007, the FASB issued FASB Staff Position ( FSP ) FIN No. 48-1, Definition of Settlement in FASB Interpretation No. 48 ( FSP FIN No. 48-1 ). FSP FIN No. 48-1 provides guidance on how a company should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN No. 48-1 is effective upon initial adoption of FIN No. 48, which the Company adopted in the first quarter of fiscal 2007.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 which is effective for fiscal years beginning after November 15, 2007. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The Company is currently evaluating the potential impact of this statement.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles, and expands disclosures about fair value measurements. The changes to current practice resulting from the application of this statement relate to the definition of fair value, the methods

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

used to measure fair value, and the expanded disclosures about fair value measurements. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of SFAS No. 157 are effective for fiscal years beginning after November 15, 2007; therefore, the Company anticipates adopting this standard as of January 1, 2008.

### **Note 14 Subsequent Event**

On or about November 13, 2007, the Company filed a complaint with the United States International Trade Commission, or ITC, seeking institution of a formal investigation by the United States government into the activities of Micronics Japan and of Phicom. The requested investigation encompasses 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. In the ITC complaint, FormFactor requests a permanent exclusion order banning importation of infringing products into the United States. The ITC has not yet initiated a formal investigation.

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

**Cautionary Statement Regarding Forward-Looking Statements**

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/A for the year ended December 30, 2006, and in the section titled "Risk Factors" and 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.

**Overview**

The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the related notes thereto included in the amended annual report on Form 10-K/A, and gives effect to the restatement of our consolidated financial statements as discussed in Note 2 "Restatement of Financial Statements" to the consolidated financial statements.

We design, develop, manufacture, sell and support precision, high performance advanced semiconductor wafer probe cards. Semiconductor manufacturers use our wafer probe cards to perform wafer sort and test on the semiconductor die, or chips, on the whole semiconductor wafer, prior to singulation of the wafer into individual chips. During wafer probe test, a wafer probe card is mounted in a prober, which is in turn connected to a semiconductor tester, and the wafer probe card is used as an interface to connect electronically with and test individual chips on a wafer. Our wafer probe cards are used by our customers in the front end of the semiconductor manufacturing process, as are our parametric or in-line probe cards, which are used in the front-end manufacturing process. At the core of our product offering are our proprietary technologies, including our MicroSpring interconnect technology and design processes. Our MicroSpring interconnect technology includes a resilient contact element manufactured at our production facilities in Livermore, California. We operate in a single industry segment and have derived our revenues primarily from the sale of wafer probe cards incorporating our MicroSpring interconnect technology.

We work closely with our customers to design, develop and manufacture custom wafer probe cards. Each wafer probe card is a custom product that is specific to the chip and wafer designs of the customer. Our customers, in turn, operate in the highly cyclical semiconductor industry and are subject to fluctuations in the demand for their products. Because of the nature of our customers and our business, our revenue growth is driven in significant part by the number of new semiconductor designs that our customers develop the technology transitions involved in these designs and our customers' production volumes. In the past, this has resulted in our being subject to demand fluctuations that have resulted in significant variations of revenues, expenses and results of operations. We expect these fluctuations, and the resulting variations in our financial results, to continue in future periods.

**Revenues.** We derive substantially all of our revenues from product sales of wafer probe cards. Wafer probe card sales, including service and non-recurring engineering revenue associated with wafer probe card sales, accounted for virtually all of our revenues in the first nine months of fiscal 2007 and 2006. Revenues from licensing of our design and manufacturing technologies have historically been insignificant. 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. Revenues from our customers





are subject to quarterly, annual and other fluctuations due to design cycles, technology adoption rates and cyclicity of the different end markets into which our customers' products are sold.

*Cost of Revenues.* Cost of revenues consists primarily of manufacturing materials, compensation and manufacturing-related overhead. In addition, cost of revenues also includes costs related to the start up of our new manufacturing facility, which we completed in early 2006. Our manufacturing operations rely upon a limited number of suppliers to provide key components and materials for our products, some of which are 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 write-downs or write-offs 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. If actual market conditions are less favorable than those projected by management, additional inventory write downs would be required. Once established, the original cost of our inventory less the related inventory reserve 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.

*Research and Development.* Research and development expenses include expenses related to product development and design, engineering and material costs. Almost all research and development costs are expensed as incurred. We plan to continue to invest a significant amount in research and development activities to develop new technologies for current and new markets and new applications in the future, and to improve or advance existing technologies. We expect these expenses to scale with revenue growth.

*Selling, General and Administrative.* Selling, general and administrative expenses include expenses related to sales, marketing, and administrative personnel, internal and outside sales representatives' commissions, market research and consulting, and other sales, marketing, and administrative activities. These expenses also include costs for enforcing our patent rights and regulatory compliance costs. We expect that selling expenses will increase as our revenues increase, and we expect that general and administrative expenses will increase in absolute dollars to support future revenue growth and our worldwide expansion.

*Use of Estimates.* Our discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amount of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to uncollectible receivables, inventory valuation, fair value of marketable securities, fair value and useful life of intangible assets, useful life of plant property and equipment, income taxes, warranty obligations, excess component and order cancellation costs, contingencies and litigation, and fair value and estimated forfeitures of stock-based compensation. Our estimates, which are based on historical experience and on various other assumptions believed to be reasonable under the circumstances, allow us to make judgments about the carrying values of assets and liabilities that are not readily apparent from other sources.

**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 29, 2007	September 30, 2006 As Restated	September 29, 2007	September 30, 2006 As Restated
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues	46.8	49.2	45.8	49.5
Gross margin	53.2	50.8	54.2	50.5
Operating expenses:				
Research and development	12.9	12.4	13.1	12.4
Selling, general and administrative	18.7	19.9	20.3	19.6
Total operating expenses	31.6	32.3	33.4	32.0
Operating income	21.6	18.5	20.8	18.5
Interest income	4.6	4.6	4.9	3.8
Other income	0.3	0.1	0.1	0.0
Income before income taxes	26.5	23.2	25.8	22.3
Provision for income taxes	8.8	7.6	8.7	7.6
Net income	17.7%	15.6%	17.1%	14.7%

*Three and Nine Months Ended September 29, 2007 and September 30, 2006*

**Revenues**

	Three Months Ended			Nine Months Ended		
	September 29, 2007	September 30, 2006	% Change	September 29, 2007	September 30, 2006	% Change
(In thousands, except percentages)						
<i>Revenues by Market:</i>						
DRAM	\$ 82,243	\$ 70,386	16.8%	\$ 237,850	\$ 203,631	16.8%
Flash	32,153	16,675	92.8	69,025	41,247	67.3
Logic	10,895	9,696	12.4	34,811	25,642	35.8
Total revenues	\$ 125,291	\$ 96,757	29.5%	\$ 341,686	\$ 270,520	26.3%

Revenues increased 29.5% and 26.3% in the three and nine months ended September 29, 2007 compared with the three and nine months ended September 30, 2006. Volume increases resulting from strong market demand for our advanced wafer probe cards continued in the third quarter of fiscal 2007 due to a variety of factors, including bit and design growth as semiconductor manufacturers transition to 70 nanometer nodes and 1 Gb devices, combined with strong growth in the demand for NOR flash memory by mobile device manufacturers.

Our revenues for the three and nine months ended September 29, 2007 were primarily generated by sales of wafer probe cards to manufacturers of DRAM devices. The increase was driven by accelerated tooling cycles for probe cards as a result of our customers' continued migration to 70 nanometer nodes to reduce their cost of test and improve productivity, and by volume production ramps for 1 Gb devices. The increase in DRAM revenues was offset by a seasonal weakness in the mobile DRAM business due to decreased demand for mobile and consumer applications. Approximately 81% and 71% of our DRAM revenues for the three and nine months ended September 29, 2007 were derived from 80 nanometer and below technology products compared to 17% and 9% for the three and nine months ended September 30, 2006.

Revenues from sales to flash memory device manufacturers increased mainly due to increased demand for our NOR flash wafer probe cards by a significant customer whose high-volume ramp resulted from the growing demand for consumer applications which utilize multi-chip packages. Semiconductors that are integrated into multi-chip packages often benefit from increased wafer level testing to validate device performance before packaging.

Revenues from manufacturers of logic devices increased primarily due to a key customer's ongoing transition to advanced technology nodes in both chipset application and high performance flip chip microprocessors which are used in personal computer, gaming and graphics applications.

## 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.

	Three Months Ended				Nine Months Ended			
	September 29, 2007	% of Revenues	September 30, 2006	% of Revenues	September 29, 2007	% of Revenues	September 30, 2006	% of Revenues
(In thousands, except percentages)								
Japan	\$ 63,498	50.7%	\$ 33,311	34.4%	\$ 140,717	41.2%	\$ 82,687	30.6%
Asia Pacific	40,386	32.2	29,479	30.5	112,345	32.9	90,357	33.4
North America	14,760	11.8	30,136	31.1	66,006	19.3	80,198	29.6
Europe	6,647	5.3	3,831	4.0	22,618	6.6	17,278	6.4
Total revenues	\$ 125,291	100.0%	\$ 96,757	100.0%	\$ 341,686	100.0%	\$ 270,520	100.0%

Geographic revenue information is based on the location to which we send the customer invoices. For example, certain Korean customers purchase through their North American subsidiaries and accordingly, revenues derived from sales to such customers are reflected in North America revenues.

The increase in Japan revenues for the three and nine months ended September 29, 2007 as compared to the same period in the prior year was primarily due to increased mobile DRAM demand directly related to implementation of 70 nanometer tooling cycles combined with increased growth in our customer base in our NOR flash and logic business. The increase in Asia Pacific for the three months ended September 29, 2007 as compared to the same period in the prior year was primarily due to increased DRAM shipments. Asia Pacific revenue remained relatively, as a percentage of revenue, was flat for the nine months ended September 29, 2007 as compared to the same period in the prior year. The decrease in revenues in North America for the three and nine months ended September 29, 2007 compared to the same period in the prior year was primarily driven by decreased demand for NAND flash and NOR flash products related to product transitions and new product delays. The increase in revenues in Europe for the three and nine months ended September 29, 2007 was primarily due to the increased demand for DRAM and Logic devices in this region.

The following customers accounted for more than 10% of our revenues for the three and nine months ended September 29, 2007 and September 30, 2006:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
Elpida Memory	26.6%	25.0%	25.4%	23.4%
Spansion	22.6	*	14.5	*
PowerChip Semiconductor	13.8	*	11.1	13.4
Hynix Semiconductor	*	10.0	*	*
Intel Corporation	*	13.8	10.9	11.8

\* Less than 10% of revenues.

### Gross Margin

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006 As Restated	September 29, 2007	September 30, 2006 As Restated
(In thousands, except percentages)				
Gross margin	\$ 66,682	\$ 49,179	\$ 185,123	\$ 136,564
% of revenues	53.2%	50.8%	54.2%	50.5%

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

Gross margin increased for the three and nine months ended September 29, 2007 compared with the three and nine months ended September 30, 2006 due to increased revenues and direct and indirect labor productivity improvement. The labor productivity improvement was partially offset by an increase in material and warranty cost arising from the introduction of new product technology into manufacturing. In addition, gross margin improved as a result of lower inventory write-offs of, which was \$9.5 million, or 2.8% of revenues compared to \$12.0 million or 4.4% of revenues for the nine months ended September 29, 2007 and September 30, 2006, respectively. The lower inventory write-offs was primarily due to cycle time

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

reductions, increase in yields and improvement in our order fulfillment process. Stock-based compensation expense increased \$0.8 million and \$1.1 million for the three and nine months ended September 29, 2007 compared to the same period in the prior year due primarily to increased headcount.

### *Research and Development*

	Three Months Ended		September 30,		September 29,		September 30,	
	September 29, 2007		2006		2007		2006	
	(In thousands, except percentages)							
Research and development	\$	16,219	\$	11,994	\$	44,704	\$	33,397
% of revenues		12.9%		12.4%		13.1%		12.4%

Research and development expenses increased for the three and nine months ended September 29, 2007 as compared to the same period in the prior year primarily due to an increase in personnel, new technology, product development related costs and facility expansion. For the three and nine months ended September 29, 2007, personnel costs increased \$1.6 million and \$4.6 million, respectively, due to increased headcount while expenses related to new technology and product development increased \$2.2 million and \$5.1 million, respectively. Depreciation increased \$0.6 million and \$1.4 million respectively due to new investment in R&D equipment and facilities expansion while stock-based compensation remained fairly consistent for the same periods. We are continuing 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 are also making incremental investments in new technologies and products as we focus on new market opportunities.

### *Selling, General and Administrative*

	Three Months Ended		September 30,		September 29,		September 30,	
	September 29, 2007		2006		2007		2006	
	(In thousands, except percentages)							
Selling, general and administrative	\$	23,365	\$	19,321	\$	69,349	\$	53,034
% of revenues		18.7%		19.9%		20.3%		19.6%

Selling, general and administrative expenses increased for the three and nine months ended September 29, 2007 compared to the same periods in the prior year primarily due to increases in expenses related to personnel costs, facilities expansion and outside legal services. For the three and nine months ended September 29, 2007 personnel related costs increased by approximately \$2.8 million and \$8.4 million, respectively, primarily due to increased headcount. Facilities expansion costs for the same period increased \$0.4 million and \$1.3 million, respectively, while combined outside legal services incurred for protecting our intellectual property portfolio, tax services and other expenses increased by approximately \$0.8 million and \$3.4 million, respectively. In addition, stock-based compensation expense also increased \$0.1 million and \$3.3 million for the three and nine months ended September 29, 2007 primarily due to increased headcount and the one-time modification charge incurred during the first quarter of fiscal 2007 resulting from the accelerated vesting of unvested stock options and restricted stock units in conjunction with the severance agreement of the Company's former President.

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

	Three Months Ended		September 30,		September 29,		September 30,	
	September 29, 2007		2006		2007		2006	
	(In thousands, except percentages)							
Interest income	\$	5,766	\$	4,485	\$	16,767	\$	10,196
% of revenue		4.6%		4.6%		4.9%		3.8%
Other income	\$	415	\$	59	\$	234	\$	45
% of revenues		0.3%		0.1%		0.1%		0.0%

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

The increase in interest income for the three and nine months ended September 29, 2007 was due to larger cash, cash equivalents and marketable securities balances and improved yields for the first nine months of fiscal 2007 as compared to



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

the first nine months of fiscal 2006. Cash, cash equivalents, restricted cash and marketable securities increased to \$539.4 million at September 29, 2007 compared with \$459.7 million at September 30, 2006. Other income for the three and nine months ended September 29, 2007 and September 30, 2006 was mainly comprised of foreign currency gains and losses primarily related to Japanese Yen.

### *Provision for Income Taxes*

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006 As Restated (In thousands, except percentages)	September 29, 2007	September 30, 2006 As Restated
Provision for income taxes \$	11,056	\$ 7,282	\$ 29,532	\$ 20,613
Effective tax rate	33.2%	32.5%	33.5%	34.1%

Our effective tax rate was 33.2% and 33.5% for the three and nine months ended September 29, 2007 compared to 32.5% and 34.1% for the three and nine months ended September 30, 2006. The effective tax rate for the three months ended September 29, 2007 remained consistent with the same period in the prior year and decreased for the first nine months of fiscal 2007 compared to the first nine months of fiscal 2006 primarily due to the reinstatement of the federal research and development tax credit in December 2006 offset by the elimination of the Extraterritorial Income tax benefit which expired after December 2006. Our tax rate in the current quarter benefited from the release of tax reserves due to the expiration of the statute of limitations. This benefit was offset due to an increase of expected losses in Singapore as further detailed below.

We anticipate our effective rate for the remainder of 2007 to be approximately 39% not including the effect of employee's disqualifying dispositions of stock based awards which are recognized in the quarter these dispositions occur. In the second half we began funding part of our research and development investments out of Singapore as we expand our operations there. We expect these investments by our Singapore subsidiary will generate losses for the remainder of the year. Generally, these losses could be carried forward and offset future Singapore taxable profits, but due to the tax holiday status granted to us, these losses will not reduce future taxes. Therefore, these losses do not provide a current tax benefit to our tax provision.

### **Critical Accounting Policies and Estimates**

For a description of the critical accounting policies that affect our more significant judgments and estimates used in the preparation of our condensed consolidated financial statements, refer to our Annual Report on Form 10-K/A for the year ended December 30, 2006. There have been no changes to our critical accounting policies since December 30, 2006, other than with respect to income taxes.

*Accounting for Income Taxes.* We adopted FIN 48 on December 31, 2006, the first day of the first quarter of fiscal 2007. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return that results in a tax benefit. Additionally, FIN 48 provides guidance on de-recognition, statement of operations classification of interest and penalties, accounting in interim periods, disclosure, and transition. As a result of the implementation of FIN 48, our tax assets and liabilities did not differ from the assets and liabilities before adoption therefore, we did not record any adjustments as of the adoption date. In addition, consistent with the provisions of FIN 48, we reclassified \$9.8 million of income tax liabilities from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date and we are unable to make a reasonably reliable estimate when cash settlement with a taxing authority will occur. At the adoption date of December 31, 2006, we had \$16.7 million of total gross unrecognized tax benefits, of which \$14.0 million (net of the federal benefit on state issues) of unrecognized tax benefits would impact our effective tax rate if recognized. We continue to recognize interest and penalties related to uncertain tax positions in income tax expense.

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes. This process involves estimating our actual current tax liability together with assessing temporary differences that may result in deferred tax assets. Management judgment is required in determining any valuation allowance recorded against our net deferred tax assets. Any such valuation allowance would be based on our estimates of income and the period over which our deferred tax assets would be recoverable. While management has considered taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for a valuation allowance, if we were to determine that we would not be able to realize all or part of our net deferred tax assets in the future, an adjustment to the deferred tax assets would result in additional income tax expense in such period.



Given our increasing levels of profitability, we concluded that it is more likely than not that we will be able to realize all of our U.S. deferred tax assets. For the deferred tax asset resulting from non-U.S. net operating losses we have concluded that it is more likely than not that this asset will not be utilized and therefore, we have recorded a full valuation allowance for those deferred tax assets.

We calculate our current and deferred tax provision based on estimates and assumptions that could differ from the actual results reflected in income tax returns filed. Differences between our tax provision and tax return may occur and such adjustments are recorded when identified.

The amount of income taxes we pay is subject to ongoing audits by federal, state and foreign 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 we have adequately provided for any reasonable 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.

### **Liquidity and Capital Resources**

As of September 29, 2007, we had \$539.4 million in cash, cash equivalents and marketable securities compared to \$492.4 million as of December 30, 2006.

Net cash provided by operating activities was \$42.0 million and \$58.8 million for the nine months ended September 29, 2007 and September 30, 2006, respectively. Net cash provided by operating activities decreased as a result of an increase in accounts receivable, inventory, and other asset balances combined with a decrease in accrued liabilities. Non-cash items, primarily depreciation and amortization expense, deferred income taxes and stock-based compensation also contributed to the decrease in cash provided by operating activities.

Accounts receivable increased \$31.6 million for the nine months ended September 29, 2007 compared with a \$10.1 million decrease for the nine months ended September 30, 2006, respectively due to the increase in worldwide sales and timing of shipments to customers. Our days sales outstanding from receivables, or DSO, was to 48 days at September 29, 2007 compared to 42 days at September 30, 2006, respectively. The increase in DSO is due to an increased mix of customers with longer standard payment terms.

Inventories increased \$23.1 million and \$16.2 million (as restated) for the nine months ended September 29, 2007 and September 30, 2006, respectively. The increase in inventories was a result of increased volume in business and the expected strong demand for our products in the fourth quarter of fiscal 2007.

Other assets increased \$8.9 million and \$0.6 million for the nine months ended September 29, 2007 and September 30, 2006, respectively, due to a prepayment of approximately \$7.0 million related to our 30-year land lease for Singapore manufacturing facility.

Accrued liabilities decreased \$8.8 million and increased \$16.9 million for the nine months ended September 29, 2007 and September 30, 2006, respectively. The decrease in accrued liabilities for the nine months ended September 29, 2007 was due primarily to the payout of employee performance bonuses and profit-sharing.

Net cash used in investing activities was \$45.9 million for the nine months ended September 29, 2007 compared with \$1.6 million for the nine months ended September 30, 2006. Capital expenditures were \$37.1 million for the nine months ended September 29, 2007 and \$26.9 million for the nine months ended September 30, 2006. Cash used in the acquisition of property and equipment resulted primarily from capital expenditures in support of factory capacity, service center and information technology system upgrades, and new product technology. In addition, the increase in purchases and decrease in sales and maturities of marketable securities contributed to net cash used in investing activities for the nine months ended September 29, 2007.

We expect capital expenditures for fiscal 2007 to increase from our target of 12% of revenues to a range of 14% to 15% of revenues. This increase is expected to continue into fiscal 2008, depending on our revenue growth, primarily as a result of the expansion of our manufacturing operations in Singapore and the related building design, construction and equipment costs that we expect to incur. In the third quarter of fiscal 2007, we signed a 30-year prepaid land lease offer for our Singapore manufacturing facility. We are moving forward with the design and construction of our new facility. The land lease is classified as an operating lease and the prepayment of approximately \$7.0 million is amortized over the term of the land lease.

Net cash provided by financing activities was \$40.3 million for the nine months ended September 29, 2007 compared with \$214.7 million for the nine months ended September 30, 2006. Net cash provided by financing activities for the nine months ended September 29, 2007 was primarily attributable to \$26.9 million of net proceeds from the exercise of stock options and \$6.6 million received from the January and July 2007 ESPP purchases. Net cash provided by financing activities for the nine months ended September 29, 2006 was mainly due to \$182.0 million of net proceeds received from an equity follow-on offering completed in March 2006 as well as \$19.6 million of net proceeds received from the exercise of employee stock options combined with proceeds from the January and July 2006 ESPP purchases. Tax benefits related to the exercise of stock options during the nine months ended September 29, 2007 were \$7.5 million compared to \$13.4 million for the nine months ended September 30, 2006.

We believe that cash generated from operations, together with the liquidity provided by our existing cash, cash equivalents and marketable securities, will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the cost of increasing manufacturing capacity to meet projected demand, including our expansion plans in Singapore and the requirements of any potential investments in, or acquisitions of, complementary businesses, products or technologies that we may enter into in the future. Depending upon our future capital requirements, we may seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

#### **Contractual Commitments**

*Income Taxes.* As of September 29, 2007, our unrecognized tax benefits amounted to \$16.2 million and are classified as deferred and other long-term tax liabilities on our condensed consolidated balance sheets. As of September 29, 2007, the settlement period for our income tax liabilities cannot be determined; however it is not expected to be due within the next twelve months.

#### **Off-Balance Sheet Arrangements**

As part of our ongoing business, we do not participate in transactions that generate 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 29, 2007 we are not involved in any such off-balance sheet arrangements.

#### **Recent Accounting Pronouncements**

In May 2007, the FASB issued FASB Staff Position ( FSP ) FIN No. 48-1, Definition of Settlement in FASB Interpretation No. 48 ( FSP FIN No. 48-1 ). FSP FIN No. 48-1 provides guidance on how a company should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. FSP FIN No. 48-1 is effective upon initial adoption of FIN No. 48, which we adopted in the first quarter of fiscal 2007. See Note 8 Income Taxes of the Notes to Unaudited Condensed Consolidated Financial Statements for additional information.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115 which is effective for fiscal years beginning after November 15, 2007. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. We are currently evaluating the potential impact of this statement.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles, and expands disclosures about fair value measurements. The changes to current practice resulting from the application of this statement relate to the definition of fair value, the methods used to measure fair value, and the expanded disclosures about fair value measurements. The provisions of this statement are to be applied prospectively as of the beginning of the fiscal year in which this statement is initially applied, with any transition adjustment recognized as a cumulative-effect adjustment to the opening balance of retained earnings. The provisions of SFAS No. 157 are effective for the fiscal years beginning after November 15, 2007; therefore, we anticipate adopting this standard as of January 1, 2008.

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

#### **Interest Rate Sensitivity**

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The fair market value of our fixed rate securities may be adversely impacted by increases in interest rates while income earned on floating rate securities may decline as a result of decreases in interest rates. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes. We attempt to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in investment grade securities. We have historically maintained a relatively short average maturity for our investment portfolio, and we believe a hypothetical 100 basis point adverse move in interest rates along the entire interest rate yield curve would not materially affect the fair value of our interest-sensitive financial instruments.

#### **Foreign Currency Exchange Risk**

We conduct certain operations in foreign currencies. We enter into currency forward exchange contracts to hedge a portion of, but not all, existing foreign currency denominated amounts. Gains and losses on these contracts are generally recognized in income. Because the effect of movements in currency exchange rates on the currency forward exchange contracts generally offsets the related effect on the underlying items being hedged, these financial instruments are not expected to subject us to risks that would otherwise result from changes in currency exchange rates. We do not use derivative financial instruments for trading or speculative purposes. The Company recognized losses of \$2.2 million and \$1.0 million for the three and nine months ended September 29, 2007, respectively, from the fluctuation in foreign exchange rates and the valuation of these hedge contracts in other expense.

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

#### **Evaluation of Disclosure Controls and Procedures**

Our management, including our Chief Executive Officer and Chief Financial Officer, conducted an evaluation as of September 29, 2007 of the effectiveness of our disclosure controls and procedures as defined in Exchange Act Rule 13a-15(e). Based on that evaluation and in light of the material weakness described below, our Chief Executive Officer and Chief Financial Officer concluded that as of September 29, 2007, our disclosure controls and procedures were not effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in rules and forms of the SEC, and is accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosure.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

The Company identified the following material weakness in internal control over financial reporting as of September 29, 2007. The Company did not maintain effective controls over the valuation of inventory and the related cost of revenues accounts. Specifically, the Company did not maintain effective controls to ensure that the estimation process to value inventory complied with the Company's accounting policies. This control deficiency resulted in the restatement of the Company's annual and interim financial statements for 2006 and interim financial statements for the first and second quarters of 2007. Additionally, this control deficiency could result in a misstatement of the inventory and cost of revenues accounts that would result in a material misstatement of the Company's financial statements that would not be prevented or detected.

Notwithstanding the material weakness, the interim financial statements included in this Form 10-Q fairly present, in all material respects, the financial condition, results of operations and cash flows of the Company as of and for the periods presented in accordance with generally accepted accounting principles.

**Management's Plan for Remediation**

Management is in the process of completing its plan to remediate the material weakness. The remediation plan addresses the design of controls over inventory valuation and is expected to include:

Completion of analysis of changes in the level of excess and obsolete inventory by category;

Review of analysis of changes in the level of excess and obsolete inventory by category;

Separate re-performance of excess and obsolete inventory calculation; and

Hiring personnel with requisite cost accounting experience and providing ongoing training and supervision.

**Changes in Internal Control over Financial Reporting**

There were no changes in our internal control over financial reporting during the most recently ended fiscal quarter that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**CEO and CFO Certifications**

We have attached as exhibits to this Quarterly Report on 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 10 - Commitments and Contingencies of the Notes to Unaudited 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 Quarterly Report on Form 10-Q, you should carefully consider the risk factors discussed in our Annual Report on Form 10-K/A for the year ended December 30, 2006 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. Accordingly, the trading price of our common stock would likely 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/A 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.

We disclosed the risk factors below in our Annual Report on Form 10-K/A for the year ended December 30, 2006. We have updated these risk factors to reflect changes for the third quarter of fiscal 2007.

***If demand for our products in the memory device and flip chip logic device markets declines or fails to grow as we anticipate, our revenues could decline.***

We derive substantially all of our revenues from wafer probe cards that we sell to manufacturers of DRAM memory and flash memory devices and manufacturers of microprocessor, chipset and other logic devices. In the microprocessor, chipset and other logic device markets, our products are primarily used for devices employing flip chip packaging, which are commonly referred to as flip chip logic devices. For the three months ended September 29, 2007 and September 30, 2006, sales to manufacturers of DRAM devices accounted for 65.6% and 72.8%, respectively, of our revenues, sales to manufacturers of logic devices accounted for 8.7% and 10.0%, respectively, of our revenues, and sales to manufacturers of flash memory devices accounted for 25.7% and 17.2%, respectively, of our revenues. For the nine months ended September 29, 2007 and September 30, 2006, sales to manufacturers of DRAM devices accounted for 69.6% and 75.3%, respectively, of our revenues, sales to manufacturers of logic devices accounted for 10.2% and 9.5%, respectively, of our revenues, and sales to manufacturers of flash memory devices accounted for 20.2% and 15.2%, respectively. Therefore, our success depends in part upon the continued acceptance of our products within these markets and our ability to continue to develop and introduce new products on a timely basis for these markets. In particular, to continue to grow our business, we need to further penetrate the flash memory market and to gain additional market share with manufacturers in this market. We also need to successfully qualify and introduce into commercial volume our DRAM and flash wafer probe card products incorporating our Harmony architecture. To the extent that we are unable to do so, or if we are not able to deliver timely our products, our revenues and business operations could be adversely impacted and our ability to grow could suffer. If chip manufacturers fail to make architecture, node or technology transitions as we anticipate, or if anticipated or announced transitions are delayed, it could adversely impact our revenues and operating results.

A substantial portion of these semiconductor devices is sold to manufacturers of personal computers and computer-related products and to manufacturers of personal electronic devices. Both the personal computer market and the personal electronic devices market have historically been characterized by significant fluctuations in demand and continuous efforts to reduce costs, which in turn have affected the demand for and price of memory devices and microprocessors. The personal computer market and the personal electronic devices market might not grow in the future at historical rates or at all and design activity in those markets might decrease, which could negatively affect our revenues and operating results.

***If we are unable to successfully ramp production of our Harmony architecture-based probe card products our business may be materially adversely affected.***

In 2006, we delivered our first one-touchdown NAND flash probe cards incorporating our proprietary Harmony architecture for production use. Our Harmony architecture addresses some of the significant challenges presented by the future demands of single touchdown wafer probing and very high parallelism wafer test, and we believe will be a key building block for our future generations of large area array flash, DRAM, wafer level burn-in and high frequency probing solutions. However, we have experienced difficulties in the manufacturing ramp of the production of our Harmony product. To date, our Harmony probe card production capacity is not keeping pace with demand, and we are experiencing installation issues in the field due to the complexity of customer design requirements, including the need to integrate with varying customer test cell environments. These issues are being addressed by our manufacturing, design and engineering teams. Although we have invested additional resources by committing more personnel and equipment to the Harmony product ramp, we cannot guarantee that we will successfully transition Harmony production from a low-volume, engineering-assisted process to a high-volume manufacturing process. If we fail to ramp our Harmony production manufacturing processes to commercial volumes in a timely manner and at acceptable yields or if we fail to make continual improvements in our processes or if we fail to reduce our manufacturing costs, our Harmony architecture-based products may not be commercially successful, our revenues could be adversely affected, our customer relationships and our reputation may be harmed and our business may be materially adversely affected.

***We derive a substantial portion of our revenues from a small number of customers, and our revenues could decline significantly if any major customer cancels, reduces or delays a purchase of our products.***

A relatively small number of customers has accounted for a significant portion of our revenues in any particular period. Three customers accounted for 63.0% of our revenues for the three months ended September 29, 2007 and four customers accounted for 61.9% of our revenues for the nine months ended September 29, 2007. In the three and nine months ended September 30, 2006, four customers accounted for 57.7% and 57.2% of our revenues, respectively. Our ten largest customers accounted for 93.6% and 81.5%, respectively, of our revenues in the three and nine months ended September 29, 2007 and 89.0% and 88.6%, respectively of our revenues in the three and nine months ended September 30, 2006. 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. The cancellation or deferral of even a small number of purchases of our products could cause our revenues to decline in any particular quarter. A number of factors could cause customers to cancel or defer orders, including manufacturing delays, interruptions to our customers' operations due to fire, natural disasters or other events, or a downturn in the semiconductor industry. Our customers could cease purchasing our products with short or no notice to us or fail to pay all or part of an invoice. In some situations, our customers might be able to



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

cancel orders without a significant penalty. In addition, consolidation in the semiconductor industry, particularly among manufacturers of DRAM, could reduce our customer base and lead to lost or delayed sales and reduced demand for our wafer probe cards. Industry consolidation also could result in pricing pressures as larger DRAM manufacturers could have sufficient bargaining power to demand reduced prices and favorable nonstandard terms. Additionally, certain customers may not want to rely entirely or substantially on a single wafer probe card supplier and, as a result, such customers could reduce their purchases of our wafer probe cards.

*Because we conduct some of our business internationally, we are subject to operational, economic, financial and political risks abroad.*

Sales of our products to customers outside the United States have accounted for an important part of our revenues. Our international sales as a percentage of our revenues were 88.2% and 80.7%, respectively, for the three and nine months ended September 29, 2007 and 68.9% and 70.4%, respectively for the three and nine months ended September 30, 2006. Additionally, certain of our Korean customers purchase through their North American subsidiaries. In the future, we expect

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

international sales, particularly in Europe, Japan, South Korea and Taiwan, to continue to account for a significant percentage of our revenues. Accordingly, we will be subject to risks and challenges that we would not otherwise face if we conducted our business only in the United States. These risks and challenges include:

compliance with a wide variety of foreign laws and regulations;

legal uncertainties regarding taxes, tariffs, quotas, export controls, export licenses and other trade barriers;

political and economic instability in or foreign conflicts that involve or affect, the countries of our customers;

difficulties in collecting accounts receivable and longer accounts receivable payment cycles;

difficulties in staffing and managing personnel, distributors and representatives;

reduced protection for intellectual property rights in some countries;

currency exchange rate fluctuations, which could affect the value of our assets denominated in local currency, as well as the price of our products relative to locally produced products;

seasonal fluctuations in purchasing patterns in other countries; and

fluctuations in freight rates and transportation disruptions.

Any of these factors could harm our existing international operations and business or impair our ability to continue expanding into international markets.

***If we fail to remediate the material weakness identified in our internal control and accounting systems in October 2007 our business may be materially adversely affected.***

In October 2007, we completed a review of our historical practices with respect to inventory valuation. That review indicated that during fiscal 2006 and the first half of fiscal 2007 we did not consistently follow our accounting policies for determining inventory valuation. Specifically, we did not maintain effective review controls to ensure that the estimation process to value inventory complied with our policy. As a result, our Board of Directors determined on November 8, 2007 that we would restate our 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. Although we are implementing revised procedures designed to prevent a recurrence of the problem, we cannot assure you that we will be able to successfully address the deficiency. If we fail to remediate the material weakness identified in our internal control and accounting systems, we may not have accurate information to make investment and management decisions, investors may lose confidence in our ability to execute, our stock price may decline and our business may be materially adversely affected.

***We may not obtain the tax and other benefits that we anticipate through the expansion of our manufacturing operations into Singapore, which could negatively impact our operating results.***

We have initiated the first phase of our company's global manufacturing expansion in Singapore. Our decision to build back-end assembly and test followed by front-end wafer manufacturing in Singapore is primarily based upon the tax and other benefits that we believe are obtainable by operating in that country. These benefits include favorable tax exempt status granted by the Singapore government, subject to meeting certain conditions, as well as lower qualified technical personnel labor costs. However, if we do not fulfill the conditions for our granted tax status for any reason, we may not obtain the full tax benefits, the tax benefits could lapse and any future tax benefits that we may seek may not be granted. Consequently, our effective corporate income tax rate may not decrease as we expect but instead, may remain approximately the same or increase. In addition, the other benefits of operating in Singapore may not materialize. The inability to obtain the anticipated tax and other

benefits through our Singapore expansion could negatively impact our operating results.

**Item 6. Exhibits**

The following exhibits are filed herewith:

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

**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/ RON C. FOSTER

Ron C. Foster  
Chief Financial Officer  
*(Principal Financial Officer and  
Duly Authorized Officer)*

November 13, 2007

**EXHIBIT INDEX**

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