

FORMFACTOR INC  
Form 10-Q  
August 06, 2009  
Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE  
COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark one)

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

For the quarterly period ended June 27, 2009

or

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

For the transition period from            to

Commission file number: 000-50307

**FormFactor, Inc.**

(Exact name of registrant as specified in its charter)

Edgar Filing: FORMFACTOR INC - Form 10-Q

**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)

---

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

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

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

Large Accelerated filer

Accelerated filer

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

Smaller reporting company

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

As of July 31, 2009, 49,469,534 shares of the registrant's common stock, par value \$0.001 per share, were outstanding.



Table of Contents

**FORMFACTOR, INC.**

**FORM 10-Q FOR THE QUARTERLY PERIOD ENDED JUNE 27, 2009**

**INDEX**

|                        |   |    |
|------------------------|---|----|
| <b><u>Part I.</u></b>  | <b><u>Financial Information</u></b>   | 3  |
| <u>Item 1.</u>         | <u>Financial Statements:</u>  | 3  |
|                        | <u>Unaudited Condensed Consolidated Statements of Operations for the three and six months ended June 27, 2009 and June 28, 2008</u> | 3  |
|                        | <u>Unaudited Condensed Consolidated Balance Sheets as of June 27, 2009 and December 27, 2008</u>                                    | 4  |
|                        | <u>Unaudited Condensed Consolidated Statements of Cash Flows for the six months ended June 27, 2009 and June 28, 2008</u>           | 5  |
|                        | <u>Notes to Unaudited Condensed Consolidated Financial Statements</u>   | 6  |
| <u>Item 2.</u>         | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>  | 24 |
| <u>Item 3.</u>         | <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | 34 |
| <u>Item 4.</u>         | <u>Controls and Procedures</u>  | 34 |
| <b><u>Part II.</u></b> | <b><u>Other Information</u></b>   | 34 |
| <u>Item 1.</u>         | <u>Legal Proceedings</u>  | 34 |
| <u>Item 1A.</u>        | <u>Risk Factors</u>   | 35 |
| <u>Item 4.</u>         | <u>Submission of Matters to a Vote of Security Holders</u>  | 39 |
| <u>Item 6.</u>         | <u>Exhibits</u>   | 39 |
| <u>Signature</u>       |   | 40 |
| <u>Exhibit Index</u>   |   | 41 |

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****FORMFACTOR, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)****(Unaudited)**

|   | <b>Three Months Ended</b> |                          | <b>Six Months Ended</b>  |                          |
|---|---------------------------|--------------------------|--------------------------|--------------------------|
|   | <b>June 27,<br/>2009</b>  | <b>June 28,<br/>2008</b> | <b>June 27,<br/>2009</b> | <b>June 28,<br/>2008</b> |
| Revenues  | \$ 31,198                 | \$ 52,013                | \$ 58,567                | \$ 117,716               |
| Cost of revenues  | 32,524                    | 40,912                   | 63,572                   | 94,043                   |
| Gross profit (loss)   | (1,326)                   | 11,101                   | (5,005)                  | 23,673                   |
| Operating expenses:   |                           |                          |                          |                          |
| Research and development  | 13,938                    | 15,821                   | 28,047                   | 32,209                   |
| Selling, general and administrative                               | 18,263                    | 22,705                   | 44,574                   | 45,363                   |
| Restructuring   | 264                       | 3,223                    | 7,943                    | 8,543                    |
| Total operating expenses  | 32,465                    | 41,749                   | 80,564                   | 86,115                   |
| Operating loss  | (33,791)                  | (30,648)                 | (85,569)                 | (62,442)                 |
| Interest income   | 762                       | 3,128                    | 1,877                    | 8,003                    |
| Other income (expense), net                                       | (89)                      | (652)                    | (505)                    | 141                      |
| Loss before income taxes  | (33,118)                  | (28,172)                 | (84,197)                 | (54,298)                 |
| Provision for (benefit from) income taxes                         | 32,728                    | (9,513)                  | 19,592                   | (17,678)                 |
| Net loss  | \$ (65,846)               | \$ (18,659)              | \$ (103,789)             | \$ (36,620)              |
| Net loss per share:   |                           |                          |                          |                          |
| Basic   | \$ (1.33)                 | \$ (0.38)                | \$ (2.11)                | \$ (0.75)                |
| Diluted   | \$ (1.33)                 | \$ (0.38)                | \$ (2.11)                | \$ (0.75)                |
| Weighted-average number of shares used in per share calculations: |                           |                          |                          |                          |
| Basic   | 49,394                    | 48,835                   | 49,297                   | 48,789                   |
| Diluted   | 49,394                    | 48,835                   | 49,297                   | 48,789                   |

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

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

|   | <b>June 27,<br/>2009</b> | <b>December 27,<br/>2008</b> |
|---|--------------------------|------------------------------|
| <b>ASSETS</b>   |                          |                              |
| Current assets:   |                          |                              |
| Cash and cash equivalents   | \$ 183,106               | \$ 337,926                   |
| Marketable securities   | 303,712                  | 184,968                      |
| Accounts receivable, net of allowances for doubtful accounts of \$9,151 at June 27, 2009 and \$4,220 at December 27, 2008                   | 34,214                   | 34,127                       |
| Inventories   | 18,560                   | 18,788                       |
| Deferred tax assets   | 7,085                    | 23,039                       |
| Refundable income taxes   | 14,791                   | 29,413                       |
| Prepaid expenses and other current assets   | 8,717                    | 14,702                       |
| Total current assets  | 570,185                  | 642,963                      |
| Restricted cash   | 680                      | 680                          |
| Property and equipment, net   | 100,898                  | 113,813                      |
| Deferred tax assets   | 1,815                    | 20,580                       |
| Other assets  | 1,248                    | 7,674                        |
| Total assets  | \$ 674,826               | \$ 785,710                   |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                          |                              |
| Current liabilities:  |                          |                              |
| Accounts payable  | \$ 20,562                | \$ 33,214                    |
| Accrued liabilities   | 16,229                   | 25,693                       |
| Income taxes payable  | 190                      | 1,904                        |
| Deferred revenue  | 9,771                    | 4,946                        |
| Deferred rent   | 455                      | 452                          |
| Total current liabilities   | 47,207                   | 66,209                       |
| Long-term income taxes payable  | 6,153                    | 7,732                        |
| Deferred rent and other liabilities   | 5,424                    | 5,705                        |
| Total liabilities   | 58,784                   | 79,646                       |
| Commitments and contingencies (Note 14)   |                          |                              |
| Stockholders' equity  |                          |                              |
| Preferred stock, \$0.001 par value:   |                          |                              |
| 10,000,000 shares authorized; no shares issued and outstanding at June 27, 2009 and December 27, 2008, respectively                         |                          |                              |
| Common stock, \$0.001 par value:  |                          |                              |
| 250,000,000 shares authorized; 49,467,371 and 49,062,308 shares issued and outstanding at June 27, 2009 and December 27, 2008, respectively |                          |                              |
|   | 49                       | 49                           |
| Additional paid-in capital  | 616,926                  | 602,295                      |
| Accumulated other comprehensive income  | 1,058                    | 1,922                        |
| Retained earnings (deficit)   | (1,991)                  | 101,798                      |
| Total stockholders' equity  | 616,042                  | 706,064                      |
| Total liabilities and stockholders' equity  | \$ 674,826               | \$ 785,710                   |

Edgar Filing: FORMFACTOR INC - Form 10-Q

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

Table of Contents

## FORMFACTOR, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

|   | Six Months Ended |                  |
|---|------------------|------------------|
|   | June 27,<br>2009 | June 28,<br>2008 |
| <b>Cash flows from operating activities:</b>                                      |                  |                  |
| Net loss  | \$ (103,789)     | \$ (36,620)      |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Depreciation and amortization   | 15,989           | 15,776           |
| Stock-based compensation expense  | 11,909           | 12,811           |
| Deferred income tax provision (benefit)   | 34,642           | (2,653)          |
| Excess tax benefits from equity based compensation plans                          | (437)            | (127)            |
| Provision for doubtful accounts receivable  | 4,931            | 489              |
| Provision for excess and obsolete inventories                                     | 5,818            | 11,846           |
| Loss on disposal of property and equipment  | 144              | 982              |
| Non-cash restructuring  | 366              |                  |
| Changes in assets and liabilities:  |                  |                  |
| Accounts receivable   | (4,976)          | 23,449           |
| Inventories   | (5,545)          | (7,391)          |
| Prepays and other current assets  | 5,858            | 1,911            |
| Refundable income taxes   | 14,683           | (16,062)         |
| Other assets  | 6,389            | 224              |
| Accounts payable  | (8,252)          | (5,327)          |
| Accrued liabilities   | (8,752)          | (8,735)          |
| Income tax payable  | (3,285)          | (895)            |
| Deferred rent   | (257)            | (195)            |
| Deferred revenues   | 4,821            | 2,266            |
| Net cash used in operating activities   | (29,743)         | (8,251)          |
| <b>Cash flows from investing activities:</b>                                      |                  |                  |
| Acquisition of property and equipment   | (8,753)          | (20,772)         |
| Purchases of marketable securities  | (287,616)        | (163,568)        |
| Proceeds from maturities of marketable securities                                 | 149,430          | 147,352          |
| Proceeds from sales of marketable securities                                      | 18,905           | 153,789          |
| Net cash provided by (used) in investing activities                               | (128,034)        | 116,801          |
| <b>Cash flows from financing activities:</b>                                      |                  |                  |
| Proceeds from issuances of common stock and awards, net                           | 2,565            | 3,453            |
| Excess tax benefits from equity based compensation plans                          | 437              | 127              |
| Net cash provided by financing activities   | 3,002            | 3,580            |
| Effect of exchange rate changes on cash and cash equivalents                      | (45)             | (186)            |
| Net increase (decrease) in cash and cash equivalents                              | (154,820)        | 111,944          |
| Cash and cash equivalents, beginning of period                                    | 337,926          | 315,232          |
| Cash and cash equivalents, end of period  | \$ 183,106       | \$ 427,176       |
| <b>Supplemental cash flow disclosures:</b>  |                  |                  |
| Purchases of property and equipment through accounts payable and accruals         | \$ (5,065)       | \$ (9,153)       |
| Income taxes paid (refunded), net   | \$ (26,576)      | \$               |



Edgar Filing: FORMFACTOR INC - Form 10-Q

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

Table of Contents

**FORMFACTOR, INC.**

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

**Note 1 Basis of Presentation**

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

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

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

**Subsequent Events.** The Company has performed an evaluation of subsequent events through August 6, 2009, which is the date the financial statements were issued.

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

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (SFAS 168). SFAS 168 establishes the FASB Accounting Standards Codification (the Codification) as the single source of authoritative nongovernmental U.S. GAAP. The Codification is effective for interim and annual periods ending after September 15, 2009. The adoption of this standard will not have a material impact on the Company's financial statements.

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

In June 2009, the FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R) ( SFAS 167 ). SFAS 167 is intended to improve financial reporting by providing additional guidance to companies involved with variable interest entities and by requiring additional disclosures about a company's involvement in variable interest entities. This standard is effective for interim and annual periods ending after November 15, 2009. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

In June 2009, the FASB issued SFAS No. 166, Accounting for Transfers of Financial Assets ( SFAS 166 ). SFAS 166 is a revision to SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and will require more information about transfers of financial assets and where companies have continuing exposure to the risk related to transferred financial assets. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosure. This standard is effective for interim and annual periods ending after November 15, 2009. The adoption of this standard is not expected to have a material impact on the Company's financial statements.

For the quarter beginning March 29, 2009, the Company adopted FASB Staff Position ( FSP ) FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments ( FSP FAS 115-2 ). FSP FAS 115-2 amends the other-than-temporary impairment ( OTTI ) guidance in U.S. GAAP to make the guidance more operational and to improve the presentation of other-than-temporary impairments in a company's financial statements. Prior to FSP FAS 115-2, if OTTI was determined to exist, the Company recognized an OTTI charge into earnings in an amount equal to the difference between the investment's amortized cost basis and its fair value as of the balance sheet date of the reporting period. Under FSP 115-2, if OTTI has been incurred, and it is more-likely-than-not that the Company will not sell the investment security

Table of Contents

before the recovery of its amortized cost basis, then the OTTI is separated into (a) the amount representing the credit loss and (b) the amount related to all other factors. The amount of the total OTTI related to the credit loss is recognized in earnings. The amount of the total OTTI related to other factors is recognized in accumulated other comprehensive income ( AOCI ). There was no initial effect of adoption on March 28, 2009.

For the quarter beginning March 29, 2009, the Company adopted FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly ( FSP FAS 157-4 ). FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with SFAS 157 when the volume and level of activity for an asset or liability have significantly decreased. FSP FAS 157-4 also includes guidance on identifying circumstances that indicate a transaction is not orderly. The adoption of FSP FAS 157-4 did not have an impact on the Company's consolidated results of operations or financial condition.

For the quarter beginning March 29, 2009, the Company adopted FSP FAS 107-1 and Accounting Principles Board ( APB ) 28-1, Interim Disclosures About Fair Value of Financial Instruments ( FSP FAS 107-1 ). FSP FAS 107-1 amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments, to require disclosures about fair value of financial instruments in interim financial statements as well as in annual financial statements and also amends APB Opinion No. 28, Interim Financial Reporting, to require those disclosures in all interim financial statements. The adoption of FSP FAS 107-1 did not have an impact on the Company's consolidated results of operations or financial condition. See Note 4 for additional disclosures included in accordance with FSP FAS 107-1.

For the quarter beginning March 29, 2009, the Company adopted FASB Statement No. 165, Subsequent Events ( SFAS 165 ). SFAS 165 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date that is, whether that date represents the date the financial statements were issued or were available to be issued. This disclosure should alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented. Adoption of SFAS 165 did not have an impact on the Company's consolidated results of operations or financial condition.

The Emerging Issues Task Force ( EITF ) No. 08-1, Revenue Arrangements with Multiple Deliverables, is expected to modify the objective-and-reliable-evidence-of-fair-value threshold in EITF Issue No. 00-21, Revenue Arrangements with Multiple Deliverables. The modification would allow the use of an estimated selling price for purposes of separating elements included in multiple-element arrangements and allocating arrangement consideration when neither vendor-specific objective evidence nor acceptable third-party evidence of the selling price are available. In addition, this modification would eliminate the residual method for allocation of arrangement consideration. If this standard is enacted, it could alter the timing of how the Company records revenue for future arrangements. As the standard is not final, the Company cannot currently predict what the impact of these changes could be on its consolidated financial statements.

**Note 3 Restructuring Charges**

The Company accounts for restructuring and separation costs in accordance with Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities ( SFAS No. 146 ). The Company recorded restructuring charges of \$0.3 million and \$3.2 million for the three months ended June 27, 2009 and June 28, 2008, respectively, and \$7.9 million and \$8.5 million for the six months ended June 27, 2009 and June 28, 2008, respectively. The restructuring plan implemented in the first quarter of 2009 is discussed in detail below. For a complete discussion of all restructuring actions that were implemented prior to fiscal 2009, please refer to the Notes to Consolidated Financial Statements included in the Company's Annual Report on Form 10-K filed on February 27, 2009.



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

### Table of Contents

In the first quarter of fiscal 2009, the Company implemented a global reorganization and cost reduction plan (the Q1 2009 Restructuring Plan ) designed to lower the Company's cash breakeven level in order to enable the Company to sustain itself financially in the current market environment. The Q1 2009 Restructuring Plan extended the global cost reduction plans implemented during fiscal 2008 and included workforce reductions of 178 employees spread across all functions of the organization. The Q1 2009 Restructuring Plan also included other actions such as the elimination of 24 contractor positions as well as non-replacement of certain voluntary employee terminations. In accordance with SFAS 146, the Company recorded \$7.7 million in charges for this restructuring plan in the first quarter of fiscal 2009, of which \$7.3 million related to severance and related benefits and \$0.4 million related to write-down of certain assets taken out of service. The Company incurred approximately \$0.3 million in connection with this restructuring plan in the second quarter of fiscal 2009 related to severance and related benefits. The following table summarizes the activity related to the Q1 2009 Restructuring Plan as of June 27, 2009 (in thousands):

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

Restructuring charges are reflected separately as Restructuring in the Condensed Consolidated Statements of Operations. The remaining accrual as of June 27, 2009 relates primarily to severance benefits which will be paid within the next nine months. As such, the restructuring accrual is recorded as a current liability within Accrued Liabilities in the Condensed Consolidated Balance Sheets.

### **Note 4 Fair Value**

The Company adopted SFAS No. 157, Fair Value Measurements ( SFAS 157 ) as of the beginning of its fiscal 2008 year for its financial assets and financial liabilities. In February 2008, FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which provides a one year deferral of the effective date of SFAS 157 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. The Company adopted SFAS 157 as it relates to nonrecurring fair value measurement requirements for non-financial assets and liabilities as of the beginning of its 2009 fiscal year.

SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 applies under other accounting pronouncements that require or permit fair value measurements and does not require any new fair value measurements. The standard describes a fair value hierarchy based on three levels of inputs, the first two of which are considered observable and the last unobservable, that may be used to measure fair value:

- Level 1 - Quoted prices in active markets for identical assets or liabilities.

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

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

Table of Contents*Assets Measured at Fair Value on a Recurring Basis*

The Company measures and reports certain assets and liabilities at fair value on a recurring basis, including money market funds, U. S. government securities, municipal bonds, agency securities and foreign currency derivatives. In accordance with SFAS 157, the following table represents the Company's fair value hierarchy for its financial assets (cash equivalents and marketable securities) measured at fair value on a recurring basis as of June 27, 2009 (in thousands):

|                              | Level 1           | Level 2           | Total             |
|------------------------------|-------------------|-------------------|-------------------|
| <b>Assets:</b>               |                   |                   |                   |
| <b>Cash equivalents</b>      |                   |                   |                   |
| Money market funds           | \$ 144,660        | \$                | \$ 144,660        |
| Agency securities            |                   | 19,996            | 19,996            |
| <b>Marketable securities</b> |                   |                   |                   |
| U. S. Treasury               |                   | 48,456            | 48,456            |
| Municipal bonds              |                   | 12,083            | 12,083            |
| Agency securities            |                   | 243,175           | 243,175           |
| <b>Total</b>                 | <b>\$ 144,660</b> | <b>\$ 323,710</b> | <b>\$ 468,370</b> |

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



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

### Table of Contents

#### *Assets Measured at Fair Value on a Nonrecurring Basis*

The following table presents the Company's asset that was measured at fair value on a nonrecurring basis during the six months ended June 27, 2009 (in thousands):

|                                   | Six Months Ended |     | Fair Value Measured Using |         |         |
|-----------------------------------|------------------|-----|---------------------------|---------|---------|
|                                   | June 27, 2009    |     | Level 1                   | Level 2 | Level 3 |
| <b>Asset:</b>                     |                  |     |                           |         |         |
| Asset held for sale (included in  |                  |     |                           |         |         |
| Prepays and other current assets) | \$               | 900 | \$                        | \$      | 900     |

The Level 3 asset consisted of a building held for sale in Livermore, California. The Company used unobservable inputs to value the building held for sale reflecting the Company's assumptions that market participants would use in pricing this asset due to the absence of recent comparable market transactions and inherent lack of liquidity.

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

#### *Marketable Securities*

Marketable securities at June 27, 2009 consisted of the following (in thousands):

|  | Amortized  |    | Gross      |    | Gross      |    | Market  |
|--|------------|----|------------|----|------------|----|---------|
|  | Cost       |    | Unrealized |    | Unrealized |    | Value   |
|  |            |    | Gains      |    | Losses     |    |         |
| U. S. Treasury                                   | \$ 63,235  | \$ | 231        | \$ | (45)       | \$ | 63,421  |
| Agency Securities                                | 227,625    |    | 600        |    | (16)       |    | 228,209 |
| Obligations of states and political subdivisions | 12,015     |    | 76         |    | (9)        |    | 12,082  |
|  | \$ 302,875 | \$ | 907        | \$ | (70)       | \$ | 303,712 |

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

|                   | Amortized  |    | Gross      |    | Gross      |    | Market  |
|-------------------|------------|----|------------|----|------------|----|---------|
|                   | Cost       |    | Unrealized |    | Unrealized |    | Value   |
|                   |            |    | Gains      |    | Losses     |    |         |
| U. S. Treasury    | \$ 104,817 | \$ | 468        | \$ |            | \$ | 105,285 |
| Agency Securities | 60,943     |    | 836        |    | (24)       |    | 61,755  |

Edgar Filing: FORMFACTOR INC - Form 10-Q

|  |            |          |         |            |
|--|------------|----------|---------|------------|
| Obligations of states and political subdivisions | 17,862     | 126      | (60)    | 17,928     |
|  | \$ 183,622 | \$ 1,430 | \$ (84) | \$ 184,968 |

The Company typically invests in highly-rated securities with low probabilities of default. The Company's investment policy requires investments to be rated single-A or better, limits the types of acceptable investments, concentration as to security holder and duration of the investment. The net unrealized losses on the Company's investments during the three and six months ended June 27, 2009 were caused primarily by changes in interest rates. When evaluating the investments for other-than-temporary impairment, the Company reviews factors such as the length of time and extent to which fair value has been below the amortized cost basis, review of current market liquidity, interest rate risk, the financial condition of the issuer, as well as credit rating downgrades. The Company believes that the unrealized losses are not other-than-temporary. The Company does not have a foreseeable need to liquidate the portfolio and anticipates recovering the full cost of the securities either as market conditions improve, or as the securities mature.

Contractual maturities of marketable securities as of June 27, 2009 were as follows (in thousands):

|                                   | Amortized<br>Cost | Market<br>Value |
|-----------------------------------|-------------------|-----------------|
| Due in one year or less           | \$ 266,958        | \$ 267,346      |
| Due after one year to three years | 35,917            | 36,366          |
|                                   | \$ 302,875        | \$ 303,712      |

Table of Contents

Realized gains on sales and maturities of marketable securities were immaterial for the three and six months ended June 27, 2009. Realized gains on sales and maturities of marketable securities were immaterial for the three months ended June 28, 2008 and were \$0.5 million for the six months ended June 28, 2008.

**Note 5 Allowance for Doubtful Accounts**

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

The Company recorded a provision for doubtful accounts of \$5.2 million in the first quarter of fiscal 2009 primarily due to the heightened risk of non-payment of accounts receivable by certain customers facing financial difficulty. The Company recorded a reduction to provision for doubtful accounts of \$0.3 million in the second quarter of fiscal 2009. The allowance for doubtful accounts consisted of the following activity for the three and six months ended June 27, 2009 (in thousands):

|                                     | <b>Allowance for<br/>Doubtful<br/>Accounts Receivable</b> |       |
|-------------------------------------|---|-------|
| Balance at December 27, 2008        | \$  | 4,220 |
| Additions/(reductions) to provision |   | 5,246 |
| Deductions                          |   |       |
| Balance at March 28, 2009           |   | 9,466 |
| Additions/(reductions) to provision |   | (315) |
| Deductions                          |   |       |
| Balance at June 27, 2009            | \$  | 9,151 |

**Note 6 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. Provision for estimated excess and obsolete inventories are made based on management's analysis of inventory levels and future sales forecasts. Once the value is adjusted, the original cost of the Company's inventory less the related inventory write-down represents the new cost basis of such products. Reversal of these write-downs is recognized only when the related inventory has been scrapped or sold.

The Company designs, manufactures and sells a fully custom product into a market that has been subject to cyclicity and significant demand fluctuations. Probe cards are complex products, custom to a specific chip design and must be delivered on short lead-times. Probe cards are manufactured in low volumes; therefore, material purchases are often subject to minimum purchase order quantities in excess of the actual

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

demand. It is not uncommon for the Company to acquire production materials and start certain production activities based on estimated production yields and forecasted demand prior to or in excess of actual demand for the Company's wafer probe cards. These factors make inventory valuation adjustments part of the Company's normal recurring cost of revenue. Excess and obsolete inventory write downs were \$5.8 million, and \$11.8 million for the six months ended June 27, 2009, and June 28, 2008, respectively. The Company retains a portion of the excess inventory until the customer's design is discontinued. The inventory may be used to satisfy customer warranty obligations.

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

Edgar Filing: FORMFACTOR INC - Form 10-Q

Table of Contents

Inventories consisted of the following (in thousands):

|                             | June 27,<br>2009 | December 27,<br>2008 |
|-----------------------------|------------------|----------------------|
| Raw materials               | \$ 1,680         | \$ 2,147             |
| Work-in-progress            | 4,874            | 7,120                |
| Finished goods:             |                  |                      |
| Deferred cost of revenue    | 5,861            | 1,765                |
| Manufactured finished goods | 6,145            | 7,756                |
|                             | \$ 18,560        | \$ 18,788            |

**Note 7 Warranty**

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

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

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | June 27,<br>2009   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
| Warranty accrual beginning balance              | \$ 914             | \$ 2,303         | \$ 1,098         | \$ 1,383         |
| Accrual for warranties issued during the period | (200)              | 648              | (28)             | 2,488            |
| Settlements made during the period              | (80)               | (1,471)          | (436)            | (2,391)          |
| Warranty accrual ending balance                 | \$ 634             | \$ 1,480         | \$ 634           | \$ 1,480         |

**Note 8 Property and Equipment**

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

|   | Useful Life<br>(in years) | June 27,<br>2009 | December 27,<br>2008 |
|---|---------------------------|------------------|----------------------|
| Machinery and equipment                         | 5 to 7                    | 112,958          | 109,808              |
| Computer equipment and software                 | 3 to 5                    | 28,741           | 28,378               |
| Furniture and fixtures                          | 5                         | 7,041            | 6,860                |
| Leasehold improvements                          | 1 to 15                   | 70,438           | 70,699               |
|   |                           | 219,178          | 215,745              |
| Less: Accumulated depreciation and amortization |                           | (132,499)        | (116,900)            |

Edgar Filing: FORMFACTOR INC - Form 10-Q

|                          |            |            |
|--------------------------|------------|------------|
|                          | 86,679     | 98,845     |
| Construction-in-progress | 14,219     | 14,968     |
|                          | \$ 100,898 | \$ 113,813 |

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

Table of Contents**Note 9 Comprehensive loss**

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

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

|  | Three Months Ended |                  | Six Months Ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | June 27,<br>2009   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
| Net loss                                     | \$ (65,846)        | \$ (18,659)      | \$ (103,789)     | \$ (36,620)      |
| Unrealized loss on investments, net of taxes | (151)              | (571)            | (564)            | (835)            |
| Cumulative translation adjustments           | 359                | (554)            | (300)            | 226              |
| Other Comprehensive income (loss)            | 208                | (1,125)          | (864)            | (609)            |
| Comprehensive Loss                           | \$ (65,638)        | \$ (19,784)      | \$ (104,653)     | \$ (37,229)      |

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

|  | June 27,<br>2009 | December 27,<br>2008 |
|--|------------------|----------------------|
| Unrealized gains and losses on investments, net of tax | \$ 516           | \$ 1,080             |
| Foreign currency translation adjustments               | 542              | 842                  |
| Accumulated other comprehensive income                 | \$ 1,058         | \$ 1,922             |

**Note 10 Stockholders' Equity***Stock Option Plans*

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

Edgar Filing: FORMFACTOR INC - Form 10-Q

Table of Contents

Stock option activity under the Prior Plans and the 2002 Plan during the six months ended June 27, 2009 is set forth below:

|  | Options<br>Outstanding | Weighted Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life in Years | Aggregate<br>Intrinsic<br>Value |
|--|------------------------|------------------------------------|--|---------------------------------|
| Balance at December 27, 2008                 | 6,686,820              | \$ 27.36                           |  |                                 |
| Options granted                              | 12,500                 | 15.25                              |  |                                 |
| Options exercised                            | (42,498)               | 8.76                               |  |                                 |
| Options cancelled:                           |                        |                                    |  |                                 |
| Forfeited                                    | (220,130)              | 32.86                              |  |                                 |
| Expired                                      | (25,434)               | 38.42                              |  |                                 |
| Balance at March 28, 2009                    | 6,411,258              | 27.23                              | 4.65   | \$ 9,061,934                    |
| Options granted                              | 327,500                | 17.11                              |  |                                 |
| Options exercised                            | (104,794)              | 7.85                               |  |                                 |
| Options cancelled:                           |                        |                                    |  |                                 |
| Forfeited                                    | (243,520)              | 37.71                              |  |                                 |
| Expired                                      | (233,705)              | 30.39                              |  |                                 |
| Balance at June 27, 2009                     | 6,156,739              | \$ 26.49                           | 4.66   | \$ 7,180,708                    |
| Vested and expected to vest at June 27, 2009 | 5,795,389              | \$ 26.55                           | 4.59   | \$ 7,070,283                    |
| Ending Exercisable at June 27, 2009          | 4,375,847              | \$ 25.96                           | 4.28   | \$ 6,806,348                    |

The weighted average grant-date fair value of options granted during the three and six months ended June 27, 2009 was \$7.82 per share and \$7.81 per share, respectively. The intrinsic value of option exercises during the three and six months ended June 27, 2009 was \$1.2 million and \$1.5 million, respectively. Cash received from stock option exercises during the three and six months ended June 27, 2009 was \$0.8 million and \$1.2 million, respectively and, the gross tax benefit realized by the Company was approximately \$1.7 million and \$3.7 million for the three and six months ended June 27, 2009, respectively.



# Edgar Filing: FORMFACTOR INC - Form 10-Q

## Table of Contents

### *Restricted Stock Units*

Activity of the restricted stock units under the 2002 Plan during the six months ended June 27, 2009 is set forth below:

|   | Units     | Weighted<br>Average Grant<br>Date Fair Value |
|---|-----------|--|
| Restricted stock units at December 27, 2008 | 583,865   | \$ 19.92                                     |
| Awards granted                              | 25,300    | 14.90  |
| Awards released                             | (117,307) | 20.10  |
| Awards cancelled                            | (35,923)  | 18.87  |
| Restricted stock units at March 28, 2009    | 455,935   | 19.65  |
| Awards granted                              | 686,190   | 17.13  |
| Awards released                             | (31,730)  | 20.87  |
| Awards cancelled                            | (13,432)  | 19.18  |
| Restricted stock units at June 27, 2009     | 1,096,963 | \$ 18.05                                     |

### **Note 11 Stock-Based Compensation**

The Company applies the provisions of SFAS No. 123(R), using the modified prospective transition method. SFAS 123(R) requires companies to recognize the cost of employee services received in exchange for awards of equity instruments based upon the grant-date fair value of those awards.

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

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | June 27,<br>2009   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
| Stock-based compensation expense included in: |                    |                  |                  |                  |
| Cost of revenues                              | \$ 935             | \$ 1,189         | \$ 1,693         | \$ 2,547         |
| Research and development                      | 1,449              | 1,601            | 2,438            | 2,754            |
| Selling, general and administrative           | 4,738              | 3,758            | 7,562            | 6,887            |
| Restructuring                                 |                    | 146              | 216              | 623              |
| Total stock-based compensation                | 7,122              | 6,694            | 11,909           | 12,811           |
| Tax effect on stock-based compensation        | (2,400)            | (2,210)          | (4,018)          | (3,831)          |
| Total stock-based compensation, net of tax    | \$ 4,722           | \$ 4,484         | \$ 7,891         | \$ 8,980         |

Stock-based compensation expense for the three and six months ended June 27, 2009 includes \$2,477,000 resulting from the modification and acceleration of the vesting of a portion of the options awarded to the Company founder and former Executive Chairman of the Board of Directors in conjunction with his separation agreement and general release. Stock-based compensation expense for the six months ended June 28, 2008 includes approximately \$256,000 in stock-based compensation expense resulting from the modification and acceleration of the

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

vesting of a portion of the Company's former Chief Financial Officer's stock options in conjunction with his separation agreement and general release and approximately \$287,000 in stock-based compensation expense resulting from the acceleration of the vesting of a portion of the Company's former Senior Vice President, Product Business Group's restricted stock units in conjunction with his separation agreement and general release.

# Edgar Filing: FORMFACTOR INC - Form 10-Q

## Table of Contents

### *Stock Options*

The following weighted-average assumptions were used in the estimated grant-date fair value calculations for stock options:

|                          | Three Months Ended |                  | Six Months Ended |                  |
|--------------------------|--------------------|------------------|------------------|------------------|
|                          | June 27,<br>2009   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
| <b>Stock Options:</b>    |                    |                  |                  |                  |
| Dividend yield           |                    |                  |                  |                  |
| Expected volatility      | 53.3%              | 53.5%            | 53.4%            | 53.3%            |
| Risk-free interest rate  | 1.68%              | 2.64%            | 1.68%            | 2.99%            |
| Expected term (in years) | 4.67               | 4.75             | 4.67             | 4.75             |

### *Employee Stock Purchase Plan*

During the six months ended June 27, 2009 and June 28, 2008, 154,145 shares and 150,410 shares, respectively, were issued under the 2002 Employee Stock Purchase Plan ( ESPP ).

### *Unrecognized Compensation Costs*

At June 27, 2009, the unrecognized stock-based compensation, adjusted for estimated forfeitures, was as follows (in thousands):

|   | Unrecognized<br>Expense | Average Expected<br>Recognition Period<br>in years |
|---|-------------------------|--|
| Stock options                                       | \$ 20,063               | 1.45   |
| Restricted stock units                              | 13,064                  | 3.2  |
| Employee Stock Purchase Plan                        | 700                     | 0.8  |
| Total unrecognized share-based compensation expense | \$ 33,827               |  |

### **Note 12 Net Loss per Share**

Basic net (loss) per share is computed by dividing net (loss) by the weighted-average number of common shares outstanding for the period. Diluted net (loss) per share is computed giving effect to all potential dilutive common stock, including stock options, restricted stock units and common stock subject to repurchase. Diluted loss per share for the three and six months ended June 27, 2009 and June 28, 2008 were based only on the weighted-average number of shares outstanding during that period as the inclusion of any common stock equivalents would have been anti-dilutive.



Edgar Filing: FORMFACTOR INC - Form 10-Q

Table of Contents

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

|  | Three Months Ended |                  | Six Months Ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | June 27,<br>2009   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
| (In thousands)   |                    |                  |                  |                  |
| <b>Basic net loss per share</b>  |                    |                  |                  |                  |
| Numerator:   |                    |                  |                  |                  |
| Net loss   | \$ (65,846)        | \$ (18,659)      | \$ (103,789)     | \$ (36,620)      |
| Denominator:   |                    |                  |                  |                  |
| Weighted average common stock outstanding  | 49,394             | 48,835           | 49,297           | 48,789           |
| <b>Diluted net loss per share</b>  |                    |                  |                  |                  |
| Numerator:   |                    |                  |                  |                  |
| Net loss   | \$ (65,846)        | \$ (18,659)      | \$ (103,789)     | \$ (36,620)      |
| Denominator:   |                    |                  |                  |                  |
| Weighted-average shares used in computing basic net loss per share                         | 49,394             | 48,835           | 49,297           | 48,789           |
| Add stock options, restricted stock, ESPP, warrants and common stock subject to repurchase |                    |                  |                  |                  |
| Weighted average shares used in computing diluted net loss per share                       | 49,394             | 48,835           | 49,297           | 48,789           |

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

|                                       | Three Months Ended |                  | Six Months Ended |                  |
|---------------------------------------|--------------------|------------------|------------------|------------------|
|                                       | June 27,<br>2009   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
| Options to purchase common stock      | 5,373              | 7,021            | 5,475            | 6,981            |
| Restricted stock units                | 31                 | 46               |                  | 38               |
| Employee Stock Purchase Plan          | 98                 | 1,536            | 98               | 913              |
| Total potentially dilutive securities | 5,502              | 8,603            | 5,573            | 7,932            |

**Note 13 Income Taxes**

The Company recognized an income tax provision of \$32.7 million and \$19.6 million for the three months and six months ended June 27, 2009, respectively, despite losses before taxes. The provision is primarily due to a valuation allowance of \$44.7 million, which includes excess tax benefits recognized during the second quarter of fiscal 2009 and prior quarters, against the Company's Federal and state deferred tax assets in accordance with SFAS No. 109, Accounting for Income Taxes. The valuation allowance was recorded at the end of the second quarter of 2009 to reduce certain Federal and state net deferred tax assets to their anticipated realizable value. The remaining realizable value was determined by evaluating the potential to recover the value of these assets through the utilization of loss carrybacks.

SFAS 109 requires the consideration of a valuation allowance to reflect the likelihood of realization of deferred tax assets. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, the Company considered available positive and negative evidence giving greater weight to its recent cumulative

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

losses and its ability to carryback losses against prior taxable income and lesser weight to its projected financial results due to the challenges of forecasting future periods. The Company also considered, commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. The Company performed this evaluation as of the year ended December 27, 2008 and the three months ended March 28, 2009. At that time the Company continued to have sufficient positive evidence, primarily a cumulative profits position, the ability to carryback losses against prior taxable income and an expectation of improving operating results, showing a valuation allowance was not required. At the end of the second quarter of 2009, changes in previously anticipated expectations has necessitated a valuation allowance against the excess tax benefits recognized in this quarter and prior quarters since they are no longer more likely than not realizable. Under current tax laws, this valuation allowance will not limit the Company's ability to utilize Federal and state deferred tax assets provided it can generate sufficient future taxable income.

Table of Contents

Under FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an Interpretation of FAS 109, the Company classifies interest and penalties related to uncertain tax positions as part of income tax expense. The Company recognized interest expense of \$10,000 and \$53,000 for the three months ended June 27, 2009 and June 28, 2008, respectively, and \$130,000 and \$75,000 for the six months ended June 27, 2009 and June 28, 2008, respectively. As of June 27, 2009, the Company had approximately \$443,000 of interest and zero penalties related to uncertain tax positions.

The amount of income taxes the Company pays is subject to ongoing audits by Federal, state and non-U.S. tax authorities which might result in proposed assessments. The Company's estimate for the potential outcome for any uncertain tax issue is judgmental in nature. However, the Company believes that it has adequately provided for any reasonably foreseeable outcome related to those matters. The Company's future results may include favorable or unfavorable adjustments to its estimated tax liabilities in the period the assessments are made or resolved or when statutes of limitation on potential assessments expire. As of June 27, 2009, changes to the Company's uncertain tax positions in the next 12 months, that are reasonably possible, are not expected to have a significant impact on its financial position or results of operations.

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

Table of Contents

**Note 14 Commitments and Contingencies**

*Environmental Matters*

The Company is subject to U.S. federal, state and local, and foreign governmental laws and regulations relating to the protection of the environment, including those governing the discharge of pollutants into the air and water, the management and disposal of hazardous substances and wastes, the clean-up of contaminated sites and the maintenance of a safe workplace. The Company believes that it complies in all material respects with the environmental laws and regulations that apply to it, including those of the California Department of Toxic Substances Control, the Bay Area Air Quality Management District, the City of Livermore Water Resources Division and the California Division of Occupational Safety and Health. No provision has been made for loss from environmental remediation liabilities associated with the Company's Livermore facility because the Company believes that it is not probable that a liability has been incurred as of June 27, 2009.

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

*Legal Matters*

From time to time, the Company may be subject to legal proceedings and claims in the ordinary course of business. For the fiscal quarter ended June 27, 2009, the Company was not involved in any material legal proceedings, other than the proceedings summarized below. In the future the Company may become a party to additional legal proceedings, including proceedings designed to protect its intellectual property rights that require the Company to spend significant resources.

**Patent Litigation**

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



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

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

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

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

### Table of Contents

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

The investigation (337-TA-621) was originally referred to the Honorable Theodore R. Essex, an ITC administrative law judge, and in July 2008 was reassigned to the Honorable Charles E. Bullock, an ITC administrative law judge, who will make an initial determination as to whether there is a violation of Section 337; that initial determination is subject to review by the full ITC Commission, the Commission. On or about January 23, 2009, the administrative law judge, after a September 2008 hearing, issued a claim construction ruling interpreting and defining terms of certain of the claims of the patents-in-suit. On or about January 28, 2009, the Company voluntarily withdrew its allegations to the extent that they encompassed its U.S. Patent No. 7,168,162, and on or about February 13, 2009, the administrative law judge issued an initial determination holding invalid the asserted claims of the Company's U.S. Patent No. 6,624,648, after finding as part of the claim construction ruling that one of the terms in the asserted claims of that patent is indefinite. The Company appealed that initial determination of invalidity to the Commission on or about February 18, 2009. The Commission agreed to review the initial determination and a decision is expected within 30-60 days of the date of filing this Form 10-Q.

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

FormFactor, Micronics Japan and Phicom filed additional briefing to the Commission seeking review of parts of the ALJ's Initial Determination. The Commission can accept, reject or modify any of the ALJ's recommendations. The Commission is expected to announce which aspects of the recommendations it will review on or before August 13, 2009, and for those parts of the Initial Determination that are reviewed by the Commission, a ruling, termed the Final Determination, is scheduled to be issued by October 29, 2009. The Final Determination, which is an ITC remedial order in Section 337 cases, is effective when issued and becomes final 60 days after issuance, subject to Presidential review.

In addition to the United States litigations, the Company also initiated actions in Seoul, South Korea against Phicom. In 2004 the Company filed two actions in Seoul Southern District Court, located in Seoul, South Korea, against Phicom alleging infringement of the Company's Korean Patent Nos. 252,457, entitled Method of Fabricating Interconnections Using Cantilever Elements and Sacrificial Substrates, 324,064, entitled Contact Tip Structures for Microelectronic Interconnection Elements and Methods of Making Same, 278,342, entitled Method of Altering the Orientation of Probe Elements in a Probe Card Assembly and 399,210, entitled Probe Card Assembly; as well as two actions the Company filed in 2006 in Seoul Central District Court against Phicom alleging infringement of certain claims of its Korean Patent No. 252,457 and seeking injunctive relief. These actions are all pending, on appeal to the High Court in Seoul as (i) on April 18, 2008, the Seoul Southern District Court issued a ruling that dismissed the Company's complaint as it related to Korean Patent Nos. 252,457 and 324,064, finding certain claims of Patent Nos. 252,457 and 324,064 were invalid, and that one of the claims of each of the patents was not infringed by Phicom, (ii) in July 2008, the Seoul Central District Court dismissed the Company's complaint related to Korean Patent No. 252,457, and (iii) on November 27, 2008, the Seoul Southern District Court dismissed the Company's complaint related to Korean Patent Nos. 278,342 and 399,210. The Company did not appeal the judgment on the injunctive relief request related to Korean Patent No. 252,457 filed in the Seoul Central District.



Table of Contents

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

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

No provision has been made for patent-related litigation because the Company believes that it is not probable that a liability had been incurred as of June 27, 2009. The Company will incur material attorneys' fees in prosecuting and defending the various identified actions.

**Securities Litigation**

On October 31, 2007, a plaintiff filed a purported stockholder class action in the United States District Court for the Northern District of California in which the Company and certain of its then officers, including one former officer who was a director at the time of filing, are named as defendants under the caption *Danny McCasland, Individually and on Behalf of All Others Similarly Situated v. FormFactor, Inc., Igor Y. Khandros, Ronald C. Foster and Richard M. Freeman*. Subsequently, plaintiffs filed two other purported stockholder class actions in the United States District Court for the Northern District of California under the captions *Yuk Ling Lui, on Behalf of Herself and All Others Similarly Situated v. FormFactor, Inc., Igor Y. Khandros, Ronald C. Foster and Richard M. Freeman*, and *Victor Albertazzi, Individually and on Behalf of All Others Similarly Situated v. FormFactor, Inc., Igor Y. Khandros, Ronald C. Foster and Richard M. Freeman*. The three actions have been consolidated. The plaintiffs filed these actions following the Company's restatement of its financial statements for the fiscal year ended December 30, 2006, for each of the fiscal quarters for that year, and for the fiscal quarters ended March 31 and June 30, 2007. In April 2008, the designated lead plaintiffs filed a Consolidated Amended Complaint. The plaintiffs claimed violations of Sections 10(b) and 20(a), and Rule 10b-5 of the Securities Exchange Act of 1934, alleging that the defendants knowingly issued materially false and misleading statements regarding the Company's business and financial results prior to the restatements. On July 25, 2008, the court granted the defendants' motion to dismiss the Consolidated Amended Complaint with leave to amend. On August 22, 2008 the designated lead plaintiffs filed a Second Amended Complaint. The Second Amended Complaint also alleged violations of Sections 10(b) and 20(a), and Rule 10b-5 of the Securities Exchange Act of 1934. The plaintiffs again claimed that defendants knowingly issued materially false and misleading statements regarding the Company's business and financial results prior to the restatement, as well as regarding the development of the Harmony product line. Plaintiffs sought to recover unspecified monetary damages, equitable relief and attorneys' fees and costs. Defendants filed a motion to dismiss the Second Amended Complaint on October 6, 2008, and a hearing on the motion was held on February 6, 2009. On July 14, 2009, the court issued a ruling granting the Company's and the other defendants' motion to dismiss the second amended complaint without leave to amend. On July 28, 2009, plaintiffs filed a Motion to Alter or Amend the Judgment and to Uphold a Revised, Narrowed Second Amended Complaint. The revised complaint does not contain the accounting and restatement allegations that were included in the Second Amended Complaint but asks the Court to uphold only the Harmony-related allegations. The hearing on the Motion to Alter or Amend the Judgment is currently scheduled for September 11, 2009.

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

Plaintiffs will have thirty days from the Court's ruling on the Motion to Alter or Amend the Judgment to file an appeal with the Court of Appeals for the Ninth Circuit.

No provision has been made for the securities litigation because the Company believes that it is not probable that a liability had been incurred as of June 27, 2009.

Table of Contents

**Stockholder Derivative Litigation**

On November 19, 2007, a plaintiff filed a purported stockholder derivative action in the Superior Court of the State of California for the County of Alameda in which the Company is named as a nominal defendant and certain of its then directors and officers are named as defendants under the caption John King, Derivatively on Behalf of Nominal Defendant FormFactor, Inc. v. Dr. Igor Y. Khandros, Dr. Homa Bahrami, Dr. Thomas J. Campbell, G. Carl Everett, Jr., Lothar Maier, James A. Prestridge, Harvey A. Wagner, Ronald C. Foster and Richard M. Freeman, and FormFactor, Inc. Subsequently, another plaintiff filed a second purported stockholder class action in the Superior Court of the State of California for the County of Alameda under the caption Joseph Priestley, Derivatively on Behalf of FormFactor, Inc. v. Igor Y. Khandros, Mario Ruscev, James A. Prestridge, Thomas J. Campbell, Harvey A. Wagner, G. Carl Everett, Jr., Homa Bahrami, Lothar Maier, William H. Davidow and Joseph R. Bronson, and FormFactor, Inc. The plaintiffs filed these two later actions following the Company's restatement of its financial statements for the fiscal year ended December 30, 2006, for each of the fiscal quarters for that year, and for the fiscal quarters ended March 31 and June 30, 2007. The plaintiffs allege that the defendants breached their fiduciary duties and violated applicable law by issuing, and permitting the Company to issue, materially false and misleading statements regarding the Company's business and financial results prior to the restatements. The plaintiffs seek to recover monetary damages, and attorneys' fees and costs. The two derivative actions have been consolidated, and a consolidated amended complaint is to be filed 30 days after the United States District Court in the stockholder class action enters a final ruling on the class action plaintiffs' Motion to Alter or Amend the Judgment in that action.

No provision has been made for the stockholder derivative litigation because the Company believes that it is not probable that a liability had been incurred as of June 27, 2009.

**Commercial Litigation**

On February 20, 2009, the Company filed a complaint for breach of contract, common counts, account stated and injunctive relief against Spansion, LLC, a Delaware limited liability company (Spansion), in the state superior court located in Santa Clara County, California. The complaint alleges that Spansion, in breach of Spansion's obligations under a purchase agreement entered into by the Company and Spansion, has failed to pay the Company for probe cards that the Company designed, developed and manufactured pursuant to several purchase orders placed by Spansion with the Company pursuant to the agreement. The complaint states that as of February 13, 2009, Spansion owed the Company \$8,094,533 for probe cards delivered by the Company and not paid for by Spansion. In the complaint, the Company is seeking (i) payment of at least \$8,094,533, (ii) a temporary protective order and an injunction enjoining Spansion from assigning or in any way divesting itself of any monies that the Company believes Spansion received from a certain third party entity, (iii) a prejudgment writ of attachment in favor of the Company over Spansion's corporate assets and property, (iv) costs and (v) attorney's fees. Prior to making any appearance or filing any answer in the action, Spansion filed for protection under Chapter 11 of the Bankruptcy Laws of the United States, which served to stay the Company's complaint against Spansion. The Company has not recognized \$1.4 million of revenue related to shipments to Spansion and has reserved the remaining \$6.7 million of the outstanding receivable from Spansion as of the end of the second quarter of fiscal 2009.

The Company believes that the factual allegations and circumstances underlying the legal proceedings in this Note 14 filed against the Company are without merit. The Company also believes that it does not have a material monetary damages exposure in these legal proceedings that would individually or in the aggregate have a material adverse effect on its financial condition, liquidity or results of operations; however, these legal proceedings have been costly and it is possible the Company will incur significant, and possibly material, attorneys' fees, which may not be covered by its insurance policies. These legal proceedings may also divert the Company's management's time and attention away from business operations, which could prove to be disruptive to the Company's business operations. In addition, an unfavorable outcome or settlement of these proceedings, particularly if it is not covered by or exceeds the Company's insurance coverage, could individually or in the aggregate adversely impact the Company's financial condition, liquidity or results of operations.

**Indemnification Arrangements**

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

Table of Contents

indemnification obligations in favor of its directors, officers and agents. These indemnity arrangements may limit the type of the claim, the total amount that the Company can be required to pay in connection with the indemnification obligation and the time within which an indemnification claim can be made. The duration of the indemnification obligation may vary, and for most arrangements, survives the agreement term and is indefinite. It is not possible to determine or reasonably estimate the maximum potential amount of future payments under these indemnification obligations due to the varying terms of such obligations, the history of prior indemnification claims, the unique facts and circumstances involved in each particular contractual arrangement and in each potential future claim for indemnification, and the contingency of any potential liabilities upon the occurrence of events that are not reasonably determinable. The Company has not had any requests for indemnification under these arrangements. The Company has not recorded any liabilities for these indemnification arrangements on its condensed consolidated balance sheet as of June 27, 2009.

The Company believes that substantially all of its indemnities and commitments provide for limitations on the maximum potential future payments it could be obligated to make. However, the Company is unable to estimate the maximum amount of liability related to its indemnities and commitments because such liabilities are contingent upon the occurrence of events which are not reasonably determinable. The Company's management believes that any liability for these indemnities and commitments would not be material to its accompanying consolidated financial statements.

**Note 15 Derivative Financial Instruments**

SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, requires companies to recognize all derivative instruments as either assets or liabilities at fair value in the statement of financial position. Effective January 1, 2009, the Company adopted the changes to the disclosure requirements for derivative and hedging activities of SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* an amendment of FASB Statement No. 133. SFAS No. 161 requires the Company to provide enhanced disclosures about (a) how and why the Company uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect the Company's financial position, financial performance, and cash flows.

The Company operates and sells its products in various global markets. As a result, the Company is exposed to changes in foreign currency exchange rates. The Company utilizes foreign currency forward contracts to hedge against future movements in foreign exchange rates that affect certain existing foreign currency denominated assets and liabilities. The Company does not use derivative financial instruments for speculative or trading purposes. The Company's derivative instruments, which are generally settled in the same quarter, are not designated as hedging instruments under SFAS No.133, and therefore gains and losses are recognized in Other income (expense), net.

As of June 27, 2009, there were three outstanding foreign exchange forward contracts to sell Japanese Yen, Korean Won and Taiwan Dollars. The following table provides information about the Company's foreign currency forward contracts outstanding as of June 27, 2009 (in thousands):

|   | Contract Amount<br>(Local Currency) |    | Contract Amount<br>(U.S. Dollars) |
|---|-------------------------------------|----|-----------------------------------|
| Japanese Yen  | 1,807,353                           | \$ | 18,967                            |
| Taiwan Dollar   | 32,387                              |    | 983                               |
| Korean Won  | 3,015,469                           |    | 2,339                             |
| Total USD notional amount of outstanding foreign exchange contracts |                                     | \$ | 22,289                            |



Edgar Filing: FORMFACTOR INC - Form 10-Q

The contracts were entered into on June 26, 2009 and matured on July 28, 2009. Accordingly, there were no amounts reported in the Company's Condensed Consolidated Balance Sheets as of June 27, 2009 related to these contracts. Additionally, no gains or losses relating to the outstanding derivative contracts were recorded in the fiscal quarter ending June 27, 2009.

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

### Table of Contents

The location and amount of gains and losses related to non-designated derivative instruments that matured in the fiscal quarter ended June 27, 2009 in the Condensed Consolidated Statement of Operations are as follows (in thousands):

| <b>Derivatives Not Designated as Hedging Instruments Under SFAS No. 133</b> | <b>Location of Gain or (loss) Recognized in Loss on Derivative</b> | <b>Amount of Gain or (Loss) Recognized in Loss on Derivative</b> |
|---|--|--|
| Foreign exchange forward contracts  | Other Income (expense), net  | \$ (792)   |
| Total   |  | \$ (792)   |

### **Note 16 Departure of Executive Officer**

The Company entered into a Separation Agreement and Mutual Release as of May 1, 2009 (the Separation Agreement) with its founder and former Executive Chairman Dr. Igor Khandros, who retired from the Company and the board of directors. Under the terms of the Separation Agreement, the Company accelerated vesting of options to acquire 75,000 shares and permitted certain vested stock options to be exercisable until the earlier of (i) May 1, 2014 or (ii) the original expiration date of the applicable stock option (Refer to Note 11). The Company and Dr. Khandros also entered into a consulting agreement effective as of May 1, 2009 under which Dr. Khandros will continue to serve as a key advisor to the Company for a term of one-year for a quarterly consulting fee of \$75,000. The consulting agreement was terminated by Dr. Khandros effective July 1, 2009.

### **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 for the year ended December 27, 2008, 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

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

Table of Contents

The oversupply of memory devices coupled with the overall global economic downturn and uncertainty in fiscal 2008 had a significant impact on global semiconductor device manufacturing. As the second quarter of fiscal 2009 progressed, we saw our markets continued to be affected by the continuing global macroeconomic downturn which resulted in a significant decrease in demand and a challenging environment for our advanced wafer probe cards. Revenues for the second quarter of fiscal 2009 were \$31.2 million, reflecting a decline of 40% from the second quarter of fiscal 2008. This revenue decline was in each of the product markets we address Dynamic Random Access Memory, or DRAM, NAND and NOR Flash memory and System on a Chip, or SoC, and was primarily due to a number of factors including the relative supply and demand of various semiconductor devices and end products incorporating those devices, semiconductor manufacturers' efforts to curtail spending and conserve cash by taking capacity offline, reducing production, delaying the transition to new technology nodes and postponing the implementation of tooling cycles.

We incurred a net loss of \$65.8 million in the second quarter of fiscal 2009 as compared to net loss of \$18.7 million for the second quarter of fiscal 2008 primarily due to lower revenues as well as the inclusion of a \$44.7 million valuation allowance for our deferred tax assets. We incurred a net loss of \$103.8 million in the first half of fiscal 2009 as compared to net loss of \$36.6 million for the first half of fiscal 2008 primarily due to lower revenues, the inclusion of a valuation allowance of \$44.7 million for our deferred tax assets, the inclusion of \$7.9 million of restructuring charges as well as \$4.9 million in provision for bad debts due to the heightened risk of non-payment of certain accounts receivable. Net loss for the first half of fiscal 2008 included \$8.5 million in restructuring charges and \$0.5 million in provision for doubtful debts. In the first quarter of fiscal 2009, we initiated a global reorganization and cost reduction plan designed to lower our cash breakeven level in order to enable us to sustain ourselves financially in the current market environment. As part of the plan, we reduced our workforce by approximately 22%. We also implemented certain non-severance measures that we expect to result in future cost savings.

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

We established a valuation allowance of \$44.7 million against the excess tax benefits recognized in prior quarters. This charge resulted in an income tax expense, rather than an income tax benefit, for the three and six months ended June 27, 2009. This valuation allowance was based on our quarterly assessment of the realizability of our deferred tax assets. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, we considered available positive and negative evidence giving greater weight to our recent cumulative losses, ability to carryback losses against prior taxable income and lesser weight to our projected financial results due to the challenges of forecasting future periods. We also considered, commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. The necessity for this valuation allowance and any future adjustments will be based on the available positive and negative evidence at that time, commensurate with its objective verifiability. Under current tax law, this valuation allowance will not limit our ability to utilize Federal and state deferred tax assets provided we can generate sufficient future taxable income. Our tax provisions in future periods will primarily consist of income taxes on our profits in certain jurisdictions outside of the US.

Our cash, cash equivalents and marketable securities totaled approximately \$486.8 million as of June 27, 2009 as compared to \$522.9 million at December 27, 2008. While there are no specific significant transactions or arrangements that are likely to materially affect liquidity, economic uncertainty and weak credit markets are driving our customers to delay their procurement as well as payment decisions which could adversely delay and affect our cash collections. We believe that we will be able to satisfy our working capital requirements for the next twelve months with the liquidity provided by our existing cash, cash equivalents and marketable securities. If we are unsuccessful in improving our operating efficiency, reducing our cash outlays or increasing our available cash through financing, our cash, cash equivalents and marketable securities

will further decline in the second half of fiscal 2009.

Table of Contents

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

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

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

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

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

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

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

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

*Use of Estimates.* Our discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements. The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States of America ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Estimates may change as new information is obtained. Significant items that are subject to such estimates include the fair value of revenue elements, fair value of marketable securities, allowance for doubtful accounts, reserves for product warranty, valuation of obsolete and slow moving inventory, valuation and recognition of stock-based compensation, provision for income taxes and valuation allowance for deferred tax assets and, tax liabilities and accruals for other liabilities.

Table of Contents**Results of Operations**

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

|   | Three Months Ended |                  | Six Months Ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | June 27,<br>2009   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
| Revenues                                  | 100.0%             | 100.0%           | 100.0%           | 100.0%           |
| Cost of revenues                          | 104.3              | 78.7             | 108.5            | 79.9             |
| Gross profit (loss)                       | (4.3)              | 21.3             | (8.5)            | 20.1             |
| Operating expenses:                       |                    |                  |                  |                  |
| Research and development                  | 44.7               | 30.4             | 47.9             | 27.4             |
| Selling, general and administrative       | 58.5               | 43.7             | 76.1             | 38.4             |
| Restructuring charge                      | 0.8                | 6.2              | 13.6             | 7.3              |
| Total operating expenses                  | 104.1              | 80.3             | 137.6            | 73.1             |
| Operating loss                            | (108.3)            | (59.0)           | (146.1)          | (53.0)           |
| Interest income, net                      | 2.4                | 6.0              | 3.2              | 6.8              |
| Other income (expense)                    | (0.3)              | (1.3)            | (0.9)            | 0.1              |
| Loss before income taxes                  | (106.2)            | (54.3)           | (143.8)          | (46.1)           |
| Provision for (benefit from) income taxes | 104.9              | (18.3)           | 33.5             | (15.0)           |
| Net loss                                  | (211.1)%           | (36.0)%          | (177.2)%         | (31.1)%          |

**Three and Six Months Ended June 27, 2009 and June 28, 2008:****Revenues**

|                                    | Three Months Ended |                  |          | Six Months Ended |                  |          |
|------------------------------------|--------------------|------------------|----------|------------------|------------------|----------|
|                                    | June 27,<br>2009   | June 28,<br>2008 | % Change | June 27,<br>2009 | June 28,<br>2008 | % Change |
| (In thousands, except percentages) |                    |                  |          |                  |                  |          |
| Revenues by Market:                |                    |                  |          |                  |                  |          |
| DRAM                               | \$ 25,267          | \$ 31,721        | (20.3)%  | \$ 48,813        | \$ 71,896        | (32.1)%  |
| Flash                              | 1,852              | 11,519           | (83.9)   | 2,471            | 27,737           | (91.1)   |
| Logic                              | 4,079              | 8,773            | (53.5)   | 7,283            | 18,083           | (59.7)   |
| Total revenues                     | \$ 31,198          | \$ 52,013        | (40.0)%  | \$ 58,567        | \$ 117,716       | (50.2)%  |

The decrease in revenue for the three and six months ended June 27, 2009 was primarily due to weak demand for our advanced wafer probe cards caused by the continued weakness in the semiconductor market. For certain of our products we also experienced pricing pressure due to the availability of competitive products, which also contributed to the decrease in revenues.

Our revenues for the three and six months ended June 27, 2009 were primarily generated by sales of wafer probe cards to manufacturers of DRAM devices. Revenues for our products that address the DRAM segment declined significantly in the three and six months ended June 27, 2009 as compared to the comparable periods in the prior year, primarily due to continued weak market conditions in which DRAM device



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

pricing fell below the industry average of semiconductor manufacturers' cash costs. Given the current price of DRAM devices, our customers that manufacture DRAM devices took certain actions, including decisions to delay transitions to new technology nodes, test capacity expansions and ramping of key devices. We also experienced pricing pressure on certain DRAM test products due to the competitive environment.

Revenues from sales to Flash memory device manufacturers also decreased significantly in the three months and six ended June 27, 2009 compared to the comparable periods in the prior year, with the decrease driven by sales decline in both NOR and NAND Flash wafer probe cards. The weakness in NOR Flash can be attributed to a decline in purchases by certain key customers. The decrease was primarily driven by a decline in revenues from NOR Flash wafer probe cards resulting from our largest NOR customer filing for bankruptcy protection in the first quarter of fiscal 2009. Additionally, revenues from NAND Flash wafer probe cards declined as NAND Flash memory device manufacturers significantly reduced their output in the first quarter of fiscal 2009, in an attempt to promote industry absorption of excess inventories.

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

### Table of Contents

Revenues from manufacturers of SoC devices decreased in the three and six months ended June 27, 2009 compared to the comparable periods in the prior year, primarily due to the overall downturn in the semiconductor industry which negatively impacted the revenues from sales of our wafer probe cards.

The weak macroeconomic and credit environments have adversely impacted the profitability of our customers and their capital spending and are likely to result in product revenues in the near term that are lower than our revenue levels in comparable periods during prior fiscal years.

### *Revenue by Geographic Region*

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

|                                   | June 27,<br>2009 | Three Months Ended<br>% of<br>Revenues | June 28,<br>2008 | % of<br>Revenues | June 27,<br>2009 | Six Months Ended<br>% of<br>Revenues | June 28,<br>2008 | % of<br>Revenues |
|-----------------------------------|------------------|--|------------------|------------------|------------------|--------------------------------------|------------------|------------------|
| (In thousands except percentages) |                  |  |                  |                  |                  |                                      |                  |                  |
| Japan                             | \$ 14,018        | 44.9%                                  | \$ 18,611        | 35.8%            | \$ 33,884        | 57.9%                                | \$ 40,666        | 34.5%            |
| North America                     | 6,232            | 20.0                                   | 12,344           | 23.7             | 9,180            | 15.7                                 | 24,480           | 20.8             |
| Asia Pacific                      | 9,794            | 31.4                                   | 15,779           | 30.3             | 13,035           | 22.3                                 | 42,532           | 36.1             |
| Europe                            | 1,154            | 3.7                                    | 5,279            | 10.1             | 2,468            | 4.2                                  | 10,038           | 8.5              |
| Total revenues                    | \$ 31,198        | 100%                                   | \$ 52,013        | 100%             | \$ 58,567        | 100%                                 | \$ 117,716       | 100%             |

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

The decreases in Japan and Asia Pacific for the three and six months ended June 27, 2009 as compared to the same period in the prior year was primarily due to the decrease in our DRAM product sales in the region. The decrease in revenues in North America for the three and six months ended June 27, 2009 compared to the same period in the prior year was primarily driven by decreased demand for all our products in this region. Revenue in Europe decreased for the three months ended June 27, 2009 primarily due to the decreased demand for all of our products in this region.

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

|                   | Three Months Ended<br>June 27,<br>2009 | June 28,<br>2008 | Six Months Ended<br>June 27,<br>2009 | June 28,<br>2008 |
|-------------------|--|------------------|--------------------------------------|------------------|
| Elpida Memory     | 42.8%                                  | 29.6%            | 56.0%                                | 26.9%            |
| Spansion          | *                                      | 12.5             | *                                    | 15.1             |
| Intel Corporation | *                                      | 17.4             | *                                    | 14.7             |

---

\* Less than 10% of revenues.

Table of Contents**Gross Profit**

|                     | Three Months Ended                |                  | Six Months Ended |                  |
|---------------------|-----------------------------------|------------------|------------------|------------------|
|                     | June 27,<br>2009                  | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
|                     | (In thousands except percentages) |                  |                  |                  |
| Gross profit (loss) | \$ (1,326)                        | \$ 11,101        | \$ (5,005)       | \$ 23,673        |
| Gross margin (loss) | (4.3)%                            | 21.3%            | (8.5)%           | 20.1%            |

Gross margin fluctuates with revenue levels, product mix, selling prices, factory loading, and material costs. For the three and six months ended June 27, 2009, gross margin declined compared to the same period in the prior year, primarily due to the significant decline in revenue driving lower factory utilization, thereby increasing unit manufacturing costs, combined with declines in average selling prices as well as unfavorable change in product mix from higher margin to lower margin products. This decline was partially mitigated by lower personnel costs as a result of our fiscal 2008 and 2009 global cost reduction plans as well as a decline in inventory write-downs. Inventory provision decreased from \$11.8 million or 10% of revenues in the first six months of fiscal 2008 to \$5.8 million, or 9.9% of revenues, in the first six months of fiscal 2009. The higher inventory write-downs in first six months of fiscal 2008 were associated with deterioration in the DRAM memory segment in that period. Excess custom inventories are not uncommon for us as our advanced wafer probe cards are custom designs manufactured in low volumes and must be delivered on relatively short lead times, which requires us to acquire production materials and start certain production activities based on estimated production yields and forecasted demand prior to or in excess of actual demand for our wafer probe cards. Stock-based compensation included in gross margin was \$0.9 million or 3.0% of revenues, and \$1.2 million, or 2.3% of revenues, in the three months ended June 27, 2009 and June 28, 2008, respectively, and \$1.7 million, or 2.9% of revenues and \$2.5 million, or 2.2% of revenues for the six months ended June 27, 2009 and June 28, 2008, respectively. The decline of stock-based compensation, in absolute dollars, was primarily as a result of reductions in headcount as a result of our 2008 and 2009 global cost reduction plans.

In the near future, our gross margins will likely continue to be adversely affected by lower levels of product revenues in comparison to the same periods in the prior fiscal year, even though we have taken significant steps to reduce our production levels and operating cost structure. Additionally, we may be required to record additional inventory write-downs if estimated average selling prices of products held in finished goods and work in process inventories at a quarter-end date are below the manufacturing cost of those products.

**Research and Development**

|                          | Three Months Ended                |                  | Six Months Ended |                  |
|--------------------------|-----------------------------------|------------------|------------------|------------------|
|                          | June 27,<br>2009                  | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
|                          | (In thousands except percentages) |                  |                  |                  |
| Research and development | \$ 13,938                         | \$ 15,821        | \$ 28,047        | \$ 32,209        |
| % of revenues            | 44.7%                             | 30.4%            | 47.9%            | 27.4%            |

Research and development expenses decreased in absolute dollars for the three and six months ended June 27, 2009 compared to the same period in the prior year primarily due to a decrease in certain new technology product development related costs, personnel costs and depreciation, facilities and information technology allocations. For the three and six months ended June 27, 2009, personnel costs decreased \$1.4 million and \$2.8 million, respectively, primarily due to reductions in headcount as a result of our global reorganization plans, expenses related to new technology and product development increased slightly, and depreciation and facilities and information technology allocations decreased \$0.7 million and \$0.9 million, respectively, primarily due to the implementation of corporate cost reduction initiatives. Stock-based

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

compensation included within research and development was \$1.4 million for the three months ended June 27, 2009 compared to \$1.6 million for the three months ended June 28, 2008, and \$2.5 million for the first half of fiscal 2009 as compared to \$2.8 million for the first half of fiscal 2008. The decline in stock-based compensation in absolute dollars was primarily due to reductions in headcount due to the 2008 and 2009 global cost reduction plans.

As a percent of revenues, research and development expenses increased during the three and six months ended June 27, 2009 as compared to the comparable periods in the prior year, primarily due to the declining revenue base.

Table of Contents

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

***Selling, General and Administrative***

|                                     | Three Months Ended                |                  | Six Months Ended |                  |
|-------------------------------------|-----------------------------------|------------------|------------------|------------------|
|                                     | June 27,<br>2009                  | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
|                                     | (In thousands except percentages) |                  |                  |                  |
| Selling, general and administrative | \$ 18,263                         | \$ 22,705        | \$ 44,574        | \$ 45,363        |
| % of revenues                       | 58.5%                             | 43.7%            | 76.1%            | 38.4%            |

Selling, general and administrative expenses decreased in absolute dollars for the three and months ended June 27, 2009 compared to the same period in the prior year primarily due to a decrease in personnel-related costs, other discretionary spending, facilities-related costs and depreciation. For the three and six months ended June 27, 2009, personnel related costs decreased by approximately \$2.3 and \$4.7 million, respectively, primarily due to the work force reductions, other discretionary spending decreased by \$0.4 million and \$0.9 million, respectively, due to the newly implemented corporate cost reduction initiatives and facilities-related costs and depreciation decreased \$0.8 million and \$1.1 million, respectively. Outside legal and other professional fees decreased by \$1.5 million in the three months ended June 27, 2009 and increased by \$0.3 million in the six months ended June 27, 2009, as compared to the comparable periods in the prior year. The change in legal fees for the three and six months ended June 27, 2009 was primarily due to the scheduling of the International Trade Commission hearing on the investigation (337-TA-621) arising out of our complaint filed in late 2007. The increase for the six months ended June 27, 2009 was due to the fact the hearing was conducted during the first quarter of fiscal 2009, during which we also incurred fees and costs related to hearing preparation activities. The decrease during the three months ended June 27, 2009 reflects that the majority of the fees and costs related to the hearing and post hearing activities were completed by the end of the first quarter of fiscal 2009. In comparison, in the second quarter of fiscal 2008, we were engaged in active discovery activities.

Additionally, we recorded a reduction in the provision for doubtful accounts of \$0.3 million in the three months ended June 27, 2009, compared to a provision of \$0.5 million in the three months ended June 28, 2008. Provision for doubtful accounts was \$4.9 million in the six months ended June 27, 2009 compared to \$0.5 million in the comparable period in the prior year. In addition, stock-based compensation included within selling, general and administrative expense was \$4.7 million and \$7.6 million for the three and six months ended June 27, 2009, compared to \$3.8 million and \$6.9 million for the three and six months ended June 28, 2008. The increase in stock-based compensation was due to an option modification charge of \$2.5 million in connection with the retirement of Dr. Igor Y. Khandros, our founder and former executive chairman of our board of directors in May 2009, offset in part by a decrease due to reductions in headcount as a result of our 2008 and 2009 global cost reduction plans.

As a percent of revenue, selling, general and administrative expenses increased in three and six months ended June 27, 2009 as compared to the comparable periods in the prior year, primarily due to the declining revenue base.

***Restructuring Charges***

Edgar Filing: FORMFACTOR INC - Form 10-Q

|                       | Three Months Ended                |                  | Six Months Ended |                  |
|-----------------------|-----------------------------------|------------------|------------------|------------------|
|                       | June 27,<br>2009                  | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
|                       | (In thousands except percentages) |                  |                  |                  |
| Restructuring charges | \$ 264                            | \$ 3,223         | \$ 7,943         | \$ 8,543         |
| % of revenues         | 0.8%                              | 6.2%             | 13.6%            | 7.3%             |

Table of Contents

In the first quarter of fiscal 2009, we implemented the Q1 2009 Restructuring Plan that included reducing our global workforce by 22%. The Q1 2009 Restructuring Plan extended the cost reduction plans implemented during fiscal 2008 and impacted employees across all functions of the organization. We recorded \$7.7 million in relation to the Q1 2009 Restructuring Plan in the first quarter of fiscal 2009 and \$0.3 million in relation to the Q1 2009 Restructuring Plan in the second quarter of fiscal 2009. The plan consisted primarily of involuntary employee terminations and benefit costs and write-down of certain assets taken out of service. During the three and six months ended June 27, 2009, we paid \$0.8 million and \$6.1 million of severance and benefits related to the Q1 Restructuring 2009 Plan. We anticipate that the remainder of the employee-related charges resulting from the cost reduction plan implemented in the first quarter of fiscal 2009 will be paid within the next nine months. We expect to realize a quarterly cost savings of approximately \$3.4 million as a result of the actions taken in the first quarter of fiscal 2009 related to this plan.

In both the first and second quarters of fiscal 2008, we implemented global cost reduction plans that included reducing our global workforce. We recorded \$3.2 million and \$8.5 million in restructuring charges in the three and six months ended June 28, 2008, respectively. Both plans consisted primarily of involuntary employee termination and benefit costs and facility impairment charges related to vacating buildings in Livermore, California. Substantially all of the employee related charges related to the first quarter of fiscal 2008 and second quarter of fiscal 2008 cost reduction plans were paid by the end of fiscal 2008.

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

|                        | Three Months Ended                |                  | Six Months Ended |                  |
|------------------------|-----------------------------------|------------------|------------------|------------------|
|                        | June 27,<br>2009                  | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
|                        | (In thousands except percentages) |                  |                  |                  |
| Interest income        | \$ 762                            | \$ 3,128         | \$ 1,877         | \$ 8,003         |
| % of revenue           | 2.4%                              | 6.0%             | 3.2%             | 6.8%             |
| Other income (expense) | \$ (89)                           | \$ (652)         | \$ (505)         | \$ 141           |
| % of revenues          | (0.3)%                            | (1.3)%           | (0.9)%           | 0.1%             |

The decrease in interest income on cash, cash equivalents and marketable securities for the three and six months ended June 27, 2009 was primarily a result of lower interest yields as compared to the comparable periods in the prior year as well as lower average balances. Weighted average yields for the three months ended June 27, 2009 and June 28, 2008 were 0.73% and 2.22%, respectively and weighted average yields for the six months ended June 27, 2009 and June 28, 2008 were 0.75% and 2.81%, respectively. Cash, cash equivalents, restricted cash and marketable securities were \$487.5 million at June 27, 2009 compared to \$523.6 million at June 28, 2008. Other income (expense) for the three and six months ended June 27, 2009 was mainly comprised of bank fees and foreign currency losses primarily related to Japanese Yen offset by net realized gains related to the sale of investments.

*Provision for (Benefit from) Income Taxes*

|  | Three Months Ended                 |                  | Six Months Ended |                  |
|--|------------------------------------|------------------|------------------|------------------|
|  | June 27,<br>2009                   | June 28,<br>2008 | June 27,<br>2009 | June 28,<br>2008 |
|  | (In thousands, except percentages) |                  |                  |                  |
|  | \$ 32,728                          | \$ (9,513)       | \$ 19,592        | \$ (17,678)      |



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

|   |       |         |       |         |
|---|-------|---------|-------|---------|
| Provision for (benefit from) income taxes |       |         |       |         |
| Effective tax rate                        | 98.8% | (33.8)% | 23.3% | (32.6)% |

We recognized an income tax provision of \$32.7 million and \$19.6 million for the three months and six months ended June 27, 2009, respectively, despite losses before taxes. The provision is primarily due to a valuation allowance of \$44.7 million, which includes excess tax benefits recognized during the second quarter of fiscal 2009 and prior quarters, against the our Federal and state deferred tax assets in accordance with SFAS No. 109, Accounting for Income Taxes. The valuation allowance was recorded at the end of the second quarter of 2009 to reduce certain Federal and state net deferred tax assets to their anticipated realizable value. The remaining realizable value was determined by evaluating the potential to recover the value of these assets through the utilization of loss carrybacks.

Table of Contents

SFAS 109 requires the consideration of a valuation allowance to reflect the likelihood of realization of deferred tax assets. Significant management judgment is required in determining any valuation allowance recorded against deferred tax assets. In evaluating the ability to recover deferred tax assets, we considered available positive and negative evidence giving greater weight to our recent cumulative losses and our ability to carryback losses against prior taxable income and lesser weight to our projected financial results due to the challenges of forecasting future periods. We also considered, commensurate with its objective verifiability, the forecast of future taxable income including the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. We performed this evaluation as of the year ended December 27, 2008 and the three months ended March 28, 2009. At that time we continued to have sufficient positive evidence, primarily a cumulative profits position, the ability to carryback losses against prior taxable income and an expectation of improving operating results, showing a valuation allowance was not required. At the end of the second quarter of fiscal 2009, changes in previously anticipated expectations has necessitated a valuation allowance against the excess tax benefits recognized in this quarter and prior quarters since they are no longer more likely than not realizable. Under current tax laws, this valuation allowance will not limit our ability to utilize Federal and state deferred tax assets provided we can generate sufficient future taxable income.

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

Under FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an Interpretation of FAS 109, we classify interest and penalties related to uncertain tax positions as part of income tax expense. We recognized interest expense of \$10,000 and \$53,000 for the three months ended June 27, 2009 and June 28, 2008, respectively, and \$130,000 and \$75,000 for the six months ended June 27, 2009 and June 28, 2008, respectively. As of June 27, 2009, we had approximately \$443,000 of interest and zero penalties related to uncertain tax positions.

The amount of income taxes we pay is subject to ongoing audits by Federal, state and non-U.S. tax authorities which might result in proposed assessments. Our estimate for the potential outcome for any uncertain tax issue is judgmental in nature. However, we believe that we have adequately provided for any reasonably foreseeable outcome related to those matters. Our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved or when statutes of limitation on potential assessments expire. As of June 27, 2009, changes to our uncertain tax positions in the next 12 months, that are reasonably possible, are not expected to have a significant impact on our financial position or results of operations.

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

**Liquidity and Capital Resources**

| (Dollars in thousands)                              | June 27,<br>2009 | Change | December 27,<br>2008 |
|---|------------------|--------|----------------------|
| Working capital                                     | \$ 522,978       | (9.3)% | \$ 576,754           |
| Cash and cash equivalents and marketable securities | 486,818          | (6.9)  | 522,894              |

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

**Working capital:** The decrease in working capital in the six months ended June 27, 2009 was primarily due to a decrease in our cash, cash equivalents and marketable securities balances due to use of cash for operating and investing activities, lower refundable taxes due to the receipt of a federal income tax refund of \$29.0 million in March 2009, an increase in deferred revenue due to lengthening of customer payment terms, offset in part by decreases in accounts payable and accrued liabilities.

**Cash, cash equivalents and marketable securities:** Cash and cash equivalents consist of deposits held at major banks, money market funds and U.S. government securities that at the time of purchase had maturities of 90 days or less. Marketable securities consist of U.S. government and agency securities and municipal bonds. Cash, cash equivalents and marketable securities include \$11.9 million held by our foreign subsidiaries as of June 27, 2009.

Table of Contents

**Day Sales Outstanding:** Days sales outstanding from receivables, or DSO, was 114 days at June 27, 2009 compared with 87 days at December 27, 2008. The increase in DSO is primarily due to the significant shift to longer payment terms for several customers. Additionally, with the continuing challenges in the semiconductor market, a few of our customers which are in a cash preservation mode are extending payments past their original due dates.

| (Dollars in thousands)                          | Six Months Ended |        |                  |
|---|------------------|--------|------------------|
|   | June 27,<br>2009 | Change | June 28,<br>2008 |
| Cash used in operating activities               | \$ (29,742)      | 260%   | \$ (8,251)       |
| Cash provided by (used in) investing activities | (128,034)        | (210)  | 116,801          |
| Cash provided by financing activities           | 3,002            | (16)   | 3,580            |

**Cash flows from operating activities:** Net cash used in operating activities for the six months ended June 27, 2009 was primarily driven by the operating loss offset in part by non-cash charges.

The net change in operating assets and liabilities for the six months ended June 27, 2009 consisted primarily of the increase in gross accounts receivable and deferred revenue due a shift to longer payment terms for several customers, decrease in refundable income taxes due to the receipt of a federal income tax refund of \$29.0 million in March 2009, a decrease in prepaid expenses due to the receipt of a consumption tax refund of \$3.4 million and a decrease in other assets due to the receipt of \$6.7 million related to the termination of a prepaid land lease agreement in Singapore, offset by the decrease in accounts payable and accrued liabilities.

**Cash flows from investing activities:** The cash flows used in investing activities for the six months ended June 27, 2009 primarily relate to the purchase of marketable securities and cash used for capital expenditures in support of information technology system upgrades and new product technology.

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

**Cash flows from financing activities:** The cash flows provided by financing activities for the six months ended June 27, 2009 are primarily due to \$1.9 million received from the January 2009 purchase under our 2002 Employee Stock Purchase Plan, or ESPP and net proceeds from the exercise of stock options offset by stock withheld in lieu of payment of employee taxes related to the release of restricted stock units of \$0.7 million.

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

requirements may vary materially from those now planned. However, if we are unsuccessful in improving our operating efficiency, reducing our cash outlays or increasing our available cash through financing, our cash, cash equivalents and marketable securities will further decline in the remaining quarters of fiscal 2009.

**Off-Balance Sheet Arrangements**

Historically, we have not participated in transactions that have generated relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. As of June 27, 2009, we were not involved in any such off-balance sheet arrangements.

Table of Contents

**Recent Accounting Pronouncements**

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

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

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

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

**Evaluation of Disclosure Controls and Procedures**

Based on our management's evaluation (with the participation of our principal executive officer and principal financial officer), as of the end of the period covered by this report, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, (the Exchange Act)) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms and is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

**Changes in Internal Control over Financial Reporting**

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

**Limitations on the Effectiveness of Controls**

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

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

### **CEO and CFO Certifications**

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

## **PART II. OTHER INFORMATION**

### **Item 1. *Legal Proceedings***

The information relating to *Legal Matters* set forth under Note 14 - Commitments and Contingencies of the Notes to Condensed Consolidated Financial Statements of this Form 10-Q is incorporated herein by reference.

Table of Contents

**Item 1A. Risk Factors**

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

***The global economic downturn could continue to negatively affect our business, results of operations, and financial condition.***

The ongoing financial crisis and resulting global economic downturn have caused and could continue to cause adverse effects on our business. Our customers could continue to curtail their capital expenditures and to defer their adoption of emerging technologies in response to slow demand for consumer and other products incorporating devices tested with our wafer probes. We may also experience the insolvency of key suppliers, leading to delays in the development and shipment of our products, increased expense and a loss of revenue. For example, Electroglas, Inc., which has been an important technology partner in the development of certain manufacturing equipment for future products, filed for bankruptcy protection in June 2009 and its business is expected to be sold in the bankruptcy proceedings. The future of Electroglas's business is uncertain, and if Electroglas, or the acquirer of Electroglas's business, fails to perform its obligations under its agreements with us our ability to complete our new products on a timely basis could be impaired. While we have internal capabilities regarding the manufacturing equipment development effort and have also engaged with third parties on the development of manufacturing equipment having similar functionality, it is possible that those internal efforts and engagements will have a lengthy bring-up time and negatively impact our ability to complete new products and realize revenue from those products.

We may also experience increased impairment charges due to declines in the fair values of marketable debt securities. Further, a protracted downturn could result in additional customers filing for bankruptcy protection or insolvency proceedings, which would continue to negatively impact our ability to collect accounts receivables and realize revenue for product shipped to such customers. For example, in fiscal 2009, our customers, Spansion and Qimonda filed such actions in the United States and other jurisdictions. Continued turbulence in the U.S. and international markets and economies may adversely affect our liquidity and financial condition, and the liquidity and financial condition of our customers and their ability to obtain financing.

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

A relatively small number of customers have accounted for a significant portion of our revenues in any particular period. One customer accounted for 42.8% of our revenues in the quarter ended June 27, 2009, and three customers accounted for 58.6% of our revenues in the quarter ended June 27, 2009. In the second quarter of fiscal 2009, our ten largest customers accounted for 83.1% of our revenues. We anticipate that sales of our products to a relatively small number of customers will continue to account for a significant portion of our revenues. In the first quarter of fiscal 2009, fewer than ten customers accounted for all of our revenues. As a result of the ongoing global economic and semiconductor downturns, we have experienced significant declines in our revenues. In the future, the cancellation, reduction or deferral of even a small number of purchases of our products could significantly reduce our revenues in any particular quarter. Cancellations, reductions or deferrals could result from a prolonged or another downturn in the semiconductor industry, manufacturing delays, quality or reliability issues with our products, or interruptions to our customers' operations due to fire, natural disasters or other events. Furthermore, because our probe



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

cards are custom products designed for our customers' unique wafer designs, any cancellations, reductions or delays can result in significant, non-recoverable costs. In some situations, our customers might be able to cancel or reduce orders without a significant penalty. Our customers could also fail to pay all or part of an invoice for our products. In the current global economic and semiconductor industry downturns, we are more exposed to this non-payment risk because of concerns regarding the financial viability of certain semiconductor manufacturers. For example, in the first quarter of fiscal 2009, we recorded a \$5.2 million pre-tax expense to increase our allowance for doubtful accounts as a result of the heightened non-payment risk of accounts receivable primarily related to three customers. Additionally, on February 20, 2009, we filed a complaint in a California state superior court against Spansion, LLC in which we are seeking, among other things, payment of approximately \$8.1 million for probe cards purchased by and delivered to Spansion; the action was stayed by Spansion LLC's filing for bankruptcy protection in the United States. We may be unable to recognize revenue and we may incur additional charges for bad debt reserve to the extent certain of our customers continue to face financial difficulties during this downturn. It is also possible that if we make the decision to file one or more additional actions against customers to seek payment of outstanding receivables that it will negatively impact a customer relationship and result in lost revenues in the future. Customers with financial difficulties may be forced to materially reduce or discontinue operations, file for bankruptcy or other relief, or may be acquired by one of our other customers, any of which would further reduce our customer base.

Table of Contents

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

We are experiencing increased competition in the wafer probe card market and we expect competition to intensify in the future. Increased competition has resulted and in the future is likely to result in price reductions, reduced gross margins or loss of market share. Competitors might introduce new competitive products for the same markets that our products currently serve. These products may have better performance, lower prices and/or broader acceptance than our products. In addition, for products such as wafer probe cards, semiconductor manufacturers typically qualify more than one source, to avoid dependence on a single source of supply. As a result, our customers would likely purchase products from our competitors. Current and potential competitors include Aehr Test Systems, AMST Co., Ltd., Feinmetall GmbH, Japan Electronic Materials Corporation, Korea Instrument Co., Ltd., SV Probe Inc., Micronics Japan Co., Ltd., Microfriend Inc., MicroProbe Inc., Phicom Corporation, Technoprobe Asia Pte. Ltd., Tokyo Cathode Laboratory Co., Ltd., TSE Co., Ltd., Verigy Ltd., and Wentworth Laboratories, Inc., among others. Many of our current and potential competitors have greater name recognition, larger customer bases, more established customer relationships or greater financial, technical, manufacturing, marketing and other resources than we do. As a result, they might be able to respond more quickly to new or emerging technologies and changes in customer requirements, devote greater resources to the development, promotion, sale and support of their products, and reduce prices to increase market share. Some of our competitors also supply other types of test equipment, or offer both advanced wafer probe cards and needle probe cards. Those competitors that offer both advanced wafer probe cards and needle probe cards might have strong, existing relationships with our existing customers or with potential customers. Because we do not offer a needle probe card or other conventional technology wafer probe card for less advanced applications, it may be difficult for us to introduce our advanced wafer probe cards to these customers and potential customers for certain wafer test applications. It is also possible that one or more of our competitors may be able to increase their relative revenue with mutual customers, resulting in a loss of revenue share to us. It is further possible that existing or new competitors, including test equipment manufacturers, may offer new technologies that reduce the value of our wafer probe cards.

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

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

- our means of protecting our proprietary rights will be adequate;
  
- patents will be issued from our pending or future applications;
  
- our existing or future patents will be sufficient in scope or strength to provide any meaningful protection or commercial advantage to us;

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

- our patents or other intellectual property will not be invalidated, circumvented or successfully challenged in the United States or foreign countries; or
- others will not misappropriate our proprietary technologies or independently develop similar technologies, duplicate our products or design around any of our patents or other intellectual property, or attempt to manufacture and sell infringing products in countries that do not strongly enforce intellectual property rights.

We have spent in the past and may be required to spend in the future significant resources to monitor and protect our intellectual property rights. We presently believe that it is likely that two or more of our competitors are using methodologies or have implemented structures into certain of their products that are covered by one or more of our intellectual property rights. We have in the past brought claims to protect our rights, and we are currently involved in patent infringement litigation, including an ongoing proceeding against two competitors before the International Trade Commission, or ITC. The ITC administrative law judge issued a decision, or initial determination, on June 29, 2009, which did not find infringement of our asserted claims under the four U.S. patents at issue and therefore, did not find a violation of Section 337 of the Tariff Act of 1930. We have filed additional briefing to the ITC seeking review of parts of the June 29th initial determination. We, however, may not obtain a favorable ruling from the ITC. In certain cases, our competitors have initiated re-examination proceedings in the U.S. Patent and Trademark Office and

Table of Contents

invalidity proceedings in foreign patent offices against certain of our patents. Any litigation, whether or not resolved in our favor, and whether initiated by us or by a third party, could result in significant and possibly material expense to us and divert the efforts of our management and technical personnel. In addition, while patents are territorial and a ruling on a certain given patent does not necessarily impact the validity or enforceability of a corresponding or related patent in a different country, an adverse ruling in one country might negatively impact our ability to enforce the corresponding or related patent in other countries. Finally, certain of our customer contracts contain provisions that require us to defend and/or indemnify our customers for third party intellectual property infringement claims, which would increase the cost to us of an adverse ruling in such a claim. An adverse determination could also negatively impact our ability to license certain of our technologies and methods to others, and result in our competitors being allowed to sell products with, or add to their products, features and benefits contained in our products, thereby reducing our competitive advantages over these competing products.

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

We must continue to innovate and to invest in research and development to improve our competitive position and to meet the testing requirements of our customers. Our future growth depends, in significant part, upon our ability to work effectively with and anticipate the testing needs of our customers and to develop and support new products and product enhancements to meet these needs on a timely and cost-effective basis. Our customers' testing needs are becoming more challenging as the semiconductor industry continues to experience rapid technological change driven by the demand for complex circuits that are shrinking in size and at the same time are increasing in speed and functionality and becoming less expensive to produce. Examples of trends driving demand for technological research and development include semiconductor manufacturers' transitions to 70 and below nanometer technology nodes, to one gigabit density devices, to Double Data Rate II, or DDR II, architecture devices, and to Double Data Rate III, or DDR III, architecture devices. Our customers expect that they will be able to integrate our wafer probe cards into any manufacturing process as soon as it is deployed. Therefore, to meet these expectations and remain competitive, we must continually design, develop and introduce on a timely basis new products and product enhancements with improved features. Successful product design, development and introduction on a timely basis require that we:

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

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

- respond effectively to technological changes or product announcements by others; and
- adjust to changing market conditions quickly and cost-effectively.

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

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

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

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

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

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

We recorded material restructuring charges related to our global workforce reductions and impairment charges related to our long-lived assets in the first and second quarters of fiscal 2008 and the first quarter of fiscal 2009. If the current challenging economic conditions persist, we may implement additional cost-reduction actions, which would require us to take additional, potentially material, restructuring charges related to, among other things, employee terminations or asset disposal or exit costs. We may also be required to write off additional inventory if our product build plans or usage of inventory experience further declines, and such additional write-offs could constitute material charges. In addition, a further decline in our stock price or significant adverse change in market conditions could require us to take additional material

Table of Contents

impairment charges related to our long-lived assets. Our long-lived assets with estimable useful lives are amortized over their respective estimated useful lives using the straight-line method, and are reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*. The valuation of our long-lived assets requires assumptions and estimates of many critical factors, including revenue and market growth, operating cash flows, market multiples, and discount rates. Declines in our stock price, or any other adverse change in market conditions, particularly if such change has the effect of changing one of the critical assumptions or estimates we used to calculate the amount of impairment charge, could result in a change to the estimation of fair value that could result in future impairment charges. Any such additional material charges, whether related to restructuring or asset impairment, may have a material negative impact on our operating results and related financial statements.

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

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

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

Our 2002 Equity Incentive Plan and 2002 Employee Stock Purchase Plan have evergreen provisions that automatically increase the number of shares available for issuance under these plans each year without stockholder approval. Specifically, our 2002 Equity Incentive Plan's evergreen provision increases the number of shares available for issuance on each January 1st by an amount equal to 5% of the total amount of the company's outstanding common stock as of December 31st of the prior year, and our 2002 Employee Stock Purchase Plan's evergreen provision increases the number of shares available for issuance on each January 1st by an amount equal to 1% of the total amount of the company's outstanding common stock as of December 31st of the prior year. These evergreen provisions, which have a compounding effect, have been in place since the adoption of the plans in 2003. In 2009, these evergreen provisions added 2,453,115 shares to the 2002 Equity Incentive Plan and 490,623 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2009. In 2008, these evergreen provisions added 2,432,112 shares to the 2002 Equity Incentive Plan and 486,422 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2008, and we had 49,062,308 shares of common stock outstanding on December 27, 2008. In 2007, these evergreen provisions added 2,343,067 shares to the 2002 Equity Incentive Plan and 468,613 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2007, and we had 48,642,258 shares of common stock outstanding on December 29, 2007. In 2006, these evergreen provisions added 2,011,834 shares to the 2002 Equity Incentive Plan and 402,366 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2006, and we had 46,861,334 shares of common stock outstanding on December 30, 2006. In 2005, these evergreen provisions added 1,944,281 shares to the 2002 Equity Incentive Plan and 388,856 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2005, and we had 40,236,686 shares of common stock outstanding on December 31, 2005. In 2004, these evergreen provisions added 1,840,502 shares to the 2002 Equity

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

Incentive Plan and 368,100 shares to the 2002 Employee Stock Purchase Plan, which shares were available for issuance on January 1, 2004, and we had 38,885,637 shares of common stock outstanding on December 25, 2004. Since the adoption of the plans, we have added 13,024,911 shares to the 2002 Equity Incentive Plan and 2,604,980 shares under the 2002 Employee Stock Purchase Plan. Due to the annual increase in the amount of shares available for issuance under these equity plans and to the extent that we issue these shares and they become outstanding, you will experience dilution. While the equity plans are in effect, it is more likely that due to the plans' evergreen provision, we will not ask our stockholders to approve or disapprove further additions to the plans. In addition, while the equity plans are in effect, it is more likely that due to the plans' evergreen provisions, we will not ask our stockholders to approve or disapprove the adoption of any new equity plans.



Table of Contents

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

We held our 2009 Annual Meeting of Stockholders on May 20, 2009 at our corporate headquarters at 7005 Southfront Road, Livermore, California 94551. At the meeting, our stockholders voted on the following two proposals and cast their votes as follows to approve such proposals:

Proposal 1: To elect two Class III directors to our board of directors, each to serve on our Board of Directors until his successor has been elected and qualified or until his earlier death, resignation or removal. The director nominees were:

| Nominee             | For        | Withheld |
|---------------------|------------|----------|
| James A. Prestridge | 46,610,369 | 485,143  |
| Harvey A. Wagner    | 46,543,774 | 551,738  |

Our board of directors consists of seven members and is divided into three classes – Class I, II and III. Each director is elected for a three-year term of office, with one class of directors being elected at each annual meeting of stockholders.

Proposal 2: To ratify the selection of PricewaterhouseCoopers LLP as our independent registered public accounting firm for fiscal year 2009:

| For        | Against | Abstain |
|------------|---------|---------|
| 46,972,720 | 54,817  | 67,975  |

**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              |

Edgar Filing: FORMFACTOR INC - Form 10-Q

\* This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.

Table of Contents

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FORMFACTOR, INC.

By:

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

Date: August 6, 2009

Table of Contents

**EXHIBIT INDEX**

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

---

\* This exhibit shall not be deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934 or otherwise subject to the liabilities of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language in any filings.