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NUMERICAL TECHNOLOGIES INC

Form 10-Q

October 25, 2001

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2001
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: 000-30005

NUMERICAL TECHNOLOGIES, INC.
(Exact name of registrant as specified in its charter)

Delaware 94-3232104
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) Identification Number)

70 West Plumeria Drive 95134-2134
San Jose, California (Zip Code)
(Address of principal executive offices)

Registrant's telephone number, including area code: (408) 919-1910

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

The number of shares outstanding of the registrant's
Common Stock, par value \$0.0001
per share, as of October 17, 2001 was 33,216,940.

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PART I - FINANCIAL INFORMATION

Item 1 Financial Statements

NUMERICAL TECHNOLOGIES, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)
(unaudited)

| | September 30, 2001 | December 31, 2000 |
|--|-----------------------|----------------------|
| | ----- | ----- |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 40,419 | \$ 30,607 |
| Short-term investments | 24,706 | 23,281 |
| Accounts receivable | 6,022 | 4,983 |
| Prepaid and other | 1,858 | 3,177 |
| | ----- | ----- |
| Total current assets | 73,005 | 62,048 |
| Property and equipment, net | 2,843 | 3,209 |
| Goodwill and other intangible assets | 140,369 | 175,402 |
| Other assets | 111 | 315 |
| | ----- | ----- |
| | \$ 216,328 | \$ 240,974 |
| | ===== | ===== |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,953 | \$ 3,208 |
| Accrued expenses and other liabilities | 5,308 | 4,608 |
| Deferred revenue | 10,054 | 6,320 |

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| | | |
|--|------------|------------|
| Total current liabilities | 18,315 | 14,136 |
| Deferred tax liability | 5,548 | 7,704 |
| Stockholders' equity: | | |
| Convertible preferred stock, \$0.0001 par value: | | |
| Authorized: 5,000 shares; | | |
| Issued and outstanding: none | -- | -- |
| Common stock, \$0.0001 par value: | | |
| Authorized: 100,000 shares; | | |
| Issued and outstanding: 33,211 and 32,834 shares in 2001 and 2000, respectively | 3 | 3 |
| Additional paid in capital | 322,021 | 319,541 |
| Receivable from stockholders | (4,398) | (4,050) |
| Deferred stock compensation | (14,800) | (30,572) |
| Accumulated deficit | (110,301) | (65,751) |
| Accumulated other comprehensive loss | (60) | (37) |
| Total stockholders' equity | 192,465 | 219,134 |
| | \$ 216,328 | \$ 240,974 |

See the accompanying notes to these condensed consolidated financial statements.

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NUMERICAL TECHNOLOGIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|-----------|
| | 2001 | 2000 | 2001 | 2000 |
| Revenue | \$ 12,824 | \$ 6,636 | \$ 34,847 | \$ 14,834 |
| Costs and expenses: | | | | |
| Cost of revenue | 1,191 | 591 | 3,294 | 1,221 |
| Research and development | 3,970 | 3,386 | 11,780 | 9,235 |
| Sales and marketing | 3,385 | 2,432 | 10,816 | 6,364 |
| General and administrative | 1,674 | 1,277 | 5,079 | 3,366 |
| Depreciation and amortization | 12,193 | 4,811 | 36,754 | 14,571 |
| Amortization of deferred stock compensation(*) | 4,525 | 4,865 | 14,752 | 15,606 |
| Total costs and expenses | 26,938 | 17,362 | 82,475 | 50,363 |
| Loss from operations | (14,114) | (10,726) | (47,628) | (35,529) |

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| | | | | |
|--|-------------|------------|-------------|-------------|
| Interest expense | -- | -- | -- | (893) |
| Interest income and other | 699 | 942 | 2,238 | 1,960 |
| | ----- | ----- | ----- | ----- |
| Loss before benefit from (provision for) income taxes | (13,415) | (9,784) | (45,390) | (34,462) |
| Benefit from (provision for) income taxes | (225) | (107) | 840 | (107) |
| | ----- | ----- | ----- | ----- |
| Net Loss | \$ (13,640) | \$ (9,891) | \$ (44,550) | \$ (34,569) |
| | ===== | ===== | ===== | ===== |
| Net loss per common share, basic and diluted | \$ (0.45) | \$ (0.37) | \$ (1.48) | \$ (1.80) |
| | ===== | ===== | ===== | ===== |
| Weighted average common shares outstanding, basic and diluted | 30,619 | 26,382 | 30,076 | 19,625 |
| | ===== | ===== | ===== | ===== |
| (*)Amortization of deferred stock compensation | | | | |
| Cost of sales | \$ 208 | \$ 364 | \$ 704 | \$ 789 |
| Research and development | 2,533 | 2,094 | 8,000 | 7,098 |
| Sales and marketing | 1,059 | 1,172 | 3,583 | 3,758 |
| General and administrative | 725 | 1,235 | 2,465 | 3,961 |
| | ----- | ----- | ----- | ----- |
| | \$ 4,525 | \$ 4,865 | \$ 14,752 | \$ 15,606 |
| | ===== | ===== | ===== | ===== |

See the accompanying notes to these condensed consolidated financial statements.

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NUMERICAL TECHNOLOGIES, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

| | For the Nine Months September 2001 |
|--|---------------------------------------|
| | ----- 2001 ----- |
| Cash flows from operating activities: | |
| Net loss | \$(44,550) |
| Adjustments to reconcile net loss to cash flows from operating activities: | |
| Depreciation | 1,421 |
| Amortization of deferred stock compensation | 14,752 |
| Amortization of acquired intangibles | 35,333 |
| Issuance of common stock in exchange for services | 146 |
| Changes in assets and liabilities: | |
| Accounts receivable | (1,039) |
| Prepaid and other | 1,319 |
| Other assets | 204 |
| Accounts payable | (255) |

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| | |
|---|-----------|
| Accrued expenses and other liabilities | 400 |
| Deferred revenue | 3,734 |
| Deferred tax | (2,156) |
| | ----- |
| Net cash provided by (used in) operating activities | 9,309 |
| | ----- |
| Cash flows from investing activities: | |
| Proceeds from sales of short-term investments | 55,978 |
| Purchase of short-term investments | (57,403) |
| Purchase of property and equipment | (1,055) |
| | ----- |
| Net cash used in investing activities | (2,480) |
| | ----- |
| Cash flows from financing activities: | |
| Proceeds from initial public offering | - |
| Repayment on notes payable | - |
| Cash received in acquisition | - |
| Proceeds from exercise of common stock options | 1,531 |
| Proceeds from employee stock purchase plan | 1,214 |
| Repurchase of common stock | (21) |
| Repayment of notes receivable for common stock | 282 |
| | ----- |
| Net cash provided by financing activities | 3,006 |
| | ----- |
| Effect of foreign currency translation on cash flows | (23) |
| | ----- |
| Net increase in cash and cash equivalents | 9,812 |
| Cash and cash equivalents at beginning of period | 30,607 |
| | ----- |
| Cash and cash equivalents at end of period | \$ 40,419 |
| | ===== |
| Supplemental disclosure of cash flow information: | |
| Stockholder notes receivable exchanged for common stock | \$ 630 |
| Issuance of common stock in exchange for services | 146 |
| Interest paid | - |

See the accompanying notes to these condensed consolidated financial statements.

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NUMERICAL TECHNOLOGIES, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1 - GENERAL

The unaudited condensed consolidated financial statements have been prepared by Numerical Technologies, Inc. (the "Company") pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles

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have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the financial position, operating results and cash flows for those periods presented. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the years ended December 31, 2000, 1999 and 1998, included in the Company's form 10-K filed with the SEC on March 27, 2001. The results of operations for the interim periods are not necessarily indicative of the results that may be expected for any other period or for the fiscal year, which ends December 31, 2001.

NOTE 2 - ACQUISITION

On October 27, 2000, the Company acquired Cadabra Design Automation Inc. (Cadabra), a limited liability company incorporated in Nova Scotia, Canada. Under the terms of the acquisition, the Company issued approximately 2,671,000 shares and 528,000 options to purchase the Company's common stock in exchange for all of the outstanding stock and the assumption of all the outstanding options of Cadabra. The total purchase price was approximately \$110.6 million, including acquisition costs of approximately \$3.0 million. The acquisition was accounted for using the purchase method of accounting.

The allocation of the purchase price is as follows (in thousands):

| | |
|---|-----------|
| Net tangible assets | \$ 1,964 |
| In process research and development | 1,630 |
| Developed technology | 660 |
| Customer base | 5,040 |
| Covenants not to compete | 2,290 |
| Work force | 1,800 |
| Goodwill | 97,244 |
| | ----- |
| Total consideration | 110,628 |
| Deferred Stock Compensation | 12,594 |
| | ----- |
| Total | \$123,222 |
| | ===== |

The estimated purchase price was allocated to the identifiable assets acquired and the liabilities assumed based upon the fair market value on the acquisition date. The net tangible assets consist primarily of accounts receivable, property and equipment, and other liabilities. Because the in-process technology had not reached the stage of technological feasibility at the acquisition date and had no alternative future use, the amount was immediately charged to operations. The amounts allocated to developed technology and customer base and trade name are amortized over the estimated useful life of four years. The amounts allocated to covenants not to compete and work force are being amortized over the estimated useful lives of two and three years, respectively. The excess amount of the purchase price over the fair market value of the identifiable assets acquired is accounted for as goodwill and is being amortized over its estimated useful life of four years. The valuation for the intangible assets has been determined using management's assumptions and the report from an independent appraiser.

Had the acquisition of Cadabra occurred on January 1, 2000, pro forma combined revenues would have been \$7,248,000 and \$18,092,000 for the three months and nine months ended September 30, 2000. Pro forma net loss allocable to common stockholders would have been \$21,244,000 or \$(0.75) per share and \$65,840,000 or \$(3.08) per share for the three months and nine months ended September 30, 2000. Pro forma adjustments have been added to record the amortization of identifiable intangible assets and goodwill and amortization of

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deferred stock compensation related to the acquisition of Cadabra as if the transaction occurred on January 1, 2000.

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NOTE 3 - NET LOSS PER SHARE

Basic net income per share is calculated using the weighted average number of common shares outstanding during the period. Diluted net income per share is calculated using the weighted average number of common shares and common stock equivalents, if dilutive, outstanding during the period. Common stock equivalents includes common shares issuable upon exercise of common stock, conversion of preferred stock and warrants. For the periods presented the Company had losses and therefore all common stock equivalents are excluded from the computation of diluted net loss per share because their effect is antidilutive.

NOTE 4 - COMPREHENSIVE INCOME (LOSS)

A summary of comprehensive income for the periods presented is as follows (in thousands):

| | Three Months Ended September 30, (unaudited) | | Nine months ended September 30, (unaudited) | |
|--|--|------------|---|------------|
| | 2001 | 2000 | 2001 | 2000 |
| | ---- | ---- | ---- | ---- |
| Net loss | \$(13,640) | \$ (9,891) | \$(44,550) | \$(34,569) |
| Foreign currency translation adjustments | 39 | - | (23) | - |
| Total comprehensive loss | \$(13,601) | \$ (9,891) | \$(44,573) | \$(34,569) |

NOTE 5 - LITIGATION

The Company is subject to various legal proceedings and claims, either asserted or unasserted, that arise in the ordinary course of business. On March 14, 2000, ASML MaskTools, Inc. filed a complaint alleging that we infringe two U.S. patents and have committed unfair or fraudulent business practice under the California Business and Professions Code. On April 28, 2001, ASML MaskTools, Inc. filed an amended complaint in which it no longer asserts claims for unfair or fraudulent business practice. The Company is currently investigating the patents and allegations. This lawsuit is in the early stages of discovery and no trial date has been set. Although the outcome of these claims cannot be predicted with certainty, management does not believe that any of these legal matters will have a material adverse effect on the Company's financial condition. Were an unfavorable ruling to occur, there exists the possibility of a material impact on the net income of the period in which the ruling occurs and thereafter.

NOTE 6 - RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets". Under SFAS No. 141, all business combinations initiated after June 30,

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2001 must be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if there are indicators such assets may be impaired) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company is required to adopt SFAS No. 142 effective January 1, 2002. The Company is currently evaluating the effect that adoption of the provisions of SFAS No. 142 will have on the Company's results of operations and financial position.

NOTE 7 - RELATED PARTY TRANSACTIONS

In November 2000, a loan was granted to an officer and stockholder of the Company for \$1.1 million. The loan, which is secured by the assets of the officer and stockholder, is non-interest bearing and was payable in full in May 2001. In May 2001, the Company extended the payment date to August 15, 2001. In August 2001 a payment of \$1.1 million was made against the note.

In July 2001, a loan was granted to an employee and stockholder of the Company for \$630,000. The loan, which is secured by the assets of the employee and stockholder, bears interest of 8% per annum and is payable in full in July 2003.

NOTE 8 - CERTAIN RISK AND CONCENTRATIONS

For the three months and nine months ended September 30, 2001, two customers accounted for 26% and 25%, and 25% and 18% of total revenue, respectively. For the three months and nine months ended September 30, 2000, one customer accounted for 22% and 23% of total revenue, respectively.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

Certain information contained or incorporated by reference in this Quarterly Report on Form 10-Q is forward-looking in nature. All statements included or incorporated by reference in this Quarterly Report on Form 10-Q or made by our management, other than statements of historical fact, are forward-looking statements. Examples of forward-looking statements include statements regarding our future financial results, operating results, business strategies, projected costs, products, competitive positions and plans and objectives of management for future operations. In some cases, forward-looking statements can be identified by terminology such as "may," "will," "should," "would," "expects," "plans," "anticipates," "believes," "estimates," "predicts," "potential," "continue," or the negative of these terms or other comparable terminology. Any expectations based on these forward-looking statements are subject to risks and uncertainties and other important factors, including without limitation those discussed in the section entitled "Factors That May Affect Our Future Results". These and many other factors could affect our future financial and operating results, and could cause actual results to differ materially from current expectations.

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Overview

We develop and market proprietary technologies and software products that enable the design and manufacture of semiconductors with subwavelength feature sizes. We derive revenue from intellectual property and software licenses, maintenance and related technical services. To date, we have derived a significant portion of our revenue from research and development licenses to integrated device manufacturers, or IDMs, and foundries of our phase shifting and attendant subwavelength technologies and software licenses, as well as licenses of photomask verification software to semiconductor equipment resellers. To date we have entered into production licenses with five semiconductor manufacturers. We expect to enter into additional production licenses as semiconductor manufacturers adopt our proprietary technologies for production. Production licenses grant licensees the right to use our phase shifting intellectual property and software to design and manufacture subwavelength integrated circuits, or ICs. In order for semiconductor manufacturers to enter into production licenses with us, these manufacturers must continue to embrace our proprietary technologies and software products and not enter into agreements with our competitors in this regard. We must also expend significant sales and marketing resources on these manufacturers with no guarantee of success.

Results of Operations

Revenue. Revenues were \$12.8 million and \$34.8 million for the three months and nine months ended September 30, 2001 compared to \$6.6 million and \$14.8 million for the same periods in 2000, representing increases of 93% and 135% for the respective periods. These increases, which were aided by our acquisition of Cadabra in October 2000, were primarily attributable to the continued adoption of our software and proprietary technology solution by companies throughout the design-to-silicon flow.

Costs and Expenses

Cost of revenue. Cost of revenues were \$1.2 million and \$3.3 million for the three months and nine months ended September 30, 2001 compared to \$591,000 and \$1.2 million for the same periods in 2000. The increase was primarily due to increased costs for engineers associated with maintenance and technical services, which resulted from an increased customer base. As a percent of revenues, cost of revenue was 9% for both the three months and nine months ended September 30, 2001 compared to 9% and 8% for the same periods in 2000. We anticipate that cost of revenues will increase in dollar amount as we support our increasing number of industry partners and customers and assist our research and development licensees to transition into production.

Research and development. Research and development expenses were \$4.0 million and \$11.8 million for the three months and nine months ended September 30, 2001 compared to \$3.4 million and \$9.2 million for the same periods in 2000. These increases were primarily due to increased costs associated with additional personnel acquired in the acquisition of Cadabra in October 2000 and, to a lesser degree, our expanding research and development efforts in subwavelength technologies and products. As a percent of revenues, research and development expenses were 31% and 34% for the three months and nine months ended September 30, 2001 compared to 51% and 62% for the same periods in 2000. We anticipate that we will continue to commit substantial

resources to research and development in the future and expect that research and development expenses will increase in dollar amounts to support increased

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research and development efforts, but decline as a percentage of revenue in the long term.

Sales and marketing. Sales and marketing expenses were \$3.4 million and \$10.8 million for the three months and nine months ended September 30, 2001 compared to \$2.4 million and \$6.4 million for the same periods in 2000. These increases were primarily due to additional sales and marketing personnel, increased personnel-related costs, and to a lesser degree as a result of additional personnel acquired in the Cadabra acquisition in October 2000. As a percent of revenues, sales and marketing expenses decreased to 26% and 31% for the three months and nine months ended September 30, 2001 compared to 37% and 43% for the same periods in 2000. We expect that sales and marketing expenses will increase in dollar amounts to support increased sales efforts, but decline as a percentage of revenue in the long term.

General and administrative. General and administrative expenses were \$1.7 million and \$5.1 million for the three months and nine months ended September 30, 2001 compared to \$1.3 million and \$3.4 million for the same periods in 2000. These increases were primarily the result of increased spending in personnel, personnel-related costs and professional fees and to a lesser degree as a result of additional personnel acquired in the Cadabra acquisition. As a percent of revenues, general and administrative expenses decreased to 13% and 15% for the three months and nine months ended September 30, 2001 compared to 19% and 23% for the same periods in 2000. We expect that general and administrative expenses will increase in dollar amounts to support increased administrative efforts, but decline as a percentage of revenue in the long term.

Depreciation and amortization. Depreciation and amortization expenses were \$12.2 million and \$36.8 million for the three months and nine months ended September 30, 2001 compared to \$4.8 million and \$14.6 million for the same periods in 2000. These increases were primarily the result of amortization of acquired intangibles associated with the acquisition of Cadabra in October 2000.

Amortization of deferred stock compensation. Amortization of deferred stock compensation represents the amount of amortization related to the difference between the exercise price of options granted and the estimated fair market value of the underlying common stock on the date of the grant. We recognized stock-based compensation of \$4.5 million and \$14.8 million for the three months and nine months ended September 30, 2001 compared to \$4.9 million and \$15.6 million for the same periods in 2000. We are amortizing these amounts over the vesting periods of the individual options, using the multiple option method.

Interest expense. Interest expense was \$0 for both the three months and nine months ended September 30, 2001 compared to \$0 and \$893,000 for the same periods in 2000. Interest expense related to the notes payable associated with the acquisition of Transcription in January 2000. In April 2000, we paid the remaining principal and interest due under these notes with proceeds from our initial public offering.

Interest income and other. Interest income and other was \$699,000 and \$2.2 million for the three months and nine months ended September 30, 2001 compared to \$942,000 and \$2.0 million for the same periods in 2000. The decrease in the three month period is the result of lower interest rates in 2001. The increase in the nine month period is attributable to having higher cash balances invested for the entire nine months in 2001 that more than offset the decreases in interest rates in 2001 compared to 2000. The cash balances invested for the nine month period ended September 30, 2000 was increased significantly during the period as a result of proceeds from our initial public offering in April 2000, whereas the monies were available for investment for the entire nine months in 2001.

Benefit from (provision for) income taxes. We recorded a provision for

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income taxes of \$225,000 and a benefit for income taxes of \$840,000 for the three months and nine months ended September 30, 2001 compared to a provision for income taxes of \$107,000 for both of the comparable periods in 2000. The tax benefit in 2001 is the result of the utilization of deferred tax liabilities associated with the amortization of intangible assets established as of result of acquisitions in 2000.

Liquidity and Capital Resources

As of September 30, 2001, we had cash and cash equivalents and short-term investments of \$65.1 million. As of the same date, we had working capital of \$54.7 million, including deferred revenue of \$10.1 million. Deferred revenue represents the excess of amount billed to licensees over revenue recognized on license and maintenance contracts.

Net cash provided by operating activities was \$9.3 million during the nine month period ended September 30, 2001, compared with cash used of \$875,000 in the comparable period in 2000. Net cash provided in the nine month period ended September 30, 2001 primarily reflects a net loss of \$44.6 million, increases in accounts receivable of \$1.0 million and decreases in deferred taxes

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of \$2.2 million, offset by amortization of intangibles and depreciation expenses of \$36.8 million, amortization of deferred stock compensation of \$14.8 million, increases in deferred revenue of \$3.7 million and decreases in prepaid and other assets of \$1.3 million.

Net cash used in investing activities was \$2.5 million during the nine month period ended September 30, 2001, compared with \$29.9 million used in the comparable period in 2000. Net cash used in the nine month period ended September 30, 2001 consisted of net purchases of short-term investments of \$1.4 million and purchases of computer hardware and software, office furniture and equipment of \$1.1 million. We expect capital spending of less than \$2.0 million in fiscal year 2001 mainly for computer hardware and software, office furniture and equipment, and business systems upgrades.

Net cash provided by financing activities was \$3.0 million during the nine month period ended September 30, 2001, compared with \$42.7 million in the comparable period in 2000. Net cash provided in the nine month period ended September 30, 2001 principally related to net proceeds from the exercise of stock options and from the employees stock purchase plan.

We are subject to various legal proceedings and claims, either asserted or unasserted, that arise in the ordinary course of business. In addition, on March 14, 2000, ASML MaskTools, Inc. filed a complaint alleging that we infringe two U.S. patents and have committed unfair or fraudulent business practice under the California Business and Professions Code. On April 28, 2001, ASML MaskTools, Inc. filed an amended complaint in which it no longer asserts claims for unfair or fraudulent business practice. We are currently investigating the patents and allegations. This lawsuit is in the early stages of discovery and no trial date has been set. Although the outcome of these claims cannot be predicted with certainty, management does not believe that any of these legal matters will have a material adverse effect on the Company's financial condition. Were an unfavorable ruling to occur it could limit our ability to offer some features of our OPC product and there exists the possibility of a material impact on the net income of the period in which the ruling occurs and thereafter.

We expect to experience growth in our operating expenses, particularly research and development and sales and marketing expenses, for the foreseeable

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future in order to execute our business strategy. As a result, we anticipate that such operating expenses, as well as planned capital expenditures, will constitute a material use of our cash resources. In addition, we may utilize cash resources to fund acquisitions of, or investments in, complementary businesses, technologies or product lines. We believe that existing cash, will be sufficient to meet our working capital and capital expenditure requirements for at least the next 12 months. Thereafter, we may find it necessary to obtain additional equity or debt financing. In the event additional financing is required, we may not be able to raise it on acceptable terms or at all.

In July 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets". Under SFAS No. 141, all business combinations initiated after June 30, 2001 must be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually (or more frequently if there are indicators such assets may be impaired) for impairment. Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, the Company is required to adopt SFAS No. 142 effective January 1, 2002. The Company is currently evaluating the effect that adoption of the provisions of SFAS No. 142 will have on the Company's results of operations and financial position.

Factors Which May Affect Future Results

If the key markets within the semiconductor industry, especially semiconductor manufacturers, do not adopt our proprietary technologies and software products, we may be unable to generate sales of our products.

If the four key markets within the semiconductor industry, which we believe are semiconductor manufacturing, semiconductor equipment manufacturing, photomask manufacturers and design, do not adopt our proprietary technologies and software products, our revenue could decline. We believe we design our technologies and products so that each key market within the semiconductor industry can work efficiently with the other markets. For example, if designers do not adopt our technologies and products, it will be more difficult for them to design semiconductors that are understood and processed efficiently by mask manufacturers that do adopt our technologies and products.

In addition, we believe semiconductor manufacturers need to adopt our proprietary technologies and software products first in order to drive adoption by the other three markets.

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Semiconductor manufacturers define and develop the manufacturing process. While designers, mask manufacturers and equipment manufacturers are not required to adopt our technologies and products in order to work with semiconductor manufacturers that do adopt them, we believe the efficiency of the manufacturing process with respect to such designers, mask manufacturers and equipment manufacturers is diminished if they do not. If each key market of the semiconductor industry does not perceive our proprietary technologies and software products as the industry standard, our technologies and products could become less valuable and more difficult to license. Factors that may limit adoption of our subwavelength solution within the markets include:

- . our current and potential industry partners and customers may fail to adopt our technologies and products;

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- . the semiconductor industry may not need subwavelength processes if there is a slowdown in semiconductor manufacturing or a decrease in the demand for smaller semiconductor feature sizes; and
- . the industry may develop alternative methods to produce subwavelength features with existing capital equipment due to a rapidly evolving market and the likely emergence of new technologies.

In order for potential industry partners and customers to adopt, and expend their own resources to implement, our technologies and products, we must expend significant marketing resources, with no guarantee of success.

Our proprietary technologies and software products involve a new approach to the subwavelength gap problem. As a result, we must employ intensive and sophisticated marketing and sales efforts to educate prospective industry partners and customers about the benefits of our technologies and products. Our sales and marketing expenses increased to \$10.8 million in the nine months ended September 30, 2001 from \$6.4 million in the nine months ended September 30, 2000. In addition, even if our industry partners and customers adopt our proprietary technologies and software products, they must devote the resources necessary to fully integrate our technologies and products into their operations. This is especially true for our industry partners so that they can begin to resell and market our solution to their customers. If they do not make these expenditures, establishing our technologies and products as the industry standard to the subwavelength gap problem will be difficult.

We depend on the growth of the semiconductor industry and the current economic slowdown in this industry may cause a decrease in the demand for our proprietary technologies and software products and revenue.

We are dependent upon the general economic cycles of the semiconductor industry. Our ability to increase or even maintain our current revenue is largely dependent upon the continued demand by semiconductor manufacturers and each other key market within the semiconductor industry for integrated circuits, or ICs, and IC-related technologies. The semiconductor industry has from time to time experienced economic downturns characterized by decreased product demand, production over-capacity, price erosion, work slowdowns and layoffs. We believe the semiconductor industry is currently experiencing such an economic downturn and, as a result, the sales of some of our proprietary technologies and software products have decreased and may continue to decrease.

Our limited operating history and dependence on new technologies make it difficult to evaluate our future prospects.

We only have a limited operating history on which you can base your valuation of our business. We face a number of risks as an emerging company in a new market. For example, the key markets within the semiconductor industry may fail to adopt our proprietary technologies and software products, or we may not be able to establish distribution channels. Our company incorporated in October 1995. In February 1997, we shipped our initial software product, IC Workbench. We have only recently begun to expand our operations significantly. For example, we grew from 123 employees as of September 30, 2000 to 215 employees as of September 30, 2001.

We have a history of losses, we expect to incur losses in the future and we may be unable to achieve profitability.

We may not achieve profitability if our revenue increases more slowly than we expect or not at all. In addition, our operating expenses are largely fixed, and any shortfall in anticipated revenue in any given period could cause our operating results to decrease. For example, for the nine months ended September

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30, 2001, revenues from Cadabra Design Automation, Inc, a corporation that we recently acquired, were less than anticipated.

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We have not been profitable in any quarter, and our accumulated deficit was approximately \$110.3 million as of September 30, 2001. We expect to continue to incur significant operating expenses in connection with increased funding for research and development and expansion of our sales and marketing efforts. In addition, we expect to incur additional non-cash charges relating to amortization of intangibles and deferred stock compensation. As a result, we will need to generate significant revenue to achieve and maintain profitability. If we do achieve profitability, we may be unable to sustain or increase profitability on a quarterly or annual basis.

If we fail to protect our intellectual property rights, competitors may be able to use our technologies which could weaken our competitive position, reduce our revenue or increase our costs.

Our success depends heavily upon proprietary technologies, specifically our patent portfolio. The rights granted under our patents and patent applications may not provide competitive advantages to us. In addition, litigation may be necessary to enforce our intellectual property rights or to determine the validity and scope of the proprietary rights of others. As a result of any such litigation, we could lose our proprietary rights and incur substantial unexpected operating costs. Litigation could also divert our resources, including our managerial and engineering resources. We rely primarily on a combination of patents, copyrights, trademarks and trade secrets to protect our proprietary rights and prevent competitors from using our proprietary technologies in their products. These laws and procedures provide only limited protection. Our pending patent applications may not result in issued patents, and our existing and future patents may not be sufficiently broad to protect our proprietary technologies. Also, patent protection in foreign countries may be limited or unavailable where we have filed for and need such protection. Furthermore, if we fail to adequately protect our trademark rights, this could impair our brand identity and ability to compete effectively. If we do not successfully protect our trademark rights, this could force us to incur costs to re-establish our name or our product names, including significant marketing activities.

If third parties assert that our proprietary technologies and software products infringe their intellectual property rights, this could injure our reputation and limit our ability to license or sell our proprietary technologies or software products.

Third parties, for competitive or other reasons, could assert that our proprietary technologies and software products infringe their intellectual property rights. These claims could injure our reputation and decrease or block our ability to license or sell our software products. For example, on March 14, 2000, ASML MaskTools, Inc. filed a complaint alleging we infringe two U.S. patents and have committed unfair or fraudulent business practice under the California Business and Professions Code. On April 28, 2001, ASML MaskTools, Inc. filed an amended complaint in which it no longer asserts claims for unfair or fraudulent business practice. We are currently investigating the patents and allegations. The defense of these claims could divert management's attention from the day to day operations of our company, as well as divert resources from current planned uses, such as hiring and supporting additional engineering personnel. Litigation is inherently uncertain, and an adverse decision could limit our ability to offer some features in our OPC product. In addition, third parties have advised us of literature which they believe to be relevant to our

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patents. It is possible that this literature or literature we may be advised of in the future could negatively affect the scope or enforceability of our present or future patents and/or result in costly litigation. In addition, we are aware of and are evaluating certain patents with which our products, patents or patent applications may conflict. If any of these patents are found to be valid, and we are unable to license such patents on reasonable terms, or if our products, patents, or patent applications are found to conflict with these patents, we could be prevented from selling our products, our patents may be declared invalid or our patent applications may not result in issued patents. In addition, a company could invite us to take a patent license. If we do not take the license, the requesting company could contact our industry partners or customers and suggest that they not use our software products because we are not licensed under their patents. This action by the requesting company could affect our relationships with these industry partners and customers and may prevent future industry partners and customers from licensing our software products. The intensely competitive nature of our industry and the important nature of our technologies to our competitors' businesses may contribute to the likelihood of being subject to third party claims of this nature.

Any potential dispute involving our patents or other intellectual property could include our industry partners and customers, which could trigger our indemnification obligations with them and result in substantial expense to us.

In any potential dispute involving our patents or other intellectual property, our licensees could also become the target of litigation. This could trigger our technical support and indemnification obligations in some of our license agreements which could result in substantial expense to us. In addition to the time and expense required for us to supply such support or indemnification to our licensees, any such litigation could severely disrupt or shut down the

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business of our licensees, which in turn could hurt our relations with our customers and cause the sale of our proprietary technologies and software products to decrease.

Defects in our proprietary technologies and software products could decrease our revenue and our competitive market share.

If our industry partners and customers discover any defects after they implement our proprietary technologies and software products, these defects could significantly decrease the market acceptance and sales of our software products, which could decrease our competitive market share. Any actual or perceived defects with our proprietary technologies and software products may also hinder our ability to attract or retain industry partners or customers, leading to a decrease in our revenue. These defects are frequently found during the period following introduction of new products or enhancements to existing products. Despite testing prior to introduction, our software products may contain software errors not discovered until after customer implementation. If our software products contain errors or defects, it could require us to expend significant resources to alleviate these problems, which could result in the diversion of technical and other resources from our other development efforts.

If we do not continue to introduce new technologies and software products or product enhancements ahead of rapid technological change in the market for subwavelength solutions, our operating results could decline and we could lose our competitive position.

We must continually devote significant engineering resources to enable us

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to introduce new technologies and software products or product enhancements to address the evolving needs of key markets within the semiconductor industry in solving the subwavelength gap problem. We must introduce these innovations and the key markets within the semiconductor industry must adopt them before changes in the semiconductor industry, such as the introduction by our current and potential competitors of more advanced products or the emergence of alternative technologies, render the innovations obsolete, which could cause us to lose our competitive position. These innovations are inherently complex, require long development cycles and a substantial investment before we can determine their commercial viability. Moreover, designers, mask manufacturers and equipment manufacturers must each respond to the demand of the market to design and manufacture masks and equipment for increasingly smaller and complex semiconductors. Our innovations must be viable and meet the needs of these key markets within the semiconductor industry before the consumer market demands even smaller semiconductors, rendering the innovations obsolete. We may not have the financial resources necessary to fund any future innovations. In addition, any revenue that we receive from enhancements or new generations of our proprietary technologies and software products may be less than the costs of development.

We rely on a small number of customers for a substantial amount of our revenue, and if our contracts with such customers were terminated, or if the revenues we expect to receive are otherwise reduced, we would need to replace this revenue through other sources.

Approximately 50% of our revenue for the three months ended September 30, 2001 is derived from two customers. If any of the contracts with these customers were to be terminated or not extended or renewed, or if the revenues we expect to receive are otherwise reduced, we could lose a material portion of our revenue. We would need to replace this revenue with revenue from other customers by increasing the sale of our proprietary technologies and software products to our current customers and industry partners, or by entering into new contracts with new customers either of which would result in an unexpected diversion of management efforts and possible increases to operating expenses, with no immediate increase in revenue.

Our chief executive officer and chief technology officer, as well as the co-founders of Transcription and the key executive officer of Cadabra, are critical to our business and they may not remain with us in the future.

Our future success will depend to a significant extent on the continued services of: Y. C. (Buno) Pati, our President and Chief Executive Officer; Yao-Ting Wang, our Chief Technology Officer and Senior Vice President of Engineering; Roger Sturgeon, one of our directors and a senior executive of Transcription; Kevin MacLean, Senior Vice President and General Manager of Transcription; and Martin Lefebvre, a member of our Office of Technology and senior executive of Cadabra. If we lose the services of any of these key executives, it could slow our product development processes and searching for their replacements could divert our other senior management's time and increase our operating expenses. In addition, our industry partners and customers could become concerned about our future operations, which could injure our reputation. We do not have long-term employment agreements with these executives and we do not maintain any key person life insurance policies on their lives. In October 2001, Faysal Sohail, former Senior Vice President of Worldwide Field Operations and a key employee of Cadabra, left the Company.

Many of our current competitors have longer operating histories and significantly greater financial, technical, marketing and other resources than

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we do and as a result, they may acquire a significant market share before we do.

Our current competitors, or alliances among these competitors, may rapidly acquire significant market share. These competitors may have greater name recognition and more customers which they could use to gain market share to our detriment. We encounter direct competition from other direct providers of phase shifting, optical proximity correction, or OPC, manufacturing data and automated cell generation technologies. These competitors include such companies as Avant!, Mentor Graphics and Prolific, Inc. We also compete with companies that have developed or have the ability to develop their own proprietary phase shifting and OPC solutions, such as IBM. These companies may wish to promote their internally developed products and may be reluctant to purchase products from us or other independent vendors. Our competitors may offer a wider range of products than we do and thus may be able to respond more quickly to new or changing opportunities, technologies and customer requirements. These competitors may also be able to undertake more extensive promotional activities, offer more attractive terms to customers than we do and adopt more aggressive pricing policies. Moreover, our competitors may establish relationships among themselves or with industry partners to enhance their services, including industry partners with which we may desire to establish a relationship.

The market for software solutions that address the subwavelength gap problem is new and rapidly evolving. We expect competition to intensify in the future, which could slow our ability to grow or execute our strategy.

We believe that the demand for solutions to the subwavelength gap problem may encourage many competitors to enter into our market. As the market for software solutions to the subwavelength gap problem proliferates, if our competitors are able to attract industry partners or customers on a more accelerated pace than we can and retain them more effectively, we would not be able to grow and execute our strategy as quickly. In addition, if customer preferences shift away from our technologies and software products as a result of the increase in competition, we must develop new proprietary technologies and software products to address these new customer demands. This could result in the diversion of management attention or our development of new technologies and products may be blocked by other companies' patents. We must offer better products, customer support, prices and response time, or a combination of these factors, than those of our potential competitors.

We intend to pursue new, and maintain our current, industry partner relationships, which could substantially divert management attention and resources, with no guarantee of success.

We expect to derive significant benefits, including increased revenue and customer awareness, from our current and potential industry partner relationships. In our pursuit to maintain and establish partner relationships within each of the key markets in the semiconductor industry, we could expend significant management attention, resources and sales personnel efforts, with no guarantee of success. To establish and maintain our partner relationships, we expend our limited financial resources on increasing our sales and business development personnel, trade shows and marketing within trade publications. If we did not have to pursue potential industry partners, we could focus these resources exclusively on direct sales to our customers. In addition, through our partner relationships, our partners resell, market, either jointly with us unilaterally, and promote our technologies and products. If these relationships terminate, such as due to our material breach of the contracts or the partners' election to cancel the contract, which generally is permissible with prior notice to us, we would have to increase our own limited marketing and sales resources for these activities. Further, we may be unable to enter into new industry partner relationships if any of the following occur:

- . current or potential industry partners develop their own solutions to

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the subwavelength gap problem; or

- . our current or potential competitors establish relationships with industry partners with which we seek to establish a relationship.

We have only recently entered into many of our current partner relationships. These relationships may not continue or they may not be successful. We also may be unable to find additional suitable industry partners.

We recently acquired Cadabra Design Automation Inc. If we are not successful in integrating Cadabra's products and operations with ours, our revenue and operating results could decline.

Our acquisition of Cadabra will only be successful if we are able to integrate its operations with ours, which could substantially divert management's attention from the day-to-day operations of the combined company. We must successfully integrate Cadabra's products with ours. One of the elements of our strategy is to integrate our

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subwavelength technologies. We must also focus our research and development and sales and marketing efforts to realize the technological benefits of this combination. If we encounter any difficulties in the transition process, we may not be able to successfully integrate Cadabra's business or technologies and may not achieve anticipated revenue and cost benefits. We also cannot guarantee that the acquisition will result in sufficient revenues or earnings to justify our investment in, or expenses related to, the acquisition or that any synergies will develop. If we are not successful in integrating Cadabra's businesses or if expected earnings or synergies do not materialize, we would likely incur significant expenses as well as non-cash charges to write-off acquired intangible assets, which could seriously harm our financial condition and operating results. In this regard, for the nine months ended September 30, 2001, revenues from Cadabra were less than anticipated.

In addition, the process of combining our company with Cadabra could interrupt the activities of any or all of the companies' businesses. It is possible that we will not be able to retain Cadabra's key management, technical and sales personnel. The acquisition of Cadabra could also cause our industry partners and customers to be uncertain about our ability to support the combined companies' products and technologies and the direction of the combined companies' development efforts. In particular, semiconductor manufacturers, which have previously relied on and endorsed the Cadabra solution, must continue to rely on and endorse this solution under our combined company. As a result, these semiconductor manufacturers, as well as our other industry partners and customers, may delay or cancel these orders, which could significantly decrease our revenue and limit our ability to implement our combined business strategy. Moreover, the economic downturn in the semiconductor industry could compound the difficulties inherent in our integration of the Cadabra business by causing decreased revenues for the combined company and further uncertainty regarding the success of the integration.

Our acquisition of Transcription Enterprises Limited may increase the focus of the semiconductor industry on the manufacturing data preparation market, which could lead to a rapid and substantial increase in competition.

Our acquisition of Transcription may increase the semiconductor industry's awareness of the market for manufacturing data preparation software, which could lead to a substantial increase in the number of start-up companies that focus on software solutions for data preparation. Manufacturing data preparation software

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translates semiconductor designs into instructions that control manufacturing equipment. Potential competitors could pursue and execute partnership agreements with key industry partners we intend to pursue, which could make it difficult or impossible for us to develop relationships with these potential industry partners. In addition, some of our current competitors may increase their own research and development budgets relating to data preparation, or may more aggressively market competing solutions.

Fluctuations in our quarterly operating results may cause our stock price to decline.

It is likely that our future quarterly operating results may fluctuate from time to time and may not meet the expectations of securities analysts and investors in some future period. As a result, the price of our common stock could decline. Historically, our quarterly operating results have fluctuated. We may experience significant fluctuations in future quarterly operating results. The following factors may cause these fluctuations:

- . our recent acquisition of Transcription and Cadabra, as well as future potential acquisitions by us;
- . the timing and structure of our product license agreements; and
- . changes in the level of our operating expenses to support our projected growth.

The accounting rules regarding revenue recognition may cause fluctuations in our revenue independent of our booking position.

The accounting rules we are required to follow require us to recognize revenue only when certain criteria are met. As a result, for a given quarter it is possible for us to fall short in our revenue and/or earnings estimates even though total orders are according to our plan or, conversely, to meet our revenue and/or earnings estimates even though total orders fall short of our plan, due to revenue produced by deferred revenue. Orders for software support and professional services yield revenue over multiple quarters, often extending beyond the current fiscal year, or upon completion of performance rather than at the time of sale. The specific terms agreed to with a customer and/or any changes to the rules interpreting such terms may have the effect of requiring deferral of product revenue in whole or in part or, alternatively, of requiring us to accelerate the recognition of such revenue for products to be used over multiple years.

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We face operational and financial risks associated with international operations.

We derive a significant portion of our revenue from international sales. For the nine months ended September 30, 2001, compared to nine months ended September 30, 2000, the breakdown of our revenue by geographic region, as a percentage of our total revenue, was North America, 68% and 57%, Asia, 24% and 34%, Europe, 5% and 8%, and other, 3% and 1%, respectively. In addition, as a result of our acquisition of Cadabra, a Nova Scotia limited liability company, 44 of our 215 employees as of September 30, 2001 were located in Ontario, Canada. We have only limited experience in developing, marketing, selling and supporting our proprietary technologies and software products, and managing our employees and operations, internationally. We may not succeed in maintaining or

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expanding our international operations, which could slow our revenue growth. We are subject to risks inherent in doing business in international markets. These risks include:

- . fluctuations in exchange rates which may negatively affect our operating results;
- . export controls which could prevent us from shipping our software products into and from some markets;
- . changes in import/export duties and quotas could affect the competitive pricing of our software products and reduce our market share in some countries;
- . compliance with and unexpected changes in a wide variety of foreign laws and regulatory environments with which we are not familiar;
- . greater difficulty in collecting accounts receivable resulting in longer collection periods; and
- . economic or political instability.

We may be unable to continue to market our proprietary technologies and software products successfully in international markets.

We may need to raise additional funds to support our growth or execute our strategy and if we are unable to do so, we may be unable to develop or enhance our proprietary technologies and software products, respond to competitive pressures or acquire desired businesses or technologies.

We currently anticipate that our available cash resources will be sufficient to meet our presently anticipated working capital and capital expenditure requirements for at least the next 12 months. However, we may need to raise additional funds in order to:

- . support more rapid expansion;
- . develop new or enhanced products;
- . respond to competitive pressures; or
- . acquire complementary businesses or technologies.

These factors will impact our future capital requirements and the adequacy of our available funds. We may need to raise additional funds through public or private financings, strategic relationships or other arrangements.

The market price of our common stock has been and may continue to be volatile and could decline.

The market price of our common stock has fluctuated in response to factors, some of which are beyond our control, including:

- . changes in market valuations of other technology companies;
- . conditions or trends in the semiconductor industry;
- . actual or anticipated fluctuations in our operating results;
- . any deviations in net revenue or in losses from levels expected by securities analysts;

- . announcements by us or our competitors of significant technical innovations, contracts, acquisitions or partnerships;
- . volume fluctuations, which are particularly common among highly volatile securities of technology related companies; and
- . departures of key personnel.

General political or economic conditions, such as recession or interest rate or currency rate fluctuations in the United States or abroad, also could cause the market price of our common stock to decline.

The fluctuations in our stock price could result in securities class action litigation, which could result in substantial costs and diversion of our resources.

Volatility in the market price of our common stock could result in securities class action litigation. Any litigation would likely result in substantial costs and a diversion of management's attention and resources. The share prices of technology companies' stocks have been highly volatile and have recorded lows well below their historical highs. As a result, investors in these companies often buy the stock at high prices only to see the price drop a short time later, resulting in a drop in value in the stock holdings of these investors. Our stock may not trade at the same levels as other technology stocks, or at its historical prices.

We are growing rapidly and must effectively manage and support our growth in order for our business strategy to succeed.

We have grown rapidly and will need to continue to grow in all areas of operation. If we are unable to successfully integrate and support our existing and new employees, including those employees added as a result of our acquisition of Cadabra, into our operations, we may be unable to implement our business strategy in the time frame we anticipate, or at all. In addition, building and managing the support necessary for our growth places significant demands on our management as well as our limited revenue. These demands have, and may continue to, divert these resources away from the continued growth of our business and implementation of our business strategy. Further, we must adequately train our new personnel, especially our technical support personnel, to adequately, and accurately, respond to and support our industry partners and customers. If we fail to do this, it could lead to dissatisfaction among our partners or customers, which could slow our growth.

We must continually attract and retain engineering personnel or we will be unable to execute our business strategy.

We have experienced, and we expect to continue to experience, difficulty in hiring and retaining highly skilled engineers with appropriate qualifications to support our rapid growth and expansion. We must continually enhance and introduce new generations of our phase shifting and OPC technologies. As a result, our future success depends in part on our ability to identify, attract, retain and motivate qualified engineering personnel with the requisite educational background and industry experience. If we lose the services of a significant number of our engineers, it could disrupt our ability to implement our business strategy. Competition for qualified engineers is intense, especially in the Silicon Valley where our headquarters are located.

Terrorist attacks, such as the attacks that occurred in New York and Washington,

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D.C. on September 11, 2001, and other acts of violence or war may affect the markets in which we operate, our operations and our profitability.

Terrorist attacks may negatively affect our operations. These attacks or armed conflicts may directly impact our physical facilities or those of our suppliers or customers, which could result in higher expenses and/or lower revenue. Furthermore, these attacks may make travel of our sales and support staff more difficult and more expensive and ultimately affect the sales of our products.

Also as a result of terrorism, the United States has entered into an armed conflict, which could have a further impact on our domestic and international sales. Political and economic instability in some regions of the world may also result and could negatively impact our business.

Our operations are primarily located in California and, as a result, are subject to power loss and other natural disasters.

Our business operations depend on our ability to maintain and protect our facilities, computer systems and personnel, which are primarily located in or near our principal headquarters in San Jose, California. California is currently experiencing power outages due to a shortage in the supply of power within the state. In the event of an acute power shortage, California has on some occasions implemented, and may in the future continue to implement, rolling blackouts throughout California. We currently do not have backup generators or alternate sources of power in the event of a blackout, and our current insurance does not provide coverage for any damages we or our customers or industry partners may suffer as a result of any interruption in our power supply. If blackouts interrupt our power supply, we would be temporarily unable to continue operations at our facilities. Any such interruption in our ability to continue operations at our facilities could damage our reputation, harm our ability to retain existing customers and industry partners, or obtain new customers or industry partners, and could result in loss of revenue. Furthermore, the deregulation of the energy industry in California has caused power prices to increase. If wholesale prices continue to increase, our operating expenses will likely increase. In addition, San Jose exists on or near a known earthquake fault zone. Our facilities are susceptible to damage from earthquakes and other natural disasters, such as fires, floods and similar events. Although we maintain general

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business insurance against fires and some general business interruptions, there can be no assurance that the amount of coverage will be adequate in any particular case.

We may be unable to consummate other potential acquisitions or investments or successfully integrate them with our business, which may slow our ability to expand the range of our proprietary technologies and software products.

To expand the range of our proprietary technologies and software products, we recently acquired Transcription and Cadabra, and we may acquire or make investments in additional

complementary businesses, technologies or products if appropriate opportunities arise. We may be unable to identify suitable acquisition or investment candidates at reasonable prices or on reasonable terms, or consummate future acquisitions or investments, each of which could slow our growth strategy. If we do acquire additional companies or make other types of acquisitions, we may have difficulty integrating the acquired products, personnel or technologies. These

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difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses.

Item 3. Quantitative and Qualitative Disclosure about Market Risk.

Our exposure to market risk for changes in interest rates relate primarily to our investment portfolio. We do not use derivative financial instruments for speculative or trading purposes. We place our investments in instruments that meet high credit quality standards, as specified in our investment policy. The policy also limits the amount of credit exposure to any one issuer and type of instrument. We do not expect any material loss with respect to our investment portfolio.

PART II - OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

(c) Recent Sales of Unregistered Securities

On September 27, 2001, we issued 10,000 shares of our common stock to Ultratech Stepper, Inc. as consideration for our assuming from Ultratech the leadership role and decision-making authority of the Advanced Reticle Symposium. We relied upon Section 4(2) of the Securities Act of 1933 in connection with the sale and issuance of these securities.

In addition to the above transaction, during the quarter ended September 30, 2001, 1,082,110 exchangeable shares of Cadabra Design Automation Inc. ("Cadabra"), which were issued in connection with our October 2000 acquisition of Cadabra, were exchanged for an equal number of shares of our common stock. We did not receive any consideration in connection with such exchanges. These shares were exchanged pursuant to Regulation D or Regulation S of the Securities Act of 1933.

(d) Use of Proceeds from Registered Securities

In April 2000, we sold a total of 6,364,100 shares of common stock (the total amount registered) at \$14.00 per share through our initial public offering pursuant to a registration statement on Form S-1 declared effective by the Securities and Exchange Commission on April 6, 2000 (333-95695). The initial public offering commenced on April 7, 2000 and the net proceeds, after underwriters' commission and fees and other costs of an estimated \$7.9 million associated with the offering, totaled approximately \$81.2 million.

Since April 12, 2000 (the closing date of the Company's initial public offering), the Company has used the net proceeds from the Company's initial public offering to purchase and install \$2.5 million of machinery and equipment, to pay the balance \$30.2 million of principal and accrued interest under the notes payable issued in connection with the acquisition of Transcription and to fund \$48.5 million of operating expenses and increased working capital.

No payments constituted direct or indirect payments to directors, officers, general partners of the issuer or their associates, or to persons owning ten percent or more of any class of equity securities of the issuer or to affiliates of the issuer.

Item 6. Exhibits and Reports on Form 8-K

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(a) Exhibits.

The exhibits listed in the accompanying Index to Exhibits are incorporated by reference as part of this Form 10-Q.

(b) Reports on Form 8-K

No reports on Form 8-K were filed by the Company during the quarter ending September 30, 2001.

SIGNATURES

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

NUMERICAL TECHNOLOGIES, INC.

Dated October 25, 2001

By: /s/ Richard S. Mora

Richard S. Mora
Chief Operating Officer and Chief Financial
Officer (duly authorized officer and
principal financial accounting officer)

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INDEX TO EXHIBITS

These Exhibits are numbered in accordance with the Exhibit Table of Item 601 of Regulation S-K:

| EXHIBIT NUMBER ----- | DESCRIPTION ----- |
|----------------------------|--|
| 2.1 | Agreement and Plan of Reorganization, dated as of December 21, 1999, between the registrant, Transcription Enterprises Limited, Transcription Enterprises, Inc., Kevin MacLean and Roger Sturgeon.* |
| 2.2 | Agreement and Plan of Merger between the registrant and Numerical Technologies, Inc., a Delaware corporation.* |
| 2.3 | Agreement and Plan of Amalgamation, dated as of September 5, 2000, by and among Numerical Technologies, Inc., Numerical Nova Scotia Company, Numerical Acquisition Limited, 3047725 Nova Scotia Limited, Cadabra Design Automation Inc., Martin Lefebvre, and Faysal Sohail. *** |
| 3.2 | Amended and Restated Certificate of Incorporation of registrant.* |
| 3.3 | Bylaws of registrant.* |
| 4.1 | Form of registrant's common stock certificate.* |
| 4.2 | 1999 Second Amended and Restated Shareholders Rights Agreement, dated January 1, 2000, between the registrant and the parties named therein, as amended on January 14, 2000.* |
| 10.1 | Form of Indemnification Agreement entered into by registrant with each of its directors and executive officers.* |
| 10.2 | 2000 Stock Plan and related agreements.* |
| 10.3 | 1997 Stock Plan and related agreements.* |
| 10.4 | 2000 Employee Stock Purchase Plan and related agreements.* |
| 10.5 | Lease Agreement, dated June 15, 1999, by and between the registrant and CarrAmerica Realty Corporation.* |
| 10.6 | Lease Agreement, dated May 10, 1990, between Transcription Enterprises, |

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- Inc. and Los Gatos Business Park.*
- 10.7 Employment Agreement, dated January 1, 2000, by and between Transcription Enterprises, Inc. and Roger Sturgeon.*
 - 10.8 Employment Agreement, dated January 1, 2000, by and between Transcription Enterprises, Inc. and Kevin MacLean.*
 - 10.9 Non-Competition Agreement, dated January 1, 2000, by and between Numerical Technologies, Inc., Transcription Enterprises, Inc., Transcription Enterprises Limited and Roger Sturgeon.*
 - 10.10 Non-Competition Agreement, dated January 1, 2000, by and between Numerical Technologies, Inc., Transcription Enterprises, Inc., Transcription Enterprises Limited and Kevin MacLean.*
 - 10.11 Stock Option Agreement--Early Exercise, dated November 2, 1999, by and between the registrant and William Davidow.*
 - 10.12 Stock Option Agreement--Early Exercise, dated May 26, 1999, by and between the registrant and Richard Mora.*
 - 10.13 Stock Option Agreement--Early Exercise, dated December 27, 1999, by and between the registrant and Richard Mora.*
 - 10.14 Stock Option Agreement--Early Exercise, dated March 31, 1999, by and between the registrant and Atul Sharan.*
 - 10.15 Stock Option Agreement--Early Exercise, dated December 27, 1999, by and between the registrant and Atul Sharan.*
 - 10.16 Stock Option Agreement--Early Exercise, dated July 15, 1998, between the registrant and Harvey Jones.*
 - 10.17 License Agreement, dated as of October 1, 1999, between registrant and Cadence Design Systems, Inc.*+
 - 10.18 OEM Software License Agreement, dated December 31, 1997, between registrant and Zygo Corporation (fka Technical Instrument Company).**+
 - 10.19 Addendum to OEM Software License Agreement, dated March 25, 1999, between registrant and Zygo Corporation.*
 - 10.20 Software Production and Distribution Agreement, dated January 9, 1998, between registrant and KLA-Tencor Corporation.**+
 - 10.21 License Agreement, dated December 23, 1999, between registrant and Seiko

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- Instruments, Inc.*#
- 10.22 Development and Distribution Agreement, dated October 1, 1991, between Transcription Enterprises Limited and KLA Instruments Corporation.**+
 - 10.23 Addendum Number One to Development and Distribution Agreement, dated December 27, 1999, between Transcription Enterprises Limited and KLA Instruments Corporation.**+
 - 10.24 Stock Option Agreement--Early Exercise, dated February 1, 2000, by and between the registrant and Roger Sturgeon.*
 - 10.25 Stock Option Agreement--Early Exercise, dated February 1, 2000, by and between the registrant and Kevin MacLean.*
 - 10.26 Stock Option Agreement--Early Exercise, dated February 10, 2000, by and between the registrant and Y.C. (Buno) Pati.*
 - 10.27 Stock Option Agreement--Early Exercise, dated February 10, 2000, by and between the registrant and Yao-Ting Wang.*
 - 10.28 Stock Option Agreement--Early Exercise, dated October 23, 1998, by and between the registrant and Atul Sharan.*
 - 10.29 Amendment No. 1 to Atul Sharan's Stock Option Agreements dated October 23, 1998, March 31, 1999 and December 27, 1999, dated as of January 24, 2000, by and between the registrant and Atul Sharan.*
 - 10.30 Stock Option Agreement--Early Exercise, dated February 10, 2000, by and between the registrant and Naren Gupta.*
 - 10.31 PSM Software Development and License Agreement, dated as of March 10, 2000, by and between registrant and Cadence Design Systems, Inc.*+
 - 10.32 License Agreement, dated March 1, 2000, between registrant and Motorola, Inc.**+

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- 10.33 Production License Agreement, dated December 31, 2000, between registrant and United Microelectronics Corporation.*****+
- 10.34 Patent Cross License Agreement, dated April 17, 2001, between registrant and Intel Corporation. ***** +
- 10.35 2001 Nonstatutory Stock Option Plan. *****

* Incorporated by reference to registration statement on Form S-1 (333-95695) as declared effective by the Securities and Exchange Commission on April 6, 2000.

** Incorporated by reference to registration statement on Form 10-Q as filed with the Securities and Exchange Commission on May 12, 2000.

*** Incorporated by reference to the current report on Form 8-K as filed with the Securities and Exchange Commission on September 15, 2000.

**** Incorporated by reference to the registrant's Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 27, 2001.

***** Incorporated by reference to registration statement on Form 10-Q as filed with the Securities and Exchange Commission on August 2, 2001.

***** Incorporated by reference to registration statement on Form S-8 (333-71816) as filed with the Securities and Exchange Commission on October 18, 2001.

+ Confidential treatment has been requested with respect to certain portions of this exhibit. Omitted portions have been filed separately with the Securities and Exchange Commission.