

LOGICVISION INC  
Form 10-Q  
August 03, 2006

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended June 30, 2006

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 No.: 0-31773

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**LOGICVISION, INC.**

(Exact name of registrant as specified in its charter)

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

**94-3166964**  
(I.R.S. Employer  
Identification Number)

**25 Metro Drive, Third Floor  
San Jose, California 95110**  
(Address of principal executive offices)

**Telephone: (408) 453-0146**  
(Registrant's telephone number, including area code)

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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 at least the past 90 days.

YesNo

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non accelerated filer

Indicate by check mark whether the registrant is a shell company filer (as defined in Rule 12b-2 of the Exchange Act).

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YesNo

At July 31, 2006, 20,081,114 shares of Registrant's Common Stock, \$0.0001 par value were outstanding.

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LOGICVISION, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED JUNE 30, 2006

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## PART I: FINANCIAL INFORMATION

## ITEM 1: FINANCIAL STATEMENTS

**LOGICVISION, INC.**  
**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except per share data)

|   | June 30,<br>2006 | December 31,<br>2005 |
|---|------------------|----------------------|
| <b>ASSETS</b>   |                  |                      |
| Current Assets:   |                  |                      |
| Cash and cash equivalents   | \$ 6,329         | \$ 3,620             |
| Short-term investments  | 3,316            | 7,076                |
| Accounts receivable, net of allowance for doubtful accounts of \$7 and \$25, respectively     | 693              | 2,512                |
| Prepaid expenses and other current assets   | 1,296            | 1,544                |
|   | <u>11,634</u>    | <u>14,752</u>        |
| Total current assets  | 11,634           | 14,752               |
| Property and equipment, net   | 886              | 1,097                |
| Intangible assets, net  | 314              | 464                  |
| Goodwill  | 6,846            | 6,846                |
| Other long-term assets  | 934              | 1,182                |
|   | <u>20,614</u>    | <u>24,341</u>        |
| Total assets  | \$ 20,614        | \$ 24,341            |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                  |                      |
| Current Liabilities:  |                  |                      |
| Accounts payable  | \$ 511           | \$ 484               |
| Accrued liabilities   | 1,889            | 1,702                |
| Deferred revenue, current portion   | 3,388            | 3,137                |
|   | <u>5,788</u>     | <u>5,323</u>         |
| Total current liabilities   | 5,788            | 5,323                |
| Deferred revenue  | 3,025            | 3,580                |
|   | <u>8,813</u>     | <u>8,903</u>         |
| Total liabilities   | 8,813            | 8,903                |
| Commitments and contingencies   |                  |                      |
| Stockholders' Equity:   |                  |                      |
| Preferred stock, \$0.0001 par value:  |                  |                      |
| Authorized: 5,000 shares;   |                  |                      |
| Issued and outstanding: no shares issued and outstanding                                      |                  |                      |
| Common stock, \$0.0001 par value:   |                  |                      |
| Authorized: 125,000 shares;   |                  |                      |
| Issued and outstanding: 20,012 shares at June 30, 2006 and 18,892 shares at December 31, 2005 | 2                | 2                    |
| Additional paid-in capital  | 104,675          | 104,417              |
| Accumulated other comprehensive income (loss)   | 14               | (7)                  |
| Accumulated deficit   | (92,890)         | (88,974)             |
|   | <u>11,801</u>    | <u>15,438</u>        |
| Total stockholders' equity  | 11,801           | 15,438               |
| Total liabilities and stockholders' equity  | \$ 20,614        | \$ 24,341            |

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



**LOGICVISION, INC.**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)

|   | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|---|--------------------------------|-------------------|------------------------------|-------------------|
|   | 2006                           | 2005              | 2006                         | 2005              |
| <b>Revenues:</b>  |                                |                   |                              |                   |
| License   | \$ 1,305                       | \$ 1,493          | \$ 2,524                     | \$ 4,190          |
| Service   | 1,367                          | 984               | 2,497                        | 1,912             |
| Product   | 100                            | 58                | 100                          | 110               |
| <b>Total revenues</b>   | <b>2,772</b>                   | <b>2,535</b>      | <b>5,121</b>                 | <b>6,212</b>      |
| <b>Cost of revenues:</b>  |                                |                   |                              |                   |
| License   | 230                            | 203               | 487                          | 389               |
| Service   | 429                            | 531               | 853                          | 1,100             |
| Product   |                                | 25                |                              | 50                |
| <b>Total cost of revenues</b>   | <b>659</b>                     | <b>759</b>        | <b>1,340</b>                 | <b>1,539</b>      |
| <b>Gross profit</b>   | <b>2,113</b>                   | <b>1,776</b>      | <b>3,781</b>                 | <b>4,673</b>      |
| <b>Operating expenses:</b>  |                                |                   |                              |                   |
| Research and development  | 1,036                          | 1,377             | 2,123                        | 3,067             |
| Sales and marketing   | 1,779                          | 1,974             | 3,659                        | 3,750             |
| General and administrative  | 1,037                          | 1,279             | 2,001                        | 2,568             |
| <b>Total operating expenses</b>   | <b>3,852</b>                   | <b>4,630</b>      | <b>7,783</b>                 | <b>9,385</b>      |
| Loss from operations  | (1,739)                        | (2,854)           | (4,002)                      | (4,712)           |
| Interest and other income, net  | 90                             | 68                | 162                          | 130               |
| Loss before provision for income taxes                                  | (1,649)                        | (2,786)           | (3,840)                      | (4,582)           |
| Provision for income taxes  | 19                             | 14                | 76                           | 30                |
| <b>Net loss</b>   | <b>\$ (1,668)</b>              | <b>\$ (2,800)</b> | <b>\$ (3,916)</b>            | <b>\$ (4,612)</b> |
| <b>Net loss per common share, basic and diluted</b>                     | <b>\$ (0.09)</b>               | <b>\$ (0.15)</b>  | <b>\$ (0.21)</b>             | <b>\$ (0.25)</b>  |
| <b>Weighted average number of shares outstanding, basic and diluted</b> | <b>18,986</b>                  | <b>18,634</b>     | <b>18,954</b>                | <b>18,516</b>     |

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

**LOGICVISION, INC.**  
**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

|   | Six Months Ended June 30, |                 |
|---|---------------------------|-----------------|
|   | 2006                      | 2005            |
| <b>Cash flows from operating activities:</b>                                |                           |                 |
| Net loss  | \$ (3,916)                | \$ (4,612)      |
| Adjustments to reconcile net loss to net cash used in operating activities: |                           |                 |
| Depreciation and amortization   | 452                       | 460             |
| Stock-based compensation  | 219                       | 1               |
| Changes in operating assets and liabilities:                                |                           |                 |
| Accounts receivable   | 1,819                     | (332)           |
| Prepaid expenses and other current assets                                   | 248                       | 136             |
| Other long-term assets  | 248                       | 283             |
| Accounts payable  | 27                        | 423             |
| Accrued liabilities   | 187                       | (309)           |
| Deferred revenue  | (304)                     | (1,813)         |
| <b>Net cash used in operating activities</b>                                | <b>(1,020)</b>            | <b>(5,763)</b>  |
| <b>Cash flows from investing activities:</b>                                |                           |                 |
| Purchase of investments   | (2,915)                   | (3,003)         |
| Purchase of property and equipment  | (76)                      | (592)           |
| Proceeds from sales and maturities of investments                           | 6,675                     | 9,200           |
| <b>Net cash provided by investing activities</b>                            | <b>3,684</b>              | <b>5,605</b>    |
| <b>Cash flows from financing activities:</b>                                |                           |                 |
| Proceeds from issuance of common stock                                      | 39                        | 600             |
| Proceeds from short-term debt   |                           | 1,000           |
| Repayment of short-term debt  |                           | (900)           |
| <b>Net cash provided by financing activities</b>                            | <b>39</b>                 | <b>700</b>      |
| Effect of exchange rate on cash and cash equivalents                        | 6                         | (28)            |
| <b>Net increase (decrease) in cash and cash equivalents</b>                 | <b>2,709</b>              | <b>514</b>      |
| Cash and cash equivalents, beginning of period                              | 3,620                     | 5,790           |
| <b>Cash and cash equivalents, end of period</b>                             | <b>\$ 6,329</b>           | <b>\$ 6,304</b> |

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

**LOGICVISION, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include the accounts of LogicVision, Inc. ( LogicVision or the Company ) and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. The Company's fiscal year end is December 31.

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company in accordance with 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 in the United States of America ( GAAP ) have been condensed or omitted in accordance with such rules and regulations. In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments, consisting only of normal recurring adjustments, necessary to state fairly the financial position of the Company, and its results of operations and cash flows. The unaudited condensed consolidated interim financial statements contained herein should be read in conjunction with the audited financial statements and footnotes for the year ended December 31, 2005 included in the Company's Annual Report on Form 10-K as filed with the SEC.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reported period. Actual results could differ from those estimates.

The Company has incurred substantial losses and negative cash flows from operations since inception. For the year ended December 31, 2005, the Company incurred a loss from operations of approximately \$10.0 million and negative cash flows from operating activities of approximately \$11.9 million. For the six months ended June 30, 2006, the Company incurred a loss of approximately \$3.9 million and negative cash flows from operating activities of approximately \$1.0 million. As of June 30, 2006, the Company had an accumulated deficit of approximately \$92.9 million. While management believes that its current funds will be sufficient to enable the Company to meet its planned expenditures through at least December 31, 2006, the Company is subject to risks associated with companies of similar size and stage of development, including but not limited to, dependence on key individuals, competition from substitute services and larger companies, and the continued successful development and marketing of its products and services. If anticipated operating results are not achieved, management has the intent and believes it has the ability to delay or reduce expenditures so as not to require additional financing resources. Failure to generate sufficient cash flows from operations, raise additional capital or reduce certain discretionary spending could have a material adverse effect on the Company's ability to achieve its intended business objectives.

**Stock-Based Compensation Expense**

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, ( SFAS 123(R) ) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases under the Company's 2000 Employee Stock Purchase Plan based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) for periods beginning in 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ( SAB 107 ) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).



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The Company adopted SFAS 123(R) using the modified prospective transition method. The Company's Consolidated Financial Statements as of June 30, 2006 and for the three and six months ended June 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the six months ended June 30, 2006 was \$219,000, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases. No stock-based compensation expense related to employee stock options and employee stock purchases was recognized for the six months ended June 30, 2005.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statements of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation (SFAS 123). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's Consolidated Statements of Operations because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the current period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company's Consolidated Statements of Operations for the three and six months ended June 30, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all share-based payment awards will be recognized using the multiple option approach. As stock-based compensation expense recognized in the Consolidated Statements of Operations for the three and six months ended June 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS 123 for the periods ending prior to January 1, 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), the Company selected the Black-Scholes option-pricing model (Black-Scholes model) to determine the fair value of share-based awards granted beginning in fiscal 2006, the same model which was previously used for the Company's pro forma information required under SFAS 123. The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the Company's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Expected volatilities are based on the historical volatility of the Company's common stock. The Company uses historical data to estimate option exercise and employee terminations. The expected term of the options granted represents the period of time that options are expected to be outstanding, based on historical information. The risk-free interest rate is based on the U.S. Treasury zero-coupon issues with remaining terms similar to the expected term of the Company's equity awards. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore used an expected dividend yield of zero.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3 Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. This alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC Pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC Pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

For further information on stock-based compensation, see Note 8.

**Net Loss Per Share**

Statement of Financial Accounting Standards ( SFAS ) No. 128, Earnings Per Share, requires a dual presentation of basic and diluted earnings per share ( EPS ). Basic EPS excludes dilution and is computed by dividing net income or loss by the weighted average number of shares of common stock outstanding during the period. Diluted EPS reflects the potential dilution that would occur if outstanding securities to issue common stock were exercised or converted to common stock. Diluted net loss per share for the three and six months ended June 30, 2006 and 2005 does not differ from basic net loss per share since potential shares of common stock issuable upon exercise of stock options and warrants are anti-dilutive under the treasury stock method.

The following table presents the calculation of basic and diluted net loss per share (in thousands, except per share amounts):

|   | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|---|--------------------------------|------------------|------------------------------|------------------|
|   | 2006                           | 2005             | 2006                         | 2005             |
| <b>Numerator - Basic and Diluted</b>        |                                |                  |                              |                  |
| Net loss                                    | \$ (1,668)                     | \$ (2,800)       | \$ (3,916)                   | \$ (4,612)       |
| <b>Denominator - Basic and Diluted</b>      |                                |                  |                              |                  |
| Weighted average common stock outstanding   | 18,986                         | 18,634           | 18,954                       | 18,516           |
| <b>Basic and Diluted net loss per share</b> | <b>\$ (0.09)</b>               | <b>\$ (0.15)</b> | <b>\$ (0.21)</b>             | <b>\$ (0.25)</b> |

Options and warrants to purchase an aggregate of 4.0 million shares of common stock outstanding at June 30, 2006 and 4.8 million shares at June 30, 2005, were excluded from the computation of diluted shares because of their antidilutive effect on net loss per share for the three and six months then ended.

**Recently Issued Accounting Standards**

In June 2006, the FASB issued FASB Interpretation No.48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), which prescribes accounting for and disclosure of uncertainty in tax positions. This interpretation defines the criteria that must be met for the benefits of a tax position to be recognized. The provisions of FIN 48 are effective as of the beginning of the Company s 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements.

**Note 2. Cash and Cash Equivalents and Investments**

The Company considers all highly liquid investment instruments purchased with original maturities of three months or less at the acquisition date to be cash equivalents. Investment instruments purchased with original maturities of more than three months, which mature in less than twelve months, are considered to be short-term investments. All investments are classified as available-for-sale and are reported at fair value. Interest and realized gains and losses are included in interest and other income, net. Realized gains and losses are recognized based on the specific identification method.

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Cash, cash equivalents and investments consist of the following (in thousands):

|  | June 30,<br>2006 | December 31,<br>2005 |
|--|------------------|----------------------|
| <b>Cash and cash equivalents:</b>      |                  |                      |
| Cash                                   | \$ 967           | \$ 847               |
| Money market funds                     | 3,271            | 1,151                |
| Commerical paper                       | 596              | 1,197                |
| U.S. government agency notes           | 1,495            | 425                  |
| <b>Total cash and cash equivalents</b> | <b>\$ 6,329</b>  | <b>\$ 3,620</b>      |
| <b>Short-term investments:</b>         |                  |                      |
| Certificates of Deposit                | \$ 200           | \$ 450               |
| Commercial Paper                       | 792              |                      |
| U.S. government agency notes           | 2,324            | 6,626                |
| <b>Total short-term investments</b>    | <b>\$ 3,316</b>  | <b>\$ 7,076</b>      |

**Note 3. Intangible Assets**

The following table summarizes the components of goodwill, other intangible assets and related accumulated amortization balances (in thousands):

|                                 | June 30, 2006               |                             |                           | December 31, 2005           |                             |                           |
|---------------------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
|                                 | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Net<br>Carrying<br>Amount |
| Goodwill                        | \$ 6,846                    | \$                          | \$ 6,846                  | \$ 6,846                    | \$                          | \$ 6,846                  |
| <b>Other Intangible Assets:</b> |                             |                             |                           |                             |                             |                           |
| Developed technology            | \$ 640                      | \$ (356)                    | \$ 284                    | \$ 640                      | \$ (250)                    | \$ 390                    |
| Non-compete agreement           | 177                         | (147)                       | 30                        | 177                         | (103)                       | 74                        |
| <b>Total</b>                    | <b>\$ 817</b>               | <b>\$ (503)</b>             | <b>\$ 314</b>             | <b>\$ 817</b>               | <b>\$ (353)</b>             | <b>\$ 464</b>             |

At June 30, 2006, the estimated future amortization expense of other intangible assets in the table above was as follows (in thousands):

| Year ending December 31, | Estimated<br>Amortization<br>Expense |
|--------------------------|--------------------------------------|
| 2006                     | 136                                  |
| 2007                     | 178                                  |
|                          | <b>\$ 314</b>                        |

The Company evaluates goodwill at least on an annual basis (in the fourth quarter) and whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flow. No assurances can be given that future evaluations of goodwill will not result in charges as a result of future impairment.

**Note 4. Loan Agreement**

The Company has a loan agreement with a bank under which it may borrow, on a revolving basis, up to \$1.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 8.25% at June 30, 2006. The agreement is unsecured and is not collateralized by the Company's assets. Under the agreement, the Company must comply with certain operating and reporting covenants and is not permitted to pay dividends, or make material investments or dispositions without the prior written consent of the bank. If the Company fails to comply with its covenants under the agreement, the bank can declare any outstanding amounts immediately due and payable and cease advancing money or extending credit to or for the Company. The agreement expires on February 28, 2007. At June 30, 2006 there were no outstanding borrowings under the agreement. At that date, the Company was in compliance with the covenants under the agreement.

**Note 5. Commitments and Contingencies****Lease obligations**

The Company and its subsidiaries in Canada and Japan rent office facilities under noncancelable operating leases which expire through July 2011. The Company and its subsidiaries are responsible for certain maintenance costs, taxes and insurance under the respective leases. Total future minimum payments under such operating leases at June 30, 2006 were as follows (in thousands):

| <b>Year ending December 31,</b> |                 |
|---------------------------------|-----------------|
| 2006                            | \$ 273          |
| 2007                            | 484             |
| 2008                            | 431             |
| 2009                            | 419             |
| 2010                            | 187             |
| Thereafter                      | 64              |
|                                 | <u>1,858</u>    |
|                                 | <u>\$ 1,858</u> |

**Off-balance Sheet Arrangements**

The Company's off-balance sheet arrangements consist solely of operating leases as described above.

**Indemnification Obligations**

The Company enters into standard license agreements in the ordinary course of business. Pursuant to these agreements, the Company agrees to indemnify its customers for losses suffered or incurred by them as a result of any patent, copyright, or other intellectual property infringement claim by any third party with respect to the Company's products. These indemnification obligations have perpetual terms. The Company's normal business practice is to limit the maximum amount of indemnification to the amount received from the customer. On occasion, the maximum amount of indemnification the Company may be required to make may exceed its normal business practices. The Company estimates the fair value of its indemnification obligations as insignificant, based upon its historical experience concerning product and patent infringement claims. Accordingly, the Company had no liabilities recorded for indemnification under these agreements as of June 30, 2006.

The Company has agreements whereby its officers and directors are indemnified for certain events or occurrences while the officer or director is, or was, serving at the Company's request in such capacity. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a directors and officers insurance policy that reduces its exposure and enables the Company to recover a portion of future amounts paid. As a result of the Company's insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of June 30, 2006.

### Warranties

The Company offers its customers a warranty that its products will conform to the documentation provided with the products. To date, there have been no payments or material costs incurred related to fulfilling these warranty obligations. Accordingly, the Company has no liabilities recorded for these warranties as of June 30, 2006. The Company assesses the need for a warranty reserve on a quarterly basis, and there can be no guarantee that a warranty reserve will not become necessary in the future.

### Note 6. Concentration of Revenues and Credit Risks

The Company has been dependent on a relatively small number of customers for a substantial portion of its revenue, although the customers comprising this group have changed from time to time. Customers accounting for more than 10 percent of revenue are as follows:

|                       | Three Months Ended June 30, |      | Six Months Ended June 30, |      |
|-----------------------|-----------------------------|------|---------------------------|------|
|                       | 2006                        | 2005 | 2006                      | 2005 |
| Agere Systems         | 20%                         | 22%  | 22%                       | 18%  |
| Broadcom Corporation  | 18%                         | 11%  | 17%                       | 9%   |
| Freescale             | 4%                          | 11%  | 4%                        | 7%   |
| LSI Logic Corporation | 7%                          | 3%   | 6%                        | 15%  |

At June 30, 2006, four customers accounted for 18%, 14%, 13% and 11% of net accounts receivable, respectively. At December 31, 2005, one customer accounted for approximately 73% of net accounts receivable.

### Note 7. Comprehensive Loss

Comprehensive loss is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources. SFAS 130, Reporting Comprehensive Income, requires companies to classify items of other comprehensive income by their nature in the financial statements and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the stockholders' equity section of the balance sheet.

The Company's other comprehensive income (loss) consists primarily of adjustments to translate the financial statements of the Company's foreign subsidiaries into U.S. dollars upon consolidation, and unrealized gains (losses) on available-for-sale investments. The functional currency of the Company's foreign subsidiaries is the local currency and therefore, the translation adjustments of those statements into U.S. dollars are recorded in accumulated other comprehensive income (loss), which is reported as a separate component of stockholders' equity.

For the three and six months ended June 30, 2006 and 2005, comprehensive loss, which was comprised of the Company's net loss for the periods and changes in foreign currency translation adjustments and unrealized gains (losses) on investments were as follows (in thousands):

|   | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|---|--------------------------------|-------------------|------------------------------|-------------------|
|   | 2006                           | 2005              | 2006                         | 2005              |
| Net loss  | \$ (1,668)                     | \$ (2,800)        | \$ (3,916)                   | \$ (4,612)        |
| Other comprehensive income (loss) -                           |                                |                   |                              |                   |
| Cumulative translation adjustment                             | (1)                            | (16)              | (5)                          | (26)              |
| Unrealized gain (loss) on available-for-sale investments, net | 15                             | 49                | 33                           | (65)              |
| <b>Comprehensive loss</b>                                     | <b>\$ (1,654)</b>              | <b>\$ (2,767)</b> | <b>\$ (3,888)</b>            | <b>\$ (4,703)</b> |

**Note 8. Stock Option Plans****Stock Option Plan**

The Company's 2000 Stock Incentive Plan (the "2000 Plan") is a successor to the 1994 Flexible Stock Option Plan (the "1994 Plan"). The number of shares reserved for issuance under the 2000 Plan are increased on the first day of each of the Company's fiscal years from 2002 to 2010 by the lesser of 750,000 shares, 3.5% of the outstanding shares of the Company's common stock on that date or a lesser amount determined by the Board of Directors and are also increased by any forfeitures under the 1994 Plan. On January 26, 2006, the Board of Directors approved an increase of 650,000 shares for issuance under the 2000 Plan. As of June 30, 2006, options to purchase a total of 3,408,175 and 473,481 shares of common stock were outstanding under the 2000 Plan and the 1994 Plan, respectively. In addition, the Board of Directors has granted 700,500 non-qualified options, of which options to purchase 7,500 shares remained outstanding at June 30, 2006. A total of 5,721,175 shares are reserved for future issuance at June 30, 2006.

Under the 2000 Plan, the Board of Directors has the authority to determine the type of option and the number of shares subject to each option. The exercise price is generally equal to fair value of the underlying stock at the date of grant. Options generally become exercisable over a four-year period and, if not exercised, expire ten years from the date of grant. The option plan also provides for accelerated vesting if there is a change in control of the Company (as defined in the 2000 Plan).

Under the 2000 Plan, the Board of Directors has the discretion to grant options to nonemployee directors. Each nonemployee director will be granted an option to purchase 20,000 shares when they first join the Board. In addition, each nonemployee director will be granted an option to purchase 10,000 shares on the day following the Company's annual meeting of stockholders.

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The following table summarizes all option activities from December 31, 2005 through June 30, 2006 (shares in thousands, except per share data):

|                                      | June 30,<br>2006    |   |
|--------------------------------------|---------------------|---|
|                                      | Number of<br>Shares | Weighted<br>Average<br>Exercise<br>Price<br>per Share |
| Options outstanding:                 |                     |   |
| Beginning balance                    | 4,357               | \$ 3.56   |
| Granted                              | 576                 | \$ 1.29   |
| Exercised                            | (50)                | \$ 0.77   |
| Forefeited                           | (994)               | \$ 4.17   |
| Ending balance                       | 3,889               | \$ 3.10   |
| Options exercisable at end of period | 2,995               | \$ 3.59   |

The weighted-average grant-date fair value of options granted during the six months ended June 30, 2006 and 2005 were \$1.29 and \$2.64, respectively. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005 were \$28,000 and \$851,000, respectively. The Company issues new shares upon the exercise of options. There was no tax benefit realized from exercised options. The value of the option grants has been calculated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

|                                 |            |
|---------------------------------|------------|
| Expected average life of option | 4.26 years |
| Risk-free interest rate         | 4.36%      |
| Expected dividends              |            |
| Expected volatility             | 83%        |

The options outstanding and currently exercisable by exercise price at June 30, 2006 were as follows (options in thousands):

| Range of Exercise Prices | Options Outstanding                          |   |  | Options Exercisable                          |  |
|--------------------------|--|---|--|--|--|
|                          | Number of<br>Shares<br>Underlying<br>Options | Weighted<br>average<br>remaining<br>contractual<br>life (years) | Weighted<br>average<br>exercise<br>price | Number of<br>Shares<br>Underlying<br>Options | Weighted<br>average<br>exercise<br>price |
| \$0.60-\$1.72            | 1,022  | 7.7   | \$ 1.34                                  | 393  | \$ 1.42                                  |
| \$1.76-\$2.64            | 1,149  | 7.8   | \$ 2.21                                  | 884  | \$ 2.30                                  |
| \$2.79-\$4.85            | 1,297  | 7.4   | \$ 4.00                                  | 1,297  | \$ 4.00                                  |
| \$5.00-\$10.00           | 421  | 5.0   | \$ 7.06                                  | 421  | \$ 7.06                                  |
|                          | 3,889  | 7.4   | \$ 3.10                                  | 2,995  | \$ 3.59                                  |

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The aggregate intrinsic value of vested options in the preceding table, based on the Company's closing stock price of \$1.70 as of June 30, 2006, was \$108,000. The total fair value of options vested during the three months ended June 30, 2006 and 2005 were \$130,000 and \$364,000, respectively. As of June 30, 2006, total compensation cost related to nonvested stock options not yet recognized was \$332,000 which is expected to be recognized over the next 4 years.

### Stock Purchase Plan

Under the Company's Employee Stock Purchase Plan (Purchase Plan) a total of 625,000 shares of common stock were reserved for issuance at December 31, 2005. The number of shares reserved for issuance under the Purchase Plan is increased on the first day of each fiscal year, by the lesser of 125,000 shares, 1% of the outstanding shares on that date or a lesser amount as determined by the Board of Directors. On January 26, 2006, the Board of Directors voted to increase the shares reserved for issuance by 125,000. The Purchase Plan, which is intended to qualify under Section 423 of the Internal Revenue Code of 1986, as amended, is administered by the Compensation Committee of the Company's Board of Directors.

The estimated fair value of purchase rights under the Company's Purchase Plan was determined using the Black-Scholes pricing model with the following assumptions:

|                                 | June 30,<br>2006 |
|---------------------------------|------------------|
| Expected average life of option | 7 months         |
| Risk-free interest rate         | 4.34%            |
| Expected dividends              | -                |
| Expected volatility             | 87%              |

The weighted average per share fair value of purchase rights under the Purchase Plan was \$0.52 and \$1.09 for the six months ended June 30, 2006 and 2005, respectively.

### Valuation and Expense Information under SFAS 123(R)

On January 1, 2006, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company's employees and directors, including employee stock options and employee stock purchases related to the Purchase Plan based on estimated fair values. The following table summarizes stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) for the three and six months ended June 30, 2006 which was allocated as follows (in thousands):

|  | Three Months Ended<br>June 30, 2006 | Six Months Ended<br>June 30, 2006 |
|--|-------------------------------------|-----------------------------------|
| <b>Cost of revenues:</b>   |                                     |                                   |
| Service  | \$ 10                               | \$ 16                             |
|  | 10                                  | 16                                |
| <b>Stock-based compensation expense included in cost of sales</b>  |                                     |                                   |
|  | 10                                  | 16                                |
|  | 10                                  | 16                                |
| <b>Operating expenses:</b>   |                                     |                                   |
| Research and development   | 27                                  | 42                                |
| Sales and marketing  | 48                                  | 81                                |
| General and administrative   | 39                                  | 80                                |
|  | 114                                 | 203                               |
| <b>Stock-based compensation expense included in operating expenses</b>                                       |                                     |                                   |
|  | 114                                 | 203                               |
|  | 114                                 | 203                               |
| <b>Total stock-based compensation expense related to employee stock options and employee stock purchases</b> | \$ 124                              | \$ 219                            |



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The table below reflects net income and diluted net income per share for the three and six months ended June 30, 2006 compared with the pro forma information for the three and six months ended June 30, 2005 as follows (in thousands except per-share amounts):

|  | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--|--------------------------------|------------|------------------------------|------------|
|  | 2006                           | 2005       | 2006                         | 2005       |
| Net loss - as reported for the prior period (1)                          | N/A                            | \$ (2,800) | N/A                          | \$ (4,612) |
| Stock-based compensation expense (2)                                     | \$ 124                         | 1,087      | \$ 219                       | 2,051      |
| Net income, including the effect of stock-based compensation expense (3) | \$ (1,668)                     | \$ (3,887) | \$ (3,916)                   | \$ (6,663) |
| Loss per share:  |                                |            |                              |            |
| Basic and diluted - as reported (1)                                      | N/A                            | \$ (0.15)  | N/A                          | \$ (0.25)  |
| Basic and diluted, including the effect of stock-based compensation (3)  | \$ (0.09)                      | \$ (0.21)  | \$ (0.21)                    | \$ (0.36)  |

- (1) Net income and net income per share prior to January 1, 2006 did not include stock-based compensation expense for employee stock options and employee stock purchases under SFAS 123 because the Company did not adopt the recognition provisions of SFAS 123.
- (2) Stock-based compensation expense prior to January 1, 2006 is calculated based on the pro forma application of SFAS 123.
- (3) Net income and net income per share prior to January 1, 2006 represents pro forma information based on SFAS 123.

The weighted-average estimated value of employee stock options granted during the six months ended June 30, 2005 was \$2.64 per share using the Black-Scholes model with the following weighted-average assumptions:

**Stock Option Plan**

|                                 | Three Months<br>Ended June 30,<br>2005 | Six Months<br>Ended June 30,<br>2005 |
|---------------------------------|--|--------------------------------------|
| Expected average life of option | 5.55 years                             | 5.81 years                           |
| Risk-free interest rate         | 3.92%                                  | 3.98%                                |
| Expected dividends              |  |                                      |
| Expected volatility             | 72%                                    | 67%                                  |

The value of the purchase rights under the Company's Purchase Plan has been calculated on the date of grant using the Black-Scholes options pricing model with the following weighted-average assumptions:

**Purchase Plan**

|                                 | <b>Three Months<br/>Ended June 30,<br/>2005</b> | <b>Six Months<br/>Ended June 30,<br/>2005</b> |
|---------------------------------|---|---|
| Expected average life of option | 0.4 years                                       | 0.5 years                                     |
| Risk-free interest rate         | 2.00%   | 1.85%   |
| Expected dividends              |   |   |
| Expected volatility             | 72%   | 67%   |

Upon adoption of SFAS 123(R), the Company began estimating the value of employee stock options on the date of grant using the Black-Scholes model. Prior to the adoption of SFAS 123(R), the value of each employee stock option was estimated on the date of grant using the Black-Scholes model for the purpose of the pro forma financial information in accordance with SFAS 123.

As stock-based compensation expense recognized in the Consolidated Statement of Operations for the first half of fiscal 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In the Company's pro forma information required under SFAS 123 for the periods prior to January 1, 2006, the Company accounted for forfeitures as they occurred.

**Note 9. Segment Reporting**

The Company has adopted SFAS 131, *Disclosure about Segments of an Enterprise and Related Information*. Although the Company offers various design and manufacturing embedded test software products and services to its customers, the Company does not manage its operations by these products and services, but instead views the Company as one operating segment when making business decisions. The Company does not manage its operations on a geographical basis. Revenues attributed to the United States and to all foreign countries are based on the geographical location of the customers. The Company uses one measurement of profitability for its business.

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The table below sets forth revenues by product line (in thousands):

|                       | Three Months Ended<br>June 30, |                 | Six Months Ended<br>June 30, |                 |
|-----------------------|--------------------------------|-----------------|------------------------------|-----------------|
|                       | 2006                           | 2005            | 2006                         | 2005            |
| ETCreate              | \$ 1,999                       | \$ 2,211        | \$ 3,743                     | \$ 5,092        |
| ETAccess              | 624                            | 279             | 1,087                        | 1,056           |
| SiVision and other    | 149                            | 45              | 291                          | 64              |
| <b>Total revenues</b> | <b>\$ 2,772</b>                | <b>\$ 2,535</b> | <b>\$ 5,121</b>              | <b>\$ 6,212</b> |

The following is a summary of the Company's revenues by geographic operations (in thousands):

|               | Three Months Ended<br>June 30, |                 | Six Months Ended<br>June 30, |                 |
|---------------|--------------------------------|-----------------|------------------------------|-----------------|
|               | 2006                           | 2005            | 2006                         | 2005            |
| United States | \$ 2,394                       | \$ 2,163        | \$ 4,459                     | \$ 4,990        |
| Japan         | 275                            | 214             | 481                          | 881             |
| Others        | 103                            | 158             | 181                          | 341             |
|               | <b>\$ 2,772</b>                | <b>\$ 2,535</b> | <b>\$ 5,121</b>              | <b>\$ 6,212</b> |

The following is a summary of the Company's long-lived assets (in thousands):

**Long-lived assets:**

|               | June 30,<br>2006 | December 31,<br>2005 |
|---------------|------------------|----------------------|
| United States | \$ 641           | \$ 778               |
| India         | 5                | 93                   |
| Canada        | 225              | 203                  |
| Japan         | 15               | 23                   |
|               | <b>\$ 886</b>    | <b>\$ 1,097</b>      |

**Note 10. Restructuring Costs**

In the fourth quarter of 2005, the Company implemented a restructuring plan to reduce operating costs by reducing its workforce and consolidating facilities and resources. Accordingly the Company recognized a restructuring charge of approximately \$0.7 million for the workforce reduction, facility abandonment expenses, other contractual charges associated with the facilities and other related expenses. The restructuring plan eliminated 31 employees located in the United States, Canada and India, primarily in marketing, engineering and administrative functions. One facility in Canada and the facility in India were eliminated; the restructuring plan was substantially completed by the end of December 2005.

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The following is a summary of activities in accrued restructuring and excess facilities costs for the six months ended June 30, 2006 (in thousands):

|                                 | Severance<br>and<br>Benefits | Excess<br>Facilities | Asset<br>Related | Total  |
|---------------------------------|------------------------------|----------------------|------------------|--------|
| Balance as of December 31, 2005 | \$ 198                       | \$ 18                | \$ 74            | \$ 290 |
| Cash charges                    | (191)                        | (18)                 | (61)             | (270)  |
| Non-cash charges                |                              |                      | (13)             | (13)   |
| Balance as of June 30, 2006     | \$ 7                         | \$                   | \$               | \$ 7   |

The remaining accrued severance and benefits costs represent the cost of COBRA benefits which the Company is obligated to pay.

**Note 11. Issuance of additional shares**

On June 27, 2006, the Company issued 1,070,499 shares of common stock to certain former shareholders of SiVerion, Inc. in exchange for the Additional Cash Exchange Rights (as defined below) held by those former shareholders. The Company completed the acquisition of SiVerion, Inc. in November 2004. The purchase price included a contingent payment of up to \$2 million in cash payable on November 5, 2006 (the Additional Cash Exchange Rights) if the average closing price of the Company's common stock for the 10 trading days immediately prior thereto is less than \$3.00. The 1,070,499 shares issued effectively reduce the contingent payment to no more than \$148,000, payable to those remaining SiVerion, Inc. shareholders in the event the Company's common stock is less than \$3.00 as determined above.

**ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto set forth in Item 1 of this report and the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

*When used in this Report, the words expects, anticipates, intends, estimates, plans, believes, and similar expressions are intended to identify forward-looking statements. These are statements that relate to future periods and include statements about the features, benefits and performance of our current and future products, services and technology, plans for future products and services and for enhancements of existing products and services, our expectations regarding future operating results, including backlog, revenues, sources of revenues and expenses, net losses, fluctuations in future operating results, our estimates regarding the adequacy of our capital resources, our capital requirements and our needs for additional financing, planned capital expenditures, use of our working capital, our critical accounting policies and estimates, our internal control over financial reporting, our patent applications and licensed technology, our efforts to protect intellectual property, our ability to attract customers, achieve design wins, establish license agreements and obtain orders, reliance on a limited number of customers for a substantial portion of revenues, the impact of economic and industry conditions on our customers, customer demand, our growth strategy, our marketing efforts, our business development efforts, future acquisitions or investments, our focus on larger orders with major customers, our employee matters, our competitive position, our foreign currency risk strategy, and the impact of recent accounting pronouncements. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, the possibility that orders could be modified, cancelled or not renewed, our ability to negotiate and obtain customer agreements and orders, lengthening sales cycles, the concentration of sales to large customers, dependence upon and trends in capital spending budgets in the semiconductor industry and fluctuations in general economic conditions, our ability to rapidly develop new technology and introduce new products, our ability to safeguard our intellectual property, our ability to realize the expected benefits of our restructuring and the risks set forth under Part II, Item 1A, Risk Factors. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

*In this report, all references to LogicVision, we, us, our or the Company mean LogicVision, Inc. and its subsidiaries, except where it is made clear that the term means only the parent company.*

*LogicVision and the LogicVision logo are our registered trademarks. We also refer to trademarks of other corporations and organizations in this document.*

**Critical Accounting Policies and Estimates**

LogicVision's financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States (GAAP). Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, sales and expenses. These estimates and assumptions are affected by management's application of accounting policies. Critical accounting policies for LogicVision include revenue recognition, allowance for doubtful accounts, valuation of investments, inventory, goodwill impairment, valuation of long-lived intangible assets, accounting for stock-based compensation, and accounting for income taxes, which are discussed in more detail under the caption "Critical Accounting Policies and Estimates" in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

**Stock-Based Compensation Expense**

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and

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employee stock purchases under the Company's 2000 Employee Stock Purchase Plan based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) for periods beginning in 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ( SAB 107 ) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method. The Company's Consolidated Financial Statements as of June 30, 2006 and for the three and six months ended June 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the six months ended June 30, 2006 was \$219,000, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases. No stock-based compensation expense related to employee stock options and employee stock purchases was recognized for the six months ended June 30, 2005.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statements of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's Consolidated Statements of Operations because the exercise price of the Company's stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the current period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company's Consolidated Statements of Operations for the six months ended June 30, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all share-based payment awards will be recognized using the multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statements of Operations for the six months ended June 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS 123 for the periods ending prior to January 1, 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), the Company selected the Black-Scholes option-pricing model ( Black-Scholes model ) to determine the fair value of share-based awards granted beginning in fiscal 2006, the same model which was previously used for the Company's pro forma information required under SFAS 123. The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the Company's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Expected volatilities are based on the historical volatility of the Company's common stock. The Company uses historical data to estimate option exercise and employee terminations. The expected term of the options granted represents the period of time that options are expected to be outstanding, based on historical information. The risk-free interest rate is based on the U.S. Treasury zero-coupon issues with remaining terms similar to the expected term of the Company's equity awards. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore used an expected dividend yield of zero.

**Results of Operations**

**Orders and backlog**

We received new orders of \$1.3 million in the second quarter of 2006 compared to \$3.3 million in the first quarter of 2006 and \$2.1 million in the second quarter of 2005. These new orders are for periods ranging from one to two years. Receipt of new orders may fluctuate due to the lengthy sales cycles and our dependence on relatively few customers for large orders.

Our backlog was \$19.8 million at June 30, 2006, compared with \$21.0 million at March 31, 2006 and \$15.3 million at June 30, 2005. Backlog is comprised of deferred revenues (orders which have been billed but for which revenue has not yet been recognized) plus orders which have been accepted but have not yet been billed and for which no revenue has been recognized. A significant portion of the orders which have been accepted but have not yet been billed provide customers with cancellation rights; customers may also renew contracts before their expiration or modify that portion of their orders which is cancelable. Therefore, our backlog at any particular date is not necessarily indicative of revenues to be recognized during any succeeding period. At June 30, 2006, approximately \$9.0 million of the total backlog is expected to become recognized as revenue ratably over the next 12 months.

**Revenues, cost of revenues and gross profit**

The table below sets forth the fluctuations in revenues, cost of revenues and gross profit data for the three and six months ended June 30, 2006 and 2005 (in thousands, except percentage data):

|                                      | Three Months Ended June 30, |                 |             | Six Months Ended June 30, |                 |             |
|--------------------------------------|-----------------------------|-----------------|-------------|---------------------------|-----------------|-------------|
|                                      | 2006                        | 2005            | %<br>Change | 2006                      | 2005            | %<br>Change |
| <b>Revenues:</b>                     |                             |                 |             |                           |                 |             |
| License                              | \$ 1,305                    | \$ 1,493        | -13%        | \$ 2,524                  | \$ 4,190        | -40%        |
| Service                              | 1,367                       | 984             | 39%         | 2,497                     | 1912            | 31%         |
| Product                              | 100                         | 58              | 72%         | 100                       | 110             | -9%         |
| <b>Total revenues</b>                | <b>2,772</b>                | <b>2,535</b>    | <b>9%</b>   | <b>5,121</b>              | <b>6,212</b>    | <b>-18%</b> |
| <b>Cost of revenues:</b>             |                             |                 |             |                           |                 |             |
| License                              | 230                         | 203             | 13%         | 487                       | 389             | 25%         |
| Service                              | 429                         | 531             | -19%        | 853                       | 1,100           | -22%        |
| Product                              |                             | 25              | -100%       |                           | 50              | -100%       |
| <b>Total cost of revenues</b>        | <b>659</b>                  | <b>759</b>      | <b>-13%</b> | <b>1,340</b>              | <b>1,539</b>    | <b>-13%</b> |
| <b>Gross profit</b>                  | <b>\$ 2,113</b>             | <b>\$ 1,776</b> | <b>19%</b>  | <b>\$ 3,781</b>           | <b>\$ 4,673</b> | <b>-19%</b> |
| <b>Percentage of total revenues:</b> |                             |                 |             |                           |                 |             |
| <b>Revenues:</b>                     |                             |                 |             |                           |                 |             |
| License                              | 47%                         | 59%             |             | 49%                       | 67%             |             |
| Service                              | 49%                         | 39%             |             | 49%                       | 31%             |             |
| Product                              | 4%                          | 2%              |             | 2%                        | 2%              |             |
| <b>Total revenues</b>                | <b>100%</b>                 | <b>100%</b>     |             | <b>100%</b>               | <b>100%</b>     |             |
| <b>Cost of revenues:</b>             |                             |                 |             |                           |                 |             |
| License                              | 8%                          | 8%              |             | 9%                        | 6%              |             |
| Service                              | 16%                         | 21%             |             | 17%                       | 18%             |             |
| Product                              | 0%                          | 1%              |             | 0%                        | 1%              |             |
| <b>Total cost of revenues</b>        | <b>24%</b>                  | <b>30%</b>      |             | <b>26%</b>                | <b>25%</b>      |             |
| <b>Gross profit</b>                  | <b>76%</b>                  | <b>70%</b>      |             | <b>74%</b>                | <b>75%</b>      |             |

**Total revenues** increased in the three months ended June 30, 2006 compared to the same period in fiscal 2005 primarily due to an increase in orders in the past three quarters; the revenues are being recognized ratably over the contract term period. During the quarter, license revenue decreased and service revenues increased. In accordance with the Company's revenue recognition policy, we allocate a portion of total revenues to maintenance (services) using the estimated fair value of the maintenance, which is based on maintenance renewals sold separately for similar products. The product revenue was from the sale of one Validator in the quarter.

**Total cost of revenues** decreased in the three months ended June 30, 2006 compared to the same period in fiscal 2005 primarily due to lower cost of service revenues resulting from reduced post-sales support expense. In addition, there was no cost associated with the sale of the Validator because the product costs had previously been written off.



**Revenues by product line and country**

The table below sets forth the fluctuations in revenues by product line and geographic region for the three and six months ended June 30, 2006 and 2005 (in thousands, except percentage data):

**Revenue by product line:**

|                       | Three Months Ended June 30, |                 |           | Six Months Ended June 30, |                 |             |
|-----------------------|-----------------------------|-----------------|-----------|---------------------------|-----------------|-------------|
|                       | 2006                        | 2005            | % Change  | 2006                      | 2005            | % Change    |
| ETCreate              | \$ 1,999                    | \$ 2,211        | -10%      | \$ 3,743                  | \$ 5,092        | -26%        |
| ETAccess              | 624                         | 279             | 124%      | 1,087                     | 1,056           | 3%          |
| SiVision and other    | 149                         | 45              | 231%      | 291                       | 64              | 355%        |
| <b>Total revenues</b> | <b>\$ 2,772</b>             | <b>\$ 2,535</b> | <b>9%</b> | <b>\$ 5,121</b>           | <b>\$ 6,212</b> | <b>-18%</b> |

**Revenue by geographic region:**

|               | Three Months Ended June 30, |                 |           | Six Months Ended June 30, |                 |             |
|---------------|-----------------------------|-----------------|-----------|---------------------------|-----------------|-------------|
|               | 2006                        | 2005            | % Change  | 2006                      | 2005            | % Change    |
| United States | \$ 2,394                    | \$ 2,163        | 11%       | \$ 4,459                  | \$ 4,990        | -11%        |
| Japan         | 275                         | 214             | 29%       | 481                       | 881             | -45%        |
| Others        | 103                         | 158             | -35%      | 181                       | 341             | -47%        |
|               | <b>\$ 2,772</b>             | <b>\$ 2,535</b> | <b>9%</b> | <b>\$ 5,121</b>           | <b>\$ 6,212</b> | <b>-18%</b> |

**Product line:**

**ETCreate** is the product sub-family formerly known as icBIST, which consists of embedded test intellectual property and corresponding design automation software that provides embedded test solutions for different components of an ASIC or SOC design. ETCreate revenue decreased for the six months ended June 30, 2006 primarily because the results for the six months ended June 30, 2005 included license revenues from an existing order that was recognized upfront based on payment terms.

**ETAccess** is the product sub-family which consists of hardware and software products for use with third party test platforms. ETAccess enables faster time-to-market and lower test costs through the support of interactive or test program controlled at-speed testing, datalogging, and debug of silicon designed with LogicVision's embedded test IP. ETAccess revenue increased for the three month ended June 30, 2006 primarily from wider customer adoption and therefore more sales of ETAccess product in the recent quarters.

The **SiVision** product sub-family consists of parametric analysis and visualization software that uses semiconductor manufacturing process and test data to help assess parametric yields and identify parametric yield limiters. The SiVision product was acquired with the acquisition of SiVerion, Inc. in November 2004. Revenues from SiVision and other grew primarily from the addition of SiVision and revenues from consulting and training.

**Geographic region:**

Revenue in the United States increased as a percentage of total revenue in the three months ended June 30, 2006 compared to the same period in fiscal 2005, primarily due to revenues from new North American customers. Revenue in Japan increased as a percentage of total revenue in the three months ended June 30, 2006 compared to the same period in fiscal 2005 primarily due to higher revenues from existing customers' renewal orders.

**Operating Expenses:**

The table below sets forth operating expense data for the three and six months ended June 30, 2006 and 2005 (in thousands, except percentage data):

|                                      | Three Months Ended June 30, |                 |             | Six Months Ended June 30, |                 |             |
|--------------------------------------|-----------------------------|-----------------|-------------|---------------------------|-----------------|-------------|
|                                      | 2006                        | 2005            | % Change    | 2006                      | 2005            | % Change    |
| <b>Operating expenses:</b>           |                             |                 |             |                           |                 |             |
| Research and development             | \$ 1,036                    | \$ 1,377        | -25%        | \$ 2,123                  | \$ 3,067        | -31%        |
| Sales and marketing                  | 1,779                       | 1,974           | -10%        | 3,659                     | 3,750           | -2%         |
| General and administrative           | 1,037                       | 1,279           | -19%        | 2,001                     | 2,568           | -22%        |
| <b>Total operating expenses</b>      | <b>\$ 3,852</b>             | <b>\$ 4,630</b> | <b>-17%</b> | <b>\$ 7,783</b>           | <b>\$ 9,385</b> | <b>-17%</b> |
| <b>Percentage of total revenues:</b> |                             |                 |             |                           |                 |             |
| Operating expenses:                  |                             |                 |             |                           |                 |             |
| Research and development             | 37%                         | 54%             |             | 41%                       | 49%             |             |
| Sales and marketing                  | 64%                         | 78%             |             | 71%                       | 60%             |             |
| General and administrative           | 37%                         | 50%             |             | 39%                       | 41%             |             |
| <b>Total operating expenses</b>      | <b>138%</b>                 | <b>182%</b>     |             | <b>151%</b>               | <b>151%</b>     |             |

**Research and development expenses** decreased in the three and six months ended June 30, 2006 compared to the same periods in fiscal 2005, primarily due to a reduction in the number of employees, most of which were in India, from 49 to 25, and a decrease of business consulting expense. We were previously using a third party to integrate their software into our product.

**Sales and marketing expenses** decreased in the three and six months ended June 30, 2006 compared to the same periods in fiscal 2005, primarily due to decreases in promotion and business consulting expenses.

**General and administrative expenses** decreased in the three and six months ended June 30, 2006 compared to the same periods in fiscal 2005, primarily due to a reduction in the number of employees from 16 to 10, and a decrease in business consulting expenses.

In the fourth quarter of 2005, we implemented a restructuring plan expected to reduce operating costs by approximately \$3 million annually by reducing our workforce and consolidating facilities and resources. Our restructuring plan included a workforce reduction of 29% and the closing of excess facilities. The restructuring plan eliminated 31 jobs of employees included in administrative, marketing and engineering functions. The implementation of this plan has resulted in the reduction in expenses as noted above.

**Other Items:**

The table below sets forth other data for the three and six months ended June 30, 2006 and 2005 (in thousands, except percentage data):

|                                      | Three Months Ended June 30, |       |             | Six Months Ended June 30, |        |             |
|--------------------------------------|-----------------------------|-------|-------------|---------------------------|--------|-------------|
|                                      | 2006                        | 2005  | %<br>Change | 2006                      | 2005   | %<br>Change |
| Interest and other income, net       | \$ 90                       | \$ 68 | 32%         | \$ 162                    | \$ 130 | 25%         |
| Provision for income taxes           | \$ 19                       | \$ 14 | 36%         | \$ 76                     | \$ 30  | 153%        |
| <b>Percentage of total revenues:</b> |                             |       |             |                           |        |             |
| Interest and other income, net       | 3%                          | 3%    |             | 3%                        | 2%     |             |
| Provision for income taxes           | 1%                          | 1%    |             | 1%                        | 0%     |             |

**Interest and other income, net** increased in the three and six months ended June 30, 2006 compared to the same periods in fiscal 2005, due to an increase in interest earned on investment balances, and the elimination of interest expense resulting from the repayment of our outstanding bank loan.

**Provision for income taxes.** Our net operating losses are generated domestically, and amounts attributed to our foreign operations have been insignificant for all periods presented. Our income tax provisions are primarily related to state and foreign taxes. No benefit for income taxes has been recorded due to the uncertainty of the realization of deferred tax assets. From inception through December 31, 2005, we incurred net losses for federal and state tax purposes. As of December 31, 2005, we had federal and California net operating loss carryforwards of approximately \$77.6 million and \$24.1 million available to reduce future federal and California taxable income, respectively. These federal and California carryforwards begin to expire in 2006 if not utilized. The extent to which these carryforwards can be used to offset future taxable income may be limited under Section 382 of the Internal Revenue Code and applicable state tax law.

**Liquidity and Capital Resources**

At June 30, 2006, we had cash and cash equivalents and investments of \$9.6 million and working capital of \$5.8 million.

Net cash used in operating activities was \$1.0 million and \$5.8 million in the first six months of 2006 and 2005, respectively. Net cash used in operating activities for the six months ended June 30, 2006 was primarily due to a net loss of \$3.9 million and a decrease in deferred revenue of \$0.3 million; partially offset by non-cash charges relating to depreciation and amortization and stock-based compensation of \$0.7 million, a decrease of accounts receivable of \$1.8 million due to lower billings at the end of the quarter, a decrease in prepaid expenses and other assets of \$0.5 million, and an increase in accrued liabilities of \$0.2 million. Net cash used in operating activities for the six months ended June 30, 2005 was primarily due to a net loss of \$4.6 million, a decrease in deferred revenue of \$1.8 million due to lower orders in the first six months of 2005 and an increasing preference of customers for quarterly billings, a decrease in accrued liabilities of \$0.3 million and an increase in accounts receivable of \$0.3 million; partially offset by non-cash charges relating to depreciation and amortization of \$0.5 million, an increase in accounts payable of \$0.4 million and a decrease of other assets of \$0.3 million.

Net cash provided by investing activities was \$3.7 million and \$5.6 million in the first six months of 2006 and 2005, respectively. Net cash provided by investing activities in the first six months of 2006 was primarily due to the proceeds from maturities of marketable securities of \$6.7 million, partially offset by the purchase of marketable securities of \$2.9 million and the purchase of property and equipment of \$0.1 million. Net cash provided by investing activities in the first six months of 2005 was primarily due to the proceeds from maturities of marketable securities of \$9.2 million, partially offset by the purchase of marketable securities of \$3.0 million and the purchase of property and equipment of \$0.6 million.

Net cash provided by financing activities was \$39,000 and \$0.7 million in the first six months of 2006 and 2005, respectively. Net cash provided by financing activities for the first six months of 2006 was primarily due to the proceeds from the exercises of employee stock options. Net cash provided by financing activities for the first six months of 2005 was primarily due to the proceeds from the issuance of common stock pursuant to the employee stock purchase plan and exercises of employee stock options of \$0.6 million, and net proceeds from bank loan of \$0.1 million.

The Company has a Loan Agreement with a bank under which it may borrow, on a revolving basis, up to \$1.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 8.25% at June 30, 2006. The agreement is unsecured and is not collateralized by the Company's assets. Under the agreement, the Company must comply with certain operating and reporting covenants and is not permitted to pay dividends, or make material investments or dispositions without the prior written consent of the bank. If the Company fails to comply with its covenants under the agreement, the bank can declare any outstanding amounts immediately due and payable and cease advancing money or extending credit to or for the Company. The agreement expires on February 28, 2007. At June 30, 2006 there were no outstanding borrowings under the agreement. At that date, the Company was in compliance with the covenants under the agreement.

We expect to finance our future commitments using existing cash resources. We currently anticipate that our available cash resources will be sufficient to meet our anticipated operating and capital requirements for at least the next 12 months. Our acquisition agreement with SiVerion, Inc, previously may have required us to make a cash payment of up to \$2 million on November 5, 2006 if the average closing price of the our common stock for the 10 trading days immediately prior thereto was less than \$3.00. However, the Board of Directors authorized the Company to offer to certain former shareholders of SiVerion the opportunity to exchange their right to receive the cash payment in exchange for shares of Company Common Stock. On June 27, 2006, the Company issued 1,070,499 shares of Common Stock to said former shareholders. These shares effectively reduced the contingent payment to no more than \$148,000, payable to those remaining SiVerion, Inc. shareholders in the event the Company's common stock is less than \$3.00 as determined above.

We intend to continue to invest in the development of new products and enhancements to our existing products. Our future liquidity and capital requirements will depend upon numerous factors, including the costs and timing of product development efforts and the success of these development efforts, the costs and timing of sales and marketing and customer support activities, the extent to which our existing and new products gain market acceptance, competing technological and market developments, the costs involved in maintaining and enforcing patent claims and other intellectual property rights, the level and timing of license and service revenues, available borrowings under line of credit arrangements and other factors. In addition, we may utilize cash resources to fund acquisitions of, or investments in, complementary businesses, technologies or product lines. From time to time, we may be required to raise additional funds through public or private financing, strategic relationships or other arrangements. There can be no assurance that such funding, if needed, will be available on terms attractive to us, or at all. Furthermore, any additional equity financing may be dilutive to stockholders, and debt financing, if available, may involve restrictive covenants. Strategic arrangements, if necessary to raise additional funds, may require us to relinquish our rights to certain of our technologies or products. Our failure to raise capital when needed could have a material adverse effect on our business, operating results and financial condition.

**Contractual Obligations and Other Commercial Commitments**

At June 30, 2006, our contractual obligations and commercial commitments, primarily under operating leasing arrangements for our facilities, were as follows (in thousands):

| <b>Year ending December 31,</b> |                 |
|---------------------------------|-----------------|
| 2006                            | \$ 273          |
| 2007                            | 484             |
| 2008                            | 431             |
| 2009                            | 419             |
| 2010                            | 187             |
| Thereafter                      | 64              |
|                                 | <u>\$ 1,858</u> |

### ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

#### Foreign Currency Fluctuations

In the normal course of business, we are exposed to market risk from the effect of foreign exchange rate fluctuations on the U.S. dollar value from our foreign operations. A significant portion of our revenues has been denominated in U.S. dollars; however, as we increase our direct sales activities in Japan, an increasing portion of our revenues may be denominated in the Japanese yen. In addition, the operating expenses incurred by our foreign subsidiaries are denominated in local currencies. Accordingly, we are subject to exposure from movements in foreign currency exchange rates. To date, the effect of changes in foreign currency exchange rates on our financial position and operating results has not been material. We currently do not use financial instruments to hedge foreign currency risks. We intend to assess the use of financial instruments to hedge currency exposures on an ongoing basis.

#### Interest Rate Risk

Our exposure to market risk for changes in interest rates relate primarily to our investment portfolio. We have not used derivative financial instruments in our investment portfolio. We invest our excess cash in high-quality corporate issuers and in debt instruments of the U.S. Government and, by policy, limit the amount of credit exposure to any one issuer. As stated in our policy, we are averse to principal loss and seek to preserve our invested funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in high credit quality securities and by positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer or guarantor. The portfolio includes only investments with active secondary or resale markets to ensure portfolio liquidity.

Investments in both fixed and floating rate interest-earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to rising interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. A hypothetical 100 basis point increase in interest rates would not result in any significant decline in the fair value of our available-for-sale securities at June 30, 2006.

Investments are classified as available for sale and cost of securities sold is based on the specific identification method. At June 30, 2006, we had short-term U.S. government securities of \$2.3 million.

### ITEM 4: CONTROLS AND PROCEDURES

(a) **Evaluation of disclosure controls and procedures.** We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act), that are designed 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 that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet, reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon 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.

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Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

(b) **Changes in internal controls.** There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation described in Item 4(a) above that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II OTHER INFORMATION

### ITEM 1A: RISK FACTORS

**If the semiconductor industry does not adopt embedded test technology on a widespread basis, our revenues could decline and our stock price could fall.**

To date, the semiconductor industry has not adopted embedded test technology as an alternative to current testing methods on a widespread basis. If the semiconductor industry does not adopt embedded test technology widely and in the near future, our growth will be limited, our revenues could decline, and our stock price could fall. We cannot provide assurance that integrated circuit designers and design companies' customers will accept embedded test technology as an alternative to current testing methods in the time frame we anticipate, or at all. The industry may fail to adopt embedded test technology for many reasons, including the following:

Our current and potential customers may not accept or embrace our LV2005<sup>SM</sup> integrated family of products, our SiVision<sup>TM</sup> product or our Embedded SerDes Test product;

Potential customers may determine that existing solutions adequately address their testing needs, or the industry may develop alternative technologies to address their testing needs;

Potential customers may not be willing to accept the perceived delays in the early design stages associated with implementing embedded test technology in order to achieve potential time and cost savings at later stages of silicon debugging and production testing;

Potential customers may have concerns over the reliability of embedded testing methods relative to existing test methods;

Our existing and potential customers may react to declines in demand for semiconductors by curtailing or delaying new initiatives for new complex semiconductors or by extending the approval process for new projects, thereby lengthening our sales cycles; and

Designers may be reluctant to take on the added responsibility of incorporating embedded test technology as part of their design process, or to learn how to implement embedded test technology.

**If the industries into which we sell our products experience recession or other cyclical effects impacting our customers' research and development budgets, our operating results could be negatively impacted.**

Our sales are dependent upon capital spending trends and new design projects, and a substantial portion of our costs is fixed in the near term. The demand from our customers is uncertain and difficult to predict. Slower growth in the semiconductor and systems markets such as postponed or canceled capital expenditures for previously planned expansions or new fabrication facility construction projects, a reduced number of design starts, reduction of design and test budgets or continued consolidation among our customers would harm our business and financial condition.

The primary customers for semiconductors that incorporate our embedded test technology are companies in the communications, medical products, and networking, server and consumer products industries. Any significant downturn in these particular markets or in general economic conditions which result in the cutback of research and development budgets or capital expenditures would likely result in a reduction in demand for our products and services and could harm our business. If the economy declines as a result of economic, political or social turmoil, existing and prospective customers may further reduce their design budgets or delay implementation of our products, which could harm our business and operating results.



In addition, the markets for semiconductor products are cyclical. In recent years, most countries have experienced significant economic difficulties. These difficulties triggered a significant downturn in the semiconductor market, resulting in reduced budgets for chip design tools. In addition, the electronics industry has historically been subject to seasonal and cyclical fluctuations in demand for its products, and this trend may continue in the future. These industry downturns have been, and may continue to be, characterized by diminished product demand, excess manufacturing capacity and subsequent erosion of average selling prices. As a result, our future operating results may reflect substantial fluctuations from period to period as a consequence of these industry patterns, general economic conditions affecting the timing of orders from customers and other factors. Any negative factors affecting the semiconductor industry, including the downturns described here, could significantly harm our business, financial condition and results of operations.

**We have a history of losses and an accumulated deficit of approximately \$92.9 million as of June 30, 2006. If we do not generate sufficient net revenue in the future to achieve or sustain profitability, our stock price could decline.**

We have incurred significant net losses since our inception, including losses of \$10.0 million, \$8.4 million and \$12.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. At June 30, 2006, we had an accumulated deficit of approximately \$92.9 million. We expect our future revenues to be impacted by our long sales cycle and our revenue recognition policies, and we expect to continue to invest in our research and development projects as well as service operations required to support our business development activities. These product and business development expenditures as well as other operating expenses could continue to exceed our revenues, thus preventing us from achieving and maintaining profitability. To achieve and maintain profitability, we will need to generate and sustain substantially higher revenues while maintaining reasonable cost and expense levels. If we fail to achieve profitability within the time frame expected by securities analysts or investors and our cash balances continue to decline, the market price of our common stock will likely decline. We may not achieve profitability if our revenues do not increase or if they increase more slowly than we expect. In addition, our operating expenses are largely fixed, and any shortfall in anticipated revenues in any given period could harm our operating results.

**The sales and implementation cycles for our products are typically long and unpredictable, taking from three months to one year for sales and an additional one to six months for implementation. As a result, we may have difficulty predicting future revenues and our revenues and operating results may fluctuate significantly, which could cause our stock price to fluctuate.**

Our sales cycle has ranged from three months to one year and our customers' implementation cycle has been approximately an additional one to six months. We believe that convincing a potential customer to integrate our technology into an integrated circuit at the design stage, which we refer to as a design win, is critical to retaining existing customers and to obtaining new customers. However, acceptance of our embedded test technology generally involves a significant commitment of resources by prospective customers and a fundamental change in their method of designing and testing integrated circuits. Many of our potential customers are large enterprises that generally do not adopt new design methodologies quickly. Also, we may have limited access to the key decision-makers of potential customers who can authorize the adoption of our technology. As a result, the period between our initial contact with a potential customer and the sale of our products to that customer, if any, is often lengthy and may include delays associated with our customers' budgeting and approval processes, as well as a substantial investment of our time and resources. We have incurred high customer engagement and support costs, including sales commissions, and the failure to manage these costs could harm our operating results.

If we fail to achieve a design win with a potential customer early in a given product cycle, it is unlikely that the potential customer will become a customer before its next product cycle, if at all. Because of the length of our sales cycle, our failure to achieve design wins could have a material and prolonged adverse effect on our sales and revenue growth. Our revenue streams may fluctuate significantly due to the length of our sales cycle, which may make our future revenues difficult to project and may cause our stock price to fluctuate.

**If a customer cancels its order or defaults on payment or if we renegotiate an existing order we may be unable to recognize revenue from backlog, which could have a material adverse effect on our financial condition and results of operations.**

A significant portion of the orders in our backlog provides customers with cancellation rights or is recognized as revenue when payment is due. In addition, some orders extend over periods ranging up to thirty-six months. If a customer cancels its order or delays its contractual payments we may not be able to realize revenue from backlog in the time frame expected or at all. Also, it is possible that customers from whom we expect to derive revenue from backlog will default, and as a result we may not be able to recognize expected revenue from backlog. If a customer defaults or fails to pay amounts owed, or if the level of defaults increases, our bad debt expense is likely to increase. Any material payment default by our customers could have a material adverse effect on our financial condition and results of operations.

**Fluctuations in our revenues and operating results could cause the market price of our common stock to decline.**

Our revenues and operating results have fluctuated significantly from quarter to quarter in the past and may do so in the future, which could cause the market price of our common stock to decline. Accordingly, quarter-to-quarter comparisons of our results of operations may not be an indication of our future performance. In future periods, our revenues and results of operations may be below the estimates of public market analysts and investors. This discrepancy could cause the market price of our common stock to decline.

Fluctuations in our revenues and operating results may be caused by:

Timing, terms and conditions of customer agreements;

Customers placing orders at the end of the quarter;

The mix of our license and services revenues;

Timing of customer usage of our technology in their product designs and the recognition of revenues therefrom when amounts are due based on design usage;

Timing of sales commission expenses and the recognition of license revenues from related customer agreements;

Changes in our and our customers' development schedules and levels of expenditures on research and development;

Industry patterns and changes or cyclical and seasonal fluctuations in the markets we target;

Timing and acceptance of new technologies, product releases or enhancements by us, our competitors or our customers;

Timing and completion of milestones under customer agreements; and

Market and general economic conditions.

Delays or deferrals in purchasing decisions by our customers may increase as we develop new or enhanced products. Our current dependence on a small number of customers increases the revenue impact of each customer's actions relative to these factors. Our expense levels are based, in large part, on our expectations regarding future revenues, and as a result net income for any quarterly period in which material customer agreements are delayed could vary significantly from our budget projections.

**The accounting rules regarding revenue recognition may cause fluctuations in our revenues independent of our order position.**

The accounting rules we are required to follow require us to recognize revenues only when certain criteria are met. As a result, for a given quarter it is possible for us to fall short in our revenues 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 revenues resulting from the recognition of previously deferred revenues. Orders for software support and consulting services yield revenues over multiple quarters, often 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 revenues in whole or in part or, alternatively, of requiring us to accelerate the recognition of such revenues for products to be used over multiple years.

**Intense competition in the semiconductor and systems industries, particularly in the design and test of semiconductors, could prevent us from increasing or sustaining our revenues and prevent us from achieving or sustaining profitability.**

The semiconductor and systems industries are extremely competitive and characterized by rapidly changing technology. The market for embedded test solutions is still evolving, and we expect competition to become more intense in the future. Our current principal competitors in the design phase of product development include:

Electronic design automation providers such as Cadence Design Systems, Inc., Magma Design Automation Inc., Mentor Graphics Corporation and Synopsys, Inc., all of which offer basic built-in self-test capability;

Smaller test tool providers;

Potential customers that develop test solutions internally; and

Integrated device manufacturers, such as International Business Machines Corporation, that use their own test solutions in chips manufactured for and sold to others.

Our embedded test technology also has the potential to impact the automated test equipment market, which may place us in competition with traditional hardware tester manufacturers such as Advantest Corporation, Credence Systems Corporation, Inovys Corporation, LTX Corporation, Teradyne, Inc. and Verigy Ltd. As embedded test becomes adopted more widely in the market, any of these automated test equipment companies, or others, may offer their own embedded test solutions. Some of our competitors in electronic design automation and external test equipment businesses are significantly larger than we are and have greater financial resources, greater name recognition and longer operating histories than we have. Some of our competitors offer a more comprehensive range of products covering the entire design flow and complete external test flow, and they may be able to respond more quickly or adjust prices more effectively to take advantage of new opportunities or customer requirements. In addition, all of the tester manufacturers listed above participate in our LVReady partner program through which our embedded test access software is integrated into their test platform, which may provide them with additional insight into our business and technology. Increased competition in the semiconductor industry could result in pricing pressures, reduced sales, reduced margins or failure to achieve or maintain widespread market acceptance, any of which could prevent us from increasing or sustaining our revenues and achieving or sustaining profitability.

**Our target markets are comprised of a limited number of customers. If we fail to obtain or retain customer relationships, our revenues could decline.**

We derive a significant portion of our revenues from a relatively small number of customers. Two customers accounted for approximately 22% and 17% of total revenues for the six months ended June 30, 2006. Three customers accounted for approximately 21%, 10% and 10% of total revenues in the year ended December 31, 2005, respectively; two customers accounted for 20% and 17%, respectively, of total revenues for the year ended

December 31, 2004 and two different customers accounted for 15% and 11%, respectively, of total revenues for the year ended December 31, 2003. We anticipate that we will continue to rely on a limited number of customers for a substantial portion of our future revenues and we must obtain additional large orders from customers on an ongoing basis to increase our revenues and grow our business. In addition, the loss of any significant or well-known customer could harm our operating results or our reputation. In particular, a loss of a significant customer could cause fluctuations in our results of operations because our expenses are fixed in the short term, it takes us a long time to replace customers and, because of required methods of revenue recognition, any offsetting license revenues may need to be recognized over a period of time.

**We have relied and expect to continue to rely on our ETCreat products for a significant portion of our revenues.**

Revenues from sales of our ETCreat products and related maintenance and training services accounted for 73% of our total revenues for the six months ended June 30, 2006, and 82%, 90% and 97% of our total revenues for the years ended December 31, 2005, 2004 and 2003, respectively. We currently expect that revenues from our ETCreat products will continue to account for a substantial percentage of our revenues in the foreseeable future and thereafter. Our future operating results are significantly dependent upon the continued market acceptance of our products. Our business will be harmed if our products do not continue to achieve market acceptance or if we fail to develop and market improvements to our products or enhancements thereof. A decline in demand for our ETCreat products as a result of competition, technological change or other factors could harm our business.

**Our products incorporate technology licensed from third parties, including Nortel Networks. If any of these licenses are terminated, our ability to develop and license our products could be delayed or reduced.**

We use technology, including software, which we license from third parties. In particular, we license technology from Nortel Networks under two patents for testing embedded memories and digital systems, and we use the Nortel technology in our embedded test technology. Our license agreement with Nortel may be terminated if we materially violate the terms of the agreement, if a competitor of Nortel acquires a significant percentage of our common stock without first obtaining Nortel's consent or if we bring patent infringement proceedings against Nortel under any patent embodied in, or acquired as a result of access to, the technology we license from Nortel. If we do not maintain our existing third party technology licenses or enter into licenses for alternative technologies, we could be required to cease or delay product shipments while we seek to develop alternative technologies.

**We depend on third parties to provide electronic design automation software that is compatible with our solution. If these third parties do not continue to provide compatible design products, we would need to develop alternatives, which could delay product introductions and cause our revenues and operating results to decline.**

Our customers depend on electronic design automation software to design their products using our solution. We depend on the same software to develop our products. Although we have established relationships with a variety of electronic design automation vendors to gain access to this software and to assure compatibility, these relationships may be terminated with limited notice. If any of these relationships were terminated and we were unable to obtain alternative software in a timely manner, our customers could be unable to use our solution. In addition, we could experience a significant increase in development costs, our development process could take longer, product introductions could be delayed and our revenues and operating results could decline.

**If automated test equipment companies are unwilling to work with us to make our technology compatible with theirs, we may need to pursue alternatives, which could increase the time it takes us to bring our solution to market and decrease customer acceptance of our technology.**

Although we are presently working with a number of automated test equipment companies to achieve optimal compatibility of our technologies, these companies may elect not to work with us in the future. If automated test equipment companies are unwilling to incorporate modifications into their equipment and operating systems to allow them to work with our technology, we may need to seek alternatives. These alternatives might not provide optimal levels of test function, and pursuing these alternatives could increase the time and expense it takes us to bring our technology to market, either of which could decrease customer acceptance of our technology and cause our revenues and margins to decline.

**Our future success will depend on our ability to keep pace with rapid technological advancements in the semiconductor industry. If we fail to develop and introduce new products and enhancements on a timely basis, our ability to attract and retain customers could be impaired, which would cause our operating results to decline.**

The semiconductor industry is characterized by rapidly changing technology, evolving industry standards, rapid changes in customer requirements, frequent product introductions and ongoing demands for greater speed and functionality. We must continually design, develop and introduce new products with improved features to be competitive. Our products may not achieve market acceptance or adequately address the changing needs of the marketplace, and we may not be successful in developing and marketing new products or enhancements to our existing products on a timely basis. The introduction of products embodying new technologies, the emergence of new industry standards or changes in customer requirements could render our existing products obsolete and unmarketable. We may not have the financial resources necessary to fund future innovations. If we are unable, for technical, legal, financial or other reasons, to respond in a timely manner to changing market conditions or customer requirements, our business and operating results could be seriously harmed.

**Future changes in financial accounting standards, including pronouncements and interpretations of accounting pronouncements on software revenue recognition and stock-based compensation, may cause adverse unexpected revenue fluctuations and affect our reported results of operations.**

A change in accounting policies can have a significant effect on our reported results and may even affect our reporting of transactions completed before a change is announced. In particular, new pronouncements and varying interpretations of pronouncements on software revenue recognition and stock-based compensation have occurred with frequency, may occur in the future and could impact our revenues and results of operations. Required changes in our methods of revenue recognition could result in deferral of revenues recognized in current periods to subsequent periods or accelerated recognition of deferred revenues to current periods, each of which could cause shortfalls in meeting the expectations of investors and securities analysts. Our stock price could decline as a result of any shortfall.

Accounting policies affecting many other aspects of our business, including rules relating to revenue recognition and purchase accounting for business combinations have recently been revised or are under review. Changes to those rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business.

**While we believe that we currently have adequate internal control over financial reporting, we are exposed to risks from recent legislation requiring companies to evaluate those internal controls.**

Section 404 of the Sarbanes-Oxley Act of 2002 will require our management to report on, and our independent registered public accounting firm to attest to, the effectiveness of our internal control structure and procedures for financial reporting beginning in fiscal 2007. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. This legislation is relatively new and neither companies nor accounting firms have significant experience in complying with its requirements. As a result, we expect to incur increased expense and to devote additional management resources to Section 404 compliance.

In the event our chief executive officer, chief financial officer or independent registered public accounting firm determine that our internal controls over financial reporting are not effective as defined under Section 404, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.

**Compliance with changing regulation of corporate governance and public disclosure may result in additional costs.**

Changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and recent SEC and NASDAQ rules and regulations are creating new duties and requirements for us and our executives, directors, attorneys and independent accountants. In order to comply with these new rules, we will have to incur additional costs for personnel and use additional outside legal, accounting and advisory services, which will increase our operating expenses. Management time associated with these compliance efforts necessarily reduces time available for other operating activities, which could adversely affect operating results. To date, our costs to comply with these rules have not been significant; however, we cannot predict or estimate the amount of future additional costs we may incur or the timing of such costs.

**Our products may have errors or defects that users identify after deployment, which could harm our reputation and our business.**

Our products may contain undetected errors when first introduced or when new versions or enhancements are released. We have from time to time found errors in versions of our products, and we may find errors in our products in the future. The occurrence of errors could cause sales of our products to decline, divert the attention of management and engineering personnel from our product development efforts and cause significant customer relations problems. Customer relations problems could damage our reputation, hinder market acceptance of our products and result in loss of future revenues.

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

Our strategy for encouraging the adoption of our technology requires that we employ highly skilled engineers to develop our products and work with our customers. In the past, we have experienced difficulty in hiring and retaining highly skilled engineers with appropriate qualifications to support our business. As a result, our future success depends in part on our ability to identify, attract, retain and motivate qualified engineering personnel. Competition for qualified engineers is intense, especially in the Silicon Valley where our headquarters are located. If we lose the services of a significant number of our engineers and we cannot hire and integrate additional engineers, it could disrupt our ability to develop our products and implement our business strategy.

**We may be unable to replace the technical, sales, marketing and managerial contributions of key individuals.**

We depend on our senior executives, and our research and development, sales and marketing personnel, who are critical to our business. We do not have long-term employment agreements with our key employees nor do we maintain a key person life insurance policy on any of our key employees. If we lose the services of any of these key executives, our product development processes and sales efforts could be slowed. We may also incur increased operating expenses and be required to divert the attention of other senior executives to search for their replacements. The integration of any executives or new personnel could disrupt our ongoing operations.

**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 revenues or increase our costs.**

Our success and ability to compete depend largely upon the protection of our proprietary technology. We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and licensing arrangements to establish and protect our proprietary rights. 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. Policing unauthorized use of our products is difficult and we cannot be certain that the steps we have taken will prevent the misappropriation or unauthorized use of our technologies, particularly in foreign countries where the laws may not protect our proprietary rights as fully as U.S. laws. Any patents we obtain or license may not be adequate to protect our proprietary rights. Our competitors may independently develop similar technology, duplicate our products or design around any patents issued to us or our other intellectual property rights.

Litigation may be necessary to enforce our intellectual property rights or to determine the validity or 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. We may need to take legal action to enforce our proprietary rights in the future. Any action we take to protect our intellectual property rights could be costly and could absorb significant management time and attention. In addition, failure to adequately protect our trademark rights could impair our brand identity and our ability to compete effectively.

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

In any dispute involving our patents or other intellectual property, our licensees could also become the target of litigation. This could trigger technical support and indemnification obligations in some of our license agreements which could result in substantial expenses. In addition to the time and expense required for us to support or indemnify our licensees, any such litigation could severely disrupt or shut down the business of our licensees, which in turn could hurt our relations with our customers and cause our revenues to decrease.

**Failure to obtain export licenses could harm our business.**

We must comply with U.S. Department of Commerce regulations in shipping our software and hardware products and other technologies outside the United States. Although we have not had any significant difficulty complying with these regulations to date, any significant future difficulty in complying could harm our business, operating results and financial condition.

**We have limited control over third-party representatives who market, sell and support our products in foreign markets. Loss of these relationships could decrease our revenues and harm our business.**

We offer our products and services for sale through distributors and sales representatives in China, France, Germany, Israel, Korea, Taiwan and the United Kingdom (UK). We anticipate that sales in these markets will account for a portion of our total revenues in future periods. During 2004, we appointed a new distributor in Germany. In 2005, we appointed a sales representative in Israel and distributors in France and the UK. Our third-party representatives are not obligated to continue selling our products, and they may terminate their arrangements with limited prior notice. Growing our relationship with this new distributor and sales representative, or establishing alternative distribution channels in these markets could consume substantial management time and resources, decrease our revenues and increase our expenses.

**We face business, political and economic risks because a portion of our revenues and operations are outside of the United States.**

International revenues accounted for 13% of our total revenues for the six months ended June 30, 2006, and 18%, 22% and 19% of our total revenues for the years ended December 31, 2005, 2004 and 2003, respectively. In addition to our international sales, we have operations in Canada, Japan, the UK and India. Our success depends upon continued expansion of our international operations, and we expect that international revenues will continue to be an important component of our total future revenues. Our international business involves a number of risks, including:

- Our ability to adapt our products to foreign design methods and practices;
- The uncertainty of international orders due to typically lengthy international selling cycles;
- Cultural differences in the conduct of business;
- Difficulty in attracting qualified personnel;
- Managing foreign branch offices and subsidiaries;
- Longer payment cycles for and greater difficulty collecting accounts receivable;
- Unexpected changes in regulatory requirements, royalties and withholding taxes that restrict the repatriation of earnings;
- Tariffs and other trade barriers;
- The burden of complying with a wide variety of foreign laws; and

Political, economic, health or military conditions associated with worldwide conflicts and events.

As a result of our direct selling activities in Japan, a portion of our international revenues is denominated in Japanese yen, which is subject to exposure from movements in foreign currency exchange rates. In addition, most of our remaining international revenues are denominated in U.S. dollars, creating a risk that fluctuation in currency exchange rates will make our prices uncompetitive. To the extent that profit is generated or losses are incurred in foreign countries, our effective income tax rate may be significantly affected. Any of these factors could significantly harm our future international sales and, consequently, our revenues and overall results of operations and business and financial condition.

**We may be unable to consummate future potential acquisitions or investments or successfully integrate acquired businesses or investments or foreign operations with our business, which may disrupt our business, divert management's attention and slow our ability to expand the range of our proprietary technologies and products.**

We may expand the range of our proprietary technologies and products acquire or make investments in additional complementary businesses, technologies or products, if appropriate opportunities arise. For example, in the fourth quarter of 2004, we completed the acquisition of SiVerion, Inc. 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. Our acquisition of SiVerion, Inc. and any future acquisitions may involve risks such as the following:



We may not achieve the anticipated benefits of the acquisitions;

Our acquisition and integration costs may be higher than we anticipated and may cause our quarterly and annual operating results to fluctuate;

We may be unable to retain key employees, such as management, technical or sales personnel, of the acquired businesses;

We may experience difficulty and expense in assimilating the operations and personnel of the acquired businesses, which could be further affected by the acquired businesses not being located near our existing sites;

We may incur amortization or impairment expenses if an acquisition results in significant goodwill or other intangible assets;

We may be unable to complete the development and application of the acquired technology or products or integrate the technology or products with our own;

We may be exposed to unknown liabilities of acquired companies;

We may experience difficulties in establishing and maintaining uniform standards, controls, procedures and policies;

Our relationships with key customers of acquired businesses may be impaired, due to changes in management and ownership of the acquired businesses; or

Our stockholders may be diluted if we pay for the acquisition with equity securities.

These factors could disrupt our ongoing business, distract our management and employees and increase our expenses or otherwise harm our operating results.

**Intellectual property litigation, which is common in our industry, could be costly, harm our reputation, limit our ability to license or sell our proprietary technologies or products and divert the attention of management and technical personnel.**

The semiconductor industry is characterized by frequent litigation regarding patent and other intellectual property rights. While we have not received formal notice of any infringement of the rights of any third party, questions of infringement in the semiconductor field involve highly technical and subjective analyses. Litigation may be necessary in the future to enforce any patents we may receive and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity, and we may not prevail in any future litigation. Any such litigation, whether or not determined in our favor or settled, could be costly, could harm our reputation and could divert the efforts and attention of our management and technical personnel from normal business operations. Adverse determinations in litigation could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from third parties or prevent us from licensing our technology or selling our products, any of which could harm our business.

**Our stock price may decline significantly because of stock market fluctuations that affect the prices of technology stocks. A decline in our stock price could result in securities class action litigation against us that could divert management's attention and harm our business.**

The stock market has experienced significant price and trading volume fluctuations that have adversely affected the market prices of common stock of technology companies. These broad market fluctuations may reduce the market price of our common stock. In the past, securities class action litigation has often been brought against a company after periods of volatility in the market price of securities. In the future, we may be a target of similar litigation. Securities litigation could result in substantial costs and divert our management's attention and resources, which in turn could harm our ability to execute our business plan.

**If investors price our common stock below \$1.00 per share, our stock may fail to meet the requirements for continued listing on the Nasdaq Global Market, in which case the price and liquidity of our common stock may decline.**

The Nasdaq Stock Market has quantitative maintenance criteria for the continued listing of common stock on the Nasdaq Global Market, including maintaining a minimum closing bid of \$1.00 per share. As of June 30, 2006, we were in compliance with all Nasdaq Global Market listing requirements. However, our stock price has declined significantly over the past year and has experienced volatility. If the closing bid price of our common stock falls and remains below \$1.00 per share for 30 consecutive days, our common stock may not remain listed on the Nasdaq Global Market. If we fail to maintain continued listing on the Nasdaq Global Market and must move to a market with less liquidity, our financial condition could be harmed and our stock price would likely decline. If we are delisted, it could have a material adverse effect on the market price of, and the liquidity of the trading market for, our common stock.

**Our ability to raise capital in the future may be limited and our failure to raise capital when needed could prevent us from growing.**

We believe that our existing cash resources and available debt financing will be sufficient to meet our anticipated cash needs for at least the next 12 months. However, the timing and amount of our working capital and capital expenditure requirements may vary significantly depending on numerous factors, including:

The level and timing of license and service revenues;

The costs and timing of expansion of product development efforts and the success of these development efforts;

The extent to which our existing and new products gain market acceptance;

The costs and timing of expansion of sales and marketing activities;

Competing technological and marketing developments;

The extent of international operations;

The need to adapt to changing technologies and technical requirements;

The costs involved in maintaining and enforcing patent claims and other intellectual property rights;

The existence of opportunities for expansion and for acquisitions of, investments in, complementary businesses, technologies or product lines; and

Access to and availability of sufficient management, technical, marketing and financial personnel.

If our capital resources are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity securities or debt securities or obtain debt financing. The sale of additional equity securities or debt securities would result in additional dilution to our stockholders. Additional debt would result in increased expenses and could result in covenants that would restrict our operations. If adequate funds are not available or are not available on acceptable terms, this would significantly limit our ability to hire, train or retain employees, support our expansion, take advantage of unanticipated opportunities such as acquisitions of businesses or technologies, develop or enhance products, or respond to competitive pressures.

**ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

- (a) The Annual Meeting of Stockholders was held on May 11, 2006.
- (b) The matters voted upon at the meeting and results of voting with respect to those matters were as follows:

- (1) Election of Directors

| Name              | Votes For  | Withheld |
|-------------------|------------|----------|
| Gregg E. Adkin    | 13,909,437 | 230,142  |
| Richard C. Black  | 13,287,703 | 851,876  |
| James T. Healy    | 14,055,663 | 83,916   |
| Randall A. Hughes | 14,056,911 | 82,668   |
| Matthew Raggett   | 13,909,437 | 230,142  |
| Richard C. Yonker | 13,404,856 | 734,723  |

- (2) Ratification of the appointment of PricewaterhouseCoopers LLP as the Company's independent registered public accounting firm.

| Votes For  | Against | Abstain |
|------------|---------|---------|
| 14,118,055 | 18,024  | 3,500   |

**ITEM 6: EXHIBITS**

(a) Exhibits.

- 10.1 Form of Exchange Agreement (incorporated by reference to the exhibit of the same number to the Company's Current Report on Form 8-K filed with the Commission on June 28, 2006)
- 10.2 Registration Rights Agreement (incorporated by reference to the exhibit of the same number to the Company's Current Report on Form 8-K filed with the Commission on June 28, 2006)
- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer.
- 31.2 Rule 13a-14(a) Certification of Chief Financial Officer.
- 32.1\* Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
- 32.2\* Statement of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).

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\* In accordance with Item 601(b) (32) (ii) of Regulation S-K and SEC Release Nos. 33-8238 and 34-47986, Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-Q and will not be deemed filed for purpose of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

**SIGNATURES**

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.

Dated: August 3, 2006

LOGICVISION, INC.  
(Registrant)

By: /s/ JAMES T. HEALY

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James T. Healy  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

By: /s/ BRUCE M. JAFFE

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Bruce M. Jaffe  
Vice President of Finance and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

**EXHIBIT INDEX**

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