LOGICVISION INC
Form 10-Q
May 15, 2002
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2002

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

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

Delaware	**94-3166964**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

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

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

Indicate by check mark whether the registrant (l) 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. Yes x No ¨

On April 30, 2002, 14,929,181 shares of Registrant s Common Stock, $0.0001 par value were outstanding.

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FORM 10-Q

QUARTERLY PERIOD ENDED MARCH 31, 2002

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PART I:

FINANCIAL INFORMATION

Item 1: ***Financial Statements***

The unaudited condensed consolidated financial information for the quarter ended March 31, 2002 of LogicVision, Inc. (LogicVision or the Company) and comparative unaudited condensed consolidated financial information for the corresponding period of the prior year, together with the balance sheet as of December 31, 2001, are attached hereto and incorporated herein.

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

	March 31, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 25,099	$ 34,496
Accounts receivable, net	4,005	3,184
Prepaid expenses and other current assets	660	866
Total current assets	29,764	38,546
Property and equipment, net	1,303	1,453
Marketable securities	19,973	11,984
Other long-term assets	610	749
Total assets	$ 51,650	$ 52,732
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	955	740
Accrued liabilities	1,599	1,766
Deferred revenue, current portion	3,658	4,667
Total current liabilities	6,212	7,173
Deferred revenue	772	1,319
Total liabilities	6,984	8,492
Stockholders equity:		
Preferred stock, $0.0001 par value:		
Authorized: 5,000,000 shares;		
Issued and outstanding: no shares issued and outstanding		
Common stock, $0.0001 par value:		
Authorized: 125,000,000 shares;		
Issued and outstanding: 14,875,904 shares at March 31, 2002 and 14,872,411 shares at December 31, 2001	1	1
Additional paid-in-capital	97,126	97,179
Deferred stock based compensation	(2,422)	(2,863)
Accumulated other comprehensive income	36	17
Accumulated deficit	(50,075)	(50,094)
Total stockholders equity	44,666	44,240

Total liabilities and stockholders equity	$ 51,650	$ 52,732

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

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LOGICVISION, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(in thousands, except per share data)

	Three Months Ended March 31,	
	2002	2001
Revenues:		
License	$ 4,056	$ 1,997
Service	1,774	1,142
Royalties	20	
Total revenues	5,850	3,139
Cost of revenues:		
License	306	13
Service	830	451
Total cost of revenues	1,136	464
Gross profit	4,714	2,675
Operating expenses:		
Research and development	1,292	1,378
Sales and marketing	2,289	2,678
General and administrative	959	933
Amortization of deferred stock compensation	426	673
Total operating expenses	4,966	5,662
Loss from operations	(252)	(2,987)
Interest and other income	288	113
Income (loss) before provision for income taxes	36	(2,874)
Provision for income taxes	17	14
Net income (loss)	$ 19	$ (2,888)
Accretion of redeemable convertible preferred stock		43
Net income (loss) attributable to common stockholders	$ 19	$ (2,931)
Net income (loss) per share attributable to common stockholders, basic	$ 0.00	$ (1.54)
Net income (loss) per share attributable to common stockholders, diluted	$ 0.00	$ (1.54)
Weighted average number of shares outstanding, basic	14,875	1,900
Weighted average number of shares outstanding, diluted	17,480	1,900

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

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LOGICVISION, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(in thousands)

	Three Months Ended March 31,	
	2002	**2001**
Cash flows from operating activities:		
Net income (loss)	$ 19	$ (2,888)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	305	228
Amortization of deferred stock compensation	426	673
Changes in operating assets and liabilities:		
Accounts receivable	(821)	648
Prepaid expenses and other current assets	206	2
Other long-term assets	6	(19)
Accounts payable	215	(506)
Deferred revenue	(1,556)	(406)
Accrued liabilities	(167)	(1,163)
Net cash used in operating activities	(1,367)	(3,431)
Cash flows from investing activities:		
Purchase of marketable securities	(7,989)	
Purchases of property and equipment	(21)	(62)
Purchase of technology license		(121)
Net cash used in investing activities	(8,010)	(183)
Cash flows from financing activities:		
Stock issuance costs	(44)	
Proceeds from exercise of stock options	5	20
Net cash (used in) provided by financing activities	(39)	20
Effect of exchange rate on cash	19	17
Net decrease in cash and cash equivalents	(9,397)	(3,577)
Cash and cash equivalents, beginning of period	34,496	9,708
Cash and cash equivalents, end of period	$ 25,099	$ 6,131

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

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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 after elimination of all inter-company transactions. The Company s fiscal year ends on December 31.

The accompanying unaudited condensed consolidated financial statements of LogicVision have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial information and in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with GAAP. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The December 31, 2001 fiscal year end balance sheet data was derived from the audited financial statements and does not include all disclosures required by GAAP. Operating results for the three month period ended March 31, 2002 is not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2002 or any other future periods. 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, 2001 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 and liabilities and to disclose contingent 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.

Note 2. Recently Issued Accounting Standards

In June 2001, the FASB issued SFAS No. 141 (SFAS 141), Business Combinations, and SFAS No. 142 (SFAS 142), Goodwill and Other Intangible Assets. Under SFAS 141, use of the pooling-of-interest method is prohibited for business combinations initiated after June 30, 2001. The provisions of SFAS 141 also apply to all business combinations accounted for by the purchase method that are completed after June 30, 2001 (that is, the date of the acquisition is July 1, 2001 or later). There are also transition provisions that apply to business combinations completed before July 1, 2001 that were accounted for by the purchase method. SFAS 142 is effective for fiscal years beginning after December 15, 2001 and applies to all goodwill and other intangible assets recognized in an entity s statement of financial position at that date, regardless of when those assets were initially recognized. The Company has adopted these statements. The adoption of SFAS 141 and SFAS 142 did not have a material effect on the Company s financial position or results of operations.

In August 2001, the FASB issued SFAS No. 143 (SFAS 143), Accounting for Asset Retirement Obligations. SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. SFAS 143 is effective for financial statements issued for fiscal years beginning after June 25, 2002. The Company expects that the initial application of SFAS 143 will not have an impact on its financial statements.

In October 2001, the FASB issued SFAS No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-lived Assets. The objectives of SFAS 144 are to address significant issues relating to the implementation of FASB Statement No. 121 (SFAS 121), Accounting for the Impairment of Long-lived Assets and for Long-lived assets to be Disposed Of, and to develop a single accounting model, based on the framework established by SFAS 121, for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. Although SFAS 144 supersedes SFAS 121, it retains some fundamental provisions of SFAS 121. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim

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LOGICVISION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

periods within those fiscal years. The Company has adopted this statement. The adoption of SFAS 144 did not have a material effect on the financial position or results of operations.

Note 3. Cash Equivalents and Marketable Securities

The Company considers all highly liquid investment instruments with original maturities of three months or less at the acquisition date to be cash equivalents. All marketable securities have been classified as held-to-maturity. Interest and realized gains and losses are included in interest income. Realized gains and losses are recognized based on specific identification method. Cash equivalents and marketable securities consist of the following (in thousands):

	March 31, 2002	December 31, 2001
Cash and cash equivalents:		
Cash	$ 1,179	$ 1,116
Money market funds	17,220	24,380
U.S. government agency notes	6,700	9,000
Total cash and cash equivalents	$ 25,099	$ 34,496
Marketable securities:		
U.S. government agency notes	$ 19,973	$ 11,984
Total marketable securities	$ 19,973	$ 11,984

Note 4. Concentration of Credit Risk

We have been dependent on a relatively small number of customers for a substantial portion of our revenues, although the customers comprising this group have changed from time to time. In the three month period ended March 31, 2002, two customers accounted for 20% and 16% of our revenues, respectively. In the three month period ended March 31, 2001, three customers accounted for 16%, 11% and 10% of our revenues, respectively.

Note 5. Industry and Segment Information

In fiscal 1999, the Company adopted SFAS No. 131 (SFAS 131), Disclosures about Segments of an Enterprise and Related Information. SFAS 131 establishes standards for reporting information about operating segments in annual financial statements and requires that certain selected information about operating segments be reported in interim financial reports. It also establishes standards for related disclosures about products and services and geographic areas. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker or decision making group in deciding how to allocate resources and in assessing performance.

The Company currently operates in one reportable segment, the semiconductor intellectual property segment, for financial reporting purposes, and uses one measure of profitability for its business. The Company s principal markets include North America, Asia and Europe.

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LOGICVISION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The financial statements of LogicVision s subsidiaries located outside of the U.S. generally are measured using the local currency as the functional currency. Adjustments to translate those statements into U.S dollars are accumulated in Accumulated Other Comprehensive Income and reported as a separate component of Stockholders Equity.

Net revenues are attributed to the countries in which the products and services are delivered and represent sales to unaffiliated customers (in thousands).

	Three Months Ended March 31,	
	2002	2001
Net revenues:		
North America	$ 3,677	$ 2,102
Europe	51	331
Asia	2,105	706
Others	17	
	$ 5,850	$ 3,139

Note 6. Net Income (Loss) Per Share

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 the common shares 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 months ended March 31, 2001 does not differ from basic net loss per share since potential common shares from conversion of preferred stock, stock options and warrants and outstanding shares of common stock subject to repurchase are anti-dilutive under the treasury stock method.

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

	Three Months Ended March 31,	
	2002	2001
Numerator Basic and Diluted		
Net income (loss) attributable to common stockholders	$ 19	$ (2,931)
Denominator Basic		
Common stock outstanding	14,875	1,900
Basic net income (loss) per share attributable to common stockholders	$ 0.00	$ (1.54)
Denominator Diluted		
Denominator Basic	14,875	1,900
Effect of Dilutive Securities		
Common stock options	2,118	
Common stock warrants	487	

	17,480	1,900
Diluted net income (loss) per share attributable to common stockholders	$ 0.00	$ (1.54)

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LOGICVISION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Comprehensive Income (Loss)

The Company has adopted Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income. This statement 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 equity section of the balance sheet. For the three months ended March 31, 2002 and 2001, comprehensive income (loss), which was comprised of the Company s net income (loss) for the periods and changes in foreign currency translation adjustments, was as follows (in thousands):

	Three Months Ended March 31,	
	2002	2001
Net income (loss)	$ 19	$ (2,888)
Other comprehensive income Cumulative translation adjustment	19	17
Comprehensive income (loss)	$ 38	$ (2,871)

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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, 2001.

When used in this discussion, the words expects, anticipates, estimates, and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our critical accounting policies, our estimates for future revenues, profitability and cost of revenues, our expectations regarding future expenses, including research and development, sales and marketing, and general and administrative expenses, 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, sources of revenue and anticipated revenues, including licenses of our intellectual property and software, technology development and design contracts and postcontract customer support, and the continued viability and duration of those agreements, our expectations regarding royalty features in license agreements and increased revenues from royalties, the anticipated growth of our business, our ability to attract customers and establish license agreement, expectations regarding competition and the impact of recent accounting pronouncements, 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, those risks discussed below, as well as the seasonality of the buying patterns of our customers, 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 and the matters discussed in Factors That May Affect Results. 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.

Critical Accounting Policies

The Company s discussion and analysis of its financial condition and results of operations are based upon the Company s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to customer programs and incentives, bad debts, investments, income taxes, financing operations, warranty obligations, long-term service contracts and contingencies and litigation. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the Company s more significant judgments and estimates used in the preparation of its consolidated financial statements.

Our revenue recognition policy is significant because our revenue is a key component of our results of operations. In addition, our revenue recognition determines the timing of certain expenses, such as royalties. We follow very specific and detailed guidelines in measuring revenue in accordance with the provisions of AICPA Statement of Position 97-2, Software Revenue Recognition as amended by Statement of Position 98-4 and Statement of Position 98-9; however, certain judgments affect the application of our revenue policy. Revenue results are difficult to predict, and any shortfall in revenues or delay in recognizing revenues could cause our operating results to vary significantly from quarter to quarter and could result in future operating losses. Our revenue recognition policy is further affected by estimated reductions to revenues for special pricing agreements, promotions and other volume-based incentives. If market conditions were to decline, we may take actions to increase customer incentive offerings possibly resulting in an incremental reduction of revenues at the time the incentive is offered.

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We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances may be required.

We record an investment impairment charge when we believe an investment has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investment s current carrying value, thereby possibly requiring an impairment charge in the future.

We record a valuation allowance to reduce our deferred tax assets to the amount that is more likely than not to be realized. While we have considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event we were to determine that we would be able to realize our deferred tax assets in the future in excess of our net recorded amount, an adjustment to the deferred tax asset would increase income in the period such determination was made. Likewise, should we determine that we would not be able to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

Overview

We provide proprietary technologies for embedded test that enable the more efficient design and manufacture of complex semiconductors. Our embedded test solution allows integrated circuit designers to embed into a semiconductor design test functionality that can be used during semiconductor production and throughout the useful life of the chip. In addition, our solutions allow integrated circuits to be tested after they have been assembled onto boards and systems, which enables diagnostic tests throughout the product s life.

Our proprietary technology enables semiconductor companies to embed self-testers into the chip design. Our embedded test products generate proprietary circuit structures that are incorporated into an integrated circuit to test and diagnose the chip at full speed, without the signal delay or degradation experienced by external testers. Our proprietary circuits are designed to be modular and reusable, to enable more efficient design and to address time-to-market issues.

From 1995 to 1998, most of our customers were large systems companies that used our technology in their application specific integrated circuits as part of system development and diagnostics. Beginning in 1998, we expanded our customer base to include semiconductor companies that use our technology for complex chip development and testing. We license our intellectual property and software through a direct sales force in the US and Europe, and through distributors in Japan and Israel and sales representatives in Singapore, Korea and Taiwan.

We derive our license revenues from licenses of our intellectual property and software. We derive service revenues from fixed fee technology development and design contracts and postcontract customer support. Our licenses typically have terms ranging from one year to three years. The majority of our contracts are three year licenses. Our pricing depends upon a number of factors, including the type of intellectual property, contract terms, number and complexity of designs and number of design teams and their locations. Some of our license agreements include a royalty feature under which our customers pay us additional fees for each chip design they complete that incorporates our technology. In the future, we anticipate that more of our license agreements will include a royalty feature and that revenues from royalties will increase.

We recognize the full amount of license fees upon shipment only when there is persuasive evidence of an arrangement, shipment has occurred, the fee is fixed or determinable, and collectibility of the sales proceeds is considered probable. When multiple elements exist and where vendor-specific objective evidence, or VSOE, of the

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fair value of undelivered elements such as postcontract customer support exists, we apply the residual method of accounting to the delivered elements.

Our history of selling postcontract customer support provides VSOE of fair value of postcontract customer support through contractual renewal rates. Accordingly, because we have VSOE for the postcontract customer support sold in connection with our licenses of more than one year, we typically recognize the residual amount of the contract fee as license fee upon delivery of the software. When vendor-specific objective evidence of the fair value of the undelivered element cannot be established, and the undelivered element is postcontract customer support, all related revenues are recognized ratably over the term of our postcontract customer support obligations. Because we are generally unable to establish vendor-specific objective evidence of the undelivered elements with respect to our one-year licenses, we recognize revenues from one-year licenses ratably over the license term. We also recognize the maintenance elements of all contracts ratably over the period of the maintenance contract. When we enter into a multiple element arrangement which includes the future delivery of a specified product or upgrade, all revenues under the agreement are deferred until the specified product or upgrade has been delivered.

On occasion, we offer extended payment terms beyond our normal business practice of between 30 and 60 days to certain customers. We do not have sufficient experience collecting under these extended payment term arrangements. As a result, when payment terms are extended, the fee is not considered fixed or determinable and, therefore, we recognize revenues when those payments become due.

Deferred revenues primarily consist of maintenance and support services under maintenance contracts and unearned revenue on one-year term licenses. For design services and technology development contracts, deferred revenues represent the excess of amounts invoiced or received over the revenue recognized. Deferred revenues fluctuate at each period end in accordance with the mix of contracts.

Historically, a substantial portion of our total revenues has been derived from customers outside the United States, primarily from Asia and Europe. International revenues as a percentage of our total revenues was approximately 37% and 33% in the three month periods ended March 31, 2002 and 2001, respectively. We anticipate that international revenues will remain a substantial portion of our total revenues in the future. To date, all of the revenues from international customers has been denominated in U.S. dollars.

We derive a substantial majority of all of our revenues from license and service revenues associated with the sale of products, including support and maintenance fees. Together, these license and service revenues accounted for 99.6% and 100% of total revenues in the three month periods ended March 31, 2002 and 2001, respectively. We expect that license and service revenues will continue to account for a substantial portion of our total revenues for the foreseeable future.

Cost of license revenues consists of shipping, product packaging, software license and maintenance costs, and royalties paid to third party vendors. Cost of service revenues consists of compensation and related costs and third party consultant costs associated with providing postcontract customer support and consulting services.

Research and development expenses consist primarily of compensation and related costs for personnel. All research and development costs are expensed as incurred.

Sales and marketing expenses consist primarily of compensation and related costs for sales and marketing personnel, marketing programs, public relations, promotional materials, travel and related trade show expenses.

General and administrative expenses consist primarily of compensation and related costs for general management, information technology, finance and accounting personnel, insurance, allowance for doubtful accounts, professional services and related fees and expenses.

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Results of Operations

The following table sets forth, for the periods indicated, certain financial data as a percentage of revenues:

	Three Months Ended March 31,	
	2002	2001
Revenues:		
License	69.3%	63.6%
Service	30.3	36.4
Royalties	0.4	
Total revenues	100.0	100.0
Cost of revenues:		
License	5.2	0.4
Service	14.2	14.4
Total cost of revenues	19.4	14.8
Gross profit	80.6	85.2
Operating expenses:		
Research and development	22.1	43.9
Sales and marketing	39.1	85.3
General and administrative	16.4	29.7
Amortization of deferred stock compensation	7.3	21.5
Total operating expenses	84.9	180.4
Loss from operations	(4.3)	(95.2)
Interest and other income	4.9	3.6
Income (loss) before provision for income taxes	0.6	(91.6)
Provision for income taxes	0.3	0.4
Net income (loss)	0.3%	(92.0)%

Three Months Ended March 31, 2002 Compared With the Three Months Ended March 31, 2001

Revenues

Total revenues increased $2.8 million or 86% for the three months ended March 31, 2002, as compared to the three months ended March 31, 2001. Total revenues were $5.9 million for the three months ended March 31, 2002, compared to $3.1 million for the three months ended March 31, 2001. The increase in total revenues is primarily attributable to an increase in license and service revenues of $2.1 million and $632,000, respectively. The increase in license revenues is primarily due to an increase in revenue associated with a Japanese customer of $1.3 million, which we recognized upon delivery of software products as we believe collectibility is reasonably assured and increased demand from fabless semiconductor companies, integrated device manufacturers and systems companies. The increase in service revenues is due to the completion of a pilot project service contract and increases in postcontract customer support services, which in turn increased as a result of the increase in license revenues.

Cost of Revenues

Total cost of revenues increased $672,000 or 145% for the three months ended March 31, 2002, as compared to the three months ended March 31, 2001. Total cost of revenues were $1.1 million or 19% of revenues for the three months ended March 31, 2002, compared to $464,000 or 14% of revenues for three months ended March 31, 2001. The increase was primarily due to an increase in the amortization related to capitalized technology

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license costs of $89,000, higher royalty expenses of $66,000 for licensed technology as a result of an increase in license revenues, higher third party consultant charges of $274,000 as a result of the completion of a pilot project service contract and increases in personnel related expenses of $76,000 related to higher postcontract customer support services. We expect that total cost of revenues will increase in absolute dollars to the extent that our total revenues increase, but decline as a percentage of total revenues as fixed costs are allocated over a higher total revenue base.

Research and Development

Research and development expenses decreased $86,000 or 6% for the three months ended March 31, 2002, as compared to the three months ended March 31, 2001. Research and development expenses were $1.3 million or 22% of revenues for the three months ended March 31, 2002, compared to $1.4 million or 44% of revenues for the same period in the prior year. The decrease was primarily due to an increase in the allocation of certain facility and office related expenses to sales and marketing of $68,000. We expect that our research and development expenses will increase in absolute dollars in future periods.

Sales and Marketing

Sales and marketing expenses decreased $389,000 or 15% for the three months ended March 31, 2002, as compared to the three months ended March 31, 2001. Sales and marketing expenses were $2.3 million or 39% of revenues for the three months ended March 31, 2002, compared to $2.7 million or 85% of revenues for the same period in the prior year. The decrease was primarily due to a decrease in the overall commission rate resulting in lower commissions of $202,000, consulting expenses of $46,000, travel expenses of $85,000 and an increase in the allocation of certain compensation expenses of $102,000 to cost of revenues related to an increase in postcontract customer support services, partially offset by an increase in the allocation of certain facility and office related expenses of $68,000 from research and development. We expect that our sales and marketing expenses will increase in absolute dollars as we continue to expand our sales and marketing efforts.

General and Administrative

General and administrative expenses increased $26,000 or 2.8% for the three months ended March 31, 2002, as compared to the three months ended March 31, 2001. General and administrative expenses were $959,000 or 16% of revenues for the three months ended March 31, 2002, compared to $933,000 or 30% of revenues for the same period in the prior year. We expect that general and administrative expenses will increase in absolute dollars in future periods.

Interest Income

Interest income increased $176,000 or 157% for the three months ended March 31, 2002, as compared to the three months ended March 31, 2002. Interest income was $288,000 for the three months ended March 31, 2002, compared to $112,000 for the same period in the prior year. The increase was due to increased interest income resulting from higher investment balances as a result of our initial public offering in November 2001.

Income Taxes

The income tax provision for the three months ended March 31, 2002 was $17,000 which was the result of alternative minimum taxes and tax on earnings generated from operations in certain foreign jurisdictions. No provision for federal and state income taxes has been recorded since inception because we had experienced significant net losses, which had resulted in approximately $35.0 million of federal and $10.5 million of California net operating loss carryforwards as of December 31, 2001. As of March 31, 2002, we have provided a full valuation allowance for all deferred tax assets since at present we are uncertain whether such deferred tax assets will be realized.

Liquidity and Capital Resources

We have funded our operations primarily from license and service revenues received from inception to March 31, 2002, the net proceeds of $41.1 million from our initial public offering of Common Stock in November 2001, and the proceeds of approximately $46.9 million from the sale of Preferred Stock and warrants.

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Net cash used in operating activities was $1.4 million in the three months ended March 31, 2002 and $3.4 million in the three months ended March 31, 2001. Net cash used in operating activities for the three months ended March 31, 2002 was primarily due to an increase in accounts receivable of $821,000 due to the timing of collections, a decrease in deferred revenue of $1.6 million and a decrease in accrued liabilities of $167,000. This was partially offset by non-cash charges relating to depreciation and amortization of stock based compensation of $305,000 and $426,000, respectively, a decrease in prepaid and other current expenses of $206,000 and an increase in accounts payable of $215,000. Net cash used in operating activities in the three month period ended March 31, 2001 was primarily due to a net loss of $2.9 million, a decrease in accounts payable of $506,000, a decrease in accrued expenses of $1.2 million and a decrease in deferred revenue of $406,000, partially offset by non-cash charges relating to depreciation and amortization of stock based compensation of $228,000 and $673,000, respectively, and an increase in accounts receivable of $648,000.

Net cash used in investing activities was $8.0 million for the three months ended March 31, 2002 and $183,000 for the three months ended March 31, 2001. Net cash used in investing activities for the three months ended March 31, 2002 was primarily due to the purchase of long-term investments of $8.0 million. Net cash used in investing activities for the three months ended March 31, 2001 was primarily due to the purchase of property and equipment of $62,000 and the payment related to a technology license agreement of $121,000.

Net cash used in financing activities was $39,000 for the three months ended March 31, 2002 and net cash provided by financing activities was $20,000 for the three months ended March 31, 2001. Net cash used in financing activities for the three months ended March 31, 2002 was primarily due to stock issuance costs of $44,000 related to the sale of Common Stock in our initial public offering in November 200l. Net cash provided by financing activities of $20,000 for the three months ended March 31, 2001 was due to the exercise of stock options.

In December 2001, we amended and restated our Loan Agreement with a bank under which we may borrow, on a revolving basis, up to $5.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 4.75% at March 31, 2002. Under the amended and restated agreement, the loan is unsecured and is not collateralized by our assets. Under the agreement, we must comply with certain operating and reporting covenants and are not permitted to pay dividends, or make material investments or dispositions without the prior written consent of the bank. If we fail to comply with our 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 us. The agreement expires in December 2002. At March 31, 2002, there were no amounts outstanding under this agreement and the Company has been in compliance with all the operating and reporting covenants with the bank.

At March 31, 2002, we had cash, cash equivalents and marketable securities of $45.1 million and working capital of $23.6 million.

We rent office facilities under noncancelable operating leases which expire through July 2006. We are responsible for certain maintenance costs, taxes and insurance under the respective lease agreements. Total future minimum payments under such operating leases at March 31, 2002 were $3.0 million.

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 expansion of product development efforts and the success of these development efforts, the costs and timing of expansion of sales and marketing 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. We believe that our current cash and investment balances and any cash generated from operations and from available or future debt financing will be sufficient to meet our operating and capital requirements for at least the next 12 months. However, 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.

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FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

If the semiconductor industry does not adopt embedded test technology, 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 assure you 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:

- potential customers may determine that existing solutions adequately address their testing needs, or the industry may develop alternative technologies to address their testing needs;
- our existing and potential customers may react to declining 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;
- 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 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; 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.

We have a history of losses and an accumulated deficit of approximately $50.1 million as of March 31, 2002. If we do not generate sufficient net revenues in the future to achieve or sustain profitability, our stock price could decline.

We have generated net income of $19,000 for the three months ended March 31, 2002; however, we have incurred significant net losses since our inception, including losses of $6.3 million in 2001 and $12.9 million in 2000. At March 31, 2002, we had an accumulated deficit of approximately $50.1 million. 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 continue to achieve profitability within the time frame expected by securities analysts or investors, 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. If we do achieve profitability, we may not be able to sustain or increase profitability on a quarterly or an annual basis.

The sales and implementation cycles for our products are typically long and unpredictable, taking from six months to two years for sales and an additional six to twelve 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.

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

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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.

Historically, our sales cycle has ranged from six months to two years and our customers implementation cycle has been approximately an additional six to twelve months. 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.

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, you should not rely on quarter-to-quarter comparisons of our results of operations as 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;
- timing of sales commission expenses and the recognition of license revenues from related customer agreements;
- 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;
- the mix of our license and services revenues;
- changes in our and our customers development schedules and levels of expenditures on research and development;
- customers placing orders at the end of the quarter;
- industry patterns and changes or cyclical and seasonal fluctuations in the markets we target; 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 booking 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

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even though total orders are according to our plan or, conversely, to meet our revenues and/or earnings estimates even though total orders fall short of our plan, due to revenues produced by deferred revenues. Orders for software support and professional 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 system 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 Mentor Graphics Corporation and Synopsys, Inc., both of which offer basic built-in self-test capability;
- smaller test tool providers such as SynTest Technologies, Inc.;
- potential customers that develop test solutions internally; and
- integrated device manufacturers, such as IBM, 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 Teradyne, Inc., Credence Systems Corporation, Advantest Corporation, Agilent Technologies, Inc., LTX Corporation and Schlumberger Limited. 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 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 than we do, and they may be able to respond more quickly or adjust prices more effectively to take advantage of new opportunities or customer requirements. Increased competition 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. Five customers accounted for approximately 57% of total revenues for the three months ended March 31, 2002, of which two customers accounted for 20% and 16% of total revenues, respectively. Fifteen customers accounted for approximately 50% of revenues for the year ended December 31, 2001, of which no single customer accounted for more than 10% of total revenues. We anticipate that we will continue to rely on a limited number of customers for a substantial portion of our revenues in the future. As a result, we must obtain orders from new significant 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.

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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 fail to make payments as required or otherwise 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, particularly our Nortel license, 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.

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Future changes in financial accounting standards, including pronouncements and interpretations of accounting pronouncements on software revenue recognition, 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 have occurred with frequency, may occur in the future and could impact our revenues. 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, purchase accounting for business combinations and employee stock option grants 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.

Our embedded test 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 embedded test 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.

We have experienced, and we expect to continue to experience, difficulty in hiring and retaining highly skilled engineers with appropriate qualifications to support our rapid growth and expansion. In particular, our strategy for encouraging the adoption of our technology requires that we employ highly skilled application engineers to work with our customers. 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.

Our chief executive officer, chief scientist and vice president of engineering are critical to our business, and they may not remain with us in the future.

Our future success depends to a significant extent on the continued services of Vinod K. Agarwal, our President and Chief Executive Officer, Benoit Nadeau-Dostie, our Chief Scientist, and Michael C. Howells, our Vice President of Engineering. We do not have employment agreements with these executives and key employees, and we do not maintain key person life insurance policies except on Vinod K. Agarwal. The loss of the services of any of these key executives and employees could slow our product development processes. Searching for replacements could divert senior management s attention and increase our operating expenses. In addition, our industry partners and customers could become concerned about our future operations, which could injure our reputation.

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

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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 US law. 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 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 the sale of our proprietary technologies and products to decrease.

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

We sell our products and services through distributors in Japan and Israel and sales representatives in Singapore, Korea and Taiwan. We anticipate that sales in these markets will account for a significant percentage of our total revenues in future periods. Our third-party distributors are not obligated to continue selling our products, and they may terminate their arrangements with us at any time with limited prior notice. Establishing alternative distribution channels in any of these markets could consume substantial time and resources, decrease our revenues and increase our expenses.

We face business, political and economic risks because a significant portion of our sales are to customers outside of the United States.

International revenues from sales outside the United States and Canada accounted for 37% of our total revenues for the three months ended March 31, 2002 and 27% for year ended December 31, 2001. Our success depends upon continued expansion of our international operations, and we expect that a significant portion of our total future revenues will be generated from international sales. Our international business involves a number of risks, including:

- our ability to adapt our products to foreign design methods and practices;
- cultural differences in the conduct of business;
- difficulty in attracting qualified personnel;
- 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;

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- the burden of complying with a wide variety of foreign laws; and

- political, economic or military conditions associated with current worldwide conflicts and events.

Our international sales are currently denominated in US 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 results of operations and business and financial condition.

Our growth places a significant strain on our management systems and resources, and if we fail to manage this growth, our business will be harmed.

The growth which we have experienced has placed a significant strain on our resources and increased demands on our management information and reporting systems, financial and management controls and personnel. To manage our growth, we must implement and improve additional and existing administrative, financial and operations systems, procedures and controls. We may not be able to develop the internal capabilities or collaborative relationships required to manage future growth and expansion or to support future operations. If we are unable to manage growth effectively, our revenues could decline.

We may be unable to consummate potential acquisitions or investments or successfully integrate them 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.

To expand the range of our proprietary technologies and products, we may acquire or make investments in additional complementary businesses, technologies or products, if appropriate opportunities arise. We may be unable to identify suitable acquisition or investment candidates at reasonable prices or on reasonable terms, or consummate future acquisitions or investments, each of which could slow our growth strategy. If we do acquire additional companies or make other types of acquisitions, we may have difficulty integrating the acquired products, personnel or technologies. We may not be able to retain key management, technical or sales personnel after an acquisition. These difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses.

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, including integrated device manufacturers, fabless semiconductor companies and systems providers, is uncertain and difficult to predict. Slower growth in the semiconductor and systems industries, 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, networking, server and high-end 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. For example, the US economy, including the semiconductor industry, is currently experiencing a slowdown, which may negatively impact our business and operating results. Some analysts have predicted that a further decline in the United States economy will result from the terrorist attacks in the United States. If the economy continues to decline as a result of the recent economic, political and social turmoil, existing and prospective customers may 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, some Asian countries have experienced significant economic difficulties, including devaluation and instability, business failures and a depressed business environment. These difficulties triggered a significant downturn in the semiconductor market,

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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.

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.

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 and cash equivalents, together with the net proceeds from the sale of our common stock in our initial public offering in November 2001 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 costs and timing of expansion of product development efforts and the success of these development efforts;
- the costs and timing of expansion of sales and marketing activities;
- the extent to which our existing and new products gain market acceptance;
- the need to adapt to changing technologies and technical requirements;
- competing technological and marketing developments;
- the costs involved in maintaining and enforcing patent claims and other intellectual property rights;

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the level and timing of license and service revenues;

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 3: ***Quantitative and Qualitative Disclosures About Market Risk***

Foreign Currency Fluctuations

In the normal course of business, the Company is exposed to market risk from the effect of foreign exchange rate fluctuations on the U.S. dollar value from its foreign operations and financial condition. Substantially all of our revenues are denominated in US dollars; however, 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 have 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 marketable securities 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.

Long-term investments are classified as held-to-maturity and the cost of securities sold is based on the specific identification method. At March 31, 2002, long-term securities consisted solely of U.S. Government securities of $20.0 million.

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PART II OTHER INFORMATION

Item 6: ***Exhibits and Reports on Form 8-K***

(a) Exhibits.

10.1 Amended and Restated 2000 Employee Stock Purchase Plan.

(b) Reports on Form 8-K.

On February 28, 2002, we filed our report on Form 8-K announcing the date of our Annual Meeting of Stockholders.

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SIGNATURE

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

Dated: May 15, 2002

LogicVision, Inc.
(Registrant)

By: /s/ Vinod K. Agarwal

Vinod K. Agarwal
President, Chief Executive Officer and Director
(Principal Executive Officer)

By: /s/ John H. Barnet

John H. Barnet
Vice President of Finance and Chief Financial Officer
(Principal Financial and Accounting Officer)

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EXHIBIT INDEX

	Description of Exhibit
10.1	Amended and Restated 2000 Employee Stock Purchase Plan.