

NEXTEST SYSTEMS CORP  
Form 10-Q  
November 08, 2007  
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**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-Q**

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 29, 2007.

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number: 000-51851

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**Nextest Systems Corporation**

(Exact name of Registrant as specified in its charter)

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|                                                                                      |                                                           |
|--------------------------------------------------------------------------------------|-----------------------------------------------------------|
| <b>Delaware</b><br>(State or other jurisdiction of<br>incorporation or organization) | <b>77-0470150</b><br>(IRS Employer<br>Identification No.) |
| <b>875 Embedded Way, San Jose, California 95138</b>                                  |                                                           |

(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (408) 960-2400

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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 the past 90 days.

Yes  No

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Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer as defined 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, as defined in Rule 12b-2 of the Exchange Act.

Yes  No

As of October 26, 2007, there were 17,923,656 shares of the Registrant's Common Stock outstanding, par value \$0.001.

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**NEXTEST SYSTEMS CORPORATION**

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**Table of Contents****PART I. FINANCIAL INFORMATION****ITEM 1.**

**NEXTEST SYSTEMS CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(in thousands, except par value amount)

(unaudited)

|                                                                                                                                                                   | September 29,<br>2007 | June 30,<br>2007 |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|------------------|
| <b>ASSETS</b>                                                                                                                                                     |                       |                  |
| Current assets:                                                                                                                                                   |                       |                  |
| Cash and cash equivalents                                                                                                                                         | \$ 67,676             | \$ 54,916        |
| Short-term investments                                                                                                                                            | 9,758                 | 28,313           |
| Accounts receivable, net of allowance of \$90 at September 29, 2007 and at June 30, 2007                                                                          | 19,882                | 5,940            |
| Inventory                                                                                                                                                         | 22,250                | 26,019           |
| Deferred tax assets                                                                                                                                               | 2,772                 | 2,677            |
| Restricted cash                                                                                                                                                   | 212                   | 212              |
| Prepaid expenses, taxes and other current assets                                                                                                                  | 6,111                 | 6,154            |
| <br>                                                                                                                                                              |                       |                  |
| Total current assets                                                                                                                                              | 128,661               | 124,231          |
| Property and equipment, net                                                                                                                                       | 12,072                | 5,373            |
| Restricted cash                                                                                                                                                   |                       | 5                |
| Deferred tax assets                                                                                                                                               | 1,738                 | 1,714            |
| Other assets                                                                                                                                                      | 311                   | 289              |
| <br>                                                                                                                                                              |                       |                  |
| Total assets                                                                                                                                                      | \$ 142,782            | \$ 131,612       |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                       |                       |                  |
| Current liabilities:                                                                                                                                              |                       |                  |
| Accounts payable                                                                                                                                                  | \$ 4,687              | \$ 4,920         |
| Accrued liabilities                                                                                                                                               | 7,770                 | 5,128            |
| Deferred income                                                                                                                                                   | 5,891                 | 1,690            |
| Income taxes payable                                                                                                                                              | 28                    | 1,265            |
| <br>                                                                                                                                                              |                       |                  |
| Total current liabilities                                                                                                                                         | 18,376                | 13,003           |
| Deferred income                                                                                                                                                   | 385                   | 310              |
| Other liabilities                                                                                                                                                 | 2,676                 | 809              |
| Long-term income taxes payable                                                                                                                                    | 861                   |                  |
| <br>                                                                                                                                                              |                       |                  |
| Total liabilities                                                                                                                                                 | 22,298                | 14,122           |
| <br>                                                                                                                                                              |                       |                  |
| Commitments and contingencies (Note 10)                                                                                                                           |                       |                  |
| Stockholders' equity:                                                                                                                                             |                       |                  |
| Preferred Stock: no par value, 10,000 shares authorized, none issued and outstanding                                                                              |                       |                  |
| Common Stock: \$0.001 par value; 140,000 shares authorized, 17,916 and 17,860 shares issued and outstanding at September 29, 2007 and June 30, 2007, respectively |                       |                  |
| Additional paid-in capital                                                                                                                                        | 18                    | 18               |
|                                                                                                                                                                   | 106,079               | 105,181          |
| Deferred stock-based compensation                                                                                                                                 | (85)                  | (122)            |

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|                                            |            |            |
|--------------------------------------------|------------|------------|
| Retained earnings                          | 14,472     | 12,413     |
| Total stockholders' equity                 | 120,484    | 117,490    |
| Total liabilities and stockholders' equity | \$ 142,782 | \$ 131,612 |

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

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**NEXTEST SYSTEMS CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

(unaudited)

|                                             | Three Months Ended    |                       |
|---------------------------------------------|-----------------------|-----------------------|
|                                             | September 29,<br>2007 | September 23,<br>2006 |
| Net revenue                                 | \$ 22,982             | \$ 26,859             |
| Cost of revenue                             | 11,523                | 12,358                |
| <b>Gross profit</b>                         | <b>11,459</b>         | <b>14,501</b>         |
| Operating expenses:                         |                       |                       |
| Research and development                    | 2,781                 | 2,162                 |
| Selling, general and administrative         | 6,728                 | 5,670                 |
| <b>Total operating expenses</b>             | <b>9,509</b>          | <b>7,832</b>          |
| Income from operations                      | 1,950                 | 6,669                 |
| Interest and other income, net              | 911                   | 837                   |
| Income before income taxes                  | 2,861                 | 7,506                 |
| Income tax provision                        | 1,001                 | 2,722                 |
| Net income                                  | \$ 1,860              | \$ 4,784              |
| Net income per share:                       |                       |                       |
| Basic                                       | \$ 0.10               | \$ 0.27               |
| Diluted                                     | \$ 0.10               | \$ 0.25               |
| Shares used in computing per share amounts: |                       |                       |
| Basic                                       | 17,853                | 17,508                |
| Diluted                                     | 18,895                | 18,769                |

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

**Table of Contents****NEXTEST SYSTEMS CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

(unaudited)

|                                                                               | Three Months Ended    |                       |
|-------------------------------------------------------------------------------|-----------------------|-----------------------|
|                                                                               | September 29,<br>2007 | September 23,<br>2006 |
| <b>Cash flows from operating activities:</b>                                  |                       |                       |
| Net income                                                                    | \$ 1,860              | \$ 4,784              |
| Adjustments to reconcile net income to net cash used in operating activities: |                       |                       |
| Depreciation and amortization                                                 | 523                   | 364                   |
| Provision for excess inventory                                                | 449                   | 244                   |
| Stock-based compensation                                                      | 852                   | 360                   |
| Deferred tax provision (benefit)                                              | (119)                 | 182                   |
| Tax benefits from stock-based compensation plans                              | 41                    | 186                   |
| Excess tax benefits from stock-based compensation plans                       | (46)                  | (178)                 |
| Changes in current assets and liabilities:                                    |                       |                       |
| Accounts receivable                                                           | (13,942)              | (3,666)               |
| Inventory                                                                     | 3,068                 | (1,041)               |
| Prepaid expenses, taxes and other current assets                              | 81                    | 52                    |
| Other assets                                                                  | (22)                  | (12)                  |
| Accounts payable                                                              | (392)                 | 944                   |
| Accrued and other liabilities                                                 | 2,384                 | (1,551)               |
| Deferred income                                                               | 4,276                 | (2,887)               |
| Income taxes payable                                                          | (177)                 | 1,849                 |
| Net cash used in operating activities                                         | (1,164)               | (370)                 |
| <b>Cash flows from investing activities:</b>                                  |                       |                       |
| Purchase of property and equipment                                            | (4,695)               | (92)                  |
| Sale of property and equipment                                                | 9                     |                       |
| Purchases of available-for-sale securities                                    | (8,199)               | (15,580)              |
| Sales and maturities of available-for-sale securities                         | 26,716                | 86                    |
| Changes in restricted cash                                                    | 5                     |                       |
| Net cash provided by / (used in) investing activities                         | 13,836                | (15,586)              |
| <b>Cash flows from financing activities:</b>                                  |                       |                       |
| Proceeds from exercise of stock options                                       | 42                    | 152                   |
| Excess tax benefits from stock-based compensation plans                       | 46                    | 178                   |
| Net cash provided by financing activities                                     | 88                    | 330                   |
| Net increase (decrease) in cash and cash equivalents                          | 12,760                | (15,626)              |
| Cash and cash equivalents at beginning of period                              | 54,916                | 68,667                |
| Cash and cash equivalents at end of period                                    | \$ 67,676             | \$ 53,041             |

**Supplemental disclosure of cash flow information:**

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|                                                                                      |          |        |
|--------------------------------------------------------------------------------------|----------|--------|
| Inventory capitalized as test and demonstration equipment                            | \$ 252   | \$ 169 |
| Purchases of property and equipment through accounts payable and accrued liabilities | \$ 2,284 | \$     |
| Income taxes paid, net of income tax refunds                                         | \$ 18    | \$ 506 |

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



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**NEXTEST SYSTEMS CORPORATION**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(unaudited)**

**Note 1 The Company**

Nextest Systems Corporation (the Company) was incorporated in California in November 1997 and reincorporated in Delaware in March 2006. The Company is engaged in the design, development, manufacturing, sale and service of automatic test equipment (ATE) for the semiconductor industry.

The Company's fiscal year is the 52 or 53 weeks ending on the last Saturday in June. Fiscal 2008 and fiscal 2007 are 52 and 53 week fiscal years, respectively. The periods for the three months ended September 29, 2007 and September 23, 2006 each included 13 weeks.

**Note 2 Basis of Presentation**

The accompanying condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States (US GAAP) have been condensed or omitted pursuant to such rules and regulations. The June 30, 2007 consolidated balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. However, the Company believes that the disclosures are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 2007.

In the opinion of management, the accompanying condensed consolidated financial statements contain all normal and recurring adjustments necessary, including adjustments resulting from the adoption of Financial Accounting Standards Board (the FASB) Financial Interpretation 48, Accounting for Income Tax Uncertainties (FIN 48) as discussed in Note 11 - Income Taxes, for a fair statement of financial position, results of operations and cash flows for the periods indicated.

The preparation of financial statements in conformity with US GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities (including inventory valuation, accounts receivable valuation, accrued warranty, income taxes and estimated fair values of stock options) and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of net revenue and expenses during the reporting period. Actual results could differ from those estimates.

**Note 3 Recent Accounting Pronouncements**

In July 2006, the FASB issued FIN 48. FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. FIN 48 provides guidance on the recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties. In May 2007, the FASB issued FASB Statement of Position FIN No. 48-1, Definition of Settlement in FASB Interpretation No. 48 (FSP FIN No. 48-1). FSP FIN No. 48-1 provides guidance on how a company should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. The Company adopted the provisions of FIN 48 on July 1, 2007, the first day of its 2008 fiscal year. The effect of the adoption of FIN 48 on the Company's condensed consolidated balance sheet is summarized in Note 11 - Income Taxes.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157), which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective as of the beginning of our 2009 fiscal year. The Company is currently evaluating the impact, if any, of adopting SFAS No. 157 on its financial statements.



**Table of Contents****NEXTEST SYSTEMS CORPORATION****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, ( SFAS No. 159 ), including an amendment of Statement of Financial Accounting Standards No. 115 ( SFAS No. 115 ). SFAS No. 159 allows companies to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 and will be applied prospectively. The Company is currently evaluating the impact, if any, of adopting SFAS No. 159 on its financial statements.

**Note 4 Concentration of Credit Risk**

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents, short-term investments and accounts receivable. The Company's cash equivalents and short-term investments are maintained with high-quality financial institutions. Deposits held with financial institutions may exceed the amount of insurance provided on such deposits. The Company's accounts receivable are derived from U.S. dollar denominated revenue earned from customers located primarily in North America, Europe and Asia. The Company performs on-going credit evaluations of its customers' financial condition. While the Company generally does not require collateral, in certain circumstances it may require a customer to provide an irrevocable letter of credit and/or a significant cash deposit prior to shipment. The Company assesses collectibility of its accounts receivable and provides a valuation allowance for its estimate of uncollectible amounts. The Company did not have significant provisions, write-offs or recoveries during the three months ended September 29, 2007 or the three months ended September 23, 2006.

The following table sets forth sales to customers comprising 10% or more of the Company's net revenue for the periods indicated:

| Customer | Three Months Ended    |                       |
|----------|-----------------------|-----------------------|
|          | September 29,<br>2007 | September 23,<br>2006 |
| SanDisk  | 35%                   | 27%                   |
| Samsung  | 27%                   | 25%                   |
| Atmel    | *                     | 17%                   |

\* Less than 10% of net revenue in the period.

The following table sets forth accounts receivable from customers comprising 10% or more of the Company's total accounts receivable balance at the period ends indicated:

| Customer                         | September 29, |                  |
|----------------------------------|---------------|------------------|
|                                  | 2007          | June 30,<br>2007 |
| SanDisk                          | 29%           | 11%              |
| United Test and Assembly (UTAC)  | 26%           | 31%              |
| Dallas Semiconductor Corporation | *             | 12%              |

\* Less than 10% of total accounts receivable in the period.



**Table of Contents****NEXTEST SYSTEMS CORPORATION****NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 5 Short-term Investments**

The Company classifies marketable securities with remaining maturities at the time of purchase of greater than 90 days as short-term investments as these investments are deemed to be available for use in current operations as needed. Marketable securities consist of municipal debt and auction-rate securities that are classified as available-for-sale and are reported at fair value in accordance with SFAS No. 115,

Accounting for Certain Investments in Debt and Equity Securities with net unrealized gains and losses reported within stockholders' equity. Such unrealized gains and losses at September 29, 2007 and September 23, 2006 were immaterial. Realized gains or losses on the sale or maturity of securities are determined based on specific identification and are included in interest and other income, net in the condensed consolidated statement of operations. As of September 29, 2007, short-term investments consisted of auction rate and municipal debt securities which when purchased had contractual maturity dates of greater than 90 days.

**Note 6 Balance Sheet Components**

|                             | September 29, | June 30,  |
|-----------------------------|---------------|-----------|
| (in thousands)              | 2007          | 2007      |
| <b>Inventory:</b>           |               |           |
| Raw materials               | \$ 11,201     | \$ 15,590 |
| Work-in-progress            | 4,509         | 1,825     |
| Inventory held at customers | 3,019         | 2,277     |
| Field service inventory     | 1,806         | 1,853     |
| Finished goods              | 1,715         | 4,474     |
|                             | \$ 22,250     | \$ 26,019 |

Inventory provisions for the three months ended September 29, 2007 and September 23, 2006 were \$449,000 and \$244,000, respectively. The benefits resulting from sales of previously written-down inventory for the three months ended September 29, 2007 and September 23, 2006 were \$245,000 and \$38,000, respectively.

|                                                | September 29, | June 30, |
|------------------------------------------------|---------------|----------|
| (in thousands)                                 | 2007          | 2007     |
| <b>Accrued liabilities:</b>                    |               |          |
| Payroll and related expenses                   | \$ 2,243      | \$ 1,698 |
| Accrued liability for construction in progress | 2,241         | 1,173    |
| Accrued liability for inventory in transit     | 734           | 241      |
| Customer deposits                              | 624           | 9        |
| Accrued commissions                            | 571           | 311      |
| Accrued warranty                               | 360           | 340      |
| Professional fees                              | 351           | 513      |
| Other accrued expenses                         | 646           | 843      |
|                                                | \$ 7,770      | \$ 5,128 |



**Table of Contents****NEXTEST SYSTEMS CORPORATION****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 7 Net Income Per Share**

Basic net income per share is computed by dividing the net income by the weighted-average common shares outstanding for the period. Diluted net income per share is computed giving effect to all potentially dilutive common stock, including stock options, restricted stock units and unvested restricted common shares subject to repurchase using the treasury stock method. Under the treasury stock method, the Company included the impact of assumed windfall tax benefits as part of the proceeds calculation related to options outstanding prior to the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment (SFAS No. 123 (R)).

The following table sets forth the computation of basic and diluted net income per share (in thousands, except per share data):

|                                                 | <b>Three Months Ended</b>     |                               |
|-------------------------------------------------|-------------------------------|-------------------------------|
|                                                 | <b>September 29,<br/>2007</b> | <b>September 23,<br/>2006</b> |
| <b>Numerator:</b>                               |                               |                               |
| Net income                                      | \$ 1,860                      | \$ 4,784                      |
| <b>Denominator:</b>                             |                               |                               |
| Weighted-average common shares outstanding      | 17,893                        | 17,516                        |
| Unvested common shares subject to repurchase    | (40)                          | (8)                           |
| Basic weighted shares outstanding               | 17,853                        | 17,508                        |
| <b>Effect of potential dilutive securities:</b> |                               |                               |
| Stock options                                   | 989                           | 1,257                         |
| Unvested restricted stock units                 | 47                            |                               |
| Unvested common shares subject to repurchase    | 6                             | 4                             |
| Diluted weighted shares outstanding             | 18,895                        | 18,769                        |
| Net income per common share Basic               | \$ 0.10                       | \$ 0.27                       |
| Net income per common share Diluted             | \$ 0.10                       | \$ 0.25                       |

The following outstanding stock options, unvested restricted stock units, and unvested common shares subject to repurchase were excluded from the computation of diluted net income per share as they would have had an antidilutive effect (in thousands):

|                                              | <b>Three Months Ended</b>     |                               |
|----------------------------------------------|-------------------------------|-------------------------------|
|                                              | <b>September 29,<br/>2007</b> | <b>September 23,<br/>2006</b> |
| Unvested common shares subject to repurchase |                               | 1                             |
| Unvested restricted stock units              | 51                            |                               |
| Stock options                                | 481                           |                               |





**Table of Contents****NEXTEST SYSTEMS CORPORATION****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 8 Stock-based Compensation**

The Company accounts for stock-based compensation under the provisions of SFAS No. 123 (R). Stock-based compensation expense, including amounts to non-employee directors, was included in the following statement of operations categories (in thousands):

|                                      | Three Months Ended    |                       |
|--------------------------------------|-----------------------|-----------------------|
|                                      | September 29,<br>2007 | September 23,<br>2006 |
| Cost of revenue                      | \$ 55                 | \$ 45                 |
| Research and development             | 241                   | 137                   |
| Selling, general and administrative  | 556                   | 178                   |
| Subtotal                             | 852                   | 360                   |
| Less: Income tax benefit             | (289)                 | (71)                  |
| Net stock-based compensation expense | \$ 563                | \$ 289                |

Compensation cost included in inventory and the cost portion of deferred income was \$53,000 at September 29, 2007 and \$57,000 at September 23, 2006. Compensation cost related to awards outstanding at the adoption of FAS No. 123 (R) is attributed using an accelerated amortization approach in accordance with FASB Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans. Compensation cost related to awards granted after the adoption of FAS No. 123 (R) is attributed on a straight-line basis.

Deferred stock-based compensation included in equity represents the unamortized intrinsic value of minimum value options that continue to be accounted for under APB No. 25.

The Company did not grant stock options during the three months ended September 29, 2007 or the three months ended September 23, 2006.

A summary of stock option activity for the three months ended September 29, 2007 and information regarding stock options outstanding, exercisable, and vested and expected to vest is as follows (in thousands, except per share amounts and terms):

|                              | Options | Shares | Share     | Weighted-   |           |
|------------------------------|---------|--------|-----------|-------------|-----------|
|                              |         |        |           | Average     | Remaining |
|                              |         |        | Price per | Contractual | Aggregate |
|                              |         |        | Exercise  | Term        | Intrinsic |
|                              |         |        |           | (in years)  | Value     |
| Outstanding at June 30, 2007 |         | 2,051  | \$ 5.63   |             |           |

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|                                                         |       |         |     |           |  |
|---------------------------------------------------------|-------|---------|-----|-----------|--|
| Granted                                                 |       |         |     |           |  |
| Exercised                                               | (17)  | 2.44    |     |           |  |
| Forfeited                                               | (4)   | 8.52    |     |           |  |
| Outstanding at September 29, 2007                       | 2,030 | \$ 5.65 | 6.4 | \$ 14,633 |  |
| Fully Vested and Expected to vest at September 29, 2007 | 1,973 | \$ 5.52 | 6.4 | \$ 14,480 |  |
| Exercisable at September 29, 2007                       | 1,239 | \$ 3.53 | 5.2 | \$ 11,566 |  |

As of September 29, 2007, the unrecognized compensation cost for stock options was \$3.2 million. Unrecognized compensation cost for stock options is expected to be recognized over a weighted-average period of 2.7 years.

The total intrinsic value of options exercised in the three months ended September 29, 2007 and September 23, 2006 was \$0.2 million and \$0.5 million, respectively.

**Table of Contents****NEXTEST SYSTEMS CORPORATION****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)**

A summary of all restricted stock unit and unvested restricted share activity during the three months ended September 29, 2007 is as follows (in thousands, except per share amounts and terms):

|                                        | Shares | Weighted-Average<br>Grant-Date<br>Fair<br>Value per<br>Share | Weighted-Average<br>Remaining<br>Contractual<br>Term (in<br>years) | Aggregate<br>Intrinsic<br>Value |
|----------------------------------------|--------|--------------------------------------------------------------|--------------------------------------------------------------------|---------------------------------|
| Unvested at June 30, 2007              | 578    | \$ 11.52                                                     |                                                                    |                                 |
| Granted                                | 9      | 11.50                                                        |                                                                    |                                 |
| Vested                                 | (39)   | 11.52                                                        |                                                                    |                                 |
| Forfeited                              | (3)    | 11.12                                                        |                                                                    |                                 |
| Unvested at September 29, 2007         | 545    | \$ 11.53                                                     | 2.4                                                                | \$ 7,013                        |
| Expected to vest at September 29, 2007 | 484    | \$ 11.53                                                     | 2.3                                                                | \$ 6,225                        |

As of September 29, 2007, the unrecognized compensation cost for restricted stock units and unvested restricted shares was \$5.4 million. Unrecognized compensation cost for restricted stock units and unvested restricted shares is expected to be recognized over a weighted-average period of 2.4 years. The total fair value of shares vested during the three months ended September 29, 2007 was \$0.4 million.

**Note 9 Segment and Geographic Information**

The Company operates in one segment: designing, manufacturing and marketing of automated test equipment for the semiconductor industry.

The Company markets its products and related services to customers mainly through a direct sales force. Net revenue is attributed to geographic areas based on the country to which product is shipped or its first in-use country, if known. The Company's net revenue by geographic regions was (in thousands):

|                                        | Three Months Ended    |       |                       |       |
|----------------------------------------|-----------------------|-------|-----------------------|-------|
|                                        | September 29,<br>2007 | 11.7% | September 23,<br>2006 | 29.8% |
| North America, primarily United States | \$ 2,680              |       | \$ 7,996              |       |
| Asia/Pacific                           |                       |       |                       |       |
| Korea                                  | 6,454                 | 28.1  | 7,693                 | 28.6  |
| Taiwan                                 | 8,952                 | 39.0  | 3,839                 | 14.3  |
| Thailand                               | 304                   | 1.3   | 1,259                 | 4.7   |
| People's Republic of China             | 816                   | 3.6   | 3,726                 | 13.9  |

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|                                             |           |        |           |        |
|---------------------------------------------|-----------|--------|-----------|--------|
| Philippines                                 | 3,151     | 13.7   | 340       | 1.3    |
| Other                                       | 183       | 0.7    | 155       | 0.5    |
| Total Asia Pacific                          | 19,860    | 86.4   | 17,012    | 63.3   |
| Total Europe, Middle East and Africa (EMEA) | 442       | 1.9    | 1,851     | 6.9    |
|                                             | \$ 22,982 | 100.0% | \$ 26,859 | 100.0% |

Over 90% of the Company's long-lived assets are located in the United States.

**Table of Contents****NEXTEST SYSTEMS CORPORATION****NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****(unaudited)****Note 10 Commitments and Contingencies***Warranty*

The Company generally warrants its products against defects, in material, workmanship and non-conformance to the Company's specification for a period of twelve months. The Company's warranty provision is based on the Company's best estimate, considering historical experiences with similar products as well as other assumptions that are considered reasonable under the circumstances. A provision for the estimated cost of warranty is recorded as a cost of revenue and is included in accrued liabilities when the related revenue is recognized. Adjustments are made to such estimates based on actual settlements. Changes in the Company's warranty provision were as follows (in thousands):

|                                      |        |
|--------------------------------------|--------|
| Beginning balance at June 30, 2007   | \$ 340 |
| Accrual for warranties issued        | 152    |
| Settlements made                     | (132)  |
| Ending balance at September 29, 2007 | \$ 360 |
| Beginning balance at June 24, 2006   | \$ 635 |
| Accrual for warranties issued        | 219    |
| Settlements made                     | (128)  |
| Ending balance at September 23, 2006 | \$ 726 |

*Contingencies*

The Company, as permitted under Delaware law and in accordance with its By-laws, has indemnification obligations to its officers and directors for certain events or occurrences, subject to certain limits, while they were serving at the Company's request in such capacity. The maximum amount of potential future indemnification is unlimited; however, there have been no claims to date, and the Company has a Director and Officer insurance policy that enables the directors and officers to recover a portion of any future amounts paid. As a result of the insurance policy coverage, the Company believes the fair value of these indemnification agreements is minimal.

The Company's sales agreements indemnify its customers for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is unlimited. However, to date, the Company has not paid any claims or been required to defend any lawsuits with respect to any claim.

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated. In the opinion of management, there are no pending claims of which the outcome is expected to result in a material adverse effect in the financial position, results of operations or cash flows of the Company.

*Line of Credit*

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Since April 29, 2005, the Company has maintained a \$10,000,000 maximum revolving credit facility based on certain qualifying accounts receivable with a financial institution that expires on July 28, 2008, bearing interest at the bank's prime rate per annum. The interest rate at September 29, 2007 was 7.75%. The agreement, which is collateralized by the assets of the Company, contains a minimum net worth covenant and other restrictions. As of September 29, 2007, there have been no borrowings under the line of credit and the Company was in compliance with the covenant and other restrictions.

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**NEXTEST SYSTEMS CORPORATION**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(unaudited)**

*Lease Obligation*

There were no significant changes to the Company's operating lease obligations during the quarter ended September 29, 2007.

In October 2007, the Company completed the relocation of its corporate headquarters from 1901 Monterey Road, San Jose, California to 875 Embedded Way, San Jose, California. The Company constructed improvements at the building to prepare the leased premise for its intended use. Per the terms of the lease agreement, the landlord provided a tenant improvement allowance of up to \$1.8 million of the construction costs. During the quarter ended September 29, 2007, the Company submitted to the landlord a claim for the total tenant improvement allowance of \$1.8 million. As of September 29, 2007, the Company has recorded a \$1.8 million tenant improvement allowance receivable within prepaid and other current assets, and a deferred rent balance of \$1.8 million within other liabilities on its condensed consolidated balance sheet. In accordance with FASB Technical Bulletin No. 88-1, *Issues Relating to Accounting for Leases*, the deferred rent balance will be amortized as a reduction to lease expense over the term of the lease.

*Legal Proceedings*

From time to time, the Company may be involved in litigation relating to claims arising out of day-to-day operations. As of September 29, 2007, the Company was not engaged in any legal proceedings that were expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition, results of operations, or cash flows.

**Note 11 Income Taxes**

Effective July 1, 2007, the Company adopted the provisions of FIN 48. As a result of adopting FIN 48, the Company decreased its income taxes payable by \$0.2 million with a corresponding increase to opening retained earnings as of July 1, 2007. The Company also reclassified \$0.8 million from current to non-current income taxes payable and \$0.4 million was reclassified from current taxes payable to reduce long-term deferred tax assets.

On July 1, 2007, the Company had \$1.3 million of unrecognized tax benefits. If recognized, approximately \$0.7 million, net of federal benefits, would be recorded as an income tax benefit on the Company's condensed consolidated statement of income. During the quarter-ended September 29, 2007, the Company recorded an increase of its unrecognized tax benefits of \$28,000. The Company anticipates that its total unrecognized tax benefits may change by \$0.3 million due to the expiration of statutes of limitations during the next 12 months.

After the adoption of FIN 48, the Company recognizes interest and penalties related to income tax matters as part of the income tax provision. Prior to the adoption of FIN 48, interest and penalties related to income taxes were included in interest and other income, net on the Company's consolidated income statement. Prior period financial statements were not restated to reflect the change in accounting policy. As of July 1, 2007, the Company had \$0.1 million accrued for interest. As of September 29, 2007, the Company had \$0.1 million accrued for interest. These accruals are included as components of non-current income taxes payable on the Company's condensed consolidated balance sheet.

The Company files income tax returns in the United States on a federal basis and in various U.S. state and foreign jurisdictions. The Company may be subject to the examination of its federal income tax returns by the Internal Revenue Service for years 2001 and forward. For the Company's significant state tax jurisdictions, the Company is subject to routine examination for years 2001 and forward. In addition, any research and development credit carryforwards that were generated in prior years and utilized in these years may also be subject to examination by respective state taxing authorities. Generally, the Company is subject to routine examination for years 2005 and forward in various immaterial foreign tax jurisdictions in which it operates.

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

*You should read the following discussion and analysis of financial condition and results of operations in conjunction with our consolidated financial statements and the related notes included elsewhere in this document. In addition to historical consolidated financial information, the following discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. In some cases, forward-looking statements can be identified by terms such as anticipates, believes, could, estimates, expects, may, plans, potential, predicts, projects, should, will and similar expressions intended to identify forward-looking statements. Forward-looking statements reflect our current views with respect to future events and are based on assumptions and subject to risks and uncertainties. We discuss many of these risks in greater detail under the heading Risk Factors and elsewhere in this document. Given the uncertainties, you should not place undue reliance on these forward-looking statements. Also, forward-looking statements represent our estimates and assumptions only as of the date of this document and our actual future results may be materially different from what we expect. Except as required by law, we do not intend to update such forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in such forward-looking statements, even if new information becomes available in the future.*

**Documents to Review In Connection With Management's Analysis of Financial Condition and Results of Operations**

For a full understanding of our financial position and results of operations for the three months ended September 29, 2007 and September 23, 2006, this discussion should be read in conjunction with the condensed consolidated financial statements and related notes presented in this Form 10-Q and the financial statements and related notes included in our Form 10-K filed on September 7, 2007 with the SEC.

**Overview**

We design, develop, manufacture, sell and service low-cost, high throughput ATE systems for the semiconductor industry. We address rapidly growing, high volume segments within the semiconductor industry such as flash memory, flash card, and flash memory-based system-on-chip markets. Our customers include integrated device manufacturers, packaging assembly and test providers, wafer fabrication foundries and fabless semiconductor companies. Since we introduced our first products in 1998, we have shipped over 1,800 systems to more than 60 semiconductor companies worldwide.

We provide direct sales and customer support to the major semiconductor manufacturing markets through sales personnel in the U.S., the Philippines, Thailand, Korea, Japan, the People's Republic of China, the United Kingdom, France and Italy. Many of our sales and marketing employees are applications engineers, who work as part of the sales team to assist customers in the application of the ATE. Our direct sales force earns commissions based on the sales they generate. We also use a network of independent sales representatives in the People's Republic of China, Taiwan, Malaysia, Singapore and Israel. Independent sales representatives work on commission and place customers' orders directly with us. A majority of our net revenue is generated by our direct sales force and we expect this trend to continue as we expand our internal sales organization in the future.

Historically, a significant portion of our net revenue in each quarter has been derived from sales to relatively few customers. While we seek to expand and diversify our customer base, we expect our net revenue to continue to be derived from a small number of customers. In addition, we do not have purchase contracts that require our customers to continue to purchase our products. A delay in product orders or customer acceptances or cancellations could cause our quarterly net revenue to vary significantly. Our backlog is subject to order cancellations, accelerations, changes and delays, and is not necessarily indicative of future customer purchases or revenue streams. We derive a significant percentage of our net revenue from outside of the United States, or U.S. In particular, we expect the Asia/Pacific region to continue to be a major source of revenue for us as we continue to further penetrate the major flash memory manufacturers located in that region. Virtually all of our net revenue to date has been denominated in U.S. dollars, however as we expand our business into Japan we expect much of the net revenue derived from Japan will be denominated in Japanese Yen.

We share production forecasts with our key suppliers, and quickly update them as forecasts change. Certain of our key suppliers use these forecasts to pre-position stocks of components in the supply chain so they are rapidly available to us when required. We generally do not enter into long-term contracts that commit us to specific levels of business over a longer duration than that covered by the individual purchase orders.

The semiconductor industry is highly cyclical. Consequently, our business is subject to significant demand variations and our net revenue is difficult to predict. Additionally, our net income (loss) has generally fluctuated in tandem with net revenue. These circumstances are likely to continue in the future, and therefore, we cannot be certain that we will be able to maintain or exceed our current level of business. In the past, we have implemented various initiatives during downturn periods to reduce our cost structure including reducing salaries, shortening our manufacturing work week, reducing outside contractor costs and performing various assembly functions internally.





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The following describes certain line items set forth in our statements of operations:

*Net Revenue.* Net revenue is derived from the sale of products and services and is adjusted for estimated sales returns and allowances, if any, which historically have been insignificant. We derive the majority of our net revenue from product sales. Revenue from our customers is subject to both quarterly and annual fluctuations, as a result of the cyclical nature of the semiconductor industry, and therefore past performance may not be indicative of future results. While we have shipped our systems to over 60 semiconductor companies, we derive the majority of our net revenue from a small number of customers. We expect that sales to a limited number of customers will continue to account for a significant portion of our future net revenue. We generally have limited backlog, and rely on orders that are booked and shipped in the same quarter for a significant portion of our net revenue.

*Gross Profit.* Gross profit is net revenue less cost of revenue which primarily consists of costs related to material, direct labor, manufacturing overhead, estimated warranty costs and provisions for excess and obsolete inventory. Cost of revenue also includes costs of field service support and spare parts consumed in service activities and stock-based compensation cost, as well as the impact of any benefits from sales of previously written-down inventory.

*Research and Development.* Research and Development, or R&D, expense includes costs related to engineering personnel, expensed material, outside contractors and other product development related costs. R&D is expensed as incurred. We intend to continue to invest a significant amount in R&D to develop new products. We expect these costs to increase in absolute dollars in the future. Our R&D expense tends to fluctuate from period to period, depending on requirements at the various stages of our product development cycles. In any given time period, our R&D expense may increase in absolute dollars and/or as a percentage of net revenue as we continue to invest in product development, expand our product lines, and as our net revenue fluctuates. R&D expense also includes stock-based compensation cost.

*Selling, General and Administrative.* Selling, general and administrative, or SG&A, expense includes costs related to sales and marketing personnel, applications engineering personnel, sales commissions paid to internal and outside sales representatives, outside contractor expense and other sales and marketing activities, as well as salaries and related expense for administrative, finance, human resources and executive personnel and fees for legal and accounting services. We expect that general and administrative costs will increase in absolute dollars to support future operations. Sales and marketing expense may also increase in absolute dollars as we continue to develop our global selling and marketing capabilities. In addition, the commission expense included in SG&A expenses can fluctuate with changes in revenue and changes in customer mix comprising revenue in a particular period. SG&A expense also includes stock-based compensation cost.

*Interest and Other Income, net.* Interest and other income, net primarily represents interest earned on cash, cash equivalents and short-term investments, interest expense, and gains and/or losses from transactions denominated in foreign currencies, which historically have not been material.

*Income Tax Provision.* We account for income taxes under the asset and liability method whereby the expected future tax consequences of temporary differences between the book value and the tax basis of assets and liabilities are recognized as deferred tax assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to be recognized. A valuation allowance is provided if management cannot conclude that it is more likely than not that our deferred tax assets will be realized. See Recently Issued Accounting Pronouncements and Critical Accounting Estimates below for discussions regarding our adoption of FIN 48 in the first quarter of fiscal 2008.

**Recently Issued Accounting Pronouncements**

In July 2006, the FASB issued FIN 48. FIN 48 defines the threshold for recognizing the benefits of tax return positions in the financial statements as more-likely-than-not to be sustained by the taxing authority. FIN 48 provides guidance on the recognition, measurement and classification of income tax uncertainties, along with any related interest and penalties. FIN 48 also includes guidance concerning accounting for income tax uncertainties in interim periods and increases the level of disclosures associated with any recorded income tax uncertainties. In May 2007, the FASB issued FSP FIN No. 48-1, Definition of Settlement in FASB Interpretation No. 48. FSP FIN No. 48-1 provides guidance on how a company should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. We adopted the provisions of FIN 48 on July 1, 2007, the first day of our 2008 fiscal year. The effect of the adoption of FIN 48 on our condensed consolidated balance sheet is summarized in Note 11 Income Taxes to our condensed consolidated financial statements.

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In September 2006, the FASB issued SFAS No. 157, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The provisions of SFAS No. 157 are effective as of the beginning of our 2009 fiscal year. We are currently evaluating the impact, if any, of adopting SFAS No. 157 on our financial statements.

In February 2007, the FASB issued SFAS No. 159 including an amendment of SFAS No. 115. SFAS No. 159 allows companies to choose, at specified election dates, to measure eligible financial assets and liabilities at fair value that are not otherwise required to be measured at fair value. Unrealized gains and losses shall be reported on items for which the fair value option has been elected in earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007 and will be applied prospectively. We are currently evaluating the impact, if any, of adopting SFAS No. 159 on our financial statements.

**Critical Accounting Policies**

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires us to make estimates, assumptions and judgments that affect the amounts reported in our financial statements and the accompanying notes. We base our estimates on historical experience and various other assumptions that we believe to be reasonable. Although these estimates are based on our present best knowledge of the future impact on the company of current events and actions, actual results may differ from these estimates, assumptions and judgments.

We consider critical those accounting policies that require our most subjective or complex judgments, which often result from a need to make estimates about the effect of matters that are inherently uncertain, and that are among the most important of our accounting policies in the portrayal of our financial condition and results of operations. These critical accounting policies are: revenue recognition, valuation of excess and obsolete inventory, income taxes, accrued warranty obligations, allowance for doubtful accounts receivable and stock-based compensation. Except for income taxes, there were no changes to our critical accounting estimates during the three months ended September 29, 2007.

*Income Taxes*

On July 1, 2007, the first day of our 2008 fiscal year, we adopted the provisions of FIN 48. FIN 48 addresses the determination of how tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements and contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with Statement of Financial Accounting Standards No. 109 Accounting for Income Taxes. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates it is more likely than not that the position will be sustained on audit, including the resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The adoption of FIN 48 did not have an impact on our condensed consolidated statement of income, and the impact on our condensed consolidated balance sheet is summarized in Note 11 Income Taxes to our condensed consolidated financial statements.

**Results of Operations**

Our operating results have fluctuated significantly from period to period in the past and are likely to do so in the future. The following table sets forth certain operating data as a percentage of net revenue for the periods indicated:

|                                     | <b>Three Months Ended</b>     |                               |
|-------------------------------------|-------------------------------|-------------------------------|
|                                     | <b>September 29,<br/>2007</b> | <b>September 23,<br/>2006</b> |
| Net revenue                         | 100.0%                        | 100.0%                        |
| Cost of revenue                     | 50.1                          | 46.0                          |
| Gross profit                        | 49.9                          | 54.0                          |
| Operating expenses:                 |                               |                               |
| Research and development            | 12.1                          | 8.0                           |
| Selling, general and administrative | 29.3                          | 21.2                          |

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|                                |       |        |
|--------------------------------|-------|--------|
| Total operating expenses       | 41.4  | 29.2   |
| Income from operations         | 8.5   | 24.8   |
| Interest and other income, net | 3.9   | 3.1    |
| Income before income taxes     | 12.4  | 27.9   |
| Income tax provision           | (4.3) | (10.1) |
| Net income                     | 8.1   | 17.8   |

**Table of Contents****Net Revenue**

| (dollars in thousands) | Three Months Ended    |                       | Change     |       |
|------------------------|-----------------------|-----------------------|------------|-------|
|                        | September 29,<br>2007 | September 23,<br>2006 | \$         | %     |
| Net Revenue            | \$ 22,982             | \$ 26,859             | \$ (3,877) | (14)% |

The overall decrease in net revenue for the three months ended September 29, 2007 reflected a \$4.3 million decrease in product revenue and was partially offset by a \$0.4 million increase in service revenue. Net revenue from the Magnum product line, which represents 90% of net revenue in the three months ended September 29, 2007, decreased from the three months ended September 23, 2006. Net revenue from the Maverick/Lightning product lines also decreased relative to the prior year quarter. Service revenue increased from prior year and represented 6% of net revenue for the three months ended September 29, 2007. The decrease in net revenue from the Magnum product line for the three months ended September 29, 2007 is the result of an absence of significant sales from two large customers from the same period last year. The average price per Magnum system sold increased in the three months ended September 29, 2007 due to an increase in purchases of higher pin count systems compared to the year ago quarter. The Maverick/Lightning product line decrease in net revenue is the result of a decreased number of systems sold as compared to the three months ended September 23, 2006, which we attribute primarily to customer buying patterns. We believe the Magnum product will continue to provide the majority of our product revenue. However, the specific results will fluctuate based upon specific customer buying patterns, including product configurations.

The following table provides customers that contributed 10% or more of net revenue in the three month periods ended September 29, 2007 and September 23, 2006:

| Customer | Three Months Ended    |                       |
|----------|-----------------------|-----------------------|
|          | September 29,<br>2007 | September 23,<br>2006 |
| SanDisk  | 35%                   | 27%                   |
| Samsung  | 27%                   | 25%                   |
| Atmel    | --                    | 17%                   |

\* Less than 10% of net revenue in the period.

Customers representing a significant portion of any period's net revenue will vary due to specific buying patterns and their test capacity requirements. We expect that three or four customers will continue to provide a majority of our net revenue in any particular period.

Net revenue by geographic region is based upon the ship-to or first in-use destination and during the three months ended September 29, 2007 and September 23, 2006 was as follows:

| (dollars in thousands)                 | Three months ended    |      |                       |      |
|----------------------------------------|-----------------------|------|-----------------------|------|
|                                        | September 29,<br>2007 |      | September 23,<br>2006 |      |
| North America, primarily United States | \$ 2,680              | 12%  | \$ 7,996              | 30%  |
| Asia/Pacific                           | 19,860                | 86   | 17,012                | 63   |
| EMEA (Europe, Middle East, Africa)     | 442                   | 2    | 1,851                 | 7    |
| Total                                  | \$ 22,982             | 100% | \$ 26,859             | 100% |

North America revenue decreased largely due to the decrease in Atmel net revenue for shipments to their North America locations. Net revenue by geographies will vary due to the timing of capacity additions by particular customers and the particular customer locations where the capacity is being added. We believe the Asia/Pacific region will continue to be a major geographic source of our revenue, particularly for flash memory manufacturers.

*Cost of Revenue and Gross Profit*

| (dollars in thousands) | Three Months Ended    |                       | Change     |       |
|------------------------|-----------------------|-----------------------|------------|-------|
|                        | September 29,<br>2007 | September 23,<br>2006 | \$         | %     |
| Gross Profit           | \$ 11,459             | \$ 14,501             | \$ (3,042) | (21)% |
| % of Net Revenue       | 50%                   | 54%                   |            |       |

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Gross profit decreased \$3.0 million in the three months ended September 29, 2007 as compared to the three months ended September 23, 2006 primarily due to lower revenue levels and sales to certain customers at lower than average margins, partially offset by improved factory utilization. During the three months ended September 29, 2007 we continue to produce to support current revenue and future demand. In comparison, during the three months ended September 23, 2006 production activity was reduced as we anticipated a softening in demand. In addition, we incurred duplicate facility costs of \$0.3 million during the three months ended September 29, 2007 in connection with the relocation to our new corporate headquarters facility.

The specific buying pattern of individual customers has historically had a quarter to quarter impact on our reported results. Gross profit as a percentage of net revenue will vary depending upon the mix of customers and size of systems in a particular period. We believe that if we win more market share for our testers we may experience pricing pressures that we may not be able to offset by improved absorption or reduced material cost resulting in a lower gross profit percentage.

**Research and Development Expense**

| (dollars in thousands) | Three Months Ended    |                       | Change |     |
|------------------------|-----------------------|-----------------------|--------|-----|
|                        | September 29,<br>2007 | September 23,<br>2006 | \$     | %   |
| R&D                    | \$ 2,781              | \$ 2,162              | \$ 619 | 29% |
| % of Net Revenue       | 12%                   | 8%                    |        |     |

The increase in R&D expense in the three months ended September 29, 2007 as compared to the three months ended September 23, 2006 consists primarily of a \$0.3 million increase in compensation expense resulting from a 10 person increase in the average R&D headcount, a \$0.1 increase in stock-based compensation expense, and a \$0.1 increase in engineering tooling expenses.

We will continue to invest in R&D in future periods to support ongoing enhancements to our current product offering and the research engineering activities for developing new products for other markets we plan to address. These costs may be partially offset by reduced engineering support required on existing products, including Maverick and released Magnum platforms. There can be no assurance that net revenue will increase at a rate equal to or greater than the amount that will be required for R&D expenditures.

**Selling, General and Administrative Expense**

| (dollars in thousands) | Three Months Ended    |                       | Change   |     |
|------------------------|-----------------------|-----------------------|----------|-----|
|                        | September 29,<br>2007 | September 23,<br>2006 | \$       | %   |
| SG&A                   | \$ 6,728              | \$ 5,670              | \$ 1,058 | 19% |
| % of Net Revenue       | 29%                   | 21%                   |          |     |

The increase in SG&A expense in the three months ended September 29, 2007 as compared to the three months ended September 23, 2006 resulted from a \$0.4 million increase in compensation expense due to the addition of five employees in sales and marketing and two in finance and administration; a \$0.4 million increase in stock-based compensation expense due to new grants of stock-based award grants, and a \$0.3 million increase in travel and entertainment costs due to an increase in the size of our sales force and the geography of our customers which has required increased travel.

We expect SG&A will increase in future periods as we continue our international expansion and grow our administrative capabilities. The mix of the source of revenue and its implication on commission expense may either add to, or to some extent offset, those additional expected costs.

**Interest and Other Income, Net.**

| (dollars in thousands)         | Three Months Ended    |                       | Change |    |
|--------------------------------|-----------------------|-----------------------|--------|----|
|                                | September 29,<br>2007 | September 23,<br>2006 | \$     | %  |
| Interest and Other Income, Net | \$ 911                | \$ 837                | \$ 74  | 9% |

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% of Net Revenue

4%

3%

The increase in interest and other income, net in the three months ended September 29, 2007 compared to the same period a year ago was caused by a higher average cash, cash equivalents, and short-term investment balances and higher interest rates.



**Table of Contents****Income Tax Provision**

| (dollars in thousands) | Three Months Ended    |                       |
|------------------------|-----------------------|-----------------------|
|                        | September 29,<br>2007 | September 23,<br>2006 |
| Income Tax Provision   | \$ 1,001              | \$ 2,722              |
| Effective Tax Rate     | 35%                   | 36%                   |

The decrease in the income tax provision in the three months ended September 29, 2007 as compared to the three months ended September 23, 2006, is due primarily to a decrease in the income before income taxes and also due to a higher incremental benefit from research and development tax credits.

**Liquidity and Capital Resources**

As of September 29, 2007, we had cash and cash equivalents of \$67.7 million and working capital of \$110.3 million. As of June 30, 2007, we had cash and cash equivalents of \$54.9 million and working capital of \$111.2 million. The increase in cash and cash equivalents for the quarter ended September 29, 2007 is primarily due to cash flows provided by investing activities which increased due to higher sales and maturities of available-for-sale securities and lower purchases of available for sale securities.

In October 2007, we completed the relocation of our corporate headquarters from 1901 Monterey Road, San Jose, California to 875 Embedded Way, San Jose, California. As of September 29, 2007, we were in the process of constructing improvements at the building to prepare the leased premise for its intended use. Cash expenditures for the improvements are expected to total \$8.8 million, of which \$5.7 million has been paid as of September 29, 2007, with the remainder expected to be paid during the quarter ended December 29, 2007. Per the terms of the lease agreement, the landlord provided a tenant improvement allowance of up to \$1.8 million of the construction costs. During the quarter ended September 29, 2007, we submitted to the landlord a claim for the total tenant improvement allowance of \$1.8 million. As of September 29, 2007, we have recorded a \$1.8 million tenant improvement allowance receivable within prepaid and other current assets, and a deferred rent balance of \$1.8 million on our condensed consolidated balance sheet.

**Cash Flows from Operating Activities**

Net cash used in operating activities of \$1.2 million during the three months ended September 29, 2007, consisted of (in thousands):

|                                                         |            |
|---------------------------------------------------------|------------|
| Net income                                              | \$ 1,860   |
| Non-cash charges (credits):                             |            |
| Depreciation and amortization                           | 523        |
| Provision for excess inventory                          | 449        |
| Stock-based compensation                                | 852        |
| Tax benefits from stock-based compensation plans        | 41         |
| Excess tax benefits from stock-based compensation plans | (46)       |
| Deferred tax benefit                                    | (119)      |
| Cash invested in working capital                        | (4,724)    |
|                                                         | \$ (1,164) |

The significant cash outflows during the three months ended September 29, 2007, included in the \$4.7 million increase in other working capital accounts above, consisted primarily of a \$13.9 million increase in accounts receivable due to higher sales during the quarter compared to the preceding quarter, partially offset by a \$4.3 million increase in deferred income primarily due to higher shipments during the quarter, a \$3.1 million decrease in inventory as a result of increased order activity and a \$2.4 million increase in accrued and other liabilities primarily due to costs accrued for construction in progress.

Our inventory turns were 1.9 in both the three months ended September 29, 2007 and the three months ended September 23, 2006. We are taking steps to improve inventory turns at the current level of revenues over the next several quarters.

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Days sales outstanding in our accounts receivable at September 29, 2007 were 79 days as compared to 68 days at September 23, 2006. Days sales outstanding in accounts receivable varies significantly due to the timing of shipments during the period and changes in deferred product revenue and customer deposits. We continue to monitor outstanding accounts receivable and aggressively pursue cash collections.

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In general, our ability to generate positive cash flows from operations is dependent on our ability to generate revenue and collect the related cash on a timely basis, while maintaining an efficient cost structure. As a result, sales volume is the most significant uncertainty in our ability to generate cash flows from operations. However, as sales increase, we will use cash for inventory and accounts receivable before it is converted to cash and cash equivalents, thereby putting pressure on our cash balances during periods of high revenue growth. We believe that our business strategies will allow us to generate future sales that, combined with our existing cash, cash equivalents and short-term investments, will be sufficient to fund our business for the next 12 months.

*Cash Flows from Investing Activities*

Cash provided by investing activities in the three months ended September 29, 2007 was \$13.9 million. In the three months ended September 29, 2007, we had sales and maturities of available-for-sale securities of \$18.5 million, net of purchases.

*Cash Flows from Financing Activities*

Cash provided by financing activities was \$0.1 million in the three months ended September 29, 2007. Cash provided by financing activities in the three months ended September 29, 2007 consisted of excess tax benefits from our stock-based compensation plans as well as proceeds from stock option exercises.

We believe that our current cash balances, combined with future cash flows from operations will be sufficient to meet our anticipated cash needs for operations for the next 12 months. However, a large acquisition of a complementary business, products, or technologies, or a material joint venture, could require us to obtain additional equity or debt financing, which may not be available on acceptable terms, or at all. No such activities are anticipated at this time. We are unaware of any known material trends or uncertainties that may require us to make cash management decisions that will impair our operating capabilities during the next year.

*Contractual Obligations*

Our contractual obligations consist primarily of non-cancelable operating leases expiring at various times through 2016. There was no significant change to our operating lease obligations during the quarter ended September 29, 2007. In our annual report on Form 10-K for our fiscal year ended June 30, 2007, we reported purchase obligations of \$5.7 million related to the construction of improvements on our new corporate headquarters. As of September 29, 2007, our remaining planned expenditures for the construction of improvements, excluding amounts included in our condensed consolidated balance sheet as accrued liabilities, was \$0.8 million.

As discussed in Note 11 Income Taxes to our condensed consolidated financial statements, we adopted the provisions of FIN 48 on July 1, 2007, the first day of our 2008 fiscal year. At September 29, 2007, we had long-term income taxes payable for unrecognized tax benefits and related interest and penalties totaling \$0.9 million, none of which we expect will be paid in the next 12 months.

We have not used off-balance sheet financing arrangements, issued or purchased derivative instruments linked to our stock, or used our stock as a form of liquidity.

Since April 29, 2005, we have had a \$10,000,000 maximum revolving credit facility based on certain qualifying accounts receivable with a financial institution that expires on July 28, 2008, bearing interest at the bank's prime rate per annum. The interest rate at September 29, 2007 was 7.75%. The agreement, which is collateralized by the assets of the Company, contains a minimum net worth covenant and other restrictions. As of September 29, 2007, there have been no borrowings under the line of credit and we were in compliance with the covenant and other restrictions.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***Investment and Interest Rate Risk*

The primary objective of our investment activities is to preserve principal while at the same time maximizing the income we receive from our investments without significant risk of loss. As of September 29, 2007, our cash balance is primarily in checking and money market accounts. Our cash equivalents and short-term investments are maintained with high quality financial institutions. To minimize our exposure to interest rate market risk, we have in the past limited the maturities of our fixed rate investments to relatively short periods of time. Due to the short-term nature of these instruments, it is not anticipated that a 10% change in market interest rates would have a material adverse impact on the total

value of our investment portfolio as of September 29, 2007.

*Foreign Currency Risk*

We have international operations and are, therefore, subject to foreign currency rate exposure. To date, our exposure to exchange rate volatility has been insignificant. If foreign currency rates were to fluctuate by 10% from rates at September 29, 2007, our consolidated financial position, results of operations and cash flows would not be materially affected. However, we cannot guarantee that there will not be a material impact in the future.

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**ITEM 4. CONTROLS AND PROCEDURES**

Under the supervision and with the participation of our management, including our Chairman and Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures. The SEC defines the term "disclosure controls and procedures" to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized, and reported within the time periods specified on the Commission's rules and forms and that such information is accumulated and communicated to management, including the Chairman and Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure. Our Chairman and Chief Executive Officer and our Chief Financial Officer have concluded, based on the evaluation of the effectiveness of our disclosure controls and procedures by our management, with the participation of our Chairman and Chief Executive Officer and our Chief Financial Officer, as of the end of the period covered by this report, that our disclosure controls and procedures were effective for this purpose.

Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of our financial reporting and preparation of financial statements for external purposes in accordance with generally accepted accounting principles. It should be noted that the design of any system of controls is based in part upon certain assumptions about the likelihood of future events, and our system of controls may not succeed in achieving its stated goals under all conditions.

There has been no change in our internal control over financial reporting during the quarter ended September 29, 2007 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

From time to time, we may be involved in litigation relating to claims arising out of day-to-day operations. As of September 29, 2007, we were not engaged in any legal proceedings that were expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition, results of operations, or cash flows.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended June 30, 2007, which could materially affect our business, financial condition and/or future results. The risks described in our Form 10-K are not the only risks we face. Additional risks and uncertainties not currently known to us, or that we currently deem to be immaterial, also may materially adversely affect our business, financial condition and/or future results.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

In connection with our initial public offering on March 21, 2006, we sold 4,600,000 shares of our common stock at the initial public offering price per share of \$14.00. The net offering proceeds to us after deducting underwriters' discount of \$4.5 million and other issuance costs of \$1.3 million were \$58.6 million. We received the proceeds on March 27, 2006 and have not used any proceeds. The net offering proceeds have been invested in cash equivalent instruments and short-term investments.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

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

None.

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**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

(a) *Exhibits*

- Exhibit 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- Exhibit 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- Exhibit 32.1 Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**SIGNATURES**

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

Date: November 8, 2007

NEXTEST SYSTEMS CORPORATION  
(Registrant)

By: /s/ Robin Adler  
Robin Adler  
Chairman and Chief Executive Officer  
*(Principal Executive Officer)*

By: /s/ James P. Moniz  
James P. Moniz  
Chief Financial Officer  
*(Principal Financial Officer)*



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**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description</b>                                                                                                                      |
|---------------------------|-----------------------------------------------------------------------------------------------------------------------------------------|
| 31.1                      | Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                 |
| 31.2                      | Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                                 |
| 32.1                      | Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |