LOGICVISION INC
Form 10-Q
August 12, 2003
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

**(Mark One)**

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

**For the quarterly period ended June 30, 2003**

**OR**

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

**For the transition period from ________ to ________.**

**Commission File No.: 0-31773**

# LOGICVISION, INC.

**(Exact name of registrant as specified in its charter)**

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

**101 Metro Drive, Third Floor**

**San Jose, California 95110**

**(Address of principal executive offices)**

**Telephone: (408) 453-0146**

**(Registrant s telephone number, including area code)**

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ¨ No x

At July 31, 2003, 15,677,218 shares of Registrant s Common Stock, $0.0001 par value were outstanding.

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**LOGICVISION, INC.**

**FORM 10-Q**

**QUARTERLY PERIOD ENDED JUNE 30, 2003**

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**PART I: FINANCIAL INFORMATION**

**ITEM 1: FINANCIAL STATEMENTS**

**LOGICVISION, INC.**

**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

**(in thousands, except share and per share data)**

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| **ASSETS** | | |
| Current Assets: | | |
| Cash and cash equivalents | $ 11,168 | $ 16,179 |
| Short-term investments | 11,993 | 6,992 |
| Accounts receivable, net | 934 | 1,170 |
| Prepaid expenses and other current assets | 931 | 1,174 |
| Total current assets | 25,026 | 25,515 |
| Property and equipment, net | 1,338 | 1,486 |
| Marketable securities | 10,900 | 18,390 |
| Other long-term assets, net | 533 | 1,134 |
| Total assets | $ 37,797 | $ 46,525 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current Liabilities: | | |
| Short-term debt | $ 1,000 | $ 2,500 |
| Accounts payable | 731 | 1,468 |
| Accrued liabilities | 1,245 | 1,339 |
| Deferred revenues | 2,689 | 3,153 |
| Total current liabilities | 5,665 | 8,460 |
| Deferred revenues | 648 | 270 |
| Total liabilities | 6,313 | 8,730 |
| Commitments and contingencies (See Note 5) | | |
| Stockholders Equity: | | |
| Preferred stock, $0.0001 par value: | | |
| Authorized: 5,000,000 shares; | | |
| Issued and outstanding: no shares issued and outstanding | | |
| Common stock, $0.0001 par value: | | |
| Authorized: 125,000,000 shares; | | |
| Issued and outstanding: 15,403,678 shares at June 30, 2003 and 15,245,503 shares at December 31, 2002 | 2 | 2 |
| Additional paid-in capital | 97,554 | 97,341 |

| | | |
|---|---|---|
| Deferred stock-based compensation | (608) | (1,042) |
| Accumulated other comprehensive income | 123 | 92 |
| Accumulated deficit | (65,587) | (58,598) |
| Total stockholders equity | 31,484 | 37,795 |
| Total liabilities and stockholders equity | $ 37,797 | $ 46,525 |

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

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**LOGICVISION, INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS**

**(in thousands, except per share data)**

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Revenues: | | | | |
| License | $ 444 | $ 2,519 | $ 1,644 | $ 6,595 |
| Service | 956 | 1,173 | 2,165 | 2,947 |
| Total revenues | 1,400 | 3,692 | 3,809 | 9,542 |
| Cost of revenues: | | | | |
| License | 75 | 230 | 107 | 536 |
| Service | 689 | 727 | 1,473 | 1,557 |
| Total cost of revenues | 764 | 957 | 1,580 | 2,093 |
| Gross profit | 636 | 2,735 | 2,229 | 7,449 |
| Operating expenses: | | | | |
| Research and development | 1,188 | 1,273 | 2,330 | 2,565 |
| Sales and marketing | 2,320 | 2,185 | 4,732 | 4,474 |
| General and administrative | 1,024 | 1,018 | 2,008 | 1,977 |
| Amortization of deferred stock-based compensation (1) | 231 | 426 | 437 | 852 |
| Total operating expenses | 4,763 | 4,902 | 9,507 | 9,868 |
| Loss from operations | (4,127) | (2,167) | (7,278) | (2,419) |
| Interest and other income, net | 175 | 296 | 371 | 584 |
| Loss before provision for income taxes | (3,952) | (1,871) | (6,907) | (1,835) |
| Provision for income taxes | 71 | 18 | 82 | 35 |
| Net loss | $ (4,023) | $ (1,889) | $ (6,989) | $ (1,870) |
| Net loss per common share, basic and diluted | $ (0.26) | $ (0.13) | $ (0.46) | $ (0.13) |
| Weighted average number of shares outstanding, basic and diluted | 15,391 | 14,950 | 15,342 | 14,893 |

(1) Amortization of deferred stock-based compensation:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2003 | 2002 | 2003 | 2002 |
| Total cost of revenues | $ 8 | $ 8 | $ 16 | $ 16 |
| Research and development | 50 | 106 | 107 | 212 |
| Sales and marketing | 125 | 223 | 236 | 446 |
| General and administrative | 48 | 89 | 78 | 178 |
| | $ 231 | $ 426 | $ 437 | $ 852 |

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

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**LOGICVISION, INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS**

**(in thousands)**

| | Six Months Ended June 30, 2003 | Six Months Ended June 30, 2002 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss | $ (6,989) | $ (1,870) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 1,109 | 631 |
| Amortization of deferred stock-based compensation | 437 | 852 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | 236 | 1,326 |
| Prepaid expenses and other current assets | 243 | (465) |
| Other long-term assets | (30) | 11 |
| Accounts payable | (737) | (40) |
| Deferred revenue | (94) | (2,744) |
| Accrued liabilities | (86) | (228) |
| Net cash used in operating activities | (5,911) | (2,527) |
| Cash flows from investing activities: | | |
| Purchase of marketable securities | (1,002) | (12,492) |
| Purchase of short-term investments | (5,001) | (2,002) |
| Purchase of property and equipment | (330) | (274) |
| Proceeds from sales of marketable securities | 8,492 | |
| Net cash provided by (used) in investing activities | 2,159 | (14,768) |
| Cash flows from financing activities: | | |
| Stock issuance costs | | (44) |
| Proceeds from issuance of common stock | 213 | 175 |
| Repayment of short-term debt | (1,500) | |
| Net cash provided by (used) in financing activities | (1,287) | 131 |
| Effect of exchange rate on cash | 28 | 69 |
| Net decrease in cash and cash equivalents | (5,011) | (17,095) |
| Cash and cash equivalents, beginning of period | 16,179 | 34,496 |
| Cash and cash equivalents, end of period | $ 11,168 | $ 17,401 |

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

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**LOGICVISION, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Basis of Presentation**

The accompanying unaudited condensed consolidated financial statements include the accounts of LogicVision, Inc. ( LogicVision or the Company ) and its wholly-owned subsidiaries after elimination of all inter-company transactions. The Company s fiscal year ends on December 31.

The accompanying unaudited condensed consolidated financial statements of LogicVision have been prepared in accordance with generally accepted accounting principles in the United States of America ( GAAP ) for interim financial information and in accordance with the rules and regulations of the Securities and Exchange Commission ( SEC ). Accordingly, they do not include all of the information and footnotes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with GAAP. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The December 31, 2002 fiscal year end balance sheet data was derived from the audited financial statements and does not include all disclosures required by GAAP. Operating results for the three months and six months ended June 30, 2003 is not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2003 or any other future period. The unaudited condensed consolidated interim financial statements contained herein should be read in conjunction with the audited financial statements and footnotes for the year ended December 31, 2002 included in the Company s Annual Report on Form 10-K as filed with the SEC.

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

**Note 2. Recently Issued Accounting Standards**

In November 2002, the FASB issued FASB Interpretation No. 45 ( FIN 45 ), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and measurement provisions of FIN 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor s fiscal year-end. The disclosure requirements of FIN 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company has adopted this statement. The adoption of FIN 45 did not have a material effect on the Company s financial position or results of operations.

In December 2002, the FASB issued Statement of Financial Accounting Standards ( SFAS ) No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure. SFAS No. 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. SFAS No. 148 also requires that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. Additionally, SFAS No. 148 requires disclosure of the pro forma effect in interim financial statements. The transition and annual disclosure requirements of SFAS No.

148 are effective for fiscal years ending after December 15, 2002. The interim disclosure requirements are effective for interim periods beginning after December 15, 2002. The Company has adopted this statement. The adoption of SFAS 148 did not have a material effect on the Company s financial position or results of operations.

In January 2003, the FASB issued FASB Interpretation No. 46 ( FIN 46 ), Consolidation of Variable Interest Entities. This interpretation of Accounting Research Bulletin No. 51, Consolidated Financial Statements, addresses consolidation by business enterprises of variable interest entities that possess certain characteristics. FIN 46 requires that if a business enterprise has a controlling financial interest in a variable interest entity, the assets, liabilities, and results of the activities of the variable interest entity must be included in the consolidated financial statements with those of the business enterprise. FIN 46 applies immediately to variable interest entities created after January 31, 2003 and to variable interest entities in which an enterprise obtains an interest after that date. The Company does not have any ownership in any variable interest entities as of June 30, 2003. The Company will apply the consolidation requirements of FIN 46 in future periods should interest in a variable interest entity be acquired.

In May 2003, the FASB issued SFAS No. 150 Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. SFAS No. 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity and is effective for financial instruments entered into or modified after May 31, 2003. The Company has adopted this statement. The adoption of SFAS 150 did not have a material effect on the Company s financial position or results of operations.

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**Note 3. Cash and Cash Equivalents, Short-Term Investments and Marketable Securities**

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

| | June 30, 2003 | December 31, 2002 |
|---|---|---|
| Cash and cash equivalents: | | |
| Cash | $ 1,031 | $ 1,873 |
| Money market funds | 6,187 | 11,006 |
| U.S. government agency notes | 3,950 | 3,300 |
| Total cash and cash equivalents | $ 11,168 | $ 16,179 |
| Short-term investments: | | |
| U.S. government agency notes | $ 11,993 | $ 6,992 |
| Marketable securities: | | |
| U.S. government agency notes | $ 10,900 | $ 18,390 |

**Note 4. Loan Agreement**

The Company has an unsecured Loan Agreement with a bank under which it may borrow, on a revolving basis, up to $5.0 million at an interest rate equal to the bank s prime rate, which was 4.0% at June 30, 2003. Under the agreement, the Company must comply with certain operating and reporting covenants and is not permitted to pay dividends, or make material investments or dispositions without the prior written consent of the bank. If the Company fails to comply with its covenants under the agreement, the bank can declare any outstanding amounts immediately due and payable and cease advancing money or extending credit to or for the Company. The agreement expires on January 31, 2004. At June 30, 2003, the Company had $1.0 million outstanding under this agreement, and it was in compliance with all the operating and reporting covenants with the bank.

**Note 5. Commitments and Contingencies**

**Lease Obligations**

The Company and its subsidiaries in Canada, India and Japan rent office facilities under noncancelable leases which expire on various dates through July 2006. These leases qualify for operating lease accounting treatment under SFAS No. 13, Accounting for Leases, and, as such, these facilities are not included on the Company s Unaudited Condensed Consolidated Balance Sheets. The Company and its subsidiaries are responsible for certain maintenance costs, taxes and insurance under the respective leases.

At June 30, 2003, total future minimum payments under noncancelable operating leases were as follows (in thousands):

| | |
|---|---|
| 2003 | $ 535 |
| 2004 | 1,055 |
| 2005 | 318 |
| 2006 | 46 |
| | $ 1,954 |

Rent expense for the three months and six months ended June 30, 2003 were $292,000 and $596,000, respectively. Rent expenses for the three months and six months ended June 30, 2002 were $239,000 and $489,000, respectively.

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**Indemnifications**

FASB Interpretation No. 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The Company s software license agreements typically provide for indemnification of customers for intellectual property infringement claims. To date, no such claims have been filed against the Company. The Company also warrants to customers that its products operate substantially in accordance with specifications. Historically, minimal costs have been incurred related to product warranties, and as such no accruals for warranty costs have been made.

**Note 6. Concentration of Credit Risk**

The Company has been dependent on a relatively small number of customers for a substantial portion of its revenue, although the customers comprising this group have changed from time to time. In the three months and six months ended June 30, 2003, no customer accounted for more than 10% of its revenues. In the three months ended June 30, 2002, two customers accounted for 21% and 15% of its revenues, respectively. In the six months ended June 30, 2002, two customers accounted for 18% and 12% of its revenues, respectively.

At June 30, 2003, four customers accounted for 25%, 13%, 13% and 12% of net accounts receivable, respectively. At June 30, 2002, three customers accounted for 42%, 28% and 12% of net accounts receivable, respectively.

**Note 7. Net Loss Per Share**

SFAS No. 128, Earnings Per Share, requires a dual presentation of basic and diluted earnings per share ( EPS ). Basic EPS excludes dilution and is computed by dividing net income or loss by the weighted average number of shares of common stock outstanding during the period. Diluted EPS reflects the potential dilution that would occur if outstanding securities to issue common stock were exercised or converted to common stock. Diluted net loss per share for the three and six months ended June 30, 2003 did not differ from basic net loss per share since potential shares of common stock issuable upon exercise of stock options and warrants are anti-dilutive under the treasury stock method.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Numerator - Basic and Diluted | | | | |
| Net loss | $ (4,023) | $ (1,889) | $ (6,989) | $ (1,870) |
| Denominator - Basic and Diluted | | | | |

| | | | | |
|---|---|---|---|---|
| Weighted average common stock outstanding | 15,391 | 14,950 | 15,342 | 14,893 |
| Basic and diluted net loss per share | $ (0.26) | $ (0.13) | $ (0.46) | $ (0.13) |

Options and warrants to purchase an aggregate of 4.3 million and 4.0 million shares of common stock were outstanding at June 30, 2003 and 2002, respectively, and were excluded from the computations because of their antidilutive effect on net loss per share for the three months and six months then ended.

**Note 8. Comprehensive Loss**

SFAS No. 130, Reporting Comprehensive Income, requires companies to classify items of other comprehensive income by their nature in the financial statements and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the stockholders equity section of the balance sheet.

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LogicVision s other comprehensive income consists primarily of adjustments to translate the financial statements of the Company s foreign subsidiaries into U.S. dollars for consolidation. The functional currency of the Company s foreign subsidiaries is the local currency and therefore, the translation adjustments of those statements into U.S. dollars are recorded in accumulated other comprehensive income, which is reported as a separate component of stockholders equity.

For the three and six months ended June 30, 2003 and 2002, comprehensive loss, which was comprised of the Company s net loss for the periods and changes in foreign currency translation adjustments, was as follows (in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Net loss | $ (4,023) | $ (1,889) | $ (6,989) | $ (1,870) |
| Other comprehensive income - Cumulative translation adjustment | 26 | 50 | 31 | 69 |
| Comprehensive loss | $ (3,997) | $ (1,839) | $ (6,958) | $ (1,801) |

**Note 9. Stock-Based Compensation**

The Company accounts for employee stock-based compensation plans using the intrinsic value method. Accordingly, deferred compensation is only recorded if the current market price of the underlying stock exceeds the exercise price on the date of grant.

Had compensation cost for the Company s stock-based compensation plan been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company s net loss would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Net loss, as reported | $ (4,023) | $ (1,889) | $ (6,989) | $ (1,870) |
| Add: Stock-based compensation expense included in reported net loss | 231 | 426 | 437 | 852 |
| Deduct: Total stock-based compensation expense determined under fair value based method for all awards granted | (893) | (1,229) | (1,713) | (2,433) |

| | | | | |
|---|---|---|---|---|
| Pro forma net loss | $ (4,685) | $ (2,692) | $ (8,265) | $ (3,451) |
| Net loss per share: | | | | |
| Basic and diluted - as reported | $ (0.26) | $ (0.13) | $ (0.46) | $ (0.13) |
| Basic and diluted - pro forma | $ (0.30) | $ (0.18) | $ (0.54) | $ (0.23) |

The value of the option grants has been calculated on the date of grant using the Black-Scholes options pricing model with the following weighted-average assumptions:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Expected average life of option | 4 years | 4 years | 4 years | 4 years |
| Risk-free interest rate | 1.26% | 4.18% | 2.44% | 4.13% |
| Expected dividends | | | | |
| Expected volatility | 1.53 | 2.05 | 2.40 | 2.05 |

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These pro forma amounts may not be representative of the effects for future years as options vest over several years and additional awards are generally made each year.

Stock-based compensation expense related to stock options granted to consultants is recognized as earned using the multiple option method. At each reporting date, the Company re-values the unvested portion of the option using the Black-Scholes option pricing model. As a result, the stock-based compensation expense will fluctuate as the fair market value of the Company s common stock fluctuates. For the three months and six months ended June 30, 2003, the stock-based compensation expenses related to stock options granted to consultants were $48,000 and $53,000. For the three months and six months ended June 30, 2002, the Company did not have any stock-based compensation expenses related to stock options granted to consultants.

**Note 10. Segment Reporting**

SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information, requires the presentation of segment information in a manner consistent with that of chief operating decision makers. Although the Company offers various design and manufacturing embedded test software products and services to its customers, the Company does not manage its operations by these products and services, but instead views the Company as one operating segment when making business decisions. The Company does not manage its operations on a geographical basis. Revenues attributed to the United States and to all foreign countries are based on the geographical location of the customers. The Company uses one measurement of profitability for its business.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| **Net revenues:** | | | | |
| North America | $ 1,144 | $ 3,334 | $ 3,119 | $ 7,011 |
| Europe | 78 | 58 | 128 | 126 |
| Asia | 178 | 300 | 562 | 2,405 |
| | $ 1,400 | $ 3,692 | $ 3,809 | $ 9,542 |

Long-lived assets outside the United States at June 30, 2003 and 2002 were not material.

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

This Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto set forth in Item 1 of this report and the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations in the Company s Annual Report on Form 10-K for the year ended December 31, 2002.

*When used in this discussion, the words expects, anticipates, estimates, and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our critical accounting policies, our expectations regarding future revenues, sources of revenues, cost of revenues and expenses, our estimates regarding the adequacy of our capital resources, our capital requirements and our needs for additional financing, planned capital expenditures, use of our working capital, the features and benefits of our products, customer demand, our growth strategy, our marketing efforts, our focus on larger orders with major customers, our business development efforts, expectations regarding competition, our ability to attract and retain qualified personnel, the impact of our international expansion in Japan and India and our foreign currency risk strategy, are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as the seasonality of the buying patterns of our customers, the concentration of sales to large customers, dependence upon and trends in capital spending budgets in the semiconductor industry and fluctuations in general economic conditions, our ability to rapidly develop new technology and introduce new products, our ability to safeguard our intellectual property and the matters discussed in Factors That May Affect Future Operating Results. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company s expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

**Critical Accounting Policies**

Our discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to revenue recognition, allowance for doubtful accounts, investments, income taxes, warranty obligations, long-term service contracts, and contingencies and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

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

We follow very specific and detailed guidelines in measuring revenue in accordance with the provisions of AICPA Statement of Position 97-2, Software Revenue Recognition as amended by Statement of Position 98-4 and Statement of Position 98-9; however, certain judgments affect the application of our revenue policy. We derive license revenues from software and intellectual property licenses and products, and derive service revenues from maintenance and consulting service contracts. We recognize the full amount of license fees upon shipment only when there is persuasive evidence of an arrangement, shipment has occurred, the fee is fixed or determinable, and collectibility of the sales proceeds is considered probable. When multiple elements exist and where vendor-specific objective evidence, or VSOE, of the fair value of undelivered elements such as postcontract customer support exists, we apply the residual method of accounting to the delivered elements. Our history of selling postcontract customer support provides VSOE of fair value of postcontract customer support through contractual renewal rates. Accordingly, because we have VSOE for the postcontract customer support sold in connection with our licenses of more than one year, we typically recognize the residual amount of the contract fee as license fee upon delivery of the software. When vendor-specific objective evidence of the fair value of the undelivered element cannot be established, and the undelivered element is postcontract customer support, all related revenues are recognized ratably over the term of our postcontract customer support obligations. As a result of this policy, because we are generally unable to establish vendor-specific objective evidence of the undelivered elements with respect to our one-year licenses, we recognize revenues from one-year licenses ratably over the license term. We also recognize the maintenance elements of all contracts ratably over the period of the maintenance contract. When we enter into a multiple element arrangement which includes the future delivery of a specified product or upgrade, all revenues under

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the agreement are deferred until the specified product or upgrade has been delivered. Consulting service revenues are generally recognized on a percentage of completion basis. On occasion, we offer extended payment terms beyond our normal business practice of between 30 and 60 days to certain customers. We do not have sufficient experience collecting under these extended payment term arrangements. As a result, when payment terms are extended, the fee is not considered fixed or determinable and, therefore, we recognize revenues when those payments become due.

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

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

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

**Overview**

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

Our proprietary technology enables semiconductor companies to embed self-testers into the chip design. Our embedded test products generate proprietary circuit structures that are incorporated into an integrated circuit to test and diagnose the chip at full speed, without the signal delay or degradation experienced by external testers. Our proprietary circuits are designed to be modular and reusable, to enable more efficient design and to address time-to-market issues. In June 2002, we introduced a desktop silicon debug solution, named LogicVision Validator, for at-speed debug of silicon chips incorporating our embedded test technologies. We believe the LogicVision Validator in combination with our embedded test technology can save weeks to months in time-to-market by reducing the debug time for our customers new chips prior to their release to volume production.

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

The continued adverse conditions in the general economy and in the semiconductor industry in particular, and our continued focus of our sales efforts with major customers on larger orders have lengthened our sales cycle and made us more dependent on the timing of large orders and our major customers buying patterns. In addition, we are experiencing increasing customer preference for our one-year term licenses. As a result, we expect revenues recognized on a ratable basis to increase as a percentage of license revenues.

We received new orders of $5.6 million in the second quarter of 2003 compared to $2.2 million in the first quarter of 2003. The increase in orders was primarily due to receipt of a large order from a major customer which will first be reflected as an increase in deferred revenues beginning in the third quarter of 2003, with the related revenue recognition starting in the first quarter of 2004. Our backlog for the most recent two quarters was as follows: $8.3 million at June 30, 2003 and $4.4 million at March 31, 2003. Backlog consists of only orders for which written purchase orders have been accepted and neither any billings have been generated nor any revenues have been recognized. Due to possible customer cancellations of orders, our backlog at any particular date is not necessarily indicative of actual revenues for any succeeding period.

We derive our license revenues from software and intellectual property licenses and products. We derive service revenues from fixed fee technology development and design contracts and postcontract customer support. Our licenses typically have terms ranging from one year to three years. Our pricing depends upon a number of factors, including the type of intellectual property, contract terms, number and complexity of designs and number of design teams and their locations. Some of our license agreements include a royalty feature under which our customers pay us additional fees for additional chip designs that exceed the contracted number of designs.

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Historically, a portion of our total revenues has been derived from customers outside the United States and Canada, primarily from Asia and Europe. International revenues (outside of North America) as a percentage of our total revenues were approximately 18% and 27% for the six months ended June 30, 2003 and 2002, respectively. For the three months ended June 30, 2003 and 2002, international revenues were 18% and 10%, respectively. We anticipate that international revenues will continue to represent an important portion of our total revenues in the future.

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

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

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

Sales and marketing expenses consist primarily of compensation and related costs for sales, marketing and sales application personnel, marketing programs, public relations, promotional materials, amortization of non-competition agreement, travel and related trade show expenses. With an increased emphasis on larger contracts with major electronics companies, we have increased our sales application engineering support both in the sales process and customer support activities.

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

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**Results of Operations**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | **2003** | **2002** | **2003** | **2002** |
| Revenues: | | | | |
| License | 31.7% | 68.2% | 43.2% | 69.1% |
| Service | 68.3 | 31.8 | 56.8 | 30.9 |
| Total revenues | 100.0 | 100.0 | 100.0 | 100.0 |
| Cost of revenues: | | | | |
| License | 5.4 | 6.2 | 2.8 | 5.6 |
| Service | 49.2 | 19.7 | 38.7 | 16.3 |
| Total cost of revenues | 54.6 | 25.9 | 41.5 | 21.9 |
| Gross profit | 45.4 | 74.1 | 58.5 | 78.1 |
| Operating expenses: | | | | |
| Research and development | 84.9 | 34.5 | 61.2 | 26.9 |
| Sales and marketing | 165.7 | 59.2 | 124.2 | 46.9 |
| General and administrative | 73.1 | 27.6 | 52.7 | 20.7 |
| Amortization of deferred stock-based compensation | 16.5 | 11.5 | 11.5 | 8.9 |
| Total operating expenses | 340.2 | 132.8 | 249.6 | 103.4 |
| Loss from operations | (294.8) | (58.7) | (191.1) | (25.3) |
| Interest and other income | 12.5 | 8.0 | 9.7 | 6.1 |
| Loss before provision for income taxes | (282.3) | (50.7) | (181.4) | (19.2) |
| Provision for income taxes | 5.1 | 0.5 | 2.2 | 0.4 |
| Net loss | (287.4)% | (51.2)% | (183.6)% | (19.6)% |

***Three Months Ended June 30, 2003 Compared with the Three Months Ended June 30, 2002***

*Revenues*

Total revenues decreased $2.3 million or 62.1% for the three months ended June 30, 2003, as compared to the three months ended June 30, 2002. Total revenues were $1.4 million for the three months ended June 30, 2003, compared to $3.7 million for the three months ended June 30, 2002. License revenues decreased by $2.1 million and service revenues decreased by $0.2 million. These decreases were primarily due to a decreased demand from the fabless semiconductor, integrated device manufacturers and systems companies resulting from the current downturn in the semiconductor industry, and our customers increasing preference for our one-year term licenses. License revenues associated with one-year term licenses are recognized ratably over the term of the license, which has the effect of deferring the timing of revenue recognition to future periods.

*Cost of Revenues*

Total cost of revenues decreased $0.2 million or 20.2% for the three months ended June 30, 2003, as compared to the three months ended June 30, 2002. Total cost of revenues were $0.8 million or 54.6% of revenues for the three months ended June 30, 2003, compared to $1.0 million or 25.9% of revenues the for three months ended June 30, 2002. Total cost of revenues as a percentage of total revenues increased primarily due to a decrease in revenues. The decrease in cost of license revenues as a percentage of total revenues was primarily due to a decrease in royalty expenses of $0.2 million relating to completion of required royalty payments for intellectual property in October 2002. The increase in cost of service revenues as a percentage of total revenues was primarily due to a fixed customer support costs being allocated over a lower total revenue base.

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*Research and Development*

Research and development expenses were $1.2 million or 84.9% of revenues for the three months ended June 30, 2003, compared to $1.3 million or 34.5% of revenues for the same period in the prior year. The decrease was primarily due to the departure of one employee which resulted in a decrease in payroll and related expenses of $0.1 million.

*Sales and Marketing*

Sales and marketing expenses were $2.3 million or 165.7% of revenues for the three months ended June 30, 2003, compared to $2.2 million or 59.2% of revenues for the same period in the prior year. The increase was primarily due to an increase in amortization expenses of $0.3 million resulting from the acquisition of the distributor business in Japan, and severance and other special termination benefits of $0.1 million relating to a headcount reduction of six employees, partly offset by a decrease in commission expenses of $0.2 million resulting from lower revenues, and a decrease in trade show expenses of $0.1 million.

*General and Administrative*

General and administrative expenses remained constant for the three months ended June 30, 2003, as compared to the three months ended June 30, 2002. General and administrative expenses were $1.0 million or 73.1% of revenues for the three months ended June 30, 2003, compared to $1.0 million or 27.6% of revenues for the same period in the prior year. Total general and administrative expenses as a percentage of revenue increased primarily due to decreases in revenues.

*Interest Income*

Interest income of $0.2 million decreased $0.1 million or 40.9% for the three months ended June 30, 2003, as compared to the three months ended June 30, 2002. The decrease was due to lower investment balances and lower interest rates.

*Income Taxes*

Our net operating losses are generated domestically, and amounts attributed to our foreign operations have been insignificant for all periods presented. For the three months ended June 30, 2003 and 2002, we recorded income tax provisions of $71,000 and $18,000 primarily related to state and foreign taxes. No benefit for income taxes has been recorded due to the uncertainty of the realization of deferred tax assets. From inception through December 31, 2002, we incurred net losses for federal and state tax purposes. As of December 31, 2002, we had federal and California net operating loss carryforwards of approximately $46.6 million and $21.7 million available to reduce future federal and California taxable income, respectively. These federal and California carryforwards begin to expire in 2006 and 2003, respectively, if not utilized. The extent to which these carryforwards can be used to offset future taxable income may be limited under Section 382 of the Internal Revenue Code and applicable state tax law.

***Six Months Ended June 30, 2003 Compared with the Six Months Ended June 30, 2002***

*Revenues*

Total revenues decreased $5.7 million or 60.1% for the six months ended June 30, 2003, as compared to the six months ended June 30, 2002. Total revenues were $3.8 million for the six months ended June 30, 2003, compared to $9.5 million for the six months ended June 30, 2002. License revenues decreased by $4.9 million and service revenues decreased by $0.8 million. These decreases were primarily due to decreased demand from fabless semiconductor, integrated device manufacturers and systems companies resulting from the current downturn in the semiconductor industry, and our customers increasing preference for our one-year term licenses. License revenues associated with one-year term licenses are recognized ratably over the term of the license, which has the effect of deferring the timing of revenue recognition to future periods.

*Cost of Revenues*

Total cost of revenues decreased $0.5 million or 24.5% for the six months ended June 30, 2003, as compared to the six months ended June 30, 2002. Total cost of revenues were $1.6 million or 41.5% of revenues for the six months ended June 30, 2003, compared to $2.1 million or 21.9% of revenues for six months ended June 30, 2002. Total cost of revenues as a percentage of total revenues increased primarily due to a decrease in revenues. The decrease in cost of license revenues as a percentage of total revenues was primarily due to a decrease in royalty expenses of $0.5 million relating to completion of required royalty payments for intellectual property in October 2002. The increase in cost of service revenues as a percentage of total revenues was primarily due to a fixed customer support costs allocated over a lower total revenue base.

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*Research and Development*

Research and development expenses were $2.3 million or 61.2% of revenues for the six months ended June 30, 2003, compared to $2.6 million or 26.9% of revenues for the same period in the prior year. The decrease was primarily due to the departure of one employee which resulted in a decrease in payroll and related expenses of $0.1 million, and a decrease of $0.2 million allocated to sales and marketing expenses caused by an increase in time spent by our research and development engineers on customer support activities.

*Sales and Marketing*

Sales and marketing expenses were $4.7 million or 124.2% of revenues for the six months ended June 30, 2003, compared to $4.5 million or 46.9% of revenues for the same period in the prior year. The increase was primarily comprised of an increase in amortization expenses of $0.6 million resulting from the acquisition of the distributor business in Japan, an increase in payroll and related expenses of $0.3 million associated with hiring eight additional employees for our newly established subsidiaries in Japan and India, and severance and other special termination benefits of $0.1 million relating to a workforce reduction of six employees in the second quarter of 2003, offset by a decrease in commission expenses of $0.3 million resulting from lower revenues, a decrease in trade show expenses of $0.2 million, and a decrease of $0.2 million due to less time spent by our sales application engineers on customer support activities.

*General and Administrative*

General and administrative expenses remained constant for the six months ended June 30, 2003, as compared to the six months ended June 30, 2002. General and administrative expenses were $2.0 million or 52.7% of revenues for the six months ended June 30, 2003, compared to $2.0 million or 20.7% of revenues for the same period in the prior year.

*Interest Income*

Interest income of $0.4 million decreased $0.2 million or 36.5% for the six months ended June 30, 2003, as compared to the six months ended June 30, 2002. The decrease was due to lower investment balances and lower interest rates.

*Income Taxes*

Our net operating losses are generated domestically, and amounts attributed to our foreign operations have been insignificant for all periods presented. For the six months ended June 30, 2003 and 2002, we recorded income tax provisions of $82,000 and $35,000 primarily related to state and foreign taxes.

***Liquidity and Capital Resources***

At June 30, 2003, we had cash and cash equivalents, short-term investments and marketable securities of $34.1 million and working capital of $19.4 million. We have not guaranteed any debt not included in the consolidated balance sheet. At June 30, 2003, we had an unsecured line of credit of $5.0 million of which $4.0 million was available for future borrowings.

We have funded our operations primarily from license and service revenues received from inception to June 30, 2003, the net proceeds of $41.1 million from our initial public offering of common stock in November 2001, and the proceeds of approximately $47.8 million from the sale of preferred stock and warrants, the exercise of stock options and common stock purchases from the employee stock purchase plan.

Net cash used in operating activities was $5.9 million and $2.5 million for the six months ended June 30, 2003 and 2002, respectively. Net cash used in operating activities for the six months ended June 30, 2003 was primarily due to a net loss of $7.0 million; a decrease in accounts payable of $0.7 million due to timing of payments to suppliers in order to optimize discounts and payment periods, partly offset by non-cash charges relating to depreciation and amortization and amortization of deferred stock-based compensation of $1.1 million and $0.4 million, respectively; a decrease in accounts receivable of $0.2 million; and a decrease in prepaid and other current expenses of $0.2 million. Net cash used in operating activities for the six months ended June 30, 2002 was primarily due to a net loss of $1.9 million, an increase in prepaid and other current expenses of $0.5 million, a decrease in deferred revenues of $2.7 million, and a decrease in accrued liabilities of $0.2 million, partly offset by non-cash charges relating to depreciation and amortization and amortization of deferred stock-based compensation of $0.6 million and $0.9 million, respectively, and a decrease in accounts receivable of $1.3 million.

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Net cash provided by investing activities was $2.2 million for the six months ended June 30, 2003 and net cash used in investing activities was $14.8 million for the six months ended June 30, 2002. Net cash provided by investing activities for the six months ended June 30, 2003 was primarily due to the proceeds from sales and maturity of marketable securities of $8.5 million, partly offset by the purchase of short-term investments and marketable securities of $5.0 million and $1.0 million, respectively, and the purchase of property and equipment of $0.3 million. Net cash used in investing activities for the six months ended June 30, 2002 was primarily due to the purchase of marketable securities and short-term investments of $12.5 million and $2.0 million, respectively, and the purchase of property and equipment of $0.3 million.

Net cash used in financing activities was $1.3 million for the six months ended June 30, 2003 and net cash provided by financing activities was $0.1 million for the six months ended June 30, 2002. Net cash used in financing activities for the six months ended June 30, 2003 was primarily due to repayments of a bank loan of $1.5 million, offset by proceeds of $0.2 million received from the employee stock purchase plan purchases and the issuance of common stock pursuant to exercise of employee stock options. Net cash provided by financing activities for the six months ended June 30, 2002 was primarily due to proceeds of $0.2 million received from the issuance of common stock pursuant to exercise of employee stock options, offset by stock issuance costs of $0.04 million related to the sale of common stock in our initial public offering in November 2001.

On February 11, 2003, we amended our unsecured Loan Agreement with a bank as to certain operating covenants relating to the quarterly net loss requirement. Under the agreement, we may borrow, on a revolving basis, up to $5.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 4.0% at June 30, 2003. Under the agreement, we must comply with certain operating and reporting covenants and are not permitted to pay dividends, or make material investments or dispositions without the prior written consent of the bank. If we fail to comply with its covenants under the agreement, the bank can declare any outstanding amounts immediately due and payable and cease advancing money or extending credit to or for us. The agreement expires in January 31, 2004. At June 30, 2003, we had $1.0 million outstanding under this agreement, and were in compliance with all the operating and reporting covenants with the bank.

*Contractual Obligations and Other Commercial Commitments*

Our obligations under contractual obligations and commercial commitments are primarily leasing arrangements and are as follows:

| | June 30, 2003 | | |
|---|---|---|---|
| | Payments Due by Period | | |
| | Total | Less than 1 year | 1-3 years |
| Contractual Obligations: | | | |
| Operating leases | $ 1,954 | $ 1,067 | $ 887 |

We rent office facilities under noncancelable operating leases which expire on various dates through July 2006. We are responsible for certain maintenance costs, taxes and insurance under the respective leases. Total future minimum payments under these operating leases at June 30, 2003 were $2.0 million.

We expect to finance these future commitments using existing cash resources. We currently anticipate that our available cash resources will be sufficient to meet our anticipated operating, capital requirements and business acquisitions for at least the next 12 months.

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

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**FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS**

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

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

- potential customers may determine that existing solutions adequately address their testing needs, or the industry may develop alternative technologies to address their testing needs;
- our existing and potential customers may continue to react to declining demand for semiconductors by curtailing or delaying new initiatives for new complex semiconductors or by extending the approval process for new projects, thereby lengthening our sales cycles;
- potential customers may not be willing to accept the perceived delays in the early design stages associated with implementing embedded test technology in order to achieve potential time and cost savings at later stages of silicon debugging and production testing;
- potential customers may have concerns over the reliability of embedded testing methods relative to existing test methods; and
- designers may be reluctant to take on the added responsibility of incorporating embedded test technology as part of their design process, or to learn how to implement embedded test technology.

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

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

The primary customers for semiconductors that incorporate our embedded test technology are companies in the communications, networking, server and high-end consumer products industries. Any significant downturn in these particular markets or in general economic conditions which result in the cutback of research and development budgets or capital expenditures would likely result in a reduction in demand for our products and services and could harm our business. For example, the U.S. economy, including the semiconductor industry, is currently experiencing a slowdown, which may continue to negatively impact our business and operating results as the number of design starts by current and potential customers decline. If the economy continues to decline as a result of the recent economic, political and social turmoil, existing and prospective customers may further reduce their design budgets or delay implementation of our products, which could harm our business and operating results.

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

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**Global economic, political, health and social conditions may obstruct international business and adversely affect our revenues.**

The war in Iraq and recent geopolitical and social turmoil in many parts of the world, including actual incidents and potential future acts of terrorism and war, may continue to put pressure on global economic conditions. These geopolitical, social and economic conditions and uncertainties make it difficult for us and our customers to accurately forecast and plan future business activities. This reduced predictability combined with the uncertainty of an already slow global economy challenges our ability to develop and maintain customer relationships, particularly given our lengthy sales cycle, and to promote the adoption of our embedded test technology in the semiconductor industry.

The outbreak and spread of severe acute respiratory syndrome, or SARS, became a major health concern not only in Asia but worldwide. Many companies cancelled business trips, conferences and other events in order to avoid international travel, with the effect of generally suspending international business activities. The resurgence of the disease, spread of infection, or the fear of the spread of infection, could disrupt the business of our customers in Asia, causing them to delay or cancel their design projects or their meetings with us. Employees in our San Jose facility will likely avoid contact with those who return from travel to Asia, which may disrupt our ongoing domestic business activities. In addition, a further slowdown in already weakened key economies in the Pacific Rim as a result of health concerns, whether real or perceived, may adversely affect the semiconductor industry as a whole.

**We have a history of losses and an accumulated deficit of approximately $65.6 million as of June 30, 2003. If we do not generate sufficient net revenue in the future to achieve or sustain profitability, our stock price could decline.**

We have incurred significant net losses since our inception, including losses of $7.0 million for the six months ended June 30, 2003, $8.5 million for the year ended December 31, 2002 and $6.3 million for the year ended December 31, 2001. At June 30, 2003, we had an accumulated deficit of approximately $65.6 million. We expect our future revenues to be impacted by current market and customer conditions, and we expect to continue to commit substantial investment in our research and development projects and to continue to invest in our service operations to support our business development activities. Because we expect to continue to invest in business development, our expenditures could continue to outpace growth in our revenues, thus preventing us from achieving and maintaining profitability. To achieve and maintain profitability, we will need to generate and sustain substantially higher revenues while maintaining reasonable cost and expense levels. If we fail to achieve profitability within the time frame expected by securities analysts or investors and our cash balances continue to decline, the market price of our common stock will likely decline. We may not achieve profitability if our revenues do not increase or if they increase more slowly than we expect. In addition, our operating expenses are largely fixed, and any shortfall in anticipated revenues in any given period could harm our operating results.

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

Historically, our sales cycle has ranged from six months to two years and our customers implementation cycle has been approximately an additional six to twelve months. Recently, we have been experiencing longer sales and implementation cycles for our products primarily due to the current adverse economic conditions and downturn in the semiconductor industry, and our continued focus of our sales efforts with major customers on larger orders.

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

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

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

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

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

- timing, terms and conditions of customer agreements;
- timing of sales commission expenses and the recognition of license revenues from related customer agreements;
- timing and acceptance of new technologies, product releases or enhancements by us, our competitors or our customers;
- timing and completion of milestones under customer agreements;
- the mix of our license and services revenues;
- changes in our and our customers development schedules and levels of expenditures on research and development;
- customers placing orders at the end of the quarter;
- industry patterns and changes or cyclical and seasonal fluctuations in the markets we target; and
- market and general economic conditions.

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

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

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

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

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

- electronic design automation providers such as Cadence Design Systems, Inc., Mentor Graphics Corporation and Synopsys, Inc., all of which offer basic built-in self-test capability;
- smaller test tool providers such as SynTest Technologies, Inc.;
- potential customers that develop test solutions internally; and
- integrated device manufacturers, such as International Business Machines Corporation, that use their own test solutions in chips manufactured for and sold to others.

Our embedded test technology also has the potential to impact the automated test equipment market, which may place us in competition with traditional hardware tester manufacturers such as Advantest Corporation, Agilent Technologies, Inc., Credence Systems Corporation, LTX Corporation, NP Test Inc, and Teradyne, Inc. As embedded test becomes adopted more widely in the market, any of these automated test equipment companies, or others, may offer their own embedded test solutions. Some of our competitors in electronic design automation and external test equipment businesses are significantly larger than we are and have greater financial resources, greater name recognition and longer operating histories than we have. Some of our competitors offer a more comprehensive range of products covering the entire design flow and complete external test flow, and they may be able to respond more quickly or adjust prices more effectively to take advantage of new opportunities or customer requirements. Increased competition and the current downturn in the semiconductor industry could result in pricing pressures, reduced sales, reduced margins or failure to achieve or maintain widespread market acceptance, any of which could prevent us from increasing or sustaining our revenues and achieving or sustaining profitability.

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

We derive a significant portion of our revenues from a relatively small number of customers. Six customers accounted for approximately 32% of total revenues for the six months ended June 30, 2003, of which no customers accounted for more than 10% of total revenues. 11 customers accounted for approximately 54% of total revenues for the year ended December 31, 2002, of which two customers accounted for approximately 12% and 10% of total revenues, respectively. We anticipate that we will continue to rely on a limited number of customers for a substantial portion of our revenues in the future. As a result, we must obtain orders from new significant customers on an ongoing basis to increase our revenues and grow our business. In addition, the loss of any significant or well-known customer could harm our operating results or our reputation. In particular, a loss of a significant customer could cause fluctuations in our results of operations because our expenses are fixed in the short term, it takes us a long time to replace customers and, because of required methods of revenue recognition, any offsetting license revenues may need to be recognized over a period of time.

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

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

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

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

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

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

**In June 2002, we introduced a hardware product called the LogicVision Validator. If we are unable to successfully manage the manufacturing process and service support for this product, our reputation and our operating results could be harmed.**

In June 2002, we introduced our first hardware product, the LogicVision Validator. From the fourth quarter of 2002 to June 30, 2003, we shipped an aggregate of four units. We rely on an independent subcontractor to manufacture this product for us. Because our other products are delivered in the form of software, we do not have experience in managing the manufacturing and service support for hardware products. If we are unable to accurately predict market demand for the LogicVision Validator, manage lead times in the procurement process and develop and maintain appropriate inventory controls, we may experience shortages or excess inventory. Shortages could result in lost sales opportunities and customers, and excess inventory could become obsolete, resulting in inventory write-offs which would negatively affect our financial results. In addition, we may need to customize our product to meet specifications of our customers outside of the United States.

We obtain several of the components used in this product from single or limited sources. If component manufacturers do not allocate a sufficient supply of components to meet our needs or if current suppliers do not provide components of adequate quality or compatibility, we may have to obtain these components from distributors or on the spot market at a higher cost. We do not have guaranteed supply arrangements with our suppliers, and suppliers may not be able to meet our current or future component requirements. If we are forced to use alternative suppliers of components, we may have to alter our product design to accommodate these components. Alteration of our product design to use alternative components could cause significant delays and reduce our production. In addition, we do not have specific volume purchase agreements with our subcontractor, and the subcontractor could cease supplying the product at any time with limited or no penalty. If we need to replace the subcontractor, we could incur significant manufacturing set-up costs and delays, which in turn could affect inventory levels.

Because this is our first hardware product, our customer support service personnel may experience difficulties in responding to customer needs, and we may be required to obtain third-party assistance, either directly or in the form of further training for our existing support personnel. Delays in customer service could result in rejection of our product and loss of customer confidence. Third-party assistance could be costly and divert attention of our personnel from primary support of our other products. Loss of sales, damaged reputation or increased costs could harm our revenues and profitability.

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

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

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

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

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

**Recently enacted and proposed regulatory changes may cause us to incur increased costs.**

Recently enacted and proposed changes in the laws and regulations affecting public companies, including the provisions of the Sarbanes-Oxley Act of 2002 and rules proposed by the SEC and NASDAQ, could cause us to incur increased costs as we evaluate the implications of new rules and respond to new requirements. The new rules could make it more difficult for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. The impact of these events could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, or as executive officers. We are presently evaluating and monitoring developments with respect to these new and proposed rules, and we cannot predict or estimate the amount of additional costs we may incur or the timing of such costs.

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

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

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

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

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

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

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

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

Litigation may be necessary to enforce our intellectual property rights or to determine the validity or scope of the proprietary rights of others. As a result of any such litigation, we could lose our proprietary rights and incur substantial unexpected operating costs. We may need to take legal action to enforce our proprietary rights in the future. Any action we take to protect our intellectual property rights could be costly and could absorb significant management time and attention. In addition, failure to adequately protect our trademark rights could impair our brand identity and our ability to compete effectively.

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

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

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

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

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

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

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

International revenues from sales outside the United States and Canada accounted for 18% of our total revenues for the six months ended June 30, 2003 and 21% of our total revenues for the year ended December 31, 2002. Our success depends upon continued expansion of our international operations, and we expect that a portion of our total future revenues will be generated from international sales. Our international business involves a number of risks, including:

- our ability to adapt our products to foreign design methods and practices;
- cultural differences in the conduct of business;
- difficulty in attracting qualified personnel;
- managing foreign branch offices and subsidiaries;
- longer payment cycles for and greater difficulty collecting accounts receivable;
- the uncertainty of Japanese sales due to the typically lengthy Japanese sales cycle;
- unexpected changes in regulatory requirements, royalties and withholding taxes that restrict the repatriation of earnings;
- tariffs and other trade barriers;
- the burden of complying with a wide variety of foreign laws; and
- political, economic or military conditions associated with current worldwide conflicts and events.

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

**Our historical growth has placed a significant strain on our management systems and resources, and if we fail to manage this growth and are unable to effectively control our costs and implement our business strategies, our business will be harmed.**

Our ability to license our products and manage our business successfully in an evolving market requires an effective planning and management process. Our historical growth, international expansion in Japan and India and acquisition of certain assets and customer contracts from our Japanese distributor have placed, and are expected to continue to place, a significant strain on our resources and increased demands on our management information and reporting systems, financial and management controls and personnel. To manage our growth, we must implement and improve additional and existing administrative, financial and operations systems, procedures and controls. We may not be able to develop the internal capabilities or collaborative relationships required to manage future growth and expansion or to support future operations. If we are unable to manage growth effectively, our revenues could decline.

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

Our establishment of wholly owned subsidiaries in India and Japan requires significant management attention, which could distract our management from day to day operations and could disrupt our business.

In December 2002, we completed the transfer of all designated customer contracts from our then Japanese distributor to our Japanese subsidiary. As of June 30, 2003, we are continuing the transitioning of our customer relationships to our Japanese subsidiary. If we fail to successfully transition the remaining customer relationships to our Japanese subsidiary, the revenues and operating results of our combined company could decline. To realize the benefits of this transaction, we must successfully integrate our Japanese subsidiary into our existing operations despite differences in culture, language and legal environments. In addition, because we do not have the same experience and relationships as our former distributor in Japan, we may not succeed in our efforts to develop a direct sales presence in Japan, and the cost of these efforts may be significant. If our customers are uncertain about our ability to operate on a combined basis or about developing a more direct relationship with us, they could delay or cancel orders for our products.

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We established a wholly owned subsidiary in Bangalore, India to provide engineering and customer support services to our customers worldwide. We do not have any prior operating experience in India, and our expansion in India presents a number of risks including increased difficulty in coordinating our engineering and customer support efforts, increased costs associated with establishing our remote office, obtaining required equipment and tools and training new personnel, increased communications and travel costs, and potential delays in our engineering and customer support efforts.

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

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

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

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

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

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

The Nasdaq Stock Market has quantitative maintenance criteria for the continued listing of common stock on The Nasdaq National Market, including maintaining a minimum closing bid of $1.00 per share. As of June 30, 2003, we were in compliance with all Nasdaq National Market listing requirements. However, our stock price has declined significantly over the past year and experienced volatility. If the closing bid price of our common stock price falls and remains below $1.00 per share for 30 consecutive days, our common stock may not remain listed on The Nasdaq National Market. If we fail to maintain continued listing on The Nasdaq National Market and must move to a market with less liquidity, our financial condition could be harmed and our stock price would likely decline. If we are delisted, it could have a material adverse effect on the market price of, and the liquidity of the trading market for, our common stock.

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

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

- the costs and timing of expansion of product development efforts and the success of these development efforts;
- the costs and timing of expansion of sales and marketing activities;
- the extent to which our existing and new products gain market acceptance;
- the need to adapt to changing technologies and technical requirements;
- competing technological and marketing developments;
- the costs involved in maintaining and enforcing patent claims and other intellectual property rights;
- the level and timing of license and service revenues;
- the existence of opportunities for expansion and for acquisitions of, investments in, complementary businesses, technologies or product lines; and
- access to and availability of sufficient management, technical, marketing and financial personnel.

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

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

**Foreign Currency Fluctuations**

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

**Interest Rate Risk**

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

Investments in both fixed and floating rate interest-earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to rising interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates.

Short-term investments and long-term investments are classified as held-to-maturity and the cost of securities sold is based on the specific identification method. At June 30, 2003, we had short-term U.S. government securities and long-term U.S. government securities of $12.0 million and $10.9 million, respectively.

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**ITEM 4: CONTROLS AND PROCEDURES**

(a) **Evaluation of disclosure controls and procedures.** We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act ), that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted above, our disclosure controls and procedures were effective to ensure that material information relating to us, including our consolidated subsidiaries, is made known to them by others within those entities, particularly during the period in which this Quarterly Report on Form 10-Q was being prepared.

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

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## PART II OTHER INFORMATION

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

(a) The Annual Meeting of Stockholders was held on May 15, 2003.

(b) The matters voted upon at the meeting and results of the voting with respect to those matters were as follows:

(1) Election of Directors.

| | Votes For | Withheld |
|---|---|---|
| Vinod K. Agarwal | 12,222,257 | 32,225 |
| Navindra Jain | 12,233,482 | 21,000 |
| Richard C. Black | 12,227,832 | 26,650 |
| D. James Guzy | 10,550,923 | 1,703,559 |
| Richard C. Yonker | 12,242,932 | 11,550 |

(2) Ratification of the appointment of PricewaterhouseCoopers LLP as the Company s independent accountants.

| Votes For | Against | Abstain |
|---|---|---|
| 11,312,782 | 941,000 | 700 |

### ITEM 6: EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits.

| | |
|---|---|
| 10.1 | Amended and Restated 2000 Stock Incentive Plan. |
| 10.2 | Amendments Nos. 1 and 2 and Addendum to Amended and Restated 2000 Stock Inventive Plan. |
| 10.3 | Form of agreement under the 2000 Stock Incentive Plan. |
| 10.4 | Amendment No. 1 to the Amended and Restated 2000 Employee Stock Purchase Plan. |
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a) Certification of Chief Financial Officer. |
| 32.1** | Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350). |
| 32.2** | Statement of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350). |

**

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

(b) Reports on Form 8-K.

On April 3, 2003, the Company filed a Current Report on Form 8-K announcing under item 5 the appointment of Bruce M. Jaffe as its Vice President of Finance and Chief Financial Officer.

On April 23, 2003, the Company filed a Current Report on Form 8-K furnishing under item 12 the Company s press release relating to its financial results for the quarter ended March 31, 2003.

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## SIGNATURE

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

Dated: August 12, 2003

LOGICVISION, INC.

(Registrant)

By: /s/ Vinod K. Agarwal

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

By: /s/ Bruce M. Jaffe

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

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**EXHIBIT INDEX**

| Exhibit Number | Description of Exhibit |
|---|---|
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