

LOGICVISION INC  
Form 10-K  
March 13, 2007

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

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**FORM 10-K**

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

For the fiscal year ended December 31, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-31773

**LOGICVISION, INC.**

(Exact name of registrant as specified in its charter)

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

**94-3166964**  
(IRS Employer  
Identification No.)

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

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of exchange on which registered

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**Common Stock, par value \$0.0001 per share**

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**The NASDAQ Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15 (d) of the Exchange Act.

Yes No

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required 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

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such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer

Accelerated filer

Non accelerated filer

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

Yes No

The aggregate market value of Common Stock held by non-affiliates of the registrant (based upon the closing sale price on the NASDAQ National Market on June 30, 2006) was approximately \$31.3 million. Shares held by each executive officer, director and by each person who owns 10% or more of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of February 28, 2007, there were 24,121,593 shares of Common Stock, \$0.0001 per share par value, outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Items 10 (as to directors and Section 16(a) Beneficial Ownership Reporting Compliance), 11, 12 (as to Beneficial Ownership), 13 and 14 of Part III incorporate by reference information from the registrant's proxy statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the registrant's 2007 Annual Meeting of Stockholders to be held on May 17, 2007.

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LOGICVISION, INC.

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## PART I

### Item 1. Business

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

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

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

### Overview

We are a test and yield learning company in the semiconductor design-for-manufacturing, or DFM, sector. Our proprietary technologies for embedded test and diagnostics enable more efficient test of complex semiconductor devices. Our technology allows semiconductor designers to insert test structures inside semiconductor integrated circuits. These test structures allow designers and engineers to test the functionality and performance of their devices throughout each key stage of a complex semiconductor's life cycle. The most complex of these circuits are called System-on-a-Chip, or SoC, semiconductors. Our embedded test solution has been successfully deployed in SoC's found in digital consumer products, medical products, networking and wireless communications devices, computers and satellite systems.

Our solution also allows testing of integrated circuits after they have been assembled onto boards and systems, enabling diagnostic test throughout the semiconductor's life cycle. Our analysis software aggregates and analyzes data from various semiconductor fabrication and test sources to identify whether silicon behavior meets design criteria across varying manufacturing and operating conditions. 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 and manufacturing yield issues.

We believe our products can reduce semiconductor manufacturing and test costs, accelerate silicon bring-up times, provide for yield learning, improve time-to-yield and result in less field returns. The target market for our technology is SoC designs with feature widths of 130 nanometers, 90 nanometers, 65 nanometers and smaller. A nanometer is one billionth of a meter.

We incorporated as LV Software in July 1992 in California and engaged principally in research and development activities through 1994. We first generated meaningful commercial revenues from the license of our initial embedded test product in 1995. In June 1996, we changed our corporate name to LogicVision, Inc. We reincorporated in Delaware in September 2000. In November 2004, we acquired SiVerion, Inc. SiVerion's software product aggregates and analyzes data from various semiconductor fabrication and test sources to identify whether silicon behavior meets design criteria across varying manufacturing and operating conditions.



## Technology

### *Embedded test*

We believe that embedded test technology provides significant benefits for the new and complex systems-on-a-chip ( SOC ) semiconductor devices being designed and manufactured today. Conventional test is performed with external equipment, while embedded test is performed primarily using circuitry resident in the semiconductor design. By embedding test circuit structures on the semiconductor itself, our embedded test solution eliminates many of the key limitations associated with conventional external testing. Our embedded test design software automatically analyzes the structure of complex circuits to determine requirements for at-speed testing and diagnostics, and creates and integrates our proprietary embedded test circuits with the existing design functions to address these requirements. Our embedded test manufacturing software allows external test equipment to easily operate our proprietary embedded test circuits for pass-fail testing, chip debug or manufacturing datalogging. Our technology also enables board and system level diagnostics, system bring-up and in-field testing and diagnostics.

### *Design phase*

Our embedded test technology is incorporated into integrated circuits in the form of user-configurable circuit structures that provide four functions:

*access management* necessary scan chains, shared isolation collars, boundary scan and test points to enable access to any point within complex designs;

*timing management* proprietary functionality for clock skew management, multiple cycle paths and multiple frequencies;

*test data generation and analysis* proprietary functionality created for each design block to algorithmically generate circuit test and analyze circuit test data; and

*external control* standard IEEE 1149.1 and IEEE 1149.6 compliant test access ports for access and control of all embedded test circuits.

### *Manufacturing phase*

Because our embedded test circuits are incorporated in semiconductor designs, they are manufactured as part of the semiconductor devices. When the prototypes of a new integrated circuit return from fabrication for debug and characterization, our embedded test circuits and embedded test manufacturing software can be used to accelerate this process and allow lower cost equipment to be utilized. Our embedded test circuit structures and embedded test manufacturing software also facilitate at-speed test during wafer probe and allow lower-cost test equipment to be used at wafer probe. Semiconductor devices that pass wafer probe test are then packaged, and our embedded testers and embedded test manufacturing software are used again during final test. Our embedded test circuits are designed to be activated with simple external test signals applied through the industry standard IEEE 1149.1 and IEEE 1149.6 test access ports. Our analysis software aggregates and analyzes data from various test sources to identify whether silicon behavior meets design criteria across varying manufacturing and operating conditions.

*Test Development Functions.* Using our technology, the bulk of the patterns applied to test the integrated circuit are created on-chip, with only minimal external control needed to achieve a pass-fail test. Our embedded test design and manufacturing software provides the engineer with the ability to easily create pass-fail test patterns, and then optimize them for speed, execution time, accuracy, power and results.

*Debug and Diagnostic Functions.* Our embedded test provides a number of debug and diagnostic modes to facilitate debug, diagnosis and datalogging. These are leveraged using our embedded test manufacturing software.

### *Implementation technologies*

We have developed several technologies to facilitate the mainstream design and manufacturing use of embedded test technology. These include:

design automation algorithms and implementation for embedded test;

hierarchical isolation, access and assembly technologies;

embedded test design verification technologies;

high-performance circuit fault simulation algorithms and automation technologies;

capture-by-domain for multiple-clock timing:

at-speed, multi-frequency, multi-clock logic embedded test technology;

fault-insertion technology for system diagnostics;

at-speed, embedded and external memory test technologies;

at-speed interconnect test technology;

test and measurement technologies for embedded phase-locked-loops;

manufacturing automation for simplified access and control of embedded test circuits on test equipment;

accurate real-time identification of open connection lines between interconnects on a circuit;

analysis algorithms to facilitate the identification of parametric yield limiters;

signoff process and handoff database for robust transfer of embedded test information to manufacturing; and

parametric and input/output test technology to facilitate multi-site and reduced pin-count test, debug and datalogging.

**Products**

We offer a portfolio of products for the automated development, integration, and deployment of embedded test technology:

*Technology products*

*Embedded Circuit Structures.* Our embedded test technology enables our customers to design and manufacture our embedded test circuit structures for a specific design. For a typical design of 1 million gates and above, our embedded testers are less than a few thousand gates and represent only 1% to 2% of chip area. Our user-configurable embedded test circuit structures are designed to test memory, logic, input/outputs, phased-locked-loops, cores, hierarchical blocks and interconnect.

*Design Software products*

We provide a suite of highly integrated embedded test design software products for embedded test implementation on application specific integrated circuits, or ASIC, and SOC designs. We provide design software that automatically analyzes the structure of complex circuits to determine requirements for at-speed testing and diagnostics. Our software creates and integrates our proprietary circuits with the existing design circuits to address these requirements. It also assists with the timing analysis and simulation processes necessary for proper verification, by providing timing analysis scripts and simulation test benches.

*Manufacturing Software products*

We provide embedded test manufacturing software for access and control of embedded test during chip and system test program development, debug, manufacturing test and datalogging. This enables user interaction with the embedded test circuits to evaluate and diagnose chip-level and board-level failures during manufacturing. This includes pass-fail testing, debug and basic failure diagnostics and datalogging. We support a wide set of third-party industry standard test equipment.

*Product offerings*

We currently offer our embedded test circuits, design software and manufacturing software in a variety of product bundles under the product family name LV2005™ with the product sub-families named ETCreat™, ETAccess™, ScanBurst™ and Yield Insight™.

The ETCreat product sub-family consists of embedded test intellectual property and corresponding design automation software that provide embedded test solutions for different components of an ASIC or SOC design. The individual embedded test products within this sub-family and their underlying capabilities are described below.

**Products**

**Applications**

**IC Memory BIST**

Provides intellectual property for flexible, area-optimized, at-speed, memory embedded test functionality.  
Supports single and multiport memory such as SRAMs, DRAMs and ROMs.



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Supports any size memory manufacturable in given technology.  
Provides manufacturing tools for integrated circuit and system test and diagnosis of embedded memories.

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Products	Applications
<b>Logic BIST</b>	<p>Provides intellectual property for at-speed, multi-frequency logic self-test and scan test functionality.</p> <p>Includes intellectual property for direct test access and isolation of legacy cores.</p> <p>Automates analysis, generation, assembly and verification of logic test intellectual property.</p> <p>Supports high-speed multiple clock domains, including those in excess of 100 megahertz, pipelining and multi-cycle paths.</p>
<b>Embedded Logic Test</b>	<p>Provides embedded test intellectual property for hierarchical, at-speed, embedded logic core test functionality.</p> <p>Automates a complete, hierarchical methodology for system-on-a-chip design and test.</p> <p>Supports design partitioning and core reuse for concurrent engineering.</p> <p>Facilitates transportable embedded test for functional block re-use.</p>
<b>IC Memory BIST with BIRA (Built-In Repair Analysis)</b>	<p>Provides intellectual property for flexible, area-optimized, at-speed, memory embedded test functionality.</p> <p>Includes redundancy analysis for repairability of memories.</p> <p>Supports single and multiport SRAMs, DRAMs and ROMs.</p> <p>Supports any size memory manufacturable in given technology.</p> <p>Provides manufacturing tools for integrated circuit and system test and diagnosis of embedded memories.</p>
<b>PLL BIST</b>	<p>Provides embedded test intellectual property for accurate, specification-driven test of phase-locked-loop functionality.</p> <p>Automates generation, assembly and verification of embedded test circuitry for phase-locked-loops.</p> <p>Supports measurement-based tests of jitter, loop-gain and lock-range specifications.</p> <p>Measurement resolution to 0.125 of a gate delay.</p>
<b>SerDes BIST</b>	<p>Provides embedded test intellectual property for accurate structural test that measure most SerDes performance characteristics.</p> <p>Automates generation, assembly and verification of embedded test circuitry for high speed I/O.</p> <p>Measured parameters include signal transition times, logic levels, jitter (various types, and RMS or histogram), and jitter tolerance-related timing parameters.</p> <p>Measurement resolution at sub-picosecond accuracy.</p>
<b>Programmable IC Memory BIST</b>	<p>Provides intellectual property for runtime programmable, at-speed, memory embedded test functionality.</p> <p>Supports large, embedded DRAMs and high density, embedded SRAMs.</p> <p>Supports both standard and user-proprietary memory test algorithms.</p> <p>Usable during memory debug/characterization and go/no-go manufacturing test.</p>
<b>Programmable External Memory Test</b>	<p>Provides intellectual property for runtime programmable, high-speed, board-level memory module test functionality.</p> <p>Supports timing and algorithms for use with SRAMs, DRAMs, SDRAMs and others.</p> <p>Automates generation, assembly and verification of programmable external memory embedded test controller.</p> <p>Includes manufacturing tools for system-level test and diagnosis of board-level memories.</p>

**Products****Applications****ScanBurst**

A DFT tool developed in partnership with Mentor Graphics for improved at-speed test of high-speed nanometer SoC designs.  
 Provides comprehensive design automation for generating and integrating the on-chip distributed clock and scan control logic, which enables the application of BurstMode Timing in conjunction with Mentor's FastScan and TestKompress ATPG products.  
 Complements existing ATPG based DFT techniques by providing an environment to easily insert scan and clock control structures for at-speed testing based on LogicVision's patented BurstMode Timing technology.  
 Provides intellectual property for direct test access and isolation of legacy cores.

**Yield Insight**

Addresses memory-related yield issues by leveraging customer investment in LogicVision's Memory BIST Intellectual property.  
 Allows user to analyze yield issues down to individual memories, rows, columns and bits and correlate failures to different environmental conditions.  
 Allows user to create data-mining rules that sift through the memory test data to automatically identify potential yield limiting issues.  
 Enables users to analyze and optimize memory redundancy schemes by analyzing redundancy element utilization, resulting in higher yields and better yield-redundancy tradeoffs.  
 Provides graphical analysis and scripting capabilities that allow users to automate and standardize their yield analysis processes.

The ETAccess product sub-family consists of hardware and software products for use with third party test platforms that enable faster time-to-market and lower test costs through the support of interactive or test program-controlled at-speed testing, datalogging, and debugging of silicon incorporating LogicVision's embedded test IP. The individual products within this sub-family and their underlying capabilities are described below.

**Products****Applications****ET Diagnostics Logic**

Embedded Test Diagnostics software package or test program controlled at-speed test, debug and diagnosis of embedded logic equipped with LogicVision's Embedded Logic Test IP.  
 Supports interactive pass-fail testing and debug of logic in the design.  
 Automates the creation, modification and application of test and debug patterns on specified LVReady automated test equipment.  
 Provides manufacturing tools that reduce time-to-market for prototype integrated circuits.

**ET Diagnostics Memory**

Embedded Test Diagnostics software for either interactive or test program controlled at-speed test, debug and diagnosis of embedded memories equipped with LogicVision's Embedded Memory Test IP.  
 Supports interactive pass-fail testing and debug of only the memory in the design.  
 Automates the creation, modification and application of test and debug patterns on specified LVReady automated test equipment.  
 Provides manufacturing tools that reduce time-to-market for prototype integrated circuits.

**ET Diagnostics Mixed Signal**

Embedded Test Diagnostics software for either interactive or test program controlled at-speed test, debug and diagnosis of embedded logic equipped with LogicVision's Embedded SerDes Test or Embedded PLL Test IP.  
 Supports interactive pass-fail testing and debug of PLLs and SerDes in the design.  
 Automates the creation, modification and application of test and debug patterns on specified LVReady automated test equipment.  
 Provides manufacturing tools that reduce time-to-market for prototype integrated circuits.

**Services**

*Maintenance.* We assist our customers with telephone and on-line support, bug fixes and upgrade privileges on a when and if available basis.

*Design Services.* We assist our customers with the design and manufacturing deployment of embedded test. Our design services help our customers analyze, generate, assemble and verify embedded test circuits, and help our customers and partners rapidly adopt our technologies.

*Technology Development Contracts.* As a part of our strategy to make embedded test technology more applicable to custom designs, we enter into development contracts with industry leaders for specific projects. Our development contracts include developing new embedded test capabilities and appropriate modifications to our standard automation software. These contracts help our customers and partners to rapidly adopt our technologies.

## Customers

We license our proprietary technologies and software products to companies in key markets within the semiconductor, semiconductor diagnostics and systems industries. Our customers include application specific integrated circuit or system-on-a-chip designers in systems companies, fabless companies and integrated device manufacturers. Customers accounting for more than 10 percent of revenue are as follows:

	Year Ended December 31,		
	2006	2005	2004
Agere Systems Inc.	20%	21%	20%
Broadcom Corporation	18%	10%	7%
LSI Logic Corporation	6%	10%	3%
Matsushita Electric Industrial Co. Ltd.	4%	7%	17%

## Timing of Orders

Our past operating results have been, and we expect that our future operating results will be, subject to fluctuations due to a number of factors, including unpredictability of the buying patterns of our customers, the concentration of orders with large customers, dependence upon capital spending budgets and fluctuations in general economic conditions.

## Research and Development

Our ability to meet customer needs for improved technology, and maintain our technology leadership, depends largely on whether we can continue to rapidly develop and deploy new technology and introduce new products. We have made, and intend to continue to make, significant investments in research and development. In addition to an overall knowledge of test methodologies, embedded test requires an expertise in three diverse areas: integrated circuit design and verification, electronic design automation algorithms and software development, and software development for manufacturing test and test equipment. We have assembled a highly skilled and multi-disciplinary team for this purpose.

As of December 31, 2006 our engineering team comprised 24 employees, 13 of whom have advanced degrees, and most of whom have extensive industry experience in one or more of the aforementioned areas of expertise. Our engineering team is organized into four development groups, each focusing on one of these four areas of expertise, and each contributing the related portion to the bundled product offerings. The development groups are:

*Integrated Circuit Design* Our integrated circuit design team focuses on the overall embedded test intellectual property architecture and its implementation and verification.

*Design Software* Our design software team focuses on developing the software that analyzes, generates, assembles, and verifies an integrated circuit design with embedded test.

*Manufacturing Software* Our manufacturing software team focuses on developing software for enabling test and diagnostic in manufacturing.

*Analysis Software* Our analysis software team focuses on developing software to analyze integrated circuit test and foundry data to identify and diagnose yield issues.

In addition to the four development groups, we have product engineering teams focused on software builds and release, documentation and quality assurance.

Research and development expenses were \$4.1 million, \$5.8 million and \$5.1 million during the years ended December 31, 2006, 2005 and 2004, respectively.



## Sales and Marketing

The majority of our revenues are generated by our direct sales force. In the United States, we have sales and service offices in Boston, Massachusetts; Dallas, Texas; and San Jose, California. We also use independent sales representatives in the United States. Internationally, we have a sales and service office in Japan, while sales in other countries are handled by distributors or independent sales representatives in China, Europe, Korea and Taiwan. Information regarding geographic areas is included in Note 13 to the Consolidated Financial Statements in Item 8. Sales personnel consist of sales representatives who are responsible for all business aspects of the customer relationship and application engineers who manage the technical pre-sales as well as the post-sales customer support issues. As of December 31, 2006, we had 28 employees involved in sales, marketing, application engineering and customer service.

The main goal of our sales force is to work with major systems, consumer electronics and semiconductor companies who have the expertise to implement our technology today. We focus on leading companies because they are influential in setting standards. We focus on developing customer relationships with companies in the areas of networking and wireless communications, medical products, computer servers and graphics, and consumer electronics. Additionally, as systems companies use our technology, they often require their component suppliers to supply semiconductors with our embedded test technology already designed-in for their system use. In this way we are able to create both push and pull demand for our technology.

Our marketing efforts include product and technical marketing, public relations, corporate communications and business development functions. We strive to develop relationships with industry partners such as application specific integrated circuit suppliers, silicon foundries, electronic design automation tool suppliers, hardware tester manufacturers and intellectual property providers.

Sales and marketing expenses are allocated between cost of revenues and sales and marketing expenses. Application engineering efforts devoted to revenue-generating design and technology development projects and post-contract customer support activities are recorded as cost of revenues. Sales and marketing expenses incurred for general selling and marketing activities are recorded as sales and marketing expenses.

Sales and marketing expenses were \$7.0 million, \$7.5 million and \$6.1 million during the years ended December 31, 2006, 2005 and 2004, respectively.

## Intellectual Property

We have a portfolio of intellectual property covering the areas of test and diagnosis of logic, memory and mixed-signal circuits with focus on embedded, at-speed and parametric aspects. Both design and manufacturing methods are covered. As of December 31, 2006, our intellectual property portfolio consisted of 46 issued U.S. patents and 16 pending U.S. patent applications. Generally, the term of patent protection is 20 years from the earliest effective filing date of the patent application. Our issued patents expire at various times between June 2016 and December 2024. Our portfolio also includes two patents for testing embedded memories and digital systems which are licensed from Nortel Networks and for which we have completed royalty payments. Nevertheless, 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. Our patents, and the Nortel patents we license, cover technology intended to address problems we consider fundamental to embedded test, such as timing, power consumption and parametric testing.

Our existing and future patents may be circumvented, blocked, licensed to others or challenged as to inventorship, ownership, scope, validity or enforceability. We may not receive competitive advantages from the rights granted under our patents. Furthermore, our current or future patent applications may not be issued with the scope of the claims sought by us, if at all. In addition, others may develop technologies that are similar or superior to our proprietary technologies, duplicate our proprietary technologies or design around the patents owned or licensed by us. If our products, patents or patent applications are found to conflict with any patents held by third parties, we could be prevented from selling our products, our patents may be declared invalid or our patent applications may not result in issued patents. In addition, in foreign countries, we may not receive effective patent and trademark protection. We cannot be sure that steps we take to protect our proprietary technologies will prevent misappropriation of our technologies.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights or positions. There are numerous patents in the semiconductor industry and new patents are being issued at a rapid rate. This often results in significant and often protracted and expensive litigation. Litigation may be necessary to enforce our intellectual property rights or to determine the validity or scope of the proprietary rights of others. Litigation could cause us to incur significant expenses, harm our sales of the challenged technologies or products and divert the efforts of our technical and management personnel, whether or not a court decides in our favor. From time to time third parties may notify us of intellectual property infringement claims. If it is necessary or desirable, we may seek licenses under these third party patents or intellectual property rights. However, we cannot be sure that third parties will offer licenses to us on acceptable terms or at all.



If we fail to obtain a license from a third party for proprietary technologies that we use, or receive an adverse result in any litigation, we could incur substantial liabilities, or be compelled to suspend sales of our products or our use of processes requiring the technologies or expend significant resources to develop or acquire non-infringing technology. We may not be successful in the development or acquisition of intellectual property. To date, we have had no such litigation matters concerning intellectual property.

We generally enter into confidentiality agreements with our employees, industry partners and customers, as well as generally control access to and distribution of our documentation and other proprietary information. Despite this protection, unauthorized parties may copy aspects of our current or future software products or obtain and use information that we regard as proprietary.

## **Competition**

The semiconductor and systems industries are highly competitive and characterized by rapidly changing technology. The market for embedded test is still evolving and we expect competition to continue to emerge and become more intense in the future.

### *Design*

In the design phase of product development, we face competition from traditional broad line electronic design automation providers such as Cadence Design Systems, Inc., Magma Design Automation Inc., Mentor Graphics Corporation and Synopsys, Inc. and from smaller test tool providers. These companies provide competing design-for-test technologies and some level of built-in self-test capability. We also face competition from methodologies developed internally at large integrated device manufacturers, systems companies and electronic design automation providers.

### *Manufacturing*

Because embedded test has the potential to impact the external test market, we believe traditional hardware tester manufacturers such as Advantest Corporation, Credence Systems Corporation, Inovys Corporation, LTX Corporation, Teradyne, Inc. and Verigy Ltd. all view embedded test and LogicVision as competition. Many of these companies are devoting significant resources to developing external solutions to testing complex integrated circuits, including working closely with some of our current and potential customers. Their efforts may result in the development of solutions that compete with our embedded test solution. In addition, all of the tester manufacturers above participate in our LVReady partner program through which our embedded test access software is integrated into their test platform, which may provide them with additional insight into our business and technology.

Most of the companies with whom we compete are significantly larger than we are and have greater financial resources. As embedded test is more broadly adopted in the market, we face the potential of one or more larger companies appearing as direct competition. We believe that the principal competitive factors in our market include proven technology, effective intellectual property, deployment automation, comprehensive manufacturing control and customer service. We believe we compete favorably with respect to all these factors.

## **Employees**

As of December 31, 2006, we employed 59 full time employees worldwide, of which 35 employees were located in the United States, 17 employees were located in Canada, and 7 employees were located in Asia and Europe. This included 28 in sales and marketing, 24 in research and development, and 7 in finance, information technology and administration. Our employees are not covered by any collective bargaining agreements, and we consider our relations with our employees to be good.

## **Available Information**

Our website is <http://www.logicvision.com>. We make available free of charge, on or through our website, our annual, quarterly and current reports, and any amendments to those reports, as soon as reasonably practicable after electronically filing such reports with the Securities and Exchange Commission, or SEC. Information contained on our website is not part of this report.



**Item 1A. Risk Factors**

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

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

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

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

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

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

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

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

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

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

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

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

**We have a history of losses and an accumulated deficit of approximately \$96.1 million as of December 31, 2006. If we do not generate sufficient net revenue in the future to achieve or sustain profitability, our stock price could decline.**

We have incurred significant net losses since our inception, including losses of \$7.1 million, \$10.0 million and \$8.4 million for the years ended December 31, 2006, 2005 and 2004, respectively. At December 31, 2006, we had an accumulated deficit of approximately \$96.1 million.

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We expect our future revenues to be impacted by our long sales cycle and our revenue recognition policies, and we expect to continue to invest in our research and development projects as well as service operations required to support our business development activities. These product and business development expenditures as well as other operating expenses could continue to exceed our revenues, thus preventing us from achieving and maintaining profitability. To achieve and maintain profitability, we will need to generate and sustain substantially higher revenues while maintaining reasonable cost and expense levels. If we fail to achieve profitability within the time frame expected by securities analysts or investors and our cash balances continue to decline, the market price of our common stock will likely decline. We may not achieve profitability if our revenues do not increase or if they increase more slowly than we expect. In addition, our operating expenses are largely fixed, and any shortfall in anticipated revenues in any given period could harm our operating results.

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

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

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

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

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

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

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

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

timing, terms and conditions of customer agreements;

customers placing orders at the end of the quarter;

the mix of our license and services revenues;

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

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

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

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

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

timing and completion of milestones under customer agreements; and

market and general economic conditions.



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

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

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

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

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

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

smaller test tool providers;

potential customers that develop test solutions internally; and

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

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

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

We derive a significant portion of our revenues from a relatively small number of customers. Two customers accounted for approximately 20% and 18%, respectively, of total revenues in the year ended December 31, 2006; three customers accounted for 21%, 10% and 10%, respectively, of total revenues for the year ended December 31, 2005 and two customers accounted for 20% and 17%, respectively, of total revenues for the year ended December 31, 2004. We anticipate that we will continue to rely on a limited number of customers for a substantial portion of our future revenues and we must obtain additional large orders from customers on an ongoing basis to increase our revenues and grow our business. In addition, the loss of any significant or well-known customer could harm our operating results or our reputation. In particular, a loss of a significant customer could cause fluctuations in our results of operations because our expenses are fixed in the short term, it takes us a long time to replace customers and, because of required methods of revenue recognition, any offsetting license revenues may need to be recognized over a period of time.

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

Revenues from sales of our ETCreat products and related maintenance and training services accounted for 79%, 82% and 90% of our total revenues for the years ended December 31, 2006, 2005 and 2004, respectively. We currently expect that revenues from our ETCreat products will continue to account for a substantial percentage of our revenues in the foreseeable future and thereafter. Our future operating results are significantly dependent upon the continued market acceptance of our products. Our business will be harmed if our products do not continue to achieve market acceptance or if we fail to develop and market improvements to our products or enhancements thereof. A decline in demand for our ETCreat products as a result of competition, technological change or other factors could harm our business.

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

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

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

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

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

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

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

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

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

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

For example, the adoption of the FASB's recently issued SFAS 123(R), which requires compensation costs relating to share-based payment transactions be recognized in financial statements beginning in January 2006, had a financial impact on our results of operations and loss per share.

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

**We are exposed to risks from legislation requiring companies to evaluate their internal control over financial reporting.**

Section 404 of the Sarbanes-Oxley Act of 2002 will require our management to report on the effectiveness of our internal control over financial reporting beginning in fiscal 2007. Our independent registered public accounting firm will be required to attest to the effectiveness of our internal control over financial reporting beginning in fiscal 2008. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. We expect to incur increased expense and to devote additional management resources to Section 404 compliance. In the event our chief executive officer, chief financial officer or independent registered public accounting firm determine that our internal control over financial reporting is not effective as defined under Section 404, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.

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

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

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

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

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

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

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

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



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

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

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

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

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

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

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

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

We offer our products and services for sale through distributors and sales representatives in China, France, Germany, Israel, Korea, Taiwan and the United Kingdom (UK). We anticipate that sales in these markets will account for a portion of our total revenues in future periods. During 2004, we appointed a new distributor in Germany. In 2005, we appointed a sales representative in Israel and distributors in France and the UK. In 2006, we appointed a sales representative in India. Our third-party representatives are not obligated to continue selling our products, and they may terminate their arrangements with limited prior notice. Growing our relationship with these new distributors and sales representatives, or establishing alternative distribution channels in these markets could consume substantial management time and resources, decrease our revenues and increase our expenses.

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

International revenues accounted for 16%, 18% and 22% of our total revenues for the years ended December 31, 2006, 2005 and 2004, respectively. In addition to our international sales, we have operations in Canada, Japan and the UK. Our success depends upon continued expansion of our international operations, and we expect that international revenues will continue to be an important component of our total future revenues. Our international business involves a number of risks, including:

- our ability to adapt our products to foreign design methods and practices;
- the uncertainty of international orders due to typically lengthy international selling cycles;
- cultural differences in the conduct of business;
- difficulty in attracting qualified personnel;

managing foreign branch offices and subsidiaries;

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longer payment cycles for and greater difficulty collecting accounts receivable;

unexpected changes in regulatory requirements, royalties and withholding taxes that restrict the repatriation of earnings;

tariffs and other trade barriers;

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

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

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

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

We may expand the range of our proprietary technologies and products acquire or make investments in additional complementary businesses, technologies or products, if appropriate opportunities arise. For example, in the fourth quarter of 2004, we completed the acquisition of SiVerion, Inc. We may be unable to identify suitable acquisition or investment candidates at reasonable prices or on reasonable terms, or consummate future acquisitions or investments, each of which could slow our growth strategy. Our acquisition of SiVerion, Inc. and any future acquisitions may involve risks such as the following:

we may not achieve the anticipated benefits of the acquisitions;

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

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

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

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

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

we may be exposed to unknown liabilities of acquired companies;

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

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

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

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

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

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

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require us to seek licenses from third parties or prevent us from licensing our technology or selling our products, any of which could harm our business.

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

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

**Our stock may fail to meet the requirements for continued listing on the NASDAQ Global Market, in which case the price and liquidity of our common stock may decline.**

The NASDAQ Stock Market has quantitative maintenance criteria for the continued listing of common stock on the NASDAQ Global Market, including maintaining a minimum closing bid of \$1.00 per share. As of December 31, 2006, we were in compliance with all NASDAQ Global Market listing requirements. However, our stock price has declined significantly over the past year and experienced volatility. Our stock was priced below \$1.00 for nearly 30 trading days during November and December 2006. If the closing bid price of our common stock price falls and remains below \$1.00 per share for 30 consecutive trading days, our common stock may not remain listed on the NASDAQ Global Market. If we fail to maintain continued listing on the NASDAQ Global Market and must move to a market with less liquidity, our financial condition could be harmed and our stock price would likely decline. If we are delisted, it could have a material adverse effect on the market price of, and the liquidity of the trading market for, our common stock.

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

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

the level and timing of license and service revenues;

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

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

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

competing technological and marketing developments;

the extent of international operations;

the need to adapt to changing technologies and technical requirements;

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

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

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

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

#### **Item 1B. Unresolved Staff Comments**

None.



**Item 2. Properties**

Our principal executive offices are located in San Jose, California, where we lease approximately 18,000 square feet. We believe that these offices will be adequate to meet our requirements for the next 12 months. We have research and development offices in Ottawa, Canada. We have domestic sales and service offices in Boston, Massachusetts; and Dallas, Texas. In addition, we have an international sales and service office in Tokyo, Japan and a customer service office in London.

**Item 3. Legal Proceedings**

We are not currently a party to any material legal proceedings.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Executive Officers of the Registrant**

The following table sets forth information regarding our executive officers as of December 31, 2006:

Name	Age	Position
James T. Healy	66	President, Chief Executive Officer and a director
Farhad Hayat	50	Vice President of Marketing
Bruce M. Jaffe	62	Vice President of Finance and Chief Financial Officer
Fadi Maamari	44	Vice President of Engineering
Ronald H. Mabry	59	Vice President of Field Operations and Applications Engineering

*James T. Healy* has served as our President and Chief Executive Officer since December 2003. From July 2002 to November 2003, Mr. Healy was President of Spirox USA and Executive Vice President of Business Development and Strategic Marketing, for Spirox Corporation, a provider of semiconductor manufacturing equipment and software. From April 2000 to June 2002, Mr. Healy was President of ASAT, Inc., a provider of semiconductor design, assembly and test services. From December 1999 to March 2000, Mr. Healy served as an independent consultant to software companies. He holds a B.S. in Business and a M.S. in Psychology from California State University, Hayward.

*Farhad Hayat* has served as our Vice President of Marketing since July 2006. From 2000 to 2006, Mr. Hayat served as Vice President of Marketing for the Verification Business Unit at Synopsys, Inc., and from 1998 to 2000 he served as Senior Director of Marketing of DFT product lines at Synopsys. Prior to joining Synopsys, Mr. Hayat worked at Cadence Designs Systems in various marketing roles. He holds a B.S. and MSEE with honors from the University of Tulsa.

*Bruce M. Jaffe* has served as our Vice President of Finance and Chief Financial Officer since April 2003. From 1999 until 2006, Mr. Jaffe served as a director of Pemstar, Inc, until its sale to Benchmark Electronics. From 2000 until 2005, he also served as a director of Metron Technology N.V. until its sale to Applied Materials. During 2003-2004, he also served as a director of Southwall Technologies Inc. Mr. Jaffe holds a B.S. in Business from the University of Southern California and is a certified public accountant. Mr. Jaffe currently serves on the Board of Advisors for the University of Southern California School of Business.

*Fadi Maamari* has served as our Vice President of Engineering since June 2006. From 1996 to 2006, he has worked at LogicVision, where he has held senior management positions in Applications Engineering and Marketing. From 1990 to 1996, Dr. Maamari was a member of Technical Staff at AT&T Bell Labs Engineering Research Center in Princeton, New Jersey. He holds a Ph.D. in Electrical Engineering from McGill University, and M.S. and B.S. degrees from École Polytechnique in Montreal, Canada.

*Ronald H. Mabry* has served as our Vice President of Field Operations and Applications Engineering since June 2005. From July 2003 to June 2005, Mr. Mabry was our Vice President of Marketing and Business Development. From 2002 to June 2003, Mr. Mabry was Vice President of Sales and Marketing of Pact XPP Technologies, Inc., a provider of intellectual property cores for integration into systems-on-chip and application specific systems-on-chip. From 2000 until 2001, Mr. Mabry served as Chief Marketing Officer of eChips, Inc., an internet distributor of semiconductor chips and provider of technical content.

## PART II

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock, par value \$0.0001 ( Common Stock ), is traded on the NASDAQ Global Market ( Nasdaq ) under the symbol LGVN. The following table sets forth, for the periods indicated, the range of high and low sales prices for the Common Stock on Nasdaq, as reported in its consolidated transaction reporting system.

	<u>High</u>	<u>Low</u>
<b>2006</b>		
Fourth Quarter	\$ 1.39	\$ 0.83
Third Quarter	\$ 1.75	\$ 1.17
Second Quarter	\$ 1.95	\$ 1.38
First Quarter	\$ 1.52	\$ 1.10
<b>2005</b>		
Fourth Quarter	\$ 2.24	\$ 0.98
Third Quarter	\$ 2.63	\$ 1.74
Second Quarter	\$ 2.66	\$ 1.60
First Quarter	\$ 3.10	\$ 2.26

As of February 28, 2007, our Common Stock was held by 78 stockholders of record. Because many of the shares of our Common Stock are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of beneficial owners represented by these stockholders of record. We have never declared or paid dividends on our capital stock and do not currently intend to pay any cash dividends on our Common Stock in the foreseeable future. We expect to retain future earnings, if any, to fund the development and growth of our business. Our board of directors will determine the amount and timing of future dividends, if any. Our current bank loan agreement prohibits the payment of cash dividends without the approval of the bank.



**Item 6. Selected Financial Data**

The following selected consolidated financial data are qualified by reference to, and should be read in conjunction with, Management's Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related Notes included in Item 8 of this Report. The selected consolidated balance sheet data as of December 31, 2006 and 2005 and selected consolidated statements of operations data for the years ended December 31, 2006, 2005 and 2004, are derived from our audited consolidated financial statements included elsewhere in this Report. The selected consolidated balance sheet data as of December 31, 2004, 2003 and 2002 and the selected consolidated statements of operations data for the years ended December 31, 2003 and 2002 were derived from audited consolidated financial statements not included in this Report. Our historical results are not necessarily indicative of our future results.

	Years Ended December 31,				
	2006 <sup>(2)</sup>	2005	2004	2003	2002
(in thousands, except per share data)					
<b>Consolidated statements of operations data</b>					
Revenues:					
License	\$ 4,984	\$ 6,735	\$ 5,686	\$ 4,740	\$ 10,247
Service	5,350	3,951	4,095	3,987	5,308
Product	183	196	313	275	
<b>Total revenues</b>	<b>10,517</b>	<b>10,882</b>	<b>10,094</b>	<b>9,002</b>	<b>15,555</b>
Cost of revenues:					
License	1,006	916	323	186	962
Service	1,887	2,116	2,616	2,480	3,452
Product		88	299	100	
<b>Total cost of revenues</b>	<b>2,893</b>	<b>3,120</b>	<b>3,238</b>	<b>2,766</b>	<b>4,414</b>
<b>Gross profit</b>	<b>7,624</b>	<b>7,762</b>	<b>6,856</b>	<b>6,236</b>	<b>11,141</b>
Operating expenses:					
Research and development	4,133	5,848	5,111	4,971	5,408
Sales and marketing	7,032	7,517	6,075	9,556	10,757
General and administrative	3,718	4,725	4,386	4,279	4,490
<b>Total operating expenses</b>	<b>14,883</b>	<b>18,090</b>	<b>15,572</b>	<b>18,806</b>	<b>20,655</b>
Loss from operations	(7,259)	(10,328)	(8,716)	(12,570)	(9,514)
Interest income	316	286	383	655	1,099
Other income (expense), net			12	(11)	24
Loss before provision (benefit) for income taxes	(6,943)	(10,042)	(8,321)	(11,926)	(8,391)
Provision (benefit) for income taxes	144	(69)	67	89	113
<b>Net loss</b>	<b>\$ (7,087)</b>	<b>\$ (9,973)</b>	<b>\$ (8,388)</b>	<b>\$ (12,015)</b>	<b>\$ (8,504)</b>
<b>Net loss per share, basic and diluted<sup>(1)</sup></b>	<b>\$ (0.36)</b>	<b>\$ (0.53)</b>	<b>\$ (0.51)</b>	<b>\$ (0.78)</b>	<b>\$ (0.57)</b>
<b>Weighted average common shares, basic and diluted<sup>(1)</sup></b>	<b>19,649</b>	<b>18,677</b>	<b>16,338</b>	<b>15,495</b>	<b>15,002</b>

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- (1) The diluted net loss per share computation excludes potential shares of common stock (options and warrants to purchase common stock), as their effect would be antidilutive.
  - (2) The Company adopted SFAS 123(R) effective January 1, 2006.

	December 31,				
	2006	2005	2004	2003	2002
	(in thousands)				
<b>Consolidated balance sheet data</b>					
Cash and cash equivalents and short-term investments	\$ 9,242	\$ 10,696	\$ 21,342	\$ 19,257	\$ 23,171
Marketable securities			4,960	11,801	18,390
Working capital	3,678	7,456 <sup>(1)</sup>	11,554 <sup>(1)</sup>	15,639	17,055
Total assets	19,491	24,341	39,243	36,495	46,525
Short-term debt			3,500		2,500
Total stockholders' equity	11,801	15,438	24,808	27,151	37,795

(1) Certain reclassifications have been made to prior year amounts in order to conform to the current year presentation.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with Selected Financial Data and the Consolidated Financial Statements and related Notes included elsewhere in this Report.

### Overview

#### General

We are a test and yield learning company in the semiconductor design-for-manufacturing, or DFM, sector. Our proprietary technologies for embedded test and diagnostics enable the more efficient test of complex semiconductor devices. Our technology allows semiconductor designers to insert test structures inside semiconductor integrated circuits. These test structures allow designers and engineers to test the functionality and performance of their devices throughout each key stage of a complex semiconductor's life cycle. The most complex of these circuits are called System-on-a-Chip, or SoC, semiconductors. Our embedded test solution has been successfully deployed in SoC's found in digital consumer products, medical products, networking and wireless communications devices, computers and satellite systems.

Our solution also allows testing of integrated circuits after they have been assembled onto boards and systems, enabling diagnostic test throughout the semiconductor's life cycle. Our analysis software aggregates and analyzes data from various semiconductor fabrication and test sources to identify whether silicon behavior meets design criteria across varying manufacturing and operating conditions. 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 and manufacturing yield issues.

We believe our products can reduce semiconductor manufacturing and test costs, accelerate silicon bring-up times, provide for yield learning, improve time-to-yield and result in less field returns. The target market for our technology is SoC designs with feature widths of 130 nanometers, 90 nanometers, 65 nanometers and smaller. A nanometer is one billionth of a meter.

Our customers include application specific integrated circuit or system-on-a-chip designers in systems companies, fabless companies and integrated device manufacturers that use our technology in their application specific integrated circuits or systems-on-a-chip as part of systems development and for complex chip development and testing. We license our intellectual property and software through our direct sales force in the United States and Japan, and through our distributors or independent sales representatives in China, Europe, Korea and Taiwan.

We have elected to focus our sales and marketing efforts on larger customers with greater resources. Such large customers 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 received new orders of \$9.9 million in 2006 compared to \$13.5 million in 2005. This decrease in new orders was primarily due to the receipt of large multi-year orders in 2005 from domestic customers. We expect receipt of new orders to fluctuate due to the lengthy sales cycles and our dependence on large orders. Our backlog, including deferred revenues, of orders which are expected to be recognized as revenue over the 12 months following December 31, 2006, was \$8.3 million at December 31, 2006, compared with \$7.2 million at the end of 2005. Backlog is comprised of deferred revenues (orders which have been billed but for which revenue has not yet been recognized) plus written purchase

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orders which have been accepted but have not yet been billed and for which no revenue has been recognized. A significant portion of the orders which have been accepted but have not yet been billed provides customers with cancellation rights and customers may also renew contracts before their expiration or modify that portion of their orders which is cancelable. Therefore, our backlog at any particular date is not necessarily indicative of revenues to be recognized during any succeeding period.

## **Restructuring**

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

## **Acquisition**

In November 2004, we completed the acquisition of SiVerion, Inc. for a total purchase price of \$7.4 million. At the closing we paid \$1.4 million in cash and issued 2 million shares of our common stock valued at \$3.4 million to SiVerion's stockholders and paid \$0.6 million to certain debt holders. The purchase price also included a contingent payment of up to \$2 million in cash payable on November 5, 2006 (the Additional Cash Exchange Rights) if the average closing price of our common stock for the 10 trading days immediately prior thereto was less than \$3.00.

On June 27, 2006, the Company issued 1,070,499 shares of common stock to certain former stockholders of SiVerion, Inc. in exchange for the Additional Cash Exchange Rights held by those former stockholders. In November 2006, we paid an aggregate amount of \$148,000 to the remaining former SiVerion, Inc. stockholders who held Additional Cash Exchange Rights in satisfaction of our contingent obligation.

## **Critical Accounting Policies and Estimates**

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

Our discussion and analysis of our financial condition and results of operations are based upon our 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, long-term service contracts, and contingencies. 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.

### *Revenue Recognition*

We account for our revenue under the provisions of Statement of Position 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions.

We derive our revenues from three primary sources: license revenues, comprised of fees associated with the licensing of software; service revenues, from maintenance and consulting and training services; and product revenues, from the sale of hardware products. Revenue is recognized when persuasive evidence of an arrangement exists, all obligations have been performed pursuant to the terms of such an arrangement, the product has been delivered, the fee is fixed or determinable and the collection of the resulting receivable is reasonably assured. If any of these criteria are not met, we defer revenue recognition until such time as all criteria are met. Payments received in advance of revenues being recognized are presented as deferred revenue.

*License revenues.* We have three license types:

Subscription licenses subscription licenses include software licenses and maintenance for a specific time period, generally three years or less. Maintenance is bundled into the license agreement for the term of the license and is not charged separately. Since vendor-specific objective evidence, or VSOE, of fair value does not exist for each element of the arrangement, revenues from subscription licenses are recognized ratably over the license term commencing upon the effective date of the license, if delivery and other revenue recognition criteria are met.

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**Term licenses** term licenses include software licenses for a specific time period, generally three to five years. Revenues associated with term licenses are recognized on the effective date of the license, if delivery and other revenue recognition criteria are met. Maintenance agreements for term licenses are sold separately for a specified period and may continue to be renewed for the balance of the license term.

**Perpetual licenses** perpetual licenses consist of software licensed on a perpetual basis. Revenues associated with perpetual licenses are recognized on the effective date of the license, if delivery has occurred and other revenue recognition criteria are met. We no longer offer this type of license.

The timing of revenue recognition for licenses will differ depending on the license type and on the individual terms and conditions associated with each particular license agreement. We use VSOE of fair value to allocate the total fee among all delivered and undelivered elements in those arrangements which contain multiple elements. If the arrangement includes the future delivery of a specified product or upgrade, all revenues under the arrangement are deferred until the specified product or upgrade has been delivered. If VSOE does not exist for one or more delivered elements, we apply the residual method of accounting to the delivered elements. Under the residual method, we defer the VSOE of the fair value of the undelivered elements and recognize revenue on the remaining portion of the arrangement. VSOE for maintenance is generally based upon the customer's annual renewal rates as set forth in the license agreement. When VSOE for maintenance cannot be established, we recognize all related revenues ratably over the term of our maintenance obligation. VSOE for services is generally based on the price charged when the services are sold separately. The timing of revenue recognition for both delivered and undelivered elements is in accordance with the relevant provisions of SOP 97-2.

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 we recognize revenue when the payment is due.

**Service revenues.** We recognize maintenance revenue ratably over the maintenance period. Customers generally renew maintenance agreements for term and perpetual licenses annually. We allocate a portion of the subscription license revenue to maintenance revenue using the estimated fair value of the maintenance, which is based on maintenance renewals sold separately for similar products.

We generally recognize consulting service revenues as the services are performed or when specified milestones are met. Training revenues are recognized when the training is performed.

**Product revenues.** Our hardware products are generally sold together with a subscription license for software; therefore, we have been unable to establish VSOE for the product when sold separately. Product revenues are generally recognized ratably over the term of the subscription license sold together with the product commencing upon delivery of the product if other revenue recognition criteria are met.

**Deferred revenue.** Deferred revenue consists primarily of unearned license revenues and maintenance and support services under maintenance contracts. Deferred revenue represents the excess of amounts invoiced or received over the revenue recognized. Deferred revenue fluctuates at each period end based on invoice terms and the mix of contracts.

### *Allowance for Doubtful Accounts*

We make ongoing assumptions relating to the credit worthiness of our customers in estimating our allowance for doubtful accounts. 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.

### *Valuation of Investments*

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.

### *Goodwill impairment*

Our long-lived assets include goodwill and other intangible assets. Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, requires that goodwill be tested for impairment at the reporting unit level (operating segment or one level below an operating segment) on an annual basis and between annual tests in certain circumstances. Application of the goodwill impairment test requires

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judgment, including the identification of reporting units, assigning assets and liabilities to reporting units, assigning goodwill to reporting units, and determining the fair value of the reporting unit.

Significant judgments required to estimate the fair value of a reporting unit include estimating future cash flows, determining appropriate discount rates and other assumptions. Changes in these estimates and assumptions could materially affect the determination of fair value for the reporting unit. Any impairment losses recorded in the future could have a material adverse impact on our financial condition and results of operations.

*Valuation of long-lived intangible assets*

Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, requires that we record an impairment charge on finite-lived intangibles or long-lived assets to be held and used when we determine that the carrying value of intangible assets and long-lived assets may not be recoverable. Based on the existence of one or more indicators of impairment, we measure any impairment of intangibles or long-lived assets based on a projected discounted cash flow method using a discount rate determined by our management to be commensurate with the risk inherent in our business model. Our estimates of cash flows require significant judgment based on our historical results and anticipated results and are subject to many factors.

*Accounting for Stock-Based Compensation.*

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

We adopted SFAS 123(R) using the modified prospective transition method. Our Consolidated Financial Statements as of December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was \$376,000, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases. No stock-based compensation expense related to employee stock options and employee stock purchases was recognized for the years ended December 31, 2005 or 2004.

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

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

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



term of our equity awards. We do not anticipate paying any cash dividends in the foreseeable future and therefore used an expected dividend yield of zero.

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For further information on stock-based compensation, see Note 9 of the Notes to the Consolidated Financial Statements.

### Accounting for Income Taxes

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.

### Results of Operations

The table below sets forth the fluctuations in revenues, cost of revenues and gross profit data from 2006 to 2005 and 2005 to 2004 (in thousands, except percentage data):

	Year ended December 31,			% change	
	2006	2005	2004	2006/2005	2005/2004
<b>Revenues:</b>					
License	\$ 4,984	\$ 6,735	\$ 5,686	-26.0%	18.4%
Service	5,350	3,951	4,095	35.4%	-3.5%
Product	183	196	313	-6.6%	-37.4%
<b>Total revenues</b>	<b>10,517</b>	<b>10,882</b>	<b>10,094</b>	<b>-3.4%</b>	<b>7.8%</b>
<b>Cost of revenues:</b>					
License	1,006	916	323	9.8%	183.6%
Service	1,887	2,116	2,616	-10.8%	-19.1%
Product		88	299	-100.0%	-70.6%
<b>Total cost of revenues</b>	<b>2,893</b>	<b>3,120</b>	<b>3,238</b>	<b>-7.3%</b>	<b>-3.6%</b>
<b>Gross profit</b>	<b>\$ 7,624</b>	<b>\$ 7,762</b>	<b>\$ 6,856</b>	<b>-1.8%</b>	<b>13.2%</b>
<b>Percentage of total revenues:</b>					
<b>Revenues:</b>					
License	47%	62%	56%		
Service	51%	36%	41%		
Product	2%	2%	3%		
<b>Total revenues</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>		
<b>Cost of revenues:</b>					
License	10%	8%	3%		
Service	18%	20%	26%		
Product	0%	1%	3%		
<b>Total cost of revenues</b>	<b>28%</b>	<b>29%</b>	<b>32%</b>		
<b>Gross profit</b>	<b>72%</b>	<b>71%</b>	<b>68%</b>		

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### *Total revenues*

Total revenues decreased in 2006 compared to 2005 primarily due to decreased new orders during the year. This decrease was primarily due to the receipt of large multi-year orders in 2005 from domestic customers. Service revenues were higher, and license revenues lower, because a higher percentage of certain large orders were allocated based on the number of license seats assigned to those orders.

Total revenues increased in 2005 compared to 2004 primarily due to increases in license revenues of \$1.0 million. This increase was primarily attributable to domestic customers. Products comprising ETAccess accounted for most of this increase.

### *Total cost of revenues*

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

Total cost of revenues decreased in 2006 compared to 2005 primarily due to a decrease in cost of service that resulted from less time spent on post contract customer support and consulting services. Cost of product decreased because the inventory of \$0.1 million was sold that was fully reserved in previous years.

Total cost of revenues decreased in 2005 compared to 2004. Licensing costs increased by \$0.6 million due to amortization of costs of technology incorporated into our ETCreat product. Service and product costs decreased by \$0.7 million, due in part to the establishment of an inventory reserve in 2004 to reflect current market conditions for our Validator product. Cost of post contract customer support also declined.

### **Revenues by product line and country**

The table below sets forth the fluctuations in revenues by product line and geographic region for the year ended December 31, 2006, 2005 and 2004 (in thousands, except percentage data):

	Year ended December 31,			% change	
	2006	2005	2004	2006/2005	2005/2004
<b>Revenue by product line:</b>					
ETCreate	\$ 8,320	\$ 8,911	\$ 9,112	-6.6%	-2.2%
ETAccess	2,063	1,882	982	9.6%	91.6%
SiVision	134	89		50.6%	100%
<b>Total revenues</b>	<b>\$ 10,517</b>	<b>\$ 10,882</b>	<b>\$ 10,094</b>	<b>-3.4%</b>	<b>7.8%</b>
<b>Revenue by geographic region:</b>					
United States	\$ 8,827	\$ 8,877	\$ 7,874	-0.6%	12.7%
Japan	1,176	1,348	2,096	-12.8%	-35.7%
Rest of the World	514	657	124	-21.8%	429.8%
<b>Total revenues</b>	<b>\$ 10,517</b>	<b>\$ 10,882</b>	<b>\$ 10,094</b>	<b>-3.4%</b>	<b>7.8%</b>
<b>Percentage of total revenues:</b>					
<b>Revenue by product line:</b>					
ETCreate	79%	82%	90%		
ETAccess	20%	17%	10%		
SiVision	1%	1%	0%		
<b>Total revenues</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>		
<b>Revenue by geographic region:</b>					

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United States	84%	82%	78%
Japan	11%	12%	21%
Rest of the World	5%	6%	1%
	<hr/>	<hr/>	<hr/>
Total revenues	100%	100%	100%
	<hr/>	<hr/>	<hr/>

*Product line:*

**ETCreate** is the product sub-family formerly known as icBIST, which consists of embedded test intellectual property and corresponding design automation software that provides embedded test solutions for different components of an ASIC or SOC design.

ETCreate revenue decreased in 2006 compared to 2005, and 2005 compared to 2004 due to lower license revenues from customers in Japan.

**ETAccess** is the product sub-family which consists of hardware and software products for use with third party test platforms. ETAccess enables faster time-to-market and lower test costs through the support of interactive or test program controlled at-speed testing, datalogging, and debug of silicon designed with LogicVision's embedded test IP.

ETAccess revenue increased in 2006 compared to 2005, and increased in 2005 compared to 2004, primarily as the product began to obtain customer acceptance.

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

*Geographic region:*

Revenue in the United States increased as a percentage of total rev

Revenue in the United States increased as a percentage of total revenue in 2006 compared to 2005, primarily due to revenues from new customers. Revenue in Japan decreased as a percentage of total revenue in 2006 compared to 2005 primarily due to lower revenues from existing customers.

Revenue in the United States and Rest of the World increased as a percentage of total revenue in 2005 compared to 2004, primarily due to revenues from new customers. Revenue in Japan decreased as a percentage of total revenue in 2005 compared to 2004 primarily due to lower revenues from existing customers.

**Operating Expenses:**

The table below sets forth operating expense data from 2006 to 2005 and 2005 to 2004 (in thousands, except percentage data):

	Year ended December 31,			% change	
	2006	2005	2004	2006/2005	2005/2004
<b>Operating expenses:</b>					
Research and development	\$ 4,133	\$ 5,848	\$ 5,111	-29.3%	14.4%
Sales and marketing	7,032	7,517	6,075	-6.5%	23.7%
General and administrative	3,718	4,725	4,386	-21.3%	7.7%
<b>Total operating expenses</b>	<b>\$ 14,883</b>	<b>\$ 18,090</b>	<b>\$ 15,572</b>	<b>-17.7%</b>	<b>16.2%</b>
<b>Percentage of total revenues:</b>					
<b>Operating expenses:</b>					
Research and development	39%	54%	51%		
Sales and marketing	67%	69%	60%		
General and administrative	36%	43%	43%		
<b>Total operating expenses</b>	<b>142%</b>	<b>166%</b>	<b>154%</b>		

*Research and development*

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

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Research and development expenses decreased in 2006 compared with 2005 primarily due to decreases in compensation related expenses and facility expenses of \$1.2 million resulting from the November 2005 restructuring, \$0.4 million of reduced business consulting expenses, and lower amortization of intangible assets of \$0.1 million.

Research and development expenses increased in 2005 compared with 2004 primarily due to increases in compensation related expenses of \$0.3 million resulting from the SiVerion acquisition and \$0.2 million from the restructuring in November 2005, amortization of intangible assets of \$0.1 million resulting from the SiVerion acquisition, and facility expense of \$0.1 million resulting from closing of the Montreal and India offices as part of the November 2005 restructuring.

### *Sales and marketing*

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

Sales and marketing expenses decreased in 2006 compared to 2005 primarily due to a decrease in employee related expenses of \$0.2 million resulting from the November 2005 restructuring, lower business consulting expenses of \$0.2 million, and lower trade show and other promotional expenses of \$0.1 million.

Sales and marketing expenses increased in 2005 compared to 2004 primarily due to an increase in employee related expenses of \$0.6 million resulting from headcount increases during the year, higher business consulting expense of \$0.2 million, higher trade show and other promotional expenses of \$0.1 million and increased other expenses of \$0.5 million.

### *General and administrative*

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

General and administrative expenses decreased in 2006 compared to 2005 primarily due to a \$0.9 million decrease in compensation related expenses primarily due to the November 2005 restructuring.

General and administrative expenses increased in 2005 compared to 2004 primarily due to a \$0.3 million increase in employee related expenses primarily due to the severance expense accrued in connection with the November 2005 restructuring.

### **Other Items:**

The table below sets forth other data from 2006 to 2005 and 2005 to 2004 (in thousands, except percentage data):

	Year ended December 31,			% change	
	2006	2005	2004	2006/2005	2005/2004
Interest and other income, net	\$ 316	\$ 286	\$ 395	10.5%	-27.6%
Provision (benefit) for income taxes	\$ 144	\$ (69)	\$ 67	NM	NM
<b>Percentage of total revenues:</b>					
Interest and other income, net	3%	3%	4%		
Provision (benefit) for income taxes	1%	-1%	1%		

### *Interest income*

Interest income increased in 2006 compared with 2005 primarily due to reduced interest expense from our line of credit; interest income decreased in 2005 compared with 2004 primarily due to reduced interest income resulting from lower investment balances even while yields on our investments were improving.

*Income taxes*

Our net operating losses are generated domestically, and amounts attributed to our foreign operations have been insignificant for all periods presented. In 2006 and 2004, we recorded an income tax provision of \$144,000 and \$67,000, respectively, primarily related to foreign income taxes. In 2005 we recorded income tax benefits of \$69,000 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, 2006, we incurred net losses for federal and state tax purposes. As of December 31, 2006, we had federal and California net operating loss carryforwards of approximately \$85.1 million and \$26.0 million available to reduce future federal and California taxable income, respectively. These federal and California carryforwards will begin to expire in 2007 if not utilized. The extent to which these carryforwards can be used to offset future taxable income may be limited under Section 382 of the Internal Revenue Code and applicable state tax law.

**Liquidity and Capital Resources**

At December 31, 2006, we had cash and cash equivalents and investments of \$9.2 million and working capital of \$3.7 million.

Net cash used in operating activities was \$4.3 million in 2006, \$11.9 million in 2005, and \$6.0 million in 2004. Net cash used in operating activities for 2006 was primarily due to a net loss of \$7.1 million, a decrease in deferred revenue \$1.3 million and a decrease in accounts payable \$0.2 million. This was partly offset by a decrease in accounts receivable of \$1.9 million, a decrease in prepaid expenses and other assets of \$0.9 million, an increase in accrued liabilities of \$0.3 million, and non-cash charges relating to depreciation and amortization of property and equipment and stock-based compensation totaling \$1.2 million. Net cash used in operating activities for 2005 was primarily due to a net loss of \$10.0 million, an increase in accounts receivable of \$1.4 million resulting from the timing of customer billings, a decrease in accrued liabilities of \$0.7 million, primarily from decreases of accrued employee compensation and deferred revenue of \$1.3 million. This was partly offset by a decrease in other assets of \$0.7 million resulting from amortization of a prepaid license we purchased in 2004, and non-cash charges relating to depreciation and amortization of property and equipment of \$0.9 million. Net cash used in operating activities for 2004 was primarily due to a net loss of \$8.4 million, an increase in other assets of \$1.3 million resulting from a prepaid license fee for technology incorporated in our LV 2004™ product and a decrease in accounts payable of \$0.3 million. This was partly offset by a decrease in accounts receivable of \$1.6 million resulting from the timing of customer billings, an increase in accrued liabilities of \$1.0 million, primarily due to accrued employee compensation, an increase in deferred revenue of \$0.9 million resulting from customer billings in advance of revenue recognition, and non-cash charges relating to depreciation and amortization of \$0.7 million.

Net cash provided by investing activities was \$4.6 million in 2006 and \$12.6 million in 2005. Net cash used in investing activities was \$2.5 million in 2004. Net cash provided by investing activities for 2006 was primarily from proceeds from maturities of investments of \$9.8 million, partly offset by purchases of investments of \$4.9 million and purchases of property and equipment of \$0.2 million. Net cash provided by investing activities for 2005 was primarily from proceeds from maturities of investments of \$18.5 million, partly offset by purchases of investments of \$5.1 million and purchases of property and equipment of \$0.8 million. Net cash used in investing activities for 2004 was primarily due to purchases of investments of \$13.9 million, cash payments related to the SiVerion acquisition of \$2.3 million, and purchases of property and equipment of \$0.6 million. This was offset by the proceeds from maturities of investments of \$14.3 million.

Net cash provided by financing activities was \$3.2 million in 2006. Net cash used in financing activities was \$2.8 million in 2005 and net cash provided by financing activities was \$4.2 million in 2004. Net cash provided by financing activities for 2006 was primarily from the sale in a private placement of 4.0 million shares of common stock in December 2006. Net cash used in financing activities for 2005 was primarily due to repayment of short-term debt of \$4.5 million, partly offset by net proceeds of \$0.7 million received from the employee stock purchase plan purchases and issuance of common stock pursuant to exercise of employee stock options, and proceeds of \$1.0 million borrowed under our line of credit. Net cash provided by financing activities for 2004 was due to the proceeds from short-term debt of \$3.5 million, and proceeds from issuance of common stock pursuant employee stock purchase plan purchases and exercise of employee stock options of \$0.7 million.

We have a loan agreement with a bank under which we previously could have borrowed, on a revolving basis, up to \$1.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 8.25% at December 31, 2006. 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. There were no borrowings outstanding under this agreement at December 31, 2006. We were in compliance with the covenants under the loan agreement at that date. The agreement was amended subsequent to the end of the year and now expires on February 28, 2008.



We intend to continue to invest in the development of new products and enhancements to our existing products. Our future liquidity and capital requirements will depend upon numerous factors, including the costs and timing of product development efforts and the success of these development efforts, the costs and timing of sales and marketing 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.

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

*Contractual Obligations and Other Commercial Commitments*

At December 31 2006, our contractual obligations and commercial commitments, primarily under operating lease arrangements for our facilities, were as follows (in thousands):

Year ending December 31,	
2007	\$ 734
2008	697
2009	706
2010	264
2011	68
	\$ 2,469

The above amounts include amounts for rent and estimated operating expenses required under the property leases.

*Indemnification Obligations*

We enter into standard license agreements in the ordinary course of business. Pursuant to these agreements, we agree to indemnify our customers for losses suffered or incurred by them as a result of any patent, copyright, or other intellectual property infringement claim by any third party with respect to our products. These indemnification obligations have perpetual terms. Our normal business practice is to limit the maximum amount of indemnification to the amount received from the customer. On occasion, the maximum amount of indemnification we may be required to make may exceed our normal business practices. We estimate the fair value of our indemnification obligations as insignificant, based upon our historical experience concerning product and patent infringement claims. Accordingly, we have not recorded any liabilities for indemnification under these agreements as of December 31, 2006.

We have agreements whereby our officers and directors are indemnified for certain events or occurrences while the officer or director is, or was, serving at our request in such capacity. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have a directors and officers insurance policy that reduces our exposure and enables us to recover a portion of future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of December 31, 2006.

We entered into a Registration Rights Agreement with the purchasers in the private placement of common stock. Pursuant to the Registration Rights Agreement, we filed a registration statement with the Securities and Exchange Commission and agreed to keep it effective for up to two years. In the event the registration statement becomes unavailable for use for greater than 30 consecutive days or for a total of 60 days or more during any 12 month period in which we are required to keep the registration statement effective, then we must pay to each purchaser in cash 2.0% of the portion of the purchase price paid by such purchaser for common stock in the private placement, for each 30-day period or pro rata for any portion thereof, up to 10% of the purchase price paid by such purchaser.

### *Warranties*

We offer our customers a warranty that our products will conform to the documentation provided with the products. To date, there have been no payments or material costs incurred related to fulfilling these warranty obligations. Accordingly, we have no liabilities recorded for these warranties as of December 31, 2006. We assess the need for a warranty reserve on a quarterly basis, and there can be no guarantee that a warranty reserve will not become necessary in the future.

### **Recent Accounting Pronouncements**

In November 2005, the FASB issued FASB Staff Position (FSP) FAS 123 (R)-3, *Transition Election Related to Accounting for the Tax Effects of Share Based Payment Awards*, which allowed a one-time election to adopt one of two acceptable methodologies for calculating the initial additional paid in capital (APIC) pool. In subsequent periods, the APIC pool will be increased by tax benefits from stock-based compensation and decreased by tax deficiencies caused when the recorded stock-based compensation for book purposes exceeds the allowable tax deduction. We have elected the short-cut method to establish the APIC pool required under FAS 123 (R) for fiscal year ended December 31, 2006.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of adopting FIN 48 on our consolidated financial statements.

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* (SFAS 157). The standard provides guidance for using fair value to measure assets and liabilities. The standard also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS 157 must be adopted prospectively as of the beginning of the year it is initially applied. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are still evaluating the impact this standard will have on our financial position or results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements* (SAB 108). SAB 108 addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements. SAB 108 requires an entity to quantify misstatements using a balance sheet and income-statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. The guidance is applicable for fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our consolidated financial statements.

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 creates a fair value option under which an entity may elect to record certain financial assets or liabilities at fair value upon their initial recognition. Subsequent changes in fair value would be recognized in earnings as those changes occur. The election of the fair value option would be made on a contract-by contract basis and would need to be supported by concurrent documentation or a preexisting documented policy. SFAS 159 requires an entity to separately disclose the fair value of these items on the balance sheet or in the footnotes to the financial statements and to provide information that would allow the financial statement user to understand the impact on earnings from changes in the fair value. SFAS 159 is effective for us beginning with fiscal year 2008. We are currently evaluating the impact that the adoption of SFAS 159 will have on our consolidated financial statements.

### **Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

#### **Foreign Currency Fluctuations**

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



### **Interest Rate Risk**

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

Investments in both fixed and floating rate interest-earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to rising interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. A hypothetical 100 basis point increase in interest rates would not result in any significant decline in the fair value of our available-for-sale securities at December 31, 2006.

Investments are classified as available for sale and cost of securities sold is based on the specific identification method. At December 31, 2006, we had short-term U.S. government securities and commercial paper of \$2.2 million.

**Item 8. Financial Statements and Supplementary Data**

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Financial statement schedules not listed above are either omitted because they are not applicable or the required information is shown in the Consolidated Financial Statements or in the Notes thereto.

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of LogicVision, Inc.:

We have audited the accompanying consolidated balance sheet of LogicVision, Inc. and its subsidiaries ( the Company ) as of December 31, 2006 and the related statements of operations, stockholders' equity and comprehensive loss, and cash flows for the year then ended. Our audit also included the financial statement schedule listed in Item 15(a) (2) as of and for the year ended December 31, 2006. These consolidated financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial statement schedule based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor have we been engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of LogicVision, Inc. and its subsidiaries as of December 31, 2006 and the results of their operations and their cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the related financial statement schedule, as of and for the year ended December 31, 2006, when considered in relation to the consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 2 and Note 9 to the consolidated financial statements, on January 1, 2006 the Company changed its method of accounting for stock-based compensation in accordance with guidance provided in Statement of Financial Accounting Standards No. 123(R), Share Based Payment applying the modified prospective method.

/s/ Burr, Pilger & Mayer LLP

Palo Alto, California  
March 9, 2007

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of LogicVision, Inc.:

In our opinion, the consolidated balance sheet as of December 31, 2005 and the related consolidated statements of operations, stockholders equity and comprehensive loss and cash flows for each of the two years in the period ended December 31, 2005 present fairly, in all material respects, the financial position of LogicVision, Inc. and its subsidiaries at December 31, 2005, and the results of their operations and their cash flows for each of the two years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule for each of the two years in the period ended December 31, 2005 presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and the financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and the financial statement schedule based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

/s/ PricewaterhouseCoopers LLP

San Jose, California  
March 31, 2006

## LOGICVISION, INC.

**CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share and per share data)

	December 31,	
	2006	2005
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 7,087	\$ 3,620
Short-term investments	2,155	7,076
Accounts receivable, net of allowance for doubtful accounts of \$6 and \$25, respectively	615	2,512
Prepaid expenses and other current assets	1,226	1,544
	<u>11,083</u>	<u>14,752</u>
Total current assets	11,083	14,752
Property and equipment, net	743	1,097
Intangible assets, net	178	464
Goodwill	6,846	6,846
Other long-term assets, net	641	1,182
	<u>19,491</u>	<u>24,341</u>
Total assets	\$ 19,491	\$ 24,341
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current Liabilities:		
Accounts payable	308	484
Accrued liabilities and restructuring charges	2,008	1,702
Deferred revenue, current portion	5,089	5,110
	<u>7,405</u>	<u>7,296</u>
Total current liabilities	7,405	7,296
Deferred revenue	285	1,607
	<u>7,690</u>	<u>8,903</u>
Total liabilities	7,690	8,903
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: 24,081,000 shares at December 31, 2006 and 18,892,000 shares at December 31, 2005		
	2	2
Additional paid-in capital	107,860	104,417
Accumulated other comprehensive income (loss)		(7)
Accumulated deficit	(96,061)	(88,974)
	<u>11,801</u>	<u>15,438</u>
Total stockholders' equity	11,801	15,438
Total liabilities and stockholders' equity	\$ 19,491	\$ 24,341

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



## LOGICVISION, INC.

**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)

	Year Ended December 31,		
	2006	2005	2004
<b>Revenues:</b>			
License	\$ 4,984	\$ 6,735	\$ 5,686
Service	5,350	3,951	4,095
Product	183	196	313
<b>Total revenues</b>	<b>10,517</b>	<b>10,882</b>	<b>10,094</b>
<b>Cost of revenues:</b>			
License	1,006	916	323
Service	1,887	2,116	2,616
Product		88	299
<b>Total cost of revenues</b>	<b>2,893</b>	<b>3,120</b>	<b>3,238</b>
<b>Gross profit</b>	<b>7,624</b>	<b>7,762</b>	<b>6,856</b>
<b>Operating expenses:</b>			
Research and development	4,133	5,848	5,111
Sales and marketing	7,032	7,517	6,075
General and administrative	3,718	4,725	4,386
<b>Total operating expenses</b>	<b>14,883</b>	<b>18,090</b>	<b>15,572</b>
Loss from operations	(7,259)	(10,328)	(8,716)
Interest income	316	286	383
Other income (expense), net			12
Loss before provision (benefit) for income taxes	(6,943)	(10,042)	(8,321)
Provision (benefit) for income taxes	144	(69)	67
<b>Net loss</b>	<b>\$ (7,087)</b>	<b>\$ (9,973)</b>	<b>\$ (8,388)</b>
<b>Net loss per common share, basic and diluted</b>	<b>\$ (0.36)</b>	<b>\$ (0.53)</b>	<b>\$ (0.51)</b>
<b>Weighted average number of shares outstanding, basic and diluted</b>	<b>19,649</b>	<b>18,677</b>	<b>16,338</b>

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

## LOGICVISION, INC.

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY  
AND COMPREHENSIVE LOSS**  
For the Years Ended December 31, 2006, 2005 and 2004  
(in thousands)

	Common stock		Additional paid-in capital	Deferred stock-based compensation	Accumulated other comprehensive income (loss)	Accumulated deficit	Total Stockholders Equity
	Shares	Amount					
<b>Balances, December 31, 2003</b>	15,776	\$ 2	\$ 97,759	\$ (132)	\$ 135	\$ (70,613)	\$ 27,151
Stock options exercised	227		282				282
Stock awards granted	20		51				51
Stock options cancelled			(86)	86			
Common stock and contingent consideration issued in SiVerion acquisition	2,000		5,380				5,380
Common stock issued under employee stock purchase plan	147		348				348
Stock-based compensation				45			45
Net loss						(8,388)	(8,388)
Foreign currency translation adjustment					(61)		(61)
<b>Comprehensive loss</b>							<b>(8,449)</b>
<b>Balances, December 31, 2004</b>	18,170	\$ 2	\$ 103,734	\$ (1)	\$ 74	\$ (79,001)	\$ 24,808
Stock options exercised	500		311				311
Stock awards granted	25		54				54
Common stock issued under employee stock purchase plan	197		318				318
Stock-based compensation				1			1
Net loss						(9,973)	(9,973)
Unrealized loss on investments					(21)		(21)
Foreign currency translation adjustment					(60)		(60)
<b>Comprehensive loss</b>							<b>(10,054)</b>
<b>Balances, December 31, 2005</b>	18,892	\$ 2	\$ 104,417	\$	\$ (7)	\$ (88,974)	\$ 15,438
Stock options exercised	50		39				39
Common stock issued under employee stock purchase plan	69		73				73
Additional common stock and contingent consideration issued in SiVerion acquisition	1,070		(148)				(148)
Common stock issued in private placement, net	4,000		3,103				3,103
Stock-based compensation			376				376
Net loss						(7,087)	(7,087)
Unrealized gain on investments					20		20
Foreign currency translation adjustment					(13)		(13)
<b>Comprehensive loss</b>							<b>(7,080)</b>

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<b>Balances, December 31, 2006</b>	24,081	\$	2	\$	107,860	\$	\$	\$	(96,061)	\$	11,801
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The accompanying notes are an integral part of these consolidated financial statements.

## LOGICVISION, INC.

**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)

	Year Ended December 31,		
	2006	2005	2004
<b>Cash flows from operating activities:</b>			
Net loss	\$ (7,087)	\$ (9,973)	\$ (8,388)
<b>Adjustments to reconcile net loss to net cash used in operating activities:</b>			
Depreciation and amortization	848	947	662
Stock-based compensation	376	1	45
Provision for (recovery of) allowance for doubtful accounts	(19)	13	(16)
<b>Changes in operating assets and liabilities, net of effect of business acquisition:</b>			
Accounts receivable	1,916	(1,400)	1,646
Prepaid expenses and other current assets	318	(85)	(208)
Notes receivable, related parties			60
Other long-term assets	541	655	(1,389)
Accounts payable	(176)	3	(273)
Accrued liabilities and restructuring charges	306	(683)	996
Deferred revenue	(1,343)	(1,352)	868
<b>Net cash used in operating activities</b>	<b>(4,320)</b>	<b>(11,874)</b>	<b>(5,997)</b>
<b>Cash flows from investing activities:</b>			
Purchase of investments	(4,872)	(5,037)	(13,934)
Purchase of property and equipment	(209)	(821)	(552)
Cash paid for business acquisition	(148)		(2,300)
Proceeds from maturities of investments	9,825	18,473	14,305
<b>Net cash provided by (used in) investing activities</b>	<b>4,596</b>	<b>12,615</b>	<b>(2,481)</b>
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of common stock, net	3,215	683	681
Proceeds from short-term debt		1,000	3,500
Repayment of short-term debt		(4,500)	
<b>Net cash provided by (used in) financing activities</b>	<b>3,215</b>	<b>(2,817)</b>	<b>4,181</b>
<b>Effect of foreign currency exchange rates on cash</b>	<b>(24)</b>	<b>(94)</b>	<b>(88)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>3,467</b>	<b>(2,170)</b>	<b>(4,385)</b>
Cash and cash equivalents, beginning of year	3,620	5,790	10,175
<b>Cash and cash equivalents, end of year</b>	<b>\$ 7,087</b>	<b>\$ 3,620</b>	<b>\$ 5,790</b>
<b>Supplemental disclosure of noncash activities:</b>			
Cash paid for interest	\$	\$ 164	\$ 17
Cash paid for income taxes	\$ 88	\$ (74)	\$ 16
Issuance of common stock for business acquisition	\$ 1,852	\$	\$ 3,380

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Contingent consideration issued for business acquisition	\$	(2,000)	\$		\$	2,000
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The accompanying notes are an integral part of these consolidated financial statements.

**LOGICVISION, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. THE COMPANY**

**Nature of Business**

LogicVision, Inc. (the Company) was incorporated on July 23, 1992 and was reincorporated in the State of Delaware on September 15, 2000. LogicVision is a test and yield learning company in the semiconductor design-for-manufacturing sector. We provide proprietary technologies for embedded test that enable the more efficient test of complex semiconductors. The embedded test solution allows integrated circuit designers to embed, into a semiconductor design, test functionality that can be used during semiconductor production and throughout the useful life of the chip. The technology also allows integrated circuits to be tested and characterized after they have been assembled onto boards and systems.

We have incurred substantial losses and negative cash flows from operations since inception. For the year ended December 31, 2006, we incurred a loss from operations of approximately \$7.1 million and negative cash flows from operations of approximately \$4.3 million. As of December 31, 2006, we had an accumulated deficit of approximately \$96.1 million. While management believes that its current funds will be sufficient to enable us to meet our planned expenditures through at least December 31, 2007, we are subject to risks associated with companies of similar size and stage of development, including but not limited to, dependence on key individuals, competition from substitute services and larger companies, and the continued successful development and marketing of its products and services. If anticipated operating results are not achieved, management has the intent and believes it has the ability to delay or reduce expenditures so as not to require additional financing resources. Failure to generate sufficient cash flows from operations, raise additional capital or reduce certain discretionary spending could have a material adverse effect on the Company's ability to achieve its intended business objectives.

**Reclassifications**

Certain amounts have been reclassified from the prior year to conform to the current year's presentation. Approximately \$2.0 million of deferred revenue classified as long term in the prior year has been reclassified to short term deferred revenue in accordance with a new method for allocating total deferred revenue between short and long term which better reflects the timing of when deferred revenue is expected to be recognized. This reclassification did not impact total liabilities or stockholders' equity at December 31, 2005, and had no impact on the consolidated statements of operations or of cash flows for the year ended December 31, 2005.

**2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principles of Consolidation**

The accompanying consolidated financial statements include the accounts of LogicVision, Inc. and its wholly-owned subsidiaries conducting business in the Japan, Canada, and the United Kingdom. All significant intercompany balances and transactions have been eliminated in consolidation. The Company's fiscal year end is December 31.

**Use of Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management 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, long-term service contracts and contingencies. 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.

**Cash and Cash Equivalents and Investments**

We consider all highly liquid investment instruments purchased with original maturities of three months or less at the acquisition date to be cash equivalents. Investment instruments purchased with original maturities of more than three months, which mature in less than twelve months, are considered to be short-term investments. All investments are classified as available-for-sale and are reported at fair value. At

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December 31, 2006 and 2005, the carrying value of our available-for-sale investments approximates their fair value. Interest and realized gains and losses are included in interest income. Realized gains and losses are recognized based on the specific identification method.

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

	December 31,	
	2006	2005
<b>Cash and cash equivalents:</b>		
Cash	\$ 1,241	\$ 847
Money market funds	3,234	1,151
Commerical paper	1,119	1,197
U.S. government agency notes	1,493	425
	\$ 7,087	\$ 3,620
<b>Short-term investments:</b>		
U.S. government agency notes	\$ 2,006	\$ 7,076
Commerical paper	149	\$
	\$ 2,155	\$ 7,076

The contractual maturities of debt securities classified as cash equivalents and available-for-sale investments at December 31, 2006 and 2005 are as follows (in thousands):

	Estimated Fair Value	
	2006	2005
Maturing 90 days or less from purchase	\$ 2,611	\$ 1,622
Maturing between 90 days and one year from purchase	2,155	450
Maturing more than one year from purchase		6,626
	\$ 4,766	\$ 8,698

Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties, and the Company may need to sell the investments to meet its cash needs. We had no realized gains and losses for the years ended December 31, 2006, 2005 or 2004.

### Property and Equipment

Property and equipment are stated at cost and are depreciated on a straight-line basis over their estimated useful lives of three to five years. Leasehold improvements are amortized on a straight-line basis over the estimated useful life of the asset or the lease term, if shorter. Maintenance and repairs are charged to operations as incurred.

### Long-Lived Assets

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable. We use an estimate of the future undiscounted net cash flow of the related asset or asset grouping over the remaining life in measuring whether these assets are recoverable. During the three years ended December 31, 2006, we did not record any impairment of our long-lived assets, other than amounts related to our November 2005 restructuring.

### Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, ( SFAS 123(R) ) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases under our 2000 Employee Stock Purchase Plan based on estimated



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fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) for periods beginning in 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ( SAB 107 ) relating to SFAS 123(R). We have applied the provisions of SAB 107 in its adoption of SFAS 123(R).

We adopted SFAS 123(R) using the modified prospective transition method. Our Consolidated Financial Statements as of December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, our Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R).

Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was \$376,000, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases. No stock-based compensation expense related to employee stock options and employee stock purchases was recognized for the years ended December 31, 2005 or 2004.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in our Consolidated Statements of Operations. Prior to the adoption of SFAS 123(R), we accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123,

Accounting for Stock-Based Compensation ( SFAS 123 ). Under the intrinsic value method, no stock-based compensation expense had been recognized in our Consolidated Statements of Operations because the exercise price of our stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

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

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

For further information on stock-based compensation, see Note 9.

In 2005 and 2004, we accounted for stock-based employee compensation arrangements in accordance with provisions of APB 25, as interpreted by FASB Interpretation No. 44 ( FIN 44 ), Accounting for Certain Transactions Involving Stock Compensation an Interpretation of APB 25 and Emerging Issues Task Force No. 00-23 ( EITF 00-23 ), Issues related to the Accounting for Stock Compensation under APB 25 and FIN 44, and Financial Accounting Standards Board Interpretation ( FIN ) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, and complies with the disclosure provisions of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure an amendment of SFAS 123. Under APB Opinion No. 25, compensation expense is based on the difference, if any, on the date of the grant, between the fair value of our stock and the exercise price. SFAS No. 123 as amended by SFAS No. 148 requires a fair value based method of accounting for an employee stock option or similar equity instrument. Had compensation cost for our stock-based compensation plan been determined based on the fair value at the grant date for awards for 2005 and 2004 consistent with the provisions of SFAS No. 123, our net loss and net loss per share would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

	Year Ended December 31,	
	2005	2004
Net loss, as reported	\$ (9,973)	\$ (8,388)
Add: Stock-based compensation expense included in reported net income	1	45
Deduct: Total stock-based compensation expense determined under fair value based method for all awards granted	(3,252)	(2,556)
<b>Pro forma net loss</b>	<b>\$ (13,224)</b>	<b>\$ (10,899)</b>
<b>Loss per share:</b>		
Basic and diluted - as reported	\$ (0.53)	\$ (0.51)
Basic and diluted - pro forma	\$ (0.71)	\$ (0.67)

We account for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ( EITF ) No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services. We believe that the fair value of the stock options is more reliably measured than the fair value of the services received. The fair value of each non-employee stock award (except stock awards to non-employee directors) is remeasured at each period end until a commitment date is reached, which is generally the vesting date. All of our non-employee stock awards were fully vested as of December 31, 2006.

### Revenue Recognition

We account for our revenue under the provisions of Statement of Position 97-2, Software Revenue Recognition, as amended by Statement of Position 98-9 Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions .

Our revenues are derived from three primary sources: license revenues, comprised of fees associated with the licensing of software; product revenues, from the sale of hardware products; and service revenues, from maintenance and consulting and training services. Revenue is recognized when persuasive evidence of an arrangement exists, all obligations have been performed pursuant to the terms of such an arrangement, the product has been delivered, the fee is fixed or determinable and the collection of the resulting receivable is reasonably assured. If any of these criteria are not met, revenue recognition is deferred until such time as all criteria are met. Payments received in advance of revenues being recognized are presented as deferred revenue in the accompanying balance sheets.

#### *License revenues*

We have three license types:

**Subscription licenses** subscription licenses include software licenses and maintenance for a specific time period, generally three years or less. Maintenance is bundled into the license agreement for the term of the license and is not charged separately. Since vendor-specific objective evidence ( VSOE ) of fair value does not exist for each element of the arrangement, revenues from subscription licenses are recognized ratably over the license term commencing upon the effective date of the license, if delivery and other revenue recognition criteria are met.

**Term licenses** term licenses include software licenses for a specific time period, generally three to five years. Revenues associated with term licenses are recognized on the effective date of the license, if delivery and other revenue recognition criteria are met. Maintenance agreements for term licenses are sold separately for a specified period and may continue to be renewed for the balance of the license term.

**Perpetual licenses** perpetual licenses consist of software licensed on a perpetual basis. Revenues associated with perpetual licenses are recognized on the effective date of the license, if delivery has occurred and other revenue recognition criteria are met. We no longer offer this type of license.

The timing of revenue recognition for licenses will differ depending on the license type and on the individual terms and conditions associated with each particular license agreement. We use VSOE of fair value to allocate the total fee among all delivered and undelivered elements in those arrangements which contain multiple elements. If the arrangement includes the future delivery of a specified product or upgrade, all revenues under the arrangement are deferred until the specified product or upgrade has been delivered. If VSOE does not exist for one or more delivered elements, the residual method of accounting is applied to the delivered elements. Under the residual method, the VSOE

of the fair value of the undelivered elements is deferred, and the remaining portion of the arrangement is recognized as revenue.

VSOE for maintenance is generally based upon the customer's annual renewal rates as set forth in the license agreement. When VSOE for maintenance cannot be established, all related revenues are recognized ratably over the term of the maintenance obligation. VSOE for services is generally based on the price charged when the services are sold separately.

The Company, on occasion, offers extended payment terms beyond its 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 we recognize revenue when the payment is due.

#### *Service revenues*

Maintenance revenue is recognized ratably over the maintenance period. For term and perpetual licenses, customers generally renew maintenance agreements annually. For subscription licenses, a portion of revenue is allocated to maintenance revenue using the estimated fair value of the maintenance, which is based on maintenance renewals sold separately for similar products.

Consulting service revenues are generally recognized as the services are performed. Training revenues are recognized when the training is performed.

#### *Product revenues*

The terms of our hardware product sales include annual maintenance. Product revenues are recognized ratably over the term of our maintenance obligation as we do not have a history of selling maintenance for this product separately. Once we have established VSOE for the maintenance of this product, revenues will be recognized upon delivery of the product if other revenue recognition criteria are met.

### **Research and Development**

Research and development costs are charged to operations as incurred.

### **Software Development Costs and Capitalized Technology License**

Costs related to research and development are generally charged to expense as incurred. Capitalization of material software development costs begins when a product's technological feasibility has been established in accordance with the provisions of SFAS 86, *Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed*. To date, the period between achieving technological feasibility, which we have defined as the establishment of a working model, and which typically occurs when beta testing commences, and the general availability of such software has been very short. Accordingly, software development costs have been expensed as incurred.

### **Restructuring Charges**

Restructuring charges are comprised primarily of severance and associated employee termination costs related to workforce reductions, costs related to facilities abandoned and related write-down of leasehold improvements. We account for restructuring charges in accordance with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities* which requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred.

### **Certain Risks and Concentrations**

Our cash and cash equivalents and investments are maintained at six financial institutions, three in the United States, one in Canada, one in Japan, and one in the United Kingdom. Deposits in these institutions may exceed the amount of insurance provided on such deposits.

For accounts receivable, management performs ongoing credit evaluations of its customers' financial condition and, generally, requires no collateral from its customers. Based on the expected collectibility of the accounts receivable balance, we maintain an allowance for doubtful accounts. We review our allowance for doubtful accounts monthly by assessing individual accounts receivable over a specified aging and amount, and all other balances on a pooled basis based on historical collection experience. Accounts receivable are written off on a case-by-case basis, net of any amounts that may be collected. At December 31, 2006, four customers accounted for approximately 28%, 27%, 12% and 11% of net accounts receivable, respectively. At December 31, 2005, one customer accounted for approximately 73% of net accounts receivable.

Customers accounting for more than 10 percent of revenues are as follows:

	Year Ended December 31,		
	2006	2005	2004
Agere Systems Inc.	20%	21%	20%
Broadcom Corporation	18%	10%	7%
LSI Logic Corporation	6%	10%	3%
Matsushita Electric Industrial Co. Ltd.	4%	7%	17%

There can be no assurance that the market will accept our technology as an alternative to current design test development methods. If the market does not accept our technology at all or in the time frame anticipated in our projections, our revenues, results of operations, financial condition or cash flows would be materially affected.

### Income Taxes

We account for income taxes using the liability method under which deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts expected to be realized.

### Foreign Currency Translation

We have foreign subsidiaries whose financial statements are denominated in the local currency. Foreign exchange gains and losses, which result from the process of remeasuring foreign currency financial statements into U.S. dollars, have been included on the balance sheet as a cumulative foreign currency translation adjustment included in accumulated other comprehensive income (loss).

### Fair Value of Financial Instruments

The carrying amounts of our financial instruments including cash and cash equivalents, accounts receivable, accounts payable and accrued liabilities approximate fair value due to their short maturities.

### Net Loss Per Share

Basic net loss per share is computed by dividing the net loss attributable to common stockholders for the period by the weighted average number of the common shares outstanding during the period. Diluted net loss per share does not differ from basic net loss per share since potential common shares from conversion of preferred stock, stock options and warrants and outstanding shares of common stock subject to repurchase are anti-dilutive for all periods presented. Options and warrants to purchase approximately 3.8 million, 4.4 million and 4.4 million shares of common stock have been excluded for the years ended December 31, 2006, 2005 and 2004, respectively, as they are anti-dilutive. There were no shares subject to repurchase as of December 31, 2006, 2005 and 2004.

### Comprehensive Loss

Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income requires companies to classify items of other comprehensive income (loss) by their nature in the financial statements and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in capital in the equity section of the balance sheet. For all periods presented, the primary differences between our net loss and comprehensive loss arise from foreign currency translation adjustments and unrealized gains (losses) on investments.

### Recent Accounting Pronouncements

In November 2005, the FASB issued FASB Staff Position (FSP) FAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share Based Payment Awards, ( FAS 123(R) ) which allowed a one-time election to adopt one of two acceptable methodologies for calculating the initial additional paid in capital (APIC) pool. In subsequent periods, the APIC pool will be increased by tax benefits from stock-based compensation and decreased by tax deficiencies caused when the recorded stock-based compensation for book purposes exceeds the allowable tax deduction. We have elected the short-cut method to establish our APIC pool required under FAS 123 (R) for fiscal year ended

December 31, 2006.

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In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 ( FIN 48 ). FIN 48 prescribes a recognition threshold and measurement attribute for financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return, and also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. We are currently evaluating the impact of adopting FIN 48 on our financial statements.

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* ( SFAS 157 ). The standard provides guidance for using fair value to measure assets and liabilities. The standard also responds to investors' requests for expanded information about the extent to which companies measure assets and liabilities at fair value, the information used to measure fair value, and the effect of fair value measurements on earnings. The standard applies whenever other standards require or permit assets or liabilities to be measured at fair value. The standard does not expand the use of fair value in any new circumstances. SFAS 157 must be adopted prospectively as of the beginning of the year it is initially applied. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are still evaluating the impact of this standard will have on our financial position or results of operations.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in the Current Year Financial Statements* ( SAB 108 ). SAB 108 addresses how the effects of prior-year uncorrected misstatements should be considered when quantifying misstatements in current-year financial statements. SAB 108 requires an entity to quantify misstatements using a balance sheet and income-statement approach and to evaluate whether either approach results in quantifying an error that is material in light of relevant quantitative and qualitative factors. The guidance is applicable for fiscal years ending after November 15, 2006. The adoption of SAB 108 did not have a material impact on our consolidated financial statements.

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* ( SFAS 159 ). SFAS 159 creates a fair value option under which an entity may elect to record certain financial assets or liabilities at fair value upon their initial recognition. Subsequent changes in fair value would be recognized in earnings as those changes occur. The election of the fair value option would be made on a contract-by contract basis and would need to be supported by concurrent documentation or a preexisting documented policy. SFAS 159 requires an entity to separately disclose the fair value of these items on the balance sheet or in the footnotes to the financial statements and to provide information that would allow the financial statement user to understand the impact on earnings from changes in the fair value. SFAS 159 is effective for us beginning with fiscal year 2008. We are currently evaluating the impact that the adoption of SFAS 159 will have on our consolidated financial statements.

### 3. BALANCE SHEET COMPONENTS

Property and equipment were comprised of the following (in thousands):

	December 31,	
	2006	2005
Computer Equipment and Software	\$ 3,320	\$ 3,837
Office Equipment and Leasehold Improvements	564	592
	3,884	4,429
Less: Accumulated Depreciation	(3,141)	(3,332)
	\$ 743	\$ 1,097

Depreciation and amortization expense related to property and equipment totaled \$562,000, \$642,000 and \$612,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

Accrued liabilities and restructuring charges were comprised of the following (in thousands):

	December 31,	
	2006	2005
Accrued compensation and benefits	\$ 1,371	\$ 1,218



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Accrued professional fees	300	277
Other accrued liabilities	337	207
	<u>          </u>	<u>          </u>
	\$ 2,008	\$ 1,702
	<u>          </u>	<u>          </u>

#### 4. LOAN AGREEMENT

We have a loan agreement with a bank under which we may borrow, on a revolving basis, up to \$1.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 8.25% at December 31, 2006. The agreement is unsecured and is not collateralized by our assets. Under the agreement, we must comply with certain operating and reporting covenants and are not permitted to pay dividends, or make material investments or dispositions without the prior written consent of the bank. If we fail to comply with our covenants under the agreement, the bank can declare any outstanding amounts immediately due and payable and cease advancing money or extending credit to or for the Company. The agreement expires on February 28, 2008. At December 31, 2006 there were no outstanding borrowings under the agreement and \$1.0 million was available. At that date, we were in compliance with the covenants under the agreement.

#### 5. COMMITMENTS AND CONTINGENCIES

##### Lease Obligations

The Company and its subsidiaries in Canada and Japan rent office facilities under noncancelable operating leases which expire through July 2011. The Company and its subsidiaries are responsible for certain maintenance costs, taxes and insurance under the respective leases. Total future minimum payments under such operating leases, including estimated operating costs, at December 31, 2006 were as follows (in thousands):

Year ending December 31,	
2007	\$ 734
2008	697
2009	706
2010	264
2011	68
	<u>2,469</u>
	<u>\$ 2,469</u>

Rent expense for the years ended December 31, 2006, 2005 and 2004 was \$586,000, \$677,000 and \$630,000, respectively.

##### Indemnification Obligations

We enter into standard license agreements in the ordinary course of business. Pursuant to these agreements, we agree to indemnify our customers for losses suffered or incurred by them as a result of any patent, copyright, or other intellectual property infringement claim by any third party with respect to the Company's products. These indemnification obligations have perpetual terms. Our normal business practice is to limit the maximum amount of indemnification to the amount received from the customer. On occasion, the maximum amount of indemnification we may be required to make may exceed our normal business practices. We estimate the fair value of our indemnification obligations as insignificant, based upon our historical experience concerning product and patent infringement claims. Accordingly, we had no liabilities recorded for indemnification under these agreements as of December 31, 2006.

We have agreements whereby our officers and directors are indemnified for certain events or occurrences while the officer or director is, or was, serving at our request in such capacity. The maximum potential amount of future payments we could be required to make under these indemnification agreements is unlimited; however, we have a directors and officers insurance policy that reduces our exposure and enables us to recover a portion of future amounts paid. As a result of our insurance policy coverage, we believe the estimated fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of December 31, 2006.

See also Note 11.

##### Warranties

We offer our customers a warranty that our products will conform to the documentation provided with the products. To date, there have been no payments or material costs incurred related to fulfilling these warranty obligations. Accordingly, we had no liabilities recorded for these warranties as of December 31, 2006 or 2005. We assess the need for a warranty reserve on a quarterly basis, and there can be no guarantee that a warranty reserve will not become necessary in the future.



## 6. BUSINESS COMBINATIONS

### SiVerion

In November 2004, we completed the acquisition of SiVerion, Inc. ( SiVerion ) for a total purchase price of \$7.4 million. At the closing we paid \$1.4 million in cash and issued 2 million shares of our common stock valued at \$3.4 million to SiVerion's stockholders and paid \$0.6 million to certain debt holders. The purchase price also included a contingent payment of up to \$2 million in cash payable on November 5, 2006 (the Additional Cash Exchange Rights ) if the average closing price of our common stock for the 10 trading days immediately prior thereto is less than \$3.00. SiVerion's software products aggregate and analyze data from various semiconductor fabrication and test sources to identify whether silicon behavior meets design criteria across varying manufacturing and operating conditions. The SiVerion acquisition broadened our yield enhancement solutions and, when combined with our products will provide an infrastructure for automated yield learning. We expect this combined product line will provide a more complete time-to-yield solution for advanced designs and processes to its target markets. These opportunities, along with the SiVerion workforce, were significant contributing factors to the establishment of the purchase price, resulting in the recognition of a significant amount of goodwill.

On June 27, 2006, we issued 1,070,499 shares of common stock to certain former stockholders of SiVerion, Inc. in exchange for the Additional Cash Exchange Rights held by those former stockholders. In November 2006, we paid an aggregate amount of \$148,000 to those remaining former SiVerion, Inc. stockholders who held Additional Cash Exchange Rights in satisfaction of our contingent obligation.

The acquisition was accounted for as a purchase business combination. The purchase price of \$7.4 million and \$300,000 of legal, other professional expenses and other costs directly associated with the acquisition were allocated to the fair values of the assets acquired. The fair value of the developed technology and non-compete agreements were determined by management. A summary of the purchase price allocation is as follows (in thousands):

	<b>Amount Allocated</b>
Allocation of purchase price:	
Net tangible assets acquired	\$ 17
Intangible assets acquired:	
Developed technology	640
Non-compete agreements	177
Goodwill	6,846
	<hr/>
Total purchase price	\$ 7,680

The value assigned to developed technology was based upon future discounted cash flows related to the developed technology's projected income streams using a discount rate of 26%. We believe this rate is appropriate given the business risks inherent in marketing and selling this technology. Factors considered in estimating the discounted cash flows to be derived from the developed technology included risks related to the characteristics and applications of the technology, existing and future markets and an assessment of the age of the technology within its life span.

Developed technology and non-compete intangible assets totaling \$817,000 are being amortized over their estimated economic lives of three and two years, respectively.

## 7. INTANGIBLE ASSETS

The following table summarizes the components of goodwill, other intangible assets and related accumulated amortization balances, which were recorded as a result of the SiVerion business combination described in Note 6 (in thousands):

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	December 31, 2006			December 31, 2005		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill	\$ 6,846	\$	\$ 6,846	\$ 6,846	\$	\$ 6,846
<b>Other Intangible Assets:</b>						
Developed technology	\$ 640	\$ (462)	\$ 178	\$ 640	\$ (250)	\$ 390
Non-compete agreements	177	(177)		177	(103)	74
<b>Total</b>	<b>\$ 817</b>	<b>\$ (639)</b>	<b>\$ 178</b>	<b>\$ 817</b>	<b>\$ (353)</b>	<b>\$ 464</b>

In fiscal 2006, amortization of developed technology was charged to cost of sales; amortization of the non-compete agreements was charged to sales and marketing and general and administrative expenses. In fiscal 2005, amortization of developed technology was charged to cost of sales and research and development expenses; amortization of the non-compete agreements was charged to sales and marketing and general and administrative expenses.

At December 31, 2006, the estimated future amortization expense of other intangible assets in the table above was as follows (in thousands):

	Estimated Amortization Expense
<b>Year ending December 31, 2007</b>	<b>\$ 178</b>

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

## 8. PREFERRED STOCK

At December 31, 2006 and 2005, we had 5,000,000 shares of undesignated preferred stock, \$0.0001 par value, authorized, none of which were issued or outstanding. The board of directors has the authority, without further action by the stockholders, to issue from time to time the preferred stock in one or more series and to fix the number of shares, designations, preferences, powers, and other rights of those shares. The preferences, powers, rights and restrictions of different series of preferred stock may differ with respect to dividend rates, amounts payable on liquidation, voting rights, conversion rights, redemption provisions, sinking fund provisions, and purchase funds and other matters.

## 9. STOCK OPTION PLANS AND WARRANTS

### Stock Option Plan

Our 2000 Stock Incentive Plan (the 2000 Plan) is a successor to the 1994 Flexible Stock Option Plan (the 1994 Plan). The number of shares reserved for issuance under the 2000 Plan are increased on the first day of each of our fiscal years from 2002 to 2010 by the lesser of 750,000 shares, 3.5% of the outstanding shares of our common stock on that date or a lesser amount determined by the Board of Directors and are also increased by any forfeitures under the 1994 Plan. On January 26, 2006, the Board of Directors approved an increase of 650,000 shares for issuance under the 2000 Plan. As of December 31, 2006, options to purchase a total of 3,221,487 and 468,581 shares of common stock were outstanding under the 2000 Plan and the 1994 Plan, respectively. In addition, the Board of Directors has granted 700,500 non-qualified options, of which options to purchase 7,500 shares remained outstanding at December 31, 2006. A total of 5,721,174 shares are reserved for future issuance at December 31, 2006.

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



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

In October 2005, we announced acceleration of stock option vesting under its stock option plans. All unvested stock options previously awarded with exercise prices greater than \$2.20 per share (a price which was 114% of the previous day's closing price) became immediately exercisable as a result of the vesting acceleration. The purpose of the accelerated vesting was to enable us to avoid recognizing in our statement of operation non-cash compensation expense associated with these options in future periods, upon the implementation of SFAS 123(R).

The following table summarizes all option activities from December 31, 2003 through December 31, 2006 (shares in thousands, except per share data):

	Year Ended December 31,					
	2006		2005		2004	
	Number of Shares	Weighted Average Price Per Share	Number of Shares	Weighted Average Price Per Share	Number of Shares	Weighted Average Price Per Share
Options outstanding:						
Beginning balance	4,357	\$ 3.56	4,274	\$ 3.38	3,820	\$ 3.34
Granted	681	\$ 1.31	948	\$ 2.63	1,326	\$ 3.51
Stock Awards			25		20	
Exercised	(50)	\$ 0.77	(525)	\$ 0.70	(247)	\$ 1.14
Forfeited	(1,290)	\$ 3.69	(365)	\$ 3.05	(645)	\$ 4.16
Ending Balance	3,698	\$ 3.14	4,357	\$ 3.56	4,274	\$ 3.38
Options exercisable at end of year	3,074	\$ 3.49	3,865	\$ 3.78	2,116	\$ 3.30

The weighted-average grant-date fair value of options granted during the years ended December 31, 2006, 2005 and 2004 were \$0.83, \$1.80 and \$3.45, respectively. The total intrinsic value of options exercised during the years ended December 31, 2006, 2005 and 2004 were \$28,000, \$855,000 and \$523,000, respectively. We issue new shares upon the exercise of options. There was no tax benefit realized from exercised options. For the three years ended December 31, 2006, the value of the option grants has been calculated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

	2006	2005	2004
Expected average life of option	4.2 years	4.9 years	3.9 years
Risk-free interest rate	4.37%	3.89%	3.00%
Expected dividends			
Expected volatility	83%	83%	80%

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The options outstanding and currently exercisable by exercise price at December 31, 2006 were as follows (options in thousands):

Exercise Price	Options Outstanding			Options Exercisable		
	Number of Shares Underlying Options	Weighted average remaining contractual life(years)	Weighted average exercise price	Number of Shares Underlying Options	Weighted average remaining contractual life(years)	Weighted average exercise price
\$0.60-\$1.72	1,036	7.3	\$ 1.36	509	5.6	\$ 1.41
\$1.76-\$2.64	999	7.3	\$ 2.25	903	7.1	\$ 2.29
\$2.79 - \$4.85	1,247	6.9	\$ 4.02	1,246	6.9	\$ 4.02
\$5.00-\$10.00	416	4.5	\$ 7.05	416	4.5	\$ 7.05
	<u>3,698</u>	<u>6.8</u>	<u>\$ 3.14</u>	<u>3,074</u>	<u>6.4</u>	<u>\$ 3.49</u>
Vested and expected to vest as of December 31, 2006	<u>3,543</u>	<u>6.6</u>	<u>\$ 3.22</u>			

The aggregate intrinsic value of vested options was \$28,000 in the preceding table, based on our closing stock price of \$1.22 as of December 31, 2006. The aggregate intrinsic value of vested options and those expected to vest was \$37,000. The total fair value of options vested during the years ended December 31, 2006 and 2005 were \$293,000 and \$3,652,000, respectively. As of December 31, 2006, total compensation cost related to non-vested stock options not yet recognized was \$380,000 which is expected to be recognized over the next 2.9 years.

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

On January 1, 2006, we adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and employee stock purchases related to the Purchase Plan based on estimated fair values. The following table summarizes stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) for the year ended December 31, 2006 which was allocated as follows (in thousands):

	Year Ended December 31, 2006
Cost of revenues:	
Service	\$ 27
Stock-based compensation expense included in cost of sales	<u>27</u>
Operating expenses:	
Research and development	70
Sales and marketing	146
General and administrative	133
Stock-based compensation expense included in operating expenses	<u>349</u>
Total stock-based compensation expense related to employee stock options and employee stock purchases	<u>\$ 376</u>
Effect on net loss per share, basic and diluted	\$ (0.02)

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



As stock-based compensation expense recognized in the Consolidated Statement of Operations for the year ended December 31, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience. In our pro forma information required under SFAS 123 for the periods prior to January 1, 2006, we accounted for forfeitures as they occurred.

## Warrants

At December 31, 2006, we had warrants outstanding to purchase common stock as follows:

Warrants type	Number outstanding	Expiration date	Exercise price
Warrants issued for Series G financing	78,234	December 2009	\$ 1.00

The fair value of these warrants was determined using the Black-Scholes model assuming volatility factors of 0.60, contractual lives between 4 and 10 years, and risk-free rates of return between 5.3% and 5.6%.

## 10. STOCK PURCHASE PLAN

Under our Employee Stock Purchase Plan ( Purchase Plan ) a total of 750,000 shares of common stock were reserved for issuance at December 31, 2006. The number of shares reserved for issuance under the Purchase Plan is increased on the first day of each fiscal year by the lesser of 125,000 shares, 1% of the outstanding shares on that date or a lesser amount as determined by the Board of Directors. On January 26, 2006, the Board of Directors voted to increase the shares reserved for issuance by 125,000. The Purchase Plan, which is intended to qualify under Section 423 of the Internal Revenue Code of 1986, as amended, is administered by the Compensation Committee of our Board of Directors. During the years ended December 31, 2006, 2005, and 2004, we issued 69,091, 197,862, and 146,992 shares under the Purchase Plan at average prices of \$1.06, \$1.60, and \$2.36 per share, respectively. At December 31, 2006, there were 163,348 shares available for future issuance under the Purchase Plan.

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

	Year Ended December 31,		
	2006	2005	2004
Expected average life of option	6 months	6 months	6 months
Risk-free interest rate	5.15%	3.29%	1.36%
Expected dividends			
Expected volatility	70%	87%	88%

The weighted average per share fair value of purchase rights under the Purchase Plan was \$0.48, \$0.88, and \$2.72 for the years ended December 31, 2006, 2005 and 2004, respectively.

## 11. PRIVATE PLACEMENT

On December 19, 2006, we completed a private placement of 3,905,000 shares of our common stock to certain accredited investors at a price per share equal to \$0.81, as well as the sale 95,000 shares of common stock to certain members of our management at a price per share equal to \$0.92 (the closing bid price of the Common Stock on NASDAQ Global Market on December 18, 2006), each pursuant to the terms of a Common Stock Purchase Agreement, dated December 19, 2006. The net proceeds of this private placement were approximately \$3.1 million.

We entered into a Registration Rights Agreement with the purchasers in the private placement of common stock. Pursuant to the Registration Rights Agreement, we filed a registration statement with the Securities and Exchange Commission and agreed to keep it effective for up to two years. In the event the registration statement becomes unavailable for use for greater than 30 consecutive days or for a total of 60 days or more during any 12 month period in which we are required to keep the registration statement effective, then we must pay to each purchaser in cash 2.0% of the portion of the purchase price paid by such purchaser for common stock in the private placement, for each 30-day period or pro rata for any portion thereof, up to 10% of the purchase price paid by such purchaser. In accordance with FSP EITF 00-19-2 Accounting for Registration Payment Arrangements , we have not recorded a liability for this obligation because we believe the likelihood of

having to make any payments under this arrangement is remote.

**12. INCOME TAXES**

The components of the provision (benefit) for income taxes were as follows (in thousands):

	December 31,		
	2006	2005	2004
<b>Current</b>			
Federal	\$	\$	\$
State and foreign	144	(69)	67
	144	(69)	67
<b>Deferred</b>			
Federal			
State and foreign			
<b>Total provision (benefit) for income taxes</b>	<b>\$ 144</b>	<b>\$ (69)</b>	<b>\$ 67</b>

In 2006, we recorded an income tax provision of \$144,000, primarily related to foreign taxes.

Significant components of our deferred tax assets and liabilities were as follows (in thousands):

	December 31,		
	2006	2005	2004
<b>Deferred tax assets:</b>			
Net operating losses	\$ 30,530	\$ 27,862	\$ 22,761
Reserves and accruals	241	239	260
Credits	1,852	1,720	2,038
Deferred revenue	1,215	1,075	1,584
Depreciation and amortization	690	699	1,542
	34,528	31,595	28,185
Valuation allowance	(34,528)	(31,595)	(28,185)
<b>Net deferred tax assets</b>	<b>\$</b>	<b>\$</b>	<b>\$</b>

We have established a full valuation allowance against our deferred tax assets due to the uncertainty surrounding the realization of such assets. Management evaluates, on an annual basis, the recoverability of the deferred tax assets and the level of the valuation allowance.

As of December 31, 2006, we had federal and California net operating loss carryforwards of approximately \$85.1 million and \$26.0 million available to reduce future federal and California taxable income, respectively. These federal and California carryforwards begin to expire in 2007 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.

As of December 31, 2006, we had federal and California research and experimentation tax credit carryforwards of approximately \$1.09 million and \$1.12 million, respectively. These federal tax credit carryforwards begin to expire in 2008, if not utilized. Unused California tax credit carryforwards may be carried forward indefinitely. The extent to which these tax credit carryforwards can be used to offset future taxes may be limited under Section 383 of the Internal Revenue Code and applicable state law.

In addition, there are net operating loss carryforwards in Arizona available to reduce future Arizona taxable income.

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For financial reporting purposes the tax effect of the net operating loss and tax credit carryforwards have been recorded as deferred tax assets.

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The effective tax rate differs from the statutory federal income tax rate as follows:

	December 31,		
	2006	2005	2004
Statutory federal income tax rate	(34.0)%	(34.0)%	(34.0)%
State income taxes, net of federal benefit	(5.8)	(0.4)	(1.4)
Stock-based compensation	2.1	0	0.2
Credits	(0.2)	0	1.4
Change in valuation allowance	40.5	34.0	33.7
Foreign taxes	2.3	(1.3)	0.1
Other	(3.0)	1.1	0.9
<b>Effective tax rate</b>	<b>2.0%</b>	<b>(0.6)%</b>	<b>0.9%</b>

### 13. SEGMENT REPORTING

We have adopted SFAS No. 131, Disclosure about Segments of an Enterprise and Related Information. Although we offer various design and manufacturing embedded test software products and services to our customers, we do not manage our operations by these products and services, but instead view the Company as one operating segment when making business decisions. We do not manage our 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. We use one measurement of profitability for our business.

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

	Year ended December 31,		
	2006	2005	2004
Revenue by product line:			
ETCreate	\$ 8,320	\$ 8,911	\$ 9,112
ETAccess	2,063	1,882	982
SiVision	134	89	
<b>Total revenues</b>	<b>\$ 10,517</b>	<b>\$ 10,882</b>	<b>\$ 10,094</b>

The following is a summary of our revenues by geographic operations (in thousands):

	Year Ended December 31,		
	2006	2005	2004
United States	\$ 8,827	\$ 8,877	\$ 7,874
Japan	1,176	1,348	2,096
Others	514	657	124
<b>Total revenues</b>	<b>\$ 10,517</b>	<b>\$ 10,882</b>	<b>\$ 10,094</b>

The following is a summary of our long-lived assets (in thousands):

December 31,	
2006	2005

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United States	\$	487	\$	778
India				93
Canada		246		203
Japan		10		23
		<u>          </u>		<u>          </u>
	\$	743	\$	1,097
		<u>          </u>		<u>          </u>

**14. BENEFIT PLAN**

We have a defined contribution savings plan (the 401(k) Plan ) to provide retirement income to all qualified employees of the Company. The 401(k) Plan is intended to be qualified under Section 401(k) of the Internal Revenue Code of 1986, as amended. The 401(k) Plan is funded by voluntary pre-tax contributions from employees. Contributions are invested, as directed by the participant, in investment funds available under the 401(k) Plan. We are not required to make, and we have not made, any contributions to the Plan.

**15. RESTRUCTURING COSTS**

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

The following is a summary of activities in accrued restructuring and excess facilities costs for the years ended December 31, 2006 and 2005 (in thousands):

	Severance and Benefits	Excess Facilities	Asset Related	Total
Balance as of January 1, 2005	\$	\$	\$	\$
Restructuring charge	582	61	74	717
Cash paid	(384)	(43)		(427)
Non-cash settlements				
Balance as of December 31, 2005	\$ 198	\$ 18	\$ 74	\$ 290
Cash paid	(198)	(18)		(216)
Non-cash settlements			(74)	(74)
Balance as of December 31, 2006	\$	\$	\$	\$

The restructuring charges are included in the Consolidated Statement of Operations for the Year Ended December 31, 2005 as follows (in thousands):

	Severance and Benefits	Excess Facilities	Asset Related	Total
Research and development	\$ 215	\$ 61	\$ 61	\$ 337
Sales and marketing	59		10	69
General and administrative	308		3	311
Total operating expenses	\$ 582	\$ 61	\$ 74	\$ 717

**16. SUBSEQUENT EVENTS**

On February 7, 2007, we commenced an offer (the Exchange Offer ) to our eligible employees to exchange some or all of their outstanding stock options to purchase shares of common stock for new options to be granted under the 2000 Plan. The Exchange Offer covered all employee options with an exercise price greater than \$1.48 per share. Other than eligible options tendered by our five executive officers, the exchange rate was one-for-one. The exchange ratio applicable to our executive officers was one-for-1.25.

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The Exchange Offer expired on March 8, 2007, at which time properly tendered options for 2,432,411 shares were cancelled and new options for 2,199,211 shares were granted at the closing price of our common stock on the grant date.

All new options will have an option expiration term of ten years. Each new option will have a one year vesting period, one-half of which will vest on the date that is six months after the new option's issuance date and the remainder vesting in equal monthly installments over the next six months.



**SELECTED QUARTERLY CONSOLIDATED FINANCIAL DATA (Unaudited)**

The following table presents selected unaudited consolidated financial results for each of the eight quarters in the two-year period ended December 31, 2006. In our opinion, this unaudited information has been prepared on the same basis as the audited information and includes all adjustments (consisting of only normal recurring adjustments) necessary for a fair statement of the financial information for the period presented.

**Three Months Ended**

	<b>Dec. 31, 2006</b>	<b>Sept. 30, 2006</b>	<b>June 30, 2006</b>	<b>March 31, 2006</b>	<b>Dec. 31, 2005</b>	<b>Sept. 30, 2005</b>	<b>June 30, 2005</b>	<b>March 31, 2005</b>
<b>(In thousands, except per share data)</b>								
<b>Revenues:</b>								
License	\$ 1,128	\$ 1,332	\$ 1,305	\$ 1,219	\$ 1,295	\$ 1,250	\$ 1,493	\$ 2,697
Service	1,541	1,312	1,367	1,130	1,147	892	984	928
Product	73	10	100		28	58	58	52
<b>Total revenues</b>	<b>2,742</b>	<b>2,654</b>	<b>2,772</b>	<b>2,349</b>	<b>2,470</b>	<b>2,200</b>	<b>2,535</b>	<b>3,677</b>
<b>Cost of Revenues:</b>								
License	260	259	230	257	266	261	203	186
Service	548	486	429	424	548	468	531	569
Product					13	25	25	25
<b>Total cost of revenues</b>	<b>808</b>	<b>745</b>	<b>659</b>	<b>681</b>	<b>827</b>	<b>754</b>	<b>759</b>	<b>780</b>
<b>Gross profit</b>	<b>1,934</b>	<b>1,909</b>	<b>2,113</b>	<b>1,668</b>	<b>1,643</b>	<b>1,446</b>	<b>1,776</b>	<b>2,897</b>
<b>Operating expenses:</b>								
Research and development	996	1,014	1,036	1,087	1,387	1,394	1,377	1,690
Sales and marketing	1,628	1,745	1,779	1,880	1,824	1,943	1,974	1,776
General and administrative	761	956	1,037	964	1,103	1,054	1,279	1,289
<b>Total operating expenses</b>	<b>3,385</b>	<b>3,715</b>	<b>3,852</b>	<b>3,931</b>	<b>4,314</b>	<b>4,391</b>	<b>4,630</b>	<b>4,755</b>
<b>Loss from operations</b>	<b>(1,451)</b>	<b>(1,806)</b>	<b>(1,739)</b>	<b>(2,263)</b>	<b>(2,671)</b>	<b>(2,945)</b>	<b>(2,854)</b>	<b>(1,858)</b>
Interest and other income	73	81	90	72	75	81	68	62
<b>Loss before provision for income taxes</b>	<b>(1,378)</b>	<b>(1,725)</b>	<b>(1,649)</b>	<b>(2,191)</b>	<b>(2,596)</b>	<b>(2,864)</b>	<b>(2,786)</b>	<b>(1,796)</b>
Provision (benefit) for income taxes	53	15	19	57	(108)	9	14	16
<b>Net loss</b>	<b>\$ (1,431)</b>	<b>\$ (1,740)</b>	<b>\$ (1,668)</b>	<b>\$ (2,248)</b>	<b>\$ (2,488)</b>	<b>\$ (2,873)</b>	<b>\$ (2,800)</b>	<b>\$ (1,812)</b>
<b>Net loss per share, basic and diluted</b>								
	\$ (0.07)	\$ (0.09)	\$ (0.09)	\$ (0.12)	\$ (0.13)	\$ (0.15)	\$ (0.15)	\$ (0.10)
<b>Market stock price range:</b>								
High	\$ 1.39	\$ 1.75	\$ 1.95	\$ 1.52	\$ 2.27	\$ 2.63	\$ 2.66	\$ 3.10
Low	\$ 0.83	\$ 1.17	\$ 1.38	\$ 1.10	\$ 0.98	\$ 1.74	\$ 1.60	\$ 2.26

**SCHEDULE II VALUATION AND QUALIFYING ACCOUNTS**  
**For the Years Ended December 31, 2006, 2005 and 2004**  
(in thousands)

Description	Allowance for Doubtful Accounts	Inventory Reserve
Year ended December 31, 2004:		
Balance at beginning of fiscal year	\$ 28	\$
Addition/charged to expenses	12	120
Recoveries	(28)	
Balance at end of fiscal year	<u>\$ 12</u>	<u>\$ 120</u>
Year ended December 31, 2005:		
Balance at beginning of fiscal year	\$ 12	\$ 120
Addition/charged to expenses	25	
Recoveries	(12)	(60)
Balance at end of fiscal year	<u>\$ 25</u>	<u>\$ 60</u>
Year ended December 31, 2006:		
Balance at beginning of fiscal year	\$ 25	\$ 60
Addition/charged to expenses		
Recoveries	(19)	(60)
Balance at end of fiscal year	<u>\$ 6</u>	<u>\$</u>

**Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure**

Not applicable.

**Item 9A. Controls and Procedures**

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

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

**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) that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Item 9B. Other Information**

Not applicable.

## PART III

**Item 10. Director, Executive Officers and Corporate Governance**

The information required by this item (with respect to Directors) is incorporated by reference from the information under the caption Election of Directors contained in the Company's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company's 2007 Annual Meeting of Stockholders to be held on May 17, 2007 (the Proxy Statement). Certain information required by this item concerning executive officers is set forth in Part I of this Report under the caption Executive Officers of the Registrant.

Item 405 of Regulation S-K calls for disclosure of any known late filing or failure by an insider to file a report required by Section 16(a) of the Exchange Act. This information is contained in the section called Section 16(a) Beneficial Ownership Reporting Compliance in the Proxy Statement and is incorporated herein by reference.

The Company has a separately designated standing Audit Committee established in accordance with Section 3(a) (58) (A) of the Securities Exchange Act of 1934. The members of the Audit Committee are Richard C. Yonker (Chairperson), Randall A. Hughes and Matthew Raggett. All of such members qualify as an independent director under applicable Nasdaq Stock Market standards and meet the standards established by The Nasdaq Stock Market for serving on an audit committee. The Company's Board of Directors has determined that Mr. Yonker qualifies as an audit committee financial expert under the definition outlined by the Securities and Exchange Commission.

The Company has adopted a Code of Business Conduct for all of its directors, officers and employees. The Company's Code of Business Conduct is available on the Company's website at [www.logicvision.com](http://www.logicvision.com). To date, there have been no waivers under the Company's Code of Business Conduct. The Company will disclose future amendments to certain provisions of its Code of Business Conduct and will post any waivers, if and when granted, under its Code of Business Conduct on the Company's website at [www.logicvision.com](http://www.logicvision.com).

**Item 11. Executive Compensation**

The information required by this item is incorporated by reference from the information under the captions Compensation of Directors, Executive Compensation, and Compensation Committee Interlocks and Insider Participation contained in the Proxy Statement.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this item with respect to security ownership of certain beneficial owners and management is incorporated by reference from the information under the caption Security Ownership of Certain Beneficial Owners and Management contained in the Proxy Statement.

**Equity Compensation Plan Information**

The following table sets forth certain information regarding the Company's equity compensation plans as of December 31, 2006:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders:			
1994 and 2000 Stock Option Plan	3,690,068	\$ 3.14	2,063,752(1)
2000 Employee Stock Purchase Plan			288,348(2)
	3,690,068	3.14	2,352,100
Equity compensation plans not approved by security holders	7,500(3)	5.00	
Total	3,697,568	\$ 3.14	2,352,100



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- (1) Consists of the number of shares reserved for issuance under the Company's 2000 Stock Incentive Plan. The number of shares reserved for issuance under the Company's 2000 Stock Incentive Plan will be increased on the first day of each of the Company's fiscal years from 2002 to 2010 by the lesser of 750,000 shares, 3.5% of the outstanding shares of the Company's common stock on that date or a lesser amount determined by the Company's Board of Directors. Stock options, restricted stock, restricted stock units or stock appreciation rights may be awarded under the 2000 Plan.
  - (2) Consists of the number of shares available for sale pursuant to the Company's 2000 Employee Stock Purchase Plan. Shares of common stock will be purchased at a price equal to 85% of the fair market value per share of common stock on either the first day preceding the offering period or the last date of the offering period, whichever is less. The number of shares reserved for issuance will be increased on the first day of each fiscal year, commencing in 2002, by the lesser of 125,000 shares, 1% of the outstanding common stock on that date, or such lesser number of shares as is determined by the Board of Directors.
  - (3) Consists of non-qualified options granted outside of the Company's 1994 Flexible Stock Incentive Plan in 1995 and 2000. The material features of the outstanding options which were granted outside of the 1994 Plan are as follows:

**2000 Non-plan Option Grants.** In August 2000, an option to purchase 7,500 shares of common stock was granted to Richard C. Black, a member of the Company's Board of Directors at that time, at an exercise price of \$5.00 per share, which price was not less than the per share fair market value on the date of grant as determined by the Board of Directors. The option is fully vested, has a ten year term, is subject to earlier termination, and includes provisions to adjust for any change in the Company's common stock through merger, recapitalization, stock split or other change in the capital structure of the Company to preserve but not increase the benefits to the optionee.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by this item is incorporated by reference from the information contained under the caption "Certain Relationships and Related Party Transactions" and "Director Independence" contained in the Proxy Statement.

**Item 14. Principal Accountant Fees and Services**

The information required by this item is incorporated by reference from the information contained under the caption "Pre-Approval Policies and Procedures" contained in the Proxy Statement.

**PART IV****Item 15. Exhibits and Financial Statement Schedules****(a) Documents filed as part of this report:**

- (1) Financial Statements

See Index under Item 8.

- (2) Financial Statement Schedule

See Index under Item 8.

- (3) Exhibits

See Item 15(b) below. Each compensatory plan required to be filed has been identified.

**(b) Exhibits.**

Exhibit Number	Description of Document
3(i)	Restated Certificate of Incorporation (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2001).
3(ii)	Bylaws of the Company, amended as of October 16, 2003 (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2003).
4.1	Form of Common Stock Certificate (incorporated by reference to the exhibit of the same number to Amendment No. 8 to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
4.2	Form of Warrant to Purchase Shares of Common Stock (incorporated by reference to Exhibit 4.4 to Amendment No. 5 to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
4.3	Form of Extinguishing Warrant to Purchase Shares of Common Stock (incorporated by reference Exhibit 4.5 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
4.6#	Form of Stock Option Agreement (incorporated by reference to Exhibit 4.8.2 to Amendment No. 6 to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
10.1.1#	Form of agreements under the 1994 Flexible Stock Incentive Plan (incorporated by reference to the exhibit of the same number to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
10.1.2#	1994 Flexible Stock Incentive Plan, as amended (incorporated by reference to Exhibit 99.2 to the Company's Registration Statement on Form S-8 (File No. 333-74336)).
10.2.1#	Amended and Restated 2000 Stock Incentive Plan (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004).
10.2.2#	Amendments Nos. 1 and 2 and Addendum to Amended and Restated 2000 Stock Incentive Plan (incorporated by reference to Exhibit 10.2 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003).
10.2.3#	Form of agreement under the 2000 Stock Incentive Plan (incorporated by reference to Exhibit 10.3 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2003).
10.3#	Form of Indemnification Agreement between the Registrant and its officers and directors (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2001).
10.4	Sixth Amended and Restated Registration Rights Agreement dated as of January 28, 2000 (incorporated by reference to the exhibit of the same number to the Company's Registration Statement on Form S-1 (File No. 333-43654)).





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Exhibit Number	Description of Document
10.5	Lease, dated as of August 13, 1998, by and between Spieker Properties, L.P. and the Company (incorporated by reference to the exhibit of the same number to Amendment No. 1 to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
10.6.1	Extension Agreement, dated as of January 17, 2000, by and between Spieker Properties, L.P. and the Company (incorporated by reference to Exhibit 10.6 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
10.6.2	Second Amendment, dated as of January 23, 2004, to Lease Agreement dated August 13, 1998 by and between CA-Metro Plaza, as successor in interest to Spieker Properties, L.P., and the Company (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2003).
10.6.3	Third Amendment, dated as of May 7, 2004, by and between CA-Metro Plaza, as successor in interest to Spieker Properties, L.P., and the Company (incorporated by reference to the exhibit of the same number to the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2004).
10.7.1	Agreement, dated as of September 14, 1992, between Northern Telecom Limited and the Company (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2002).
10.7.2	Amendment, dated as of October 1, 1993, to the Agreement between Northern Telecom Limited and the Company (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2002).
10.7.3	Amendment, dated as of January 11, 1994, to the Agreement between Northern Telecom Limited and the Company (incorporated by reference to the exhibit of the same number to Amendment No. 1 to the Company's Registration Statement on Form S-1 (File No. 333-43654)).
10.7.4	Amendment, dated as of March 20, 2001, to the Agreement between Nortel Networks Limited (formerly Northern Telecom Limited) and the Company (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2002).
10.8#	Amended and Restated 2000 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2004).
10.8.1#	Amendment, dated February 18, 2005, to the Amended and Restated 2000 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.2.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2005)
10.9.1	Amended and Restated Loan Agreement, dated as of February 11, 2004, by and between Comerica Bank California and the Company (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 31, 2003).
10.9.2	Second Amendment, dated as of January 31, 2005, to Second Amended and Restated Loan Agreement by and between Comerica Bank California and the Company (incorporated by reference to the exhibit of the same number to the Company's Current Report on Form 8-K filed with the Commission on February 4, 2005).
10.9.3	Third Amendment to the Second Amended and Restated Loan Agreement, dated February 9, 2006, by and between Comerica Bank and the Company (incorporated by reference to the Company's Current Report on Form 8-K filed with the Commission on February 10, 2006).
10.10#	Form of Change in Control Severance Agreement entered into by and between the Company and James T. Healy, Bruce M. Jaffe, Farad Hayat, Ronald H. Mabry and Fadi Maamari (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed February 17, 2006)
10.11	Form of Exchange Agreement (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed June 28, 2006)

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Exhibit Number	Description of Document
10.12	Registration Rights Agreement, dated as of June 28, 2006 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed June 28, 2006)
10.13	Common Stock Purchase Agreement, dated as of December 19, 2006 (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed December 20, 2006)
10.14	Registration Rights Agreement, dated as of December 19, 2006 (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed December 20, 2006)
21.1	Subsidiaries of the Company (incorporated by reference to the exhibit of the same number to the Company's Annual Report on Form 10-K for the year ended December 30, 2002).
23.1	Consent of Burr, Pilger & Mayer LLP, Independent Registered Public Accounting Firm
23.2	Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm
24.1	Power of Attorney (see page 67 of this Form 10-K)
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).

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# Indicates management contract or compensatory plan or arrangement.

\*\* 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-K and will not be deemed filed for purpose of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

**(c) Financial Statement Schedules.**

See Index under Item 8.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

LOGICVISION, INC.

Date: March 12, 2007

By: /s/ JAMES T. HEALY

James T. Healy.  
President and Chief Executive Officer

**POWER OF ATTORNEY**

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints James T. Healy and Bruce M. Jaffe, and each of them, his true and lawful attorneys-in-fact, each with full power of substitution, for him or her in any and all capacities, to sign any amendments to this report on Form 10-K and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact or their substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name	Title	Date
<u>/s/ JAMES T. HEALY</u> <b>James T. Healy</b>	President and Chief Executive Officer (Principal Executive Officer) and Director	March 12, 2007
<u>/s/ BRUCE M. JAFFE</u> <b>Bruce M. Jaffe</b>	Vice President of Finance and Chief Financial Officer (Principal Financial and Accounting Officer)	March 12, 2007
<u>/s/ GREGG ADKIN</u> <b>Gregg Adkin</b>	Director	March 12, 2007
<u>/s/ RANDALL A. HUGHES</u> <b>Randall A. Hughes</b>	Director	March 12, 2007
<u>/s/ MATTHEW RAGGETT</u> <b>Matthew Raggett</b>	Director	March 12, 2007
<u>/s/ RICHARD C. YONKER</u> <b>Richard C. Yonker</b>	Director	March 12, 2007

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23.2 Consent of PricewaterhouseCoopers LLP, Independent Registered Public Accounting Firm.  
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