LOGICVISION INC
Form 10-Q
October 30, 2002
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2002

OR

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

For the transition period from _________ to ___________ .

Commission File No.: 0-31773

LOGICVISION, INC.

(Exact name of registrant as specified in its charter)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for at least the past 90 days. Yes x No ¨

On September 30, 2002, 15,050,251 shares of Registrant s Common Stock, $0.0001 par value were outstanding.

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FORM 10-Q

QUARTERLY PERIOD ENDED SEPTEMBER 30, 2002

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PART I: FINANCIAL INFORMATION

ITEM 1: FINANCIAL STATEMENTS

LOGICVISION, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	September 30, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 15,676	$ 34,496
Short-term investment	2,001	
Accounts receivable, net	4,238	3,184
Prepaid expenses and other current assets	1,110	866
Total current assets	23,025	38,546
Property and equipment, net	1,405	1,453
Marketable securities	22,479	11,984
Other long-term assets, net	1,331	749
Total assets	$ 48,240	$ 52,732
LIABILITIES AND STOCKHOLDERS EQUITY		
Current Liabilities:		
Short-term debt	$ 500	$
Accounts payable	919	740
Accrued expenses	1,609	1,766
Deferred revenue, current portion	3,371	4,667
Total current liabilities	6,399	7,173
Deferred revenue	342	1,319
Total liabilities	6,741	8,492
Commitments and Contingencies		
Stockholders Equity:		
Preferred stock, $0.0001 par value:		
Authorized: 5,000,000 shares; Issued and outstanding: no shares issued and outstanding		
Common stock, $0.0001 par value:		
Authorized: 125,000,000 shares; Issued and outstanding: 15,050,251 shares at September 30, 2002 and 14,872,411 shares at December 31, 2001	2	1
Additional paid in capital	97,327	97,179
Deferred stock based compensation	(1,501)	(2,863)
Accumulated other comprehensive income	90	17
Accumulated deficit	(54,419)	(50,094)
Total stockholders equity	41,499	44,240
Total liabilities and stockholders equity	$ 48,240	$ 52,732

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

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LOGICVISION, INC.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	**2001**	**2002**	**2001**
Revenues:				
License	$ 2,764	$ 3,451	$ 9,339	$ 7,997
Service	1,168	1,353	4,115	3,827
Royalties	50		70	
Total revenues	3,982	4,804	13,524	11,824
Cost of revenues:				
License	273	284	809	535
Service	949	640	2,506	1,619
Total cost of revenues	1,222	924	3,315	2,154
Gross profit	2,760	3,880	10,209	9,670
Operating expenses:				
Research and development	1,145	1,134	3,710	3,911
Sales and marketing	2,684	2,246	7,158	7,438
General and administrative	1,227	442	3,204	2,031
Amortization of deferred stock compensation	415	750	1,267	2,117
Total operating expenses	5,471	4,572	15,339	15,497
Loss from operations	(2,711)	(692)	(5,130)	(5,827)
Interest and other income	273	29	857	206
Loss before provision for income taxes	(2,438)	(663)	(4,273)	(5,621)
Provision for income taxes	17	8	52	28
Net loss	$ (2,455)	$ (671)	$ (4,325)	$ (5,649)
Accretion of redeemable convertible preferred stock		43		130
Net loss attributable to common stockholders	$ (2,455)	$ (714)	$ (4,325)	$ (5,779)
Net loss per common share, basic and diluted	$ (0.16)	$ (0.37)	$ (0.29)	$ (3.00)
Weighted average number of shares outstanding, basic and diluted	15,022	1,946	14,950	1,923

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

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LOGICVISION, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30,	
	2002	**2001**
Cash flows from operating activities:		
Net loss	$ (4,325)	$ (5,649)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,217	805
Amortization of deferred stock compensation	1,267	2,117
Changes in operating assets and liabilities:		
Accounts receivable	(1,054)	1,035
Prepaid expenses and other current assets	(244)	(535)
Other long-term assets	10	(48)
Accounts payable	179	(134)
Deferred revenue	(2,273)	(782)
Accrued liabilities	(157)	(291)
Net cash used in operating activities	(5,380)	(3,482)
Cash flows from investing activities:		
Purchase of marketable securities	(17,495)	
Purchase of short-term investments	(2,001)	
Purchase of property and equipment	(503)	(688)
Purchase of technology license		(243)
Proceeds from sales of marketable securities	7,000	
Cash paid for acquisitions	(1,258)	
Net cash used in investing activities	(14,257)	(931)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	244	107
Proceeds from short-term debt	500	
Net cash provided by financing activities	744	107
Effect of exchange rate on cash	73	22
Net decrease in cash and cash equivalents	(18,820)	(4,284)
Cash and cash equivalents, beginning of period	34,496	9,708
Cash and cash equivalents, end of period	$ 15,676	$ 5,424

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

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LOGICVISION, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

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

The accompanying unaudited condensed consolidated financial statements of LogicVision have been prepared in accordance with generally accepted accounting principles in the United States of America (GAAP) for interim financial information and in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with GAAP. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. The December 31, 2001 fiscal year end balance sheet data was derived from the audited financial statements and does not include all disclosures required by GAAP. Operating results for the three month and nine month periods ended September 30, 2002 is not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2002 or any other future period. The unaudited condensed consolidated interim financial statements contained herein should be read in conjunction with the audited financial statements and footnotes for the year ended December 31, 2001 included in the Company s Annual Report on Form 10-K as filed with the SEC.

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

Note 2. Recently Issued Accounting Standards

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

In August 2001, the FASB issued SFAS No. 143 (SFAS 143), Accounting for Asset Retirement Obligations. SFAS 143 addresses financial accounting and reporting for obligations associated with the retirement of tangible long-lived assets and the associated asset retirement costs. SFAS 143 applies to all entities. It applies to legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and (or) the normal operation of a long-lived asset, except for certain obligations of lessees. SFAS 143 is effective for financial statements issued for fiscal years beginning after June 25, 2002. The Company has adopted this statement. The adoption of SFAS 143 did not have a material effect on the Company s financial position or results of operations.

In October 2001, the FASB issued SFAS No. 144 (SFAS 144), Accounting for the Impairment or Disposal of Long-lived Assets. The objectives of SFAS 144 are to address significant issues relating to the

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implementation of FASB Statement No. 121 (SFAS 121), Accounting for the Impairment of Long-lived Assets and for Long-lived assets to be Disposed Of, and to develop a single accounting model, based on the framework established by SFAS 121, for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. Although SFAS 144 supersedes SFAS 121, it retains some fundamental provisions of SFAS 121. SFAS 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The Company has adopted this statement. The adoption of SFAS 144 did not have a material effect on the Company s financial position or results of operations.

In April 2002, the FASB issued SFAS 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS 145 states that gains and losses from extinguishment of debt that do not meet the criteria for classification as extraordinary items in APB Opinion No. 30, Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions, should not be classified as extraordinary items. Accordingly, SFAS 145 rescinds SFAS 4 Reporting Gains and Losses from Extinguishment of Debt, and SFAS 64, Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements. The Company will adopt SFAS No. 145 on January 1, 2003 and does not expect any material effect on the Company s financial position or results of operations

In June 2002, the FASB issued SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS 146 addresses financial accounting and reporting for costs associated with exit or disposal activities. SFAS 146 requires that a liability for a cost associated with an exit or disposal activity is recognized when the liability is incurred. In summary, SFAS 146 requires that the liability shall be recognized and measured initially at its fair value in the period in which the liability is incurred, except for one-time termination benefits that meet certain requirements. SFAS 146 is effective prospectively for exit or disposal activities initiated after December 31, 2002. The Company will adopt SFAS No. 146 on January 1, 2003 and does not expect any material effect on the Company s financial position or results of operations

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

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

	September 30, 2002	December 31, 2001
Cash and cash equivalents:		
Cash	$ 820	$ 1,116
Money market funds	10,356	24,380
U.S. government agency notes	4,500	9,000
Total cash and cash equivalents	$ 15,676	$ 34,496
Short-term investment:		
Bank certificate of deposit	$ 2,001	$
Marketable securities:		
U.S. government agency notes	$ 22,479	$ 11,984

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Note 4. Acquisitions

On July 18, 2002, the Company entered into a Business Transfer Agreement (the Agreement) with the Company s distributor in Japan. Pursuant to this Agreement, the Company acquired certain fixed assets, customer lists, transitional services and a covenant not to compete (Non-competition agreement) for a period of one year. The Company accounted for the acquisition as a purchase. The aggregate purchase price of the transaction was $1.9 million of which $1.7 million was paid and the remaining $200,000 will be paid on December 27, 2002. The purchase price includes professional fees and other direct costs of the acquisition totaling $58,000.

The Company allocated the purchase price as supported by an independent third-party valuation analysis as follows (in thousands):

Transitional services	$	620
Non-competition agreement		1,258
Total purchase price	$	1,878

The amount allocated to transitional services will be amortized on a straight-line basis over the period of contracted services ending December 31, 2002. The amount allocated to the non-competition agreement will be amortized on a straight-line basis over the period of benefit which ends on July 17, 2003. For the three months ended September 30, 2002, the amortization expenses for the transitional services and non-competition agreement were $282,000 and $264,000, respectively.

Note 5. Short-term Debt

The Company has a Loan Agreement with a bank under which it may borrow, on a revolving basis, up to $5.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 4.75% at September 30, 2002. The agreement is unsecured and is not collateralized by the Company s assets. Under the agreement, the Company must comply with certain operating and reporting covenants and is not permitted to pay dividends, or make material investments or dispositions without the prior written consent of the bank. If the Company fails to comply with its covenants under the agreement, the bank can declare any outstanding amounts immediately due and payable and cease advancing money or extending credit to or for the Company. The agreement expires in December 2002. At September 30, 2002, the Company had a $500,000 balance outstanding under this agreement and had accrued an interest expense of $800. At September 30, 2002, the Company was in compliance with all the operating and reporting covenants with the bank.

Note 6. Concentration of Credit Risk

The Company has been dependent on a relatively small number of customers for a substantial portion of its revenues, although the customers comprising this group have changed from time to time. In the three month period ended September 30, 2002, two customers accounted for 28% and 29% of the Company s revenues, respectively. In the three month period ended September 30, 2001, one customer accounted for 18% of the Company s revenues. In the nine month period ended September 30, 2002, three customers accounted for 13%, 11% and 10% of the Company s revenues, respectively. In the nine month period ended September 30, 2001, one customer accounted for 17% of our revenues.

Note 7. Industry and Segment Information

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net revenues:				
North America	$ 3,565	$ 3,302	$ 10,576	$ 8,689
Europe	60	96	152	503
Asia	340	1,406	2,745	2,632
Others	17		51	
	$ 3,982	$ 4,804	$ 13,524	$ 11,824

Note 8. Net Loss Per Share

SFAS No. 128, Earnings Per Share, requires a dual presentation of basic and diluted earnings per share (EPS). Basic EPS excludes dilution and is computed by dividing net income or loss by the weighted average number of the common shares outstanding during the period. Diluted EPS reflects the potential dilution that would occur if outstanding securities to issue common stock were exercised or converted to common stock under the treasury stock method. Diluted net loss per share for the three month and nine month periods ended September 30, 2002 and 2001 does not differ from basic net loss per share since potential common shares from conversion of preferred stock, stock options and warrants and outstanding shares of common stock subject to repurchase are anti-dilutive under the treasury stock method.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Numerator Basic and Diluted				
Net loss attributable to common stockholders	$ (2,455)	$ (714)	$ (4,325)	$ (5,779)
Denominator Basic				
Weighted average common stock outstanding	15,022	1,946	14,950	1,923
Basic and diluted net loss per share	$ (0.16)	$ (0.37)	$ (0.29)	$ (3.00)

Options and warrants to purchase and preferred stock convertible into an aggregate of 3.9 million shares and 11.4 million shares of common stock were outstanding at September 30, 2002 and 2001, respectively, and were excluded from the computation of diluted shares because of their antidilutive effect on loss per share for the three and nine months then ended.

Note 9. Comprehensive Loss

The Company has adopted Statement of Financial Accounting Standards No. 130, Reporting Comprehensive Income. This statement requires companies to classify items of other comprehensive income by their nature in the financial statements and display the accumulated balance of other comprehensive income separately from retained earnings and additional paid-in-capital in the equity section of the balance sheet.

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

For the three month and nine month periods ended September 30, 2002 and 2001, comprehensive loss, which was comprised of the Company s net loss for the periods and changes in foreign currency translation adjustments, was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Net loss	$ (2,455)	$ (671)	$ (4,325)	$ (5,649)
Other comprehensive income (loss)				
Cumulative translation adjustment	4	(5)	73	22
Comprehensive loss	$ (2,451)	$ (676)	$ (4,252)	$ (5,627)

Note 10. Legal Proceedings

In September 2002, the Company was named as a party in a lawsuit filed by a purported shareholder of PurpleVision Technologies Private Limited in connection with the Company s proposed acquisition of PurpleVision. Since the Share Purchase Agreement pursuant to which the Company was to acquire all of the outstanding shares of PurpleVision was terminated in accordance with its terms in October 2002, the Company is seeking to be removed from the lawsuit. The Company believes that the resolution of this matter will not have a material adverse effect on the Company s operating results or financial condition.

Note 11. Subsequent Event

In October 2002, the Share Purchase Agreement pursuant to which the Company was to acquire all of the outstanding shares of PurpleVision Technologies Private Limited was terminated in accordance with its terms. Under the agreement, if the purchase transaction was not completed by October 7, 2002, the agreement was terminated. The Company recognized a charge of $196,000 for professional fee expenses associated with the negotiation and termination of the agreement.

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

This Management s Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the unaudited condensed consolidated financial statements and notes thereto set forth in Item 1 of this report and the section entitled Management s Discussion and Analysis of Financial Condition and Results of Operations in the Company s Annual Report on Form 10-K for the year ended December 31, 2001.

When used in this discussion, the words expects, anticipates, estimates, and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our critical accounting policies, our estimates for future revenues and cost of revenues, our expectations regarding future expenses, including research and development and sales and marketing expenses, our estimates regarding the adequacy of our capital resources, our capital requirements and our needs for additional financing, planned capital expenditures, use of our working capital, sources of revenue and anticipated revenues, including licenses of our intellectual property and software, technology development and design contracts and postcontract customer support, the features and benefits of our products, including our new Validator, our business development efforts, future acquisitions or investments, the impact of economic and industry conditions on us and our customers, the anticipated growth of our business, our ability to attract customers and establish license agreements, expectations regarding competition and the impact of recent accounting pronouncements, are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as our dependence upon and trends in capital spending budgets in the semiconductor industry and fluctuations in general economic conditions, the seasonality of the buying patterns of our customers, the concentration of sales to large customers, our ability to rapidly develop new technology and introduce new products, our ability to safeguard our intellectual property and the matters discussed in Factors That May Affect Results. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company s expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Critical Accounting Policies

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

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

Our revenue recognition policy is significant because our revenue is a key component of our results of operations. In addition, our revenue recognition determines the timing of certain expenses, such as royalties. We follow very specific and detailed guidelines in measuring revenue in accordance with the provisions of AICPA Statement of Position 97-2, Software Revenue Recognition as amended by Statement of Position 98-4 and Statement of Position 98-9; however, certain judgments affect the application of our revenue policy. Revenue results are difficult to predict, and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter and could result in future operating losses.

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

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

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

Overview

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

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

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

On July 18, 2002, we entered into a Business Transfer Agreement with our distributor in Japan. Pursuant to this agreement, we acquired certain fixed assets, customer lists, transitional services and a covenant not to compete (non-competition agreement) for a period of one year. We accounted for the acquisition as a purchase. The aggregate purchase price of the transaction was $1.9 million of which $1.7 million was paid and the remaining $200,000 will be paid on December 27, 2002. The purchase price includes professional fees and other direct costs of the acquisition totaling $58,000. Based on an independent third-party valuation analysis, we allocated $620,000 to transitional services from July 18, 2002 to December 31, 2002 and $1.3 million to the non-competition agreement over the period of benefit which ends on July 17, 2003.

In October 2002, the Share Purchase Agreement pursuant to which we were to acquire all of the outstanding shares of PurpleVision Technologies Private Limited was terminated in accordance with its terms. Under the agreement, if the purchase transaction was not completed by October 7, 2002, the agreement was terminated. We recognized a charge of $196,000 for professional fee expenses associated with the negotiation and termination of the agreement.

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In 2002, adverse general economic conditions and conditions in the semiconductor industry resulted in a substantial decrease in orders. We expect these conditions in the general economy and in the semiconductor industry to continue to impact adversely our existing and prospective customers ability to purchase our products and services.

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

We recognize the full amount of license fees upon shipment only when there is persuasive evidence of an arrangement, shipment has occurred, the fee is fixed or determinable, and collectibility of the sales proceeds is considered probable. When multiple elements exist and where vendor-specific objective evidence, or VSOE, of the fair value of undelivered elements such as postcontract customer support exists, we apply the residual method of accounting to the delivered elements.

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

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

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

Historically, a substantial portion of our total revenues has been derived from customers outside the United States and Canada, primarily from Asia and Europe. International revenues as a percentage of our total revenues was approximately 10% and 31% for the three month periods ended September 30, 2002 and 2001, respectively. International revenues as a percentage of our total revenues was approximately 22% and 27% for the nine month periods ended September 30, 2002 and 2001, respectively. We anticipate that international revenues will remain a substantial portion of our total revenues in the future. To date, all of the revenues from international customers have been denominated in U.S. dollars.

We derive substantially all of our revenues from license and service revenues associated with the sale of products, including support and maintenance fees. As a percentage of our total revenues, these license and service revenues accounted for 98.7% and 100% for the three month periods ended September 30, 2002 and 2001, respectively. As a percentage of our total revenues, these license and service revenues accounted for 99.5% and 100% for the nine month periods ended September 30, 2002 and 2001, respectively. We expect that license and service revenues will continue to account for a substantial portion of our total revenues for the foreseeable future.

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

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

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

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

Results of Operations

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	**2001**	**2002**	**2001**
Revenues:				
License	69.4%	71.8%	69.1%	67.6%
Service	29.3	28.2	30.4	32.4
Royalties	1.3		0.5	
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
License	6.9	5.9	6.0	4.5
Service	23.8	13.3	18.5	13.7
Total cost of revenues	30.7	19.2	&n	