

LOGICVISION INC
Form 10-Q
November 12, 2004

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2004

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
(State or other jurisdiction of
incorporation or organization)

94-3166964
(I.R.S. Employer
Identification Number)

25 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 ☒ No ☐

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

At October 29, 2004, 16,105,452 shares of Registrant's Common Stock, \$0.0001 par value were outstanding.

LOGICVISION, INC.

FORM 10-Q

QUARTERLY PERIOD ENDED SEPTEMBER 30, 2004

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PART I: FINANCIAL INFORMATION

ITEM 1: FINANCIAL STATEMENTS

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

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	September 30, 2004	December 31, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 7,539	\$15,475
Short-term investments	12,818	3,782
Accounts receivable, net	2,560	2,756
Prepaid expenses and other current assets	1,321	1,251
	<hr/>	<hr/>
Total current assets	24,238	23,264
Property and equipment, net	986	922
Marketable securities	7,365	11,801
Other long-term assets, net	2,007	508
	<hr/>	<hr/>
Total assets	\$34,596	\$36,495
	<hr/>	<hr/>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	\$ 2,360	\$ 754
Accrued liabilities	2,238	1,389
Deferred revenue	5,496	5,482
	<hr/>	<hr/>
Total current liabilities	10,094	7,625
Non-current deferred revenue	2,818	1,719
	<hr/>	<hr/>
Total liabilities	12,912	9,344
	<hr/>	<hr/>
Commitments and contingencies (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: 16,094,087 shares at September 30, 2004	2	2
and 15,775,779 shares at December 31, 2003		
Additional paid-in capital	98,315	97,759
Deferred stock-based compensation	(10)	(132)
Accumulated other comprehensive income	108	135
Accumulated deficit	(76,731)	(70,613)
	<hr/>	<hr/>
Total stockholders' equity	21,684	27,151
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$34,596	\$36,495
	<hr/>	<hr/>

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Revenues:				
License	\$1,662	\$466	\$ 4,111	\$2,046
Service	962	950	2,977	3,115
Product	69	65	278	129
Total revenues	2,693	1,481	7,366	5,290
Cost of revenues:				
License	42	58	136	144
Service	691	524	1,977	2,013
Product	99	32	266	53
Total cost of revenues	832	614	2,379	2,210
Gross profit	1,861	867	4,987	3,080
Operating expenses:				
Research and development	1,220	1,089	3,659	3,526
Sales and marketing	1,530	2,149	4,368	7,118
General and administrative	980	1,082	3,366	3,167
Total operating expenses	3,730	4,320	11,393	13,811
Loss from operations	(1,869)	(3,453)	(6,406)	(10,731)
Interest and other income, net	106	152	324	523
Loss before provision for income taxes	(1,763)	(3,301)	(6,082)	(10,208)
Provision for income taxes	4	41	36	123

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Net loss	\$ (1,767)	\$ (3,342)	\$ (6,118)	\$(10,331)
Net loss per common share, basic and diluted	\$ (0.11)	\$ (0.21)	\$ (0.38)	\$ (0.67)
Weighted average number of shares outstanding, basic and diluted	16,065	15,618	15,990	15,435

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

LOGICVISION, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(in thousands)

	Nine Months Ended September 30,	
	2004	2003
Cash flows from operating activities:		
Net loss	\$ (6,118)	\$ (10,331)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	468	1,342
Amortization of deferred stock-based compensation	39	601
Changes in operating assets and liabilities:		
Accounts receivable, net	195	(2,206)
Prepaid expenses and other current assets	(69)	220
Other long-term assets	(1,499)	(57)
Accounts payable	1,606	(862)
Deferred revenue	1,114	1,836
Accrued liabilities	849	(41)
Net cash used in operating activities	(3,415)	(9,498)
Cash flows from investing activities:		
Purchase of marketable securities	(3,283)	(4,301)
Purchase of short-term investments	(6,984)	(2,004)
Purchase of property and equipment	(528)	(395)
Proceeds from sales of marketable securities and short-term investments	5,667	8,490
Net cash provided by (used in) investing activities	(5,128)	1,790
Cash flows from financing activities:		
Proceeds from issuance of common stock	639	698
Repayment of short-term debt		(1,500)

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Net cash provided by (used in) financing activities	639	(802)
Effect of exchange rate on cash	(32)	17
Net decrease in cash and cash equivalents	(7,936)	(8,493)
Cash and cash equivalents, beginning of period	15,475	16,179
Cash and cash equivalents, end of period	\$ 7,539	\$ 7,686

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

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, 2003 fiscal year end balance sheet data was derived from the audited financial statements and does not include all disclosures required by GAAP. Operating results for the three months and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2004 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, 2003 included in the Company's Annual Report on Form 10-K as filed with the SEC.

Certain items previously presented in specific financial statement captions have been reclassified to conform with the current presentation for 2004.

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 2004, the Financial Accounting Standards Board (FASB) issued EITF Issue 03-01 The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (EITF 03-01). EITF 03-01 establishes a common approach to evaluating other-than-temporary impairment to investments in an effort to reduce the ambiguity in impairment methodology found in APB Opinion No. 18, The Equity Method of Accounting for Investments in Common Stock and Statement of Financial Accounting Standards (SFAS) No. 115,

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Accounting for Certain Investments in Debt and Equity Securities, which has resulted in inconsistent application. In September 2004, the FASB issued FASB Staff Position (FSP) No. EITF Issue 03-01-1, which deferred the effective date for the measurement and recognition guidance clarified in EITF 03-01; however, disclosure requirements have not been deferred. Disclosure requirements are effective for the Company's next annual financial statements. While the effective date for certain elements of EITF 03-01 have been deferred, the adoption of EITF 03-01 when finalized is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

On December 17, 2003, the Staff of the Securities and Exchange Commission issued Staff Accounting Bulletin No. 104 (SAB 104), Revenue Recognition, which supersedes SAB 101, Revenue Recognition in Financial Statements. SAB 104's primary purpose is to rescind the accounting guidance contained in SAB 101 related to multiple-element revenue arrangements that was superseded as a result of the issuance of EITF 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. Additionally, SAB 104 rescinds the SEC's related Revenue Recognition in Financial Statements Frequently Asked Questions and Answers issued with SAB 101 that had been codified in SEC Topic 13, Revenue Recognition. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104, which was effective upon issuance. The Company's adoption of SAB 104 did not have a material effect on its 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 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

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the specific identification method. Cash and cash equivalents, short-term investments and marketable securities consist of the following (in thousands):

	September 30, 2004	December 31, 2003
Cash and cash equivalents:		
Cash	\$ 641	\$ 1,942
Money market funds	3,800	203
Commercial paper	1,298	-
U.S. government agency notes	1,800	13,330
	<hr/>	<hr/>
Total cash and cash equivalents	7,539	15,475
	<hr/>	<hr/>
Short-term investments:		
U.S. government agency notes	11,069	3,782
Certificates of deposit	1,500	-
Commercial paper	249	-
	<hr/>	<hr/>
Total short-term investments	12,818	3,782
	<hr/>	<hr/>
Marketable securities:		
U.S. government agency notes	7,365	11,801
	<hr/>	<hr/>
	\$ 27,722	\$ 31,058

Cash and Cash Equivalents, Short-Term Investments
and Marketable Securities

Note 4. Loan Agreement

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, 2004. 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 on January 31, 2005. There were no borrowings outstanding at September 30, 2004, and the Company was in compliance with all the operating and reporting covenants under the Agreement.

Note 5. Commitments and Contingencies

Lease obligations

At September 30, 2004, total future obligations under contractual obligations and commercial commitments, primarily leasing arrangements, were as follows (in thousands):

Year ending December 31,	Operating Leases
2004	\$ 146
2005	494
2006	414
2007	325
2008	302
Thereafter	389
	<hr/>
	\$2,070
	<hr/>

Rent expense for the three months and nine months ended September 30, 2004 was \$208,000 and \$686,000, respectively. Rent expense for the three months and nine months ended September 30, 2003 was \$280,000 and \$876,000, respectively.

The Company and its subsidiaries in Canada, India and Japan rent office facilities under non-cancelable operating leases which expire through March 2010. The Company and its subsidiaries are responsible for certain maintenance costs, taxes and insurance under the respective leases.

Off-balance Sheet Arrangements

The Company's off-balance sheet arrangements consist solely of operating leases as described above.

Indemnification Obligations

The Company enters into standard license agreements in the ordinary course of business. Pursuant to these agreements, the Company agrees to indemnify its 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. The Company estimates the fair value of its indemnification obligations as insignificant, based upon its historical experience concerning product and patent infringement claims. Accordingly, the Company has no liabilities recorded for indemnification under these agreements as of September

30, 2004.

The Company has agreements whereby its officers and directors are indemnified for certain events or occurrences while the officer or director is, or was, serving at the Company's request in such capacity. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a directors and officers insurance policy that reduces its exposure and enables the Company to recover a portion of future amounts paid. As a result of the Company's insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. Accordingly, no liabilities have been recorded for these agreements as of September 30, 2004.

Warranties

The Company offers its customers a warranty that its 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, the Company has no liabilities recorded for these warranties as of September 30, 2004. The Company assesses 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.

Note 6. Concentration of Credit Risk

The Company has been dependent on a relatively small number of customers for a substantial portion of its revenue, although the customers comprising this group have changed from time to time. Three customers accounted for 19%, 16% and 13% of its revenues in the three months ended September 30, 2004 and two customers accounted for 20% and 18% of its revenues in the nine months ended September 30, 2004. In the three and nine months ended September 30, 2003, no customer accounted for more than 10% of its revenues.

At September 30, 2004, two customers accounted for 67%, and 28% of net accounts receivable, respectively. At December 31, 2003, two customers accounted for approximately 64% and 24% of net accounts receivable, respectively.

Note 7. Net Loss Per Share

SFAS No. 128, Earnings Per Share, requires a dual presentation of basic and diluted earnings per share (EPS). Basic EPS excludes dilution and is computed by dividing net income or loss by the weighted average number of shares of common stock outstanding during the period. Diluted EPS reflects the potential dilution that would occur if outstanding securities to issue common stock were exercised or converted to common stock. Diluted net loss per share for the three months and nine months ended September 30, 2004 and 2003 does not differ from basic net loss per share since potential shares of common stock issuable upon exercise of stock options and warrants are anti-dilutive under the treasury stock method.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Numerator - Basic and Diluted				
Net loss	\$ (1,767)	\$ (3,342)	\$ (6,118)	\$ (10,331)
Denominator - Basic and Diluted				
Weighted average common stock outstanding	16,065	15,618	15,990	15,435
Basic and diluted net loss per share	\$ (0.11)	\$ (0.21)	\$ (0.38)	\$ (0.67)

Options and warrants to purchase an aggregate of 4.6 million shares of common stock were outstanding at September 30, 2004, and were excluded from the computation of diluted shares because of their antidilutive effect on loss per share for the three months and nine months then ended.

Note 8. Comprehensive Loss

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

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

For the three months and nine months ended September 30, 2004 and 2003, 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,	
	2004	2003	2004	2003
Net loss	\$ (1,767)	\$ (3,342)	\$ (6,118)	\$ (10,331)
Other comprehensive income -				
Cumulative translation adjustment	10	10	(27)	41
Comprehensive loss	\$ (1,757)	\$ (3,332)	\$ (6,145)	\$ (10,290)

Note 9. Deferred Stock-Based Compensation

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

Had compensation cost for the Company's stock-based compensation plan been determined based on the minimum value at the grant date for awards consistent with the provisions of SFAS No. 123 and SFAS No. 148, the Company's net loss would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss, as reported	\$(1,767)	\$(3,342)	\$(6,118)	\$(10,331)
Add: Stock-based compensation				

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	Three Months Ended September 30,		Nine Months Ended September 30,	
expense included in reported	(46)	164	39	601
Deduct: Total stock-based compensation expense determined under fair value based method for all awards granted	(787)	(499)	(2,589)	(2,212)
Pro forma net loss	<u>\$(2,600)</u>	<u>\$(3,677)</u>	<u>\$(8,668)</u>	<u>\$(11,942)</u>
Loss per share:				
Basic and diluted as reported	<u>\$ (0.11)</u>	<u>\$ (0.21)</u>	<u>\$ (0.38)</u>	<u>\$ (0.67)</u>
Basic and diluted pro forma	<u>\$ (0.16)</u>	<u>\$ (0.24)</u>	<u>\$ (0.54)</u>	<u>\$ (0.77)</u>

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Expected average life of option	4.4years	4 years	3.6years	4 years
Risk-free interest rate	3.55%	3.72%	2.78%	2.64%
Expected dividends				
Expected volatility	2.88	2.09	2.85	2.07

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

Stock-based compensation expense related to stock options granted to consultants is recognized as earned using the multiple option method. At each reporting date, the Company re-values the unvested portion of the option using the Black-Scholes option pricing model. As a result, the stock-based compensation expense will fluctuate as the fair market value of the Company's common stock fluctuates. For the three months and nine months ended September 30, 2004, the Company did not have any stock-based compensation expenses related to stock options granted to consultants. For the three months and nine months ended September 30, 2003, the stock-based compensation expenses related to stock options granted to consultants were \$87,000 and \$140,000, respectively.

Note 10. Segment Reporting

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

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

	Three Months Ended September 30,	Nine Months Ended September 30,
Net revenues:		

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2004		2003		2004		2003	
United States	\$ 2,080	\$ 1,041		\$ 5,601	\$ 4,037		
Japan	555	324		1,562	928		
Other	58	116		203	325		
	\$ 2,693	\$ 1,481		\$ 7,366	\$ 5,290		

The following is a summary of the Company's long-lived assets (in thousands):

	September 30, 2004	December 31, 2003
United States	\$ 644	\$ 515
India	156	210
Canada	111	87
Japan	74	106
Others	1	4
	\$ 986	\$ 922

Note 11. Subsequent Event

In November 2004, the Company completed the acquisition of SiVerion, Inc. (SiVerion) for a total purchase price of \$7.4 million. At the closing, the Company paid \$1.4 million in cash and issued 2 million shares of the Company's common stock valued at \$3.4 million to SiVerion's stockholders and paid \$600,000 to certain debtholders. The purchase price also includes a contingent payment of up to \$2 million in cash payable on November 5, 2006 if the average closing price of the Company's common stock for the 10 trading days immediately prior thereto is less than \$3.00, in exchange for all of SiVerion's outstanding capital stock. 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.

Upon closing, SiVerion became a business unit of the Company, retained all of its employees, and continued its operations in Arizona. One of SiVerion's directors, who was also a beneficial owner of approximately 34% of SiVerion's capital stock, has joined the Company's board of directors.

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, 2003.

When used in this discussion, the words expects, anticipates, estimates, and similar expressions are intended to identify forward-looking statements. These statements, which include statements as to our critical accounting policies, our expectations regarding expenses, our estimates regarding our cash resources, 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, the features and

benefits of our products, customer demand, our growth strategy, our reliance on a limited number of customers, our business development efforts, expansion of our technologies and products, including by investment or acquisition, our ability to attract customers and establish license agreements, expectations regarding competition, our ability to attract and retain qualified personnel and our foreign currency risk strategy, are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, those risks discussed below, as well as the seasonality of the buying patterns of our customers, the concentration of sales to a limited number of customers, dependence upon and trends in capital spending budgets in the semiconductor industry and fluctuations in general economic conditions, our ability to rapidly develop new technology and introduce new products, our ability to safeguard our intellectual property and the matters discussed in Factors That May Affect Future Operating Results. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.

Critical Accounting Policies

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

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 and Statement of Position 81-1 Accounting for Performance of Construction-Type and Certain Production-Type Contracts.

We derive our revenues from three primary sources: license revenues, comprised of fees associated with the licensing of software; service revenues, from maintenance, 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.

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

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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 on a percentage of completion basis 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, we will recognize revenues upon delivery of the product if other revenue recognition criteria are met.

Deferred revenue. Deferred revenue consists primarily of maintenance and support services under maintenance contracts and unearned license revenues. Deferred revenue represents the excess of amounts invoiced or received over the revenue recognized. Deferred revenue fluctuates at each period end in accordance with the mix of contracts.

Use of Estimates

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 disclosures 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, inventory, 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.

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.

Inventory

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We record inventory reserves when conditions exist that suggest our inventory may be in excess of anticipated demand or is obsolete based upon our assumptions about future demand of our products or market conditions. We regularly evaluate the ability to realize the value of our inventory based on a combination of factors including sales forecasts, estimated product end of life dates and estimated current and future market value. When recorded, our reserves are intended to reduce the carrying value of our inventory to its net realizable value.

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

Cost of Revenues

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

Operating Expenses

Research and development expenses consist primarily of compensation and related costs for personnel and consulting expenses. 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, professional services and related fees and expenses.

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,	
	2004	2003	2004	2003
Revenues:				
License	61.7%	31.5%	55.8%	38.7%
Service	35.7	64.1	40.4	58.9
Product	2.6	4.4	3.8	2.4
Total revenues	100.0	100.0	100.0	100.0
Cost of revenues:				
License	1.6	3.9	1.8	2.7
Service	25.7	35.4	26.8	38.1

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Product	3.7	2.2	3.6	1.0
Total cost of revenues	31.0	41.5	32.2	41.8
Gross profit	69.0	58.5	67.8	58.2
Operating expenses:				
Research and development	45.3	73.5	49.7	66.7
Sales and marketing	56.8	145.1	59.3	134.6
General and administrative	36.4	73.1	45.7	59.9
Total operating expenses	138.5	291.7	154.7	261.2
Loss from operations	(69.5)	(233.2)	(86.9)	(203.0)
Interest and other income, net	3.9	10.3	4.4	9.9
Loss before provision for income taxes	(65.6)	(222.9)	(82.5)	(193.1)
Provision for income taxes	0.1	2.8	0.5	2.3
Net loss	(65.7)%	(225.7)%	(83.0)%	(195.4)%

Three Months Ended September 30, 2004 Compared with the Three Months Ended September 30, 2003

Revenues

Total revenues were \$2.7 million in the third quarter of 2004, a \$1.2 million or 81.8% increase from \$1.5 million in the third quarter of 2003. The increase in total revenues was primarily attributable to an increase in license revenues resulting from new subscription license orders received from customers.

Cost of revenues

Total cost of revenues increased 35.5% in the third quarter of 2004, as compared to the third quarter of 2003. Total cost of revenues was \$0.8 million in the third quarter of 2004, compared to \$0.6 million in the third quarter of 2003. The increase was primarily due to increased cost of professional services, primarily post-sales customer support, and an increase in product costs resulting from an inventory reserve.

Research and development

Research and development expenses were \$1.2 million or 45.3% of revenues for the third quarter of 2004, a slight increase as compared to \$1.1 million or 73.5% of revenue for the same period in the prior year. The increase was due to higher costs of licensed software. The decrease in research and development expenses as a percentage of total revenue was due to the increase in revenue. Research and development expenses are expected to increase in absolute terms as we continue to invest in the automation and enhancement of our product offering.

Sales and marketing

Sales and marketing expenses decreased \$0.6 million or 28.8% in the third quarter of 2004, as compared to the third quarter of 2003. Sales and marketing expenses were \$1.5 million in the third quarter of 2004, compared to \$2.1 million for the same period in the prior year. The decrease was due to lower compensation and other personnel expenses resulting from reductions in headcount, office expenses, amortization of covenant not to compete, trade show expense and stock-based compensation expense.

General and administrative

General and administrative expenses decreased \$0.1 million or 9.4% in the third quarter of 2004, as compared to the third quarter of 2003. General and administrative expenses were \$1.0 million in the third quarter of 2004, compared to \$1.1 million for the same period in the prior year. The decrease was primarily due to lower office expenses.

Interest and other income

Interest income of \$0.1 million decreased 30.3% in the third quarter of 2004, as compared to the third quarter of 2003. The decrease was primarily due to lower investment balances and lower interest rates.

Income taxes

Our net operating losses are generated domestically, and amounts attributed to our foreign operations have been insignificant for all periods presented. For the third quarter of 2004 and 2003, we recorded income tax provisions of \$4,000 and \$41,000, respectively, 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, 2003, we incurred net losses for federal and state tax purposes. As of December 31, 2003, we had federal and California net operating loss carryforwards of approximately \$53.5 million and \$22 million available to reduce future federal and California taxable income, respectively. These federal and California carryforwards begin to expire in 2006 and 2004, respectively, if not utilized. The extent to which these carryforwards can be used to offset future taxable income may be limited under Section 382 of the Internal Revenue Code and applicable state tax law.

Nine Months Ended September 30, 2004 Compared with the Nine Months Ended September 30, 2003

Revenues

Total revenues were \$7.4 million in the first nine months of 2004, a \$2.1 million or 39.2% increase from \$5.3 million in the first nine months of 2003. The increase in total revenues was primarily attributable to an increase in license revenues resulting from subscription orders and an increase in revenues from product sales.

Cost of revenues

Total cost of revenues increased \$0.2 million or 7.6% in the first nine months of 2004, as compared to the first nine months of 2003. Total cost of revenues was \$2.4 million in the first nine months of 2004, compared to \$2.2 million in the first nine months of 2003. The increase was primarily due to increases in product costs and the establishment of an inventory reserve.

Research and development

Research and development expenses increased \$0.2 million or 3.8% in the first nine months of 2004, as compared to the first nine months of 2003. Research and development expenses were \$3.7 million in the first nine months of 2004, compared to \$3.5 million for the same period in the prior year. The increase was primarily due to an increase in compensation and personnel expenses.

Sales and marketing

Sales and marketing expenses decreased \$2.7 million or 38.6% in the first nine months of 2004, as compared to the first nine months of 2003. Sales and marketing expenses were \$4.4 million in the first nine months of 2004, compared to \$7.1 million for the same period in the prior year. The decrease was primarily due to lower compensation and other personnel expenses of \$1.0 million resulting from reductions in headcount, lower amortization of a covenant not to compete of \$0.7 million, lower stock-based compensation expense of \$0.3 million, lower office expenses of \$0.3 million, lower depreciation expense of \$0.2 million, and lower trade show expenses of \$0.2 million.

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General and administrative expenses increased \$0.2 million or 6.3% in the first nine months of 2004, as compared to the first nine months of 2003. General and administrative expenses were \$3.4 million in the first nine months of 2004, compared to \$3.2 million for the same period in the prior year. The increase was primarily due to higher personnel costs of \$0.4 million resulting from increased headcount and higher business consulting expense of \$0.2 million, partially offset by decreases in office expenses of \$0.3 million and stock-based compensation expense of \$0.1 million.

Interest and other income

Interest and other income decreased \$0.2 million or 38.0% in the first nine months of 2004, as compared to the first nine months of 2003. Interest and other income was \$0.3 million in the first nine months of 2004, compared to \$0.5 million for the same period in the prior year. The decrease was primarily due to lower investment balances and lower interest rates.

Income taxes

Our net operating losses are generated domestically, and amounts attributed to our foreign operations have been insignificant for all periods presented. For the first nine months of 2004 and 2003, we recorded income tax provisions of \$36,000 and \$123,000, respectively, primarily related to state and foreign taxes.

Liquidity and Capital Resources

At September 30, 2004, we had cash and cash equivalents, short-term investments and marketable securities of \$27.7 million and working capital of \$14.1 million.

Net cash used in operating activities was \$3.4 million and \$9.5 million in the first nine months of 2004 and 2003, respectively. Net cash used in operating activities for the nine months ended September 30, 2004 was primarily due to a net loss of \$6.1 million; an increase in other long-term assets of \$1.5 million resulting from a prepaid license fee for technology incorporated in our LV 2004(TM) product and an increase in prepaid expenses of \$0.1 million; partly offset by an increase in accounts payable of \$1.6 million; an increase in deferred revenue of \$1.1 million, an increase in other accrued liabilities of \$0.9 million; an increase in non-cash charges relating to depreciation and amortization of \$0.5 million and a decrease in accounts receivable of \$0.2 million. Net cash used in operating activities for the nine months ended September 30, 2003 was primarily due to a net loss of \$10.3 million; an increase in accounts receivable of \$2.2 million; a decrease in accounts payable of \$0.9 million due to timing of payments to suppliers in order to optimize discounts and payment periods, partly offset by non-cash charges relating to depreciation and amortization and amortization of deferred stock-based compensation of \$1.3 million and \$0.6 million, respectively; and a decrease in prepaid and other current expenses of \$0.2 million and an increase in deferred revenue of \$1.8 million.

Net cash used in investing activities was \$5.1 million for the nine months ended September 30, 2004 and net cash provided by investing activities was \$1.8 million for the nine months ended September 30, 2003. Net cash used in investing activities for the nine months ended September 30, 2004 was due to the purchase of marketable securities and short-term investments of \$3.3 million and \$7.0 million, respectively, and the purchase of property and equipment of \$0.5 million, partly offset by proceeds from the maturity of marketable securities of \$5.7 million. Net cash provided by investing activities for the nine months ended September 30, 2003 was primarily due to the proceeds from sales and maturity of marketable securities of \$8.5 million, partly offset by purchases of short-term investments and marketable securities of \$4.3 million and \$2.0 million, respectively, and the purchase of property and equipment of \$0.4 million.

Net cash provided by financing activities was \$0.6 million for the nine months ended September 30, 2004 and net cash used in financing activities was \$0.8 million for the nine months ended September 30, 2003. Net cash provided by financing activities for the nine months ended September 30, 2004 was primarily due to the proceeds from the issuance of common stock pursuant to the employee stock purchase plan and exercises of employee stock options. Net cash used in financing activities for the nine months ended September 30, 2003 was primarily due to repayments of a bank loan of \$1.5 million, offset by net proceeds of \$0.7 million received from the issuance of common stock pursuant to the employee stock purchase plan and exercises of employee stock options.

We have a loan agreement with a bank under which we may borrow, on a revolving basis, up to \$5.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 4.75% at September 30, 2004. 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.

No amount was outstanding under this agreement at September 30, 2004, and the agreement expires on January 31, 2005. At September 30, 2004, we were in compliance with all the operating and reporting covenants under the loan agreement; however, because it is probable that we will not be in compliance with an operating covenant at the end of 2004, we will be required to renegotiate the loan or request a waiver of the operating covenant as of December 31, 2004 in order to continue to have the ability to borrow under the agreement.

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 and capital requirements for at least the next 12 months. We expect our cash resources before any borrowings to decrease in the short term due to cash resources required for working capital, cash paid in connection with our November 2004 acquisition of SiVerion, Inc., and to fund operating cash flows.

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

Contractual Obligations and Other Commercial Commitments

At September 30, 2004, our obligations under contractual obligations and commercial commitments, primarily leasing arrangements, were as follows (in thousands):

Year ending December 31,	Operating Leases
2004	\$ 146
2005	494
2006	414
2007	325
2008	302
Thereafter	389
	<hr/>
	\$2,070
	<hr/>

We rent office facilities under noncancelable operating leases which expire through March 2010. We are responsible for certain maintenance costs, taxes and insurance under the respective leases.

Off-balance Sheet Arrangements

The Company's off-balance sheet arrangements consist solely of operating leases as described above.

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. 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 September 30, 2004.

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,

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we believe the estimated fair value of these indemnification agreements is minimal. Accordingly, we have no liabilities recorded for these agreements as of September 30, 2004.

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 September 30, 2004. 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.

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FACTORS THAT MAY AFFECT FUTURE OPERATING RESULTS

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 assure you that integrated circuit designers and design companies' customers will accept embedded test technology as an alternative to current testing methods in the time frame we anticipate, or at all. The industry may fail to adopt embedded test technology for many reasons, including the following:

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

- our existing and potential customers may react to 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;

- 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 current and potential customers may not accept or embrace our recently released LV2004TM integrated family of products; 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

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postponed or canceled capital expenditures for previously planned expansions or new fabrication facility construction projects, a reduced number of design starts, reduction of design and test budgets or continued consolidation among our customers would harm our business and financial condition.

The primary customers for semiconductors that incorporate our embedded test technology are companies in the communications, networking, server and high-end consumer products industries. Any significant downturn in these particular markets or in general economic conditions which result in the cutback of research and development budgets or capital expenditures would likely result in a reduction in demand for our products and services and could harm our business. If the econo