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778

India

93

Canada

297

203

Japan

13

23

| | |
|---|---|
| $ | |
| | 873 |
| $ | |
| | 1,097 |

**Note 10. Restructuring Costs**

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

The following is a summary of activities in accrued restructuring and excess facilities costs for the nine months ended September 30, 2006 (in thousands):

| | Severance and Benefits | Excess Facilities | Asset Related | Total |
|---|---|---|---|---|
| Balance as of December 31, 2005 | $ 198 | $ 18 | $ 74 | $ 290 |
| Cash charges | (195) | (18) | (61) | (274) |
| Non-cash charges | | | (13) | (13) |
| Balance as of September 30, 2006 | $ 3 | $ | $ | $ 3 |

The remaining accrued severance and benefits costs represent the cost of COBRA benefits which the Company is obligated to pay.

**Note 11. Issuance of additional shares**

On June 27, 2006, the Company issued 1,070,499 shares of common stock to certain former shareholders of SiVerion, Inc. in exchange for the Additional Cash Exchange Rights (as defined below) held by those former shareholders. The Company completed the acquisition of SiVerion, Inc. in November 2004. The purchase price included a contingent payment of up to $2 million in cash payable on November 5, 2006 (the Additional Cash Exchange Rights ) if the average closing price of the Company s common stock for the 10 trading days immediately prior thereto is less than $3.00. The 1,070,499 shares issued effectively reduce the contingent payment to no more than $148,000, payable to those remaining SiVerion, Inc. shareholders in the event the Company s common stock is less than $3.00 as determined above.

**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, 2005.

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

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

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

**Critical Accounting Policies and Estimates**

LogicVision s financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States ( GAAP ). Preparing financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, sales and expenses. These estimates and assumptions are affected by management s application of accounting policies. Critical accounting policies for LogicVision include revenue recognition, allowance for doubtful accounts, valuation of investments, inventory, goodwill impairment, valuation of long-lived intangible assets, accounting for stock-based compensation, and accounting for income taxes, which are discussed in more detail under the caption Critical Accounting Policies and Estimates in the Company s Annual Report on Form 10-K for the year ended December 31, 2005.

**Stock-Based Compensation Expense**

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

Employee Stock Purchase Plan based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) for periods beginning in 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ( SAB 107 ) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method. The Company s Consolidated Financial Statements as of September 30, 2006 and for the three and nine months ended September 30, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the nine months ended September 30, 2006 was $317,000, which consisted of stock-based compensation expense related to employee stock options and employee stock purchases. No stock-based compensation expense related to employee stock options and employee stock purchases was recognized for the nine months ended September 30, 2005.

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

Stock-based compensation expense recognized during the current period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Consolidated Statements of Operations for the nine months ended September 30, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123, and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all share-based payment awards will be recognized using the multiple-option approach. As stock-based compensation expense recognized in the Consolidated Statements of Operations for the nine months ended September 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information required under SFAS 123 for the periods ending prior to January 1, 2006, the Company accounted for forfeitures as they occurred.

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

**Results of Operations**

**Orders and backlog**

We received new orders of $3.8 million in the third quarter of 2006 compared to $1.3 million in the second quarter of 2006 and $7.0 million in the third quarter of 2005. These new orders are for periods ranging from one to two years. Receipt of new orders may fluctuate due to the lengthy sales cycles and our dependence on relatively few customers for large orders.

Our backlog was $21.4 million at September 30, 2006, compared with $19.8 million at June 30, 2006 and $19.8 million at September 30, 2005. Backlog is comprised of deferred revenues (orders which have been billed but for which revenue has not yet been recognized) plus orders which have been accepted but have not yet been billed and for which no revenue has been recognized. A significant portion of the orders which have been accepted but have not yet been billed provide customers with cancellation rights; customers may also renew contracts before their expiration or modify that portion of their orders which is cancelable. Therefore, our backlog at any particular date is not necessarily indicative of revenues to be recognized during any succeeding period. At September 30, 2006, approximately $9.4 million of the total backlog is expected to become recognized as revenue ratably over the next 12 months.

**Revenues, cost of revenues and gross profit**

The table below sets forth the fluctuations in revenues, cost of revenues and gross profit data for the three and nine months ended September 30, 2006 and 2005 (in thousands, except percentage data):

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2006 | 2005 | % Change | 2006 | 2005 | % Change |
| Revenues: | | | | | | |
| License | $ 1,332 | $ 1,250 | 7% | $ 3,856 | $ 5,440 | -29% |
| Service | 1,312 | 892 | 47% | 3,809 | 2804 | 36% |
| Product | 10 | 58 | -83% | 110 | 168 | -35% |
| Total revenues | 2,654 | 2,200 | 21% | 7,775 | 8,412 | -8% |
| Cost of revenues: | | | | | | |
| License | 259 | 261 | -1% | 746 | 650 | 15% |
| Service | 486 | 468 | 4% | 1,339 | 1,568 | -15% |
| Product | | 25 | -100% | | 75 | -100% |
| Total cost of revenues | 745 | 754 | -1% | 2,085 | 2,293 | -9% |
| Gross profit | $ 1,909 | $ 1,446 | 32% | $ 5,690 | $ 6,119 | -7% |
| **Percentage of total revenues:** | | | | | | |
| Revenues: | | | | | | |
| License | 50% | 57% | | 50% | 65% | |
| Service | 50% | 40% | | 49% | 33% | |
| Product | 0% | 3% | | 1% | 2% | |
| Total revenues | 100% | 100% | | 100% | 100% | |
| Cost of revenues: | | | | | | |
| License | 10% | 12% | | 10% | 8% | |
| Service | 18% | 21% | | 17% | 18% | |
| Product | 0% | 1% | | 0% | 1% | |
| Total cost of revenues | 28% | 34% | | 27% | 27% | |
| Gross profit | 72% | 66% | | 73% | 73% | |

**Total revenues** increased in the three months ended September 30, 2006 compared to the same period in fiscal 2005 primarily due to an increase in orders in the past three quarters; the revenues are being recognized ratably over the contract term period.  During the quarter, both license revenues and service revenues increased. In accordance with the Company s revenue recognition policy, we allocate a portion of total revenues to maintenance (services) using the estimated fair value of the maintenance, which is based on maintenance renewals sold separately for similar products. The product revenue was from the rental of a Validator in the quarter.

**Total cost of revenues** decreased in the three months ended September 30, 2006 compared to the same period in fiscal 2005 primarily due to zero cost associated with the Validator product because the product costs had previously been written off.

**Revenues by product line and country**

The table below sets forth the fluctuations in revenues by product line and geographic region for the three and nine months ended September 30, 2006 and 2005 (in thousands, except percentage data):

**Revenue by product line:**

| | Three Months Ended September 30, | | % Change | Nine Months Ended September 30, | | % Change |
|---|---|---|---|---|---|---|
| | 2006 | 2005 | | 2006 | 2005 | |
| ETCreate | $ 1,946 | $ 1,834 | 6% | $ 5,689 | $ 6,926 | -18% |
| ETAccess | 552 | 340 | 62% | 1,639 | 1,396 | 17% |
| SiVision and other | 156 | 26 | 500% | 447 | 90 | 397% |
| Total revenues | $ 2,654 | $ 2,200 | 21% | $ 7,775 | $ 8,412 | -8% |

**Revenue by geographic region:**

| | Three Months Ended September 30, | | % Change | Nine Months Ended September 30, | | % Change |
|---|---|---|---|---|---|---|
| | 2006 | 2005 | | 2006 | 2005 | |
| United States | $ 2,223 | $ 1,753 | 27% | $ 6,682 | $ 6,743 | -1% |
| Japan | 307 | 254 | 21% | 788 | 1,135 | -31% |
| Others | 124 | 193 | -36% | 305 | 534 | -43% |
| | $ 2,654 | $ 2,200 | 21% | $ 7,775 | $ 8,412 | -8% |

**Product line:**

**ETCreate** is the product sub-family formerly known as icBIST, which consists of embedded test intellectual property and corresponding design automation software that provides embedded test solutions for different components of an ASIC or SOC design. ETCreate revenue decreased for the nine months ended September 30, 2006 primarily because the results for the nine months ended September 30, 2005 included license revenues from an existing order that was recognized upfront based on payment terms.

**ETAccess** is the product sub-family which consists of hardware and software products for use with third party test platforms. ETAccess enables faster time-to-market and lower test costs through the support of interactive or test program controlled at-speed testing, datalogging, and debug of silicon designed with LogicVision s embedded test IP. ETAccess revenue increased for the three months ended September 30, 2006 primarily from wider customer adoption and therefore more sales of ETAccess product in the recent quarters.

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

**Geographic region:**

Revenue in the United States increased as a percentage of total revenue in the three months ended September 30, 2006 compared to the same period in fiscal 2005, primarily due to revenues from new North American customers. Revenue in Japan increased as a percentage of total revenue in the three months ended September 30, 2006 compared to the same period in fiscal 2005 primarily due to higher revenues from existing customers new orders.

**Operating Expenses:**

The table below sets forth operating expense data for the three and nine months ended September 30, 2006 and 2005 (in thousands, except percentage data):

| | Three Months Ended September 30, | | | Nine Months Ended September 30, | | |
|---|---|---|---|---|---|---|
| | 2006 | 2005 | % Change | 2006 | 2005 | % Change |
| Operating expenses: | | | | | | |
| Research and development | $ 1,014 | $ 1,394 | -27% | $ 3,137 | $ 4,461 | -30% |
| Sales and marketing | 1,745 | 1,943 | -10% | 5,404 | 5,693 | -5% |
| General and administrative | 956 | 1,054 | -9% | 2,957 | 3,622 | -18% |
| Total operating expenses | $ 3,715 | $ 4,391 | -15% | $ 11,498 | $ 13,776 | -17% |
| **Percentage of total revenues:** | | | | | | |
| Operating expenses: | | | | | | |
| Research and development | 38% | 63% | | 40% | 53% | |
| Sales and marketing | 66% | 88% | | 70% | 68% | |
| General and administrative | 36% | 48% | | 38% | 43% | |
| Total operating expenses | 139% | 199% | | 147% | 163% | |

**Research and development expenses** decreased in the three and nine months ended September 30, 2006 compared to the same periods in fiscal 2005, primarily due to a reduction in the number of employees, most of which were in India, from 49 to 27, and a decrease in business consulting expense. We were previously using a third party to integrate their software into our product.

**Sales and marketing expenses** decreased in the three and nine months ended September 30, 2006 compared to the same periods in fiscal 2005, primarily due to decreases in compensation and promotion expenses.

**General and administrative expenses** decreased in the three and nine months ended September 30, 2006 compared to the same periods in fiscal 2005, primarily due to a reduction in the number of employees from 13 to 10.

In the fourth quarter of 2005, we implemented a restructuring plan expected to reduce operating costs by approximately $3 million annually by reducing our workforce and consolidating facilities and resources. Our restructuring plan included a workforce reduction of 29% and the closing of excess facilities. The restructuring plan eliminated 31 jobs of employees included in administrative, marketing and engineering functions. The implementation of this plan has resulted in the reduction in expenses as noted above.

**Other Items:**

The table below sets forth other data for the three and nine months ended September 30, 2006 and 2005 (in thousands, except percentage data):

| | Three Months Ended September 30, | | | | % Change | Nine Months Ended September 30, | | | | % Change |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | | 2006 | | 2005 | | |
| Interest and other income, net | $ | 81 | $ | 81 | 0% | $ | 243 | $ | 211 | 15% |
| Provision for income taxes | $ | 15 | $ | 9 | 67% | $ | 91 | $ | 39 | 133% |
| **Percentage of total revenues:** | | | | | | | | | | |
| Interest and other income, net | | 3% | | 4% | | | 3% | | 3% | |
| Provision for income taxes | | 1% | | 0% | | | 1% | | 0% | |

**Interest and other income, net** increased in the nine months ended September 30, 2006 compared to the same period in fiscal 2005, due to an increase in interest earned on investment balances, and the elimination of interest expense resulting from the repayment of our outstanding bank loan.

**Provision for income taxes.** Our net operating losses are generated domestically, and amounts attributed to our foreign operations have been insignificant for all periods presented. Our income tax provisions are 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, 2005, we incurred net losses for federal and state tax purposes. As of December 31, 2005, we had federal and California net operating loss carryforwards of approximately $77.6 million and $24.1 million available to reduce future federal and California taxable income, respectively. These federal and California carryforwards begin to expire in 2006 if not utilized. The extent to which these carryforwards can be used to offset future taxable income may be limited under Section 382 of the Internal Revenue Code and applicable state tax law.

**Liquidity and Capital Resources**

At September 30, 2006, we had cash and cash equivalents and investments of $8.0 million and working capital of $3.2 million.

Net cash used in operating activities was $2.6 million and $8.4 million in the first nine months of 2006 and 2005, respectively. Net cash used in operating activities for the nine months ended September 30, 2006 was primarily due to a net loss of $5.7 million and a decrease in deferred revenue of $0.2 million; partially offset by non-cash charges relating to depreciation and amortization and stock-based compensation of $1.0 million, a decrease of accounts receivable of $1.1 million due to lower billings at the end of the quarter, a decrease in prepaid expenses and other assets of $0.8 million, and an increase in accrued liabilities of $0.3 million. Net cash used in operating activities for the nine months ended September 30, 2005 was primarily due to a net loss of $7.5 million, a decrease in deferred revenue of $2.4 million due to an increasing preference of customers for quarterly billings, partially offset by non-cash charges relating to depreciation and amortization of $0.7 million, a decrease of other assets and prepaid expenses of $0.4 million and $0.2 million respectively, and an increase in accounts payable of $0.2 million.

Net cash provided by investing activities was $4.2 million and $9.3 million in the first nine months of 2006 and 2005, respectively. Net cash provided by investing activities in the first nine months of 2006 was primarily due to the proceeds from maturities of marketable securities of $8.9 million, partially offset by the purchase of marketable securities of $4.6 million and the purchase of property and equipment of $0.2 million. Net cash provided by investing activities in the first nine months of 2005 was primarily due to the proceeds from maturities of marketable securities of $14.8 million, partially offset by the purchase of marketable securities of $4.8 million and the purchase of property and equipment of $0.7 million.

Net cash provided by financing activities was $0.1 million in the first nine months of 2006 and net cash used by financing activities was $2.9 million in the first nine months of 2005. Net cash provided by financing activities for the first nine months of 2006 was primarily due to the proceeds from the exercises of employee stock options and the issuance of common stock pursuant to the employee stock purchase plan. Net cash used by financing activities for the first nine months of 2005 were primarily due to repayment of the bank loan of $4.5 million, partially offset by the proceeds from the bank loan of $1 million, and proceeds from the issuance of common stock pursuant to the employee stock purchase plan and exercises of employee stock options of $0.6 million.

The Company has a Loan Agreement with a bank under which it may borrow, on a revolving basis, up to $1.0 million at an interest rate equal to prime rate, which was equal to an annual rate of 8.25% at September 30, 2006. 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 February 28, 2007. At September 30, 2006 there were no outstanding borrowings under the agreement. At that date, the Company was in compliance with the covenants 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. Our acquisition agreement with SiVerion, Inc, previously may have required us to make a cash payment of up to $2 million on November 5, 2006 if the average closing price of the our common stock for the 10 trading days immediately prior thereto was less than $3.00. However, the Board of Directors authorized the Company to offer to certain former shareholders of SiVerion the opportunity to exchange their right to receive the cash payment in exchange for shares of Company Common Stock. On June 27, 2006, the Company issued 1,070,499 shares of Common Stock to said former shareholders. These shares effectively reduced the contingent payment to no more than $148,000, payable to those remaining SiVerion, Inc. shareholders in the event the Company s common stock is less than $3.00 as determined above.

We intend to continue to invest in the development of new products and enhancements to our existing products. Our future liquidity and capital requirements will depend upon numerous factors, including the costs and timing of product development efforts and the success of these development efforts, the costs and timing of sales and marketing 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, 2006, our contractual obligations and commercial commitments, primarily under operating leasing arrangements for our facilities, were as follows (in thousands):

| Year ending December 31, | |
|---|---|
| 2006 | $ 136 |
| 2007 | 452 |
| 2008 | 411 |
| 2009 | 419 |
| 2010 | 187 |
| Thereafter | 64 |
| | $ 1,669 |

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

**Foreign Currency Fluctuations**

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

**Interest Rate Risk**

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

Investments in both fixed and floating rate interest-earning instruments carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to rising interest rates, while floating rate securities may produce less income than expected if interest rates fall. Due in part to these factors, our future investment income may fall short of expectations due to changes in interest rates or we may suffer losses in principal if forced to sell securities which have declined in market value due to changes in interest rates. A hypothetical 100 basis point increase in interest rates would not result in any significant decline in the fair value of our available-for-sale securities at September 30, 2006.

Investments are classified as available for sale and cost of securities sold is based on the specific identification method. At September 30, 2006, we had short-term U.S. government securities of $2.2 million.

## ITEM 4: CONTROLS AND PROCEDURES

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

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

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

**PART II OTHER INFORMATION**

**ITEM 1A: RISK FACTORS**

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

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

Our current and potential customers may not accept or embrace our LV2005™ integrated family of products, our SiVision™ product or our Embedded SerDes Test product;

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

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

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

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

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

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

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

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

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

**We have a history of losses and an accumulated deficit of approximately $94.6 million as of September 30, 2006. If we do not generate sufficient net revenue in the future to achieve or sustain profitability, our stock price could decline.**

We have incurred significant net losses since our inception, including losses of $10.0 million, $8.4 million and $12.0 million for the years ended December 31, 2005, 2004 and 2003, respectively. At September 30, 2006, we had an accumulated deficit of approximately $94.6 million. We expect our future revenues to be impacted by our long sales cycle and our revenue recognition policies, and we expect to continue to invest in our research and development projects as well as service operations required to support our business development activities. These product and business development expenditures as well as other operating expenses could continue to exceed our revenues, thus preventing us from achieving and maintaining profitability. To achieve and maintain profitability, we will need to generate and sustain substantially higher revenues while maintaining reasonable cost and expense levels. If we fail to achieve profitability within the time frame expected by securities analysts or investors and our cash balances continue to decline, the market price of our common stock will likely decline. We may not achieve profitability if our revenues do not increase or if they increase more slowly than we expect. In addition, our operating expenses are largely fixed, and any shortfall in anticipated revenues in any given period could harm our operating results.

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

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

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

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

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

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

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

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

- Timing, terms and conditions of customer agreements;
- Customers placing orders at the end of the quarter;
- The mix of our license and services revenues;
- Timing of customer usage of our technology in their product designs and the recognition of revenues therefrom when amounts are due based on design usage;
- Timing of sales commission expenses and the recognition of license revenues from related customer agreements;
- Changes in our and our customers development schedules and levels of expenditures on research and development;
- Industry patterns and changes or cyclical and seasonal fluctuations in the markets we target;
- Timing and acceptance of new technologies, product releases or enhancements by us, our competitors or our customers;
- Timing and completion of milestones under customer agreements; and
- Market and general economic conditions.

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

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

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

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

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

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

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

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

We derive a significant portion of our revenues from a relatively small number of customers. Two customers accounted for approximately 21% and 16% of total revenues for the nine months ended September 30, 2006. Three customers accounted for approximately 21%, 10% and 10% of total revenues in the year ended December 31, 2005, respectively; two customers accounted for 20% and 17%, respectively, of total revenues for the year ended December 31, 2004 and two different customers accounted for 15% and 11%, respectively, of total revenues for the year ended December 31, 2003. We anticipate that we will continue to rely on a limited number of customers for a substantial portion of our future revenues and we must obtain additional large orders from customers on an ongoing basis to increase our revenues and grow our business. In addition, the loss of any significant or well-known customer could harm our operating results or our reputation. In particular, a loss of a significant customer could cause fluctuations in our results of operations because our expenses are fixed in the short term, it takes us a long time to replace customers and, because of required methods of revenue recognition, any offsetting license revenues may need to be recognized over a period of time.

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

Revenues from sales of our ETCreate products and related maintenance and training services accounted for 73% of our total revenues for the nine months ended September 30, 2006, and 82%, 90% and 97% of our total revenues for the years ended December 31, 2005, 2004 and 2003, respectively. We currently expect that revenues from our ETCreate products will continue to account for a substantial percentage of our revenues in the foreseeable future and thereafter. Our future operating results are significantly dependent upon the continued market acceptance of our products. Our business will be harmed if our products do not continue to achieve market acceptance or if we fail to develop and market improvements to our products or enhancements thereof. A decline in demand for our ETCreate products as a result of competition, technological change or other factors could harm our business.

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

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

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

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

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

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

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

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

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

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

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

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

Section 404 of the Sarbanes-Oxley Act of 2002 will require our management to report on the effectiveness of our internal control structure and procedures for financial reporting beginning in fiscal 2007. Our independent registered public accounting firm will be required to attest to the effectiveness of our internal control structure and procedures for financial reporting beginning in fiscal 2008. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. This legislation is relatively new and neither companies nor accounting firms have significant experience in complying with its requirements.

As a result, we expect to incur increased expense and to devote additional management resources to Section 404 compliance. In the event our chief executive officer, chief financial officer or independent registered public accounting firm determine that our internal control over financial reporting is not effective as defined under Section 404, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

International revenues accounted for 14% of our total revenues for the nine months ended September 30, 2006, and 18%, 22% and 19% of our total revenues for the years ended December 31, 2005, 2004 and 2003, respectively. In addition to our international sales, we have operations in Canada, Japan, the UK and India. Our success depends upon continued expansion of our international operations, and we expect that international revenues will continue to be an important component of our total future revenues. Our international business involves a number of risks, including:

Our ability to adapt our products to foreign design methods and practices;

The uncertainty of international orders due to typically lengthy international selling cycles;

Cultural differences in the conduct of business;

Difficulty in attracting qualified personnel;

Managing foreign branch offices and subsidiaries;

Longer payment cycles for and greater difficulty collecting accounts receivable;

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

Tariffs and other trade barriers;

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

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

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

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

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

We may not achieve the anticipated benefits of the acquisitions;

- Our acquisition and integration costs may be higher than we anticipated and may cause our quarterly and annual operating results to fluctuate;
- We may be unable to retain key employees, such as management, technical or sales personnel, of the acquired businesses;
- We may experience difficulty and expense in assimilating the operations and personnel of the acquired businesses, which could be further affected by the acquired businesses not being located near our existing sites;
- We may incur amortization or impairment expenses if an acquisition results in significant goodwill or other intangible assets;
- We may be unable to complete the development and application of the acquired technology or products or integrate the technology or products with our own;
- We may be exposed to unknown liabilities of acquired companies;
- We may experience difficulties in establishing and maintaining uniform standards, controls, procedures and policies;
- Our relationships with key customers of acquired businesses may be impaired, due to changes in management and ownership of the acquired businesses; or
- Our stockholders may be diluted if we pay for the acquisition with equity securities.

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

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

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

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

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

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

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

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

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

The level and timing of license and service revenues;

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

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

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

Competing technological and marketing developments;

The extent of international operations;

The need to adapt to changing technologies and technical requirements;

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

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

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

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

**ITEM 6: EXHIBITS**

(a) Exhibits.

31.1 Rule 13a-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a) Certification of Chief Financial Officer.

32.1* Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350).

32.2* Statement of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350).

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

**SIGNATURES**

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

Dated: October 27, 2006

LOGICVISION, INC.
(Registrant)

By: /s/ JAMES T. HEALY

James T. Healy
President, Chief Executive Officer and Director
(Principal Executive Officer)

By: /s/ BRUCE M. JAFFE

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

**EXHIBIT INDEX**

| Exhibit Number | Description of Exhibit |
|---|---|
| 31.1 | Rule 13a-14(a) Certification of Chief Executive Officer |
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| 32.1* | Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. §1350). |
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