Rockwood Holdings, Inc.
Form 8-K
January 07, 2008

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 8-K

JOINT CURRENT REPORT

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

Date of Report (Date of earliest event reported): **December 31, 2007**

Rockwood Holdings, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**001-32609**	**52-2277366**
(Jurisdiction of Incorporation)	(Commission File Number)	(IRS Employer Identification Number)

100 Overlook Center

Princeton, New Jersey 08540

(Address of registrant s principal executive office)

(609) 514-0300

(Registrant s telephone number)

Rockwood Specialties Group, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**333-109686**	**52-2277390**
(Jurisdiction of Incorporation)	(Commission File Number)	(IRS Employer Identification Number)

100 Overlook Center

Princeton, New Jersey 08540

(Address of registrant s principal executive office)

(609) 514-0300

(Registrant s telephone number)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registration under any of the following provisions:

o Written communications pursuant to Rule 425 under the Securities Act

o Soliciting material pursuant to Rule 14a-12 under the Exchange Act

o Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act

o Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act

ITEM 2.01 **COMPLETION OF ACQUISITION OR DISPOSITION OF ASSETS.**

On December 31, 2007, Rockwood Specialties Group, Inc. completed the sale of its electronics businesses, excluding its wafer reclaim business, to OM Group, Inc. (OMG) for $315.0 million, subject to a potential post-closing adjustment. The transaction included the exercise of a put option to sell its French ultra-pure chemicals business. The electronics businesses sold included the ultra-pure chemicals business and printed circuit board business, which supplied chemicals used in the manufacture of semiconductors and printed circuit boards, and the photomasks business, which supplied photo-imaging masks used in the semiconductor and integrated circuit industries. The electronics businesses, including the wafer reclaim business, represented one of our reportable segments. A copy of the Stock Purchase Agreement is attached to this Current Report on Form 8-K as Exhibit 2.1 and a copy of the press release announcing completion of the sale of the electronics businesses, excluding the wafer reclaim business, is attached to this Current Report on Form 8-K as Exhibit 99.1.

ITEM 9.01 **FINANCIAL STATEMENTS AND EXHIBITS.**

(b) Pro forma financial information.

(i) Rockwood Holdings, Inc.

ROCKWOOD HOLDINGS, INC. UNAUDITED PRO FORMA

CONDENSED FINANCIAL INFORMATION

The following unaudited pro forma condensed balance sheet and statements of operations are presented to illustrate the estimated effects of the sale by Rockwood Specialties Group, Inc., our indirect, wholly-owned subsidiary, of its electronics businesses, excluding its wafer reclaim business, to OMG.

The unaudited pro forma condensed financial information presented for the balance sheet as of September 30, 2007 and for the statements of operations for the nine months ended September 30, 2007 and the year ended December 31, 2006, is based upon the historical results of operations, adjusted to reflect the pro forma effect as if the sale of the electronics businesses, excluding the wafer reclaim business, had occurred on January 1, 2006 with respect to the statements of operations and on September 30, 2007 with respect to the balance sheet. The historical consolidated financial information presented herein should be read in conjunction with the audited consolidated financial statements and notes thereto appearing in Rockwood Holdings, Inc. s annual report on Form 10-K for the year ended December 31, 2006, and the unaudited condensed consolidated financial statements and notes thereto as of and for the nine months ended September 30, 2007 included in Rockwood Holdings, Inc. s Form 10-Q for the quarterly period ended September 30, 2007.

The unaudited pro forma condensed financial information is for illustrative purposes only. Such information does not purport to be indicative of the financial condition and the results of operations that would have been achieved had the sale of the electronics businesses, excluding the wafer reclaim business, for which Rockwood Holdings, Inc. is giving pro forma effect actually occurred on the dates referred to above or the financial condition and the results of operations that may be expected in the future. Such information has been prepared based upon currently available information and assumptions that we believe are reasonable. Such currently available information and assumptions may prove to be inaccurate over time.

For the purposes of the pro forma financial information, we have elected to assume that we will use the proceeds for general corporate purposes, which may include potential selective acquisitions, other investment opportunities and debt repayments. As a result, and in accordance with SEC guidance, we have assumed no interest income on these cash proceeds. However, we do expect to generate additional earnings through the use of these cash proceeds.

ROCKWOOD HOLDINGS, INC. AND SUBSIDIARIES

Unaudited Pro Forma Condensed Balance Sheet

as of September 30, 2007

(Dollars in millions)

	Rockwood Historical	Adjustments	Pro Forma As Adjusted
ASSETS			
Current assets:			
Cash and cash equivalents	$ 104.0	$ 302.5(a)	$ 406.5
Accounts receivable, net	548.3	(42.4)	505.9
Inventories	511.6	(17.4)	494.2
Deferred income taxes	16.0	(4.0)	12.0
Prepaid expenses and other current assets	68.1	(3.2)	64.9
Total current assets	1,248.0	235.5	1,483.5
Property, plant and equipment, net	1,531.6	(69.4)	1,462.2
Goodwill	1,826.3	(127.0)	1,699.3
Other intangible assets, net	672.2	(1.5)	670.7
Deferred debt issuance costs, net of accumulated amortization of $28.4	42.6		42.6
Deferred income taxes	21.8	3.7	25.5
Other assets	41.2	(0.1)	41.1
Total assets	$ 5,383.7	$ 41.2	$ 5,424.9
LIABILITIES AND STOCKHOLDERS EQUITY			
Current liabilities:			
Accounts payable	$ 271.2	$ (24.5)	$ 246.7
Income taxes payable	7.6	5.4	13.0
Accrued compensation	91.8	(7.8)	84.0
Restructuring liability	13.8		13.8
Accrued expenses and other current liabilities	206.3	(4.9)	201.4
Deferred income taxes	4.6		4.6
Long-term debt, current portion	107.3		107.3
Total current liabilities	702.6	(31.8)	670.8
Long-term debt	2,447.7		2,447.7
Pension and related liabilities	382.3	(0.8)	381.5
Deferred income taxes	84.5	(3.9)	80.6
Other liabilities	162.1		162.1
Total liabilities	3,779.2	(36.5)	3,742.7
Minority interest	180.8		180.8
Performance restricted stock units	1.1		1.1
Stockholders equity:			
Common stock ($0.01 par value, 400,000 shares authorized, 73,922 shares issued and 73,828 shares outstanding)	0.7		0.7
Paid-in capital	1,154.0		1,154.0
Accumulated other comprehensive income	343.3	(23.6)	319.7
Retained (deficit) earnings	(74.0)	101.3(b)	27.3
Treasury stock, at cost	(1.4)		(1.4)
Total stockholders equity	1,422.6	77.7	1,500.3
Total liabilities and stockholders equity	$ 5,383.7	$ 41.2	$ 5,424.9

Notes to Unaudited Pro Forma Condensed Balance Sheet

1. Pro Forma Assumptions and Adjustments

We have elected to assume that we will use the estimated net proceeds of $302.5 million for general corporate purposes, which may include potential selective acquisitions, other investment opportunities and debt repayments. As a result, and in accordance with SEC guidance, we have assumed no interest income on these cash proceeds. However, we do expect to generate additional earnings through the use of these cash proceeds.

(a) Represents proceeds of $315.0 million plus an estimated working capital adjustment of $1.0 million, less estimated fees and expenses of $9.8 million associated with the sale and taxes of $3.7 million.

(b) This represents the net gain on the sale, including $3.7 million of tax charges and estimated fees and expenses of $9.8 million associated with the sale. In addition, an estimated working capital adjustment of $1.0 million is included in our estimated gross proceeds, which is subject to a potential post-closing adjustment. The effects of the gain were not reflected, however, in the pro forma statements of operations as the adjustments are non-recurring in nature. We do not expect the transaction to have any U.S. federal tax effect as a result of net operating losses and valuation allowances.

ROCKWOOD HOLDINGS, INC. AND SUBSIDIARIES

Unaudited Pro Forma Condensed Statement of Operations

for the Nine Months Ended September 30, 2007

(Dollars in millions)

	Rockwood Historical	Adjustments	Pro Forma As Adjusted
Net sales	$ 2,476.4	$ (147.2)	$ 2,329.2
Cost of products sold	1,691.4	(109.4)	1,582.0
Gross profit	785.0	(37.8)	747.2
Selling, general and administrative expenses	474.6	(24.3)	450.3
Restructuring charges, net	8.9	(0.4)	8.5
Gain on sale of assets	(5.3)	0.4	(4.9)
Operating income	306.8	(13.5)	293.3
Other income (expenses):			
Interest expense	(158.7)		(158.7)
Interest income	11.0	(0.9)	10.1
Loss on early extinguishment of debt	(19.4)	0.3	(19.1)
Refinancing expenses	(0.9)		(0.9)
Foreign exchange gain, net	11.3		11.3
Other, net	(0.1)		(0.1)
Other income (expenses), net	(156.8)	(0.6)	(157.4)
Income from continuing operations before taxes and minority interest	150.0	(14.1)	135.9
Income tax provision	61.9	(2.4)	59.5
Income from continuing operations before minority interest	88.1	(11.7)	76.4
Minority interest in continuing operations	(6.2)		(6.2)
Net income from continuing operations	81.9	(11.7)	70.2
Income from discontinued operations, net of tax (a)	0.5		0.5
Gain on sale of discontinued operations, net of tax (a)	115.7		115.7
Minority interest in discontinued operations (a)	(0.1)		(0.1)
Net income	$ 198.0	$ (11.7)	$ 186.3
Basic earnings per share:			
Earnings from continuing operations	$ 1.11		$ 0.95
Earnings from discontinued operations, net of tax (a)	1.57		1.57
Basic earnings per share	$ 2.68		$ 2.52
Diluted earnings per share:			
Earnings from continuing operations	$ 1.08		$ 0.93
Earnings from discontinued operations, net of tax (a)	1.52		1.52
Diluted earnings per share	$ 2.60		$ 2.45
Weighted average number of basic shares outstanding	73,801		73,801
Weighted average number of diluted shares outstanding	76,155		76,155

Notes to Unaudited Pro Forma Condensed Statements of Operations

1. Pro Forma Assumptions and Adjustments

We have elected to assume that we will use the estimated net proceeds of $302.5 million for general corporate purposes, which may include potential selective acquisitions, other investment opportunities and debt repayments. As a result, and in accordance with SEC guidance, we have assumed no interest income on these cash proceeds. However, we do expect to generate additional earnings through the use of these cash proceeds.

(a) Discontinued operations relates to the Groupe Novasep subsidiary which was sold in January 2007.

ROCKWOOD HOLDINGS, INC. AND SUBSIDIARIES

Unaudited Pro Forma Condensed Statement of Operations

for the Year Ended December 31, 2006

(Dollars in millions)

	Rockwood Historical	Adjustments	Pro Forma As Adjusted
Net sales	$ 2,975.2	$ (187.0)	$ 2,788.2
Cost of products sold	2,045.2	(137.4)	1,907.8
Gross profit	930.0	(49.6)	880.4
Selling, general and administrative expenses	584.6	(30.5)	554.1
Impairment charges	2.2		2.2
Restructuring charges, net	5.2	(0.3)	4.9
Gain on sale of assets	(0.2)	(0.1)	(0.3)
Operating income	338.2	(18.7)	319.5
Other income (expenses):			
Interest expense	(195.7)	(2.0)	(197.7)
Foreign exchange gain, net	8.6		8.6
Other, net	1.8		1.8
Other income (expenses), net	(185.3)	(2.0)	(187.3)
Income from continuing operations before taxes and minority interest	152.9	(20.7)	132.2
Income tax provision	72.6	(6.9)	65.7
Net income from continuing operations	80.3	(13.8)	66.5
Income from discontinued operations, net of tax (a)	27.9		27.9
Minority interest in discontinued operations (a)	(5.2)		(5.2)
Net income	$ 103.0	$ (13.8)	$ 89.2
Basic earnings per share:			
Earnings from continuing operations	$ 1.09		$ 0.90
Earnings from discontinued operations, net of tax (a)	0.31		0.31
Basic earnings per share	$ 1.40		$ 1.21
Diluted earnings per share:			
Earnings from continuing operations	$ 1.07		$ 0.89
Earnings from discontinued operations, net of tax (a)	0.30		0.30
Diluted earnings per share	$ 1.37		$ 1.19
Weighted average number of basic shares outstanding	73,782		73,782
Weighted average number of diluted shares outstanding	75,044		75,044

Notes to Unaudited Pro Forma Condensed Statements of Operations

1. Pro Forma Assumptions and Adjustments

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(a) Discontinued operations relates to the Groupe Novasep subsidiary which was sold in January 2007.

(ii) Rockwood Specialties Group, Inc.

ROCKWOOD SPECIALTIES GROUP, INC. UNAUDITED PRO FORMA

CONDENSED FINANCIAL INFORMATION

The following unaudited pro forma condensed balance sheet and statements of operations are presented to illustrate the estimated effects of the sale by Rockwood Specialties Group, Inc. of its electronics businesses, excluding its wafer reclaim business, to OMG.

The unaudited pro forma condensed financial information presented for the balance sheet as of September 30, 2007 and for the statements of operations for the nine months ended September 30, 2007 and the year ended December 31, 2006, is based upon the historical results of operations, adjusted to reflect the pro forma effect as if the sale of the electronics businesses, excluding the wafer reclaim business, had occurred on January 1, 2006 with respect to the statements of operations and on September 30, 2007 with respect to the balance sheet. The historical consolidated financial information presented herein should be read in conjunction with the audited consolidated financial statements and notes thereto appearing in Rockwood Specialties Group, Inc. s annual report on Form 10-K for the year ended December 31, 2006, and the unaudited condensed consolidated financial statements and notes thereto as of and for the nine months ended September 30, 2007 included in Rockwood Specialties Group, Inc. s Form 10-Q for the quarterly period ended September 30, 2007.

The unaudited pro forma condensed financial information is for illustrative purposes only. Such information does not purport to be indicative of the financial condition and the results of operations that would have been achieved had the sale of the electronics businesses, excluding the wafer reclaim business, for which Rockwood Specialties Group, Inc. is giving pro forma effect actually occurred on the dates referred to above or the financial condition and the results of operations that may be expected in the future. Such information has been prepared based upon currently available information and assumptions that we believe are reasonable. Such currently available information and assumptions may prove to be inaccurate over time.

For the purposes of the pro forma financial information, we have elected to assume that we will use the proceeds for general corporate purposes, which may include potential selective acquisitions, other investment opportunities and debt repayments. As a result, and in accordance with SEC guidance, we have assumed no interest income on these cash proceeds. However, we do expect to generate additional earnings through the use of these cash proceeds.

ROCKWOOD SPECIALTIES GROUP, INC. AND SUBSIDIARIES

Unaudited Pro Forma Condensed Balance Sheet

as of September 30, 2007

(Dollars in millions)

	Rockwood Historical	Adjustments	Pro Forma As Adjusted
ASSETS			
Current assets:			
Cash and cash equivalents	$ 101.6	$ 302.5(a)	$ 404.1
Accounts receivable, net	548.3	(42.4)	505.9
Inventories	511.6	(17.4)	494.2
Deferred income taxes	16.1	(4.0)	12.1
Prepaid expenses and other current assets	68.1	(3.2)	64.9
Total current assets	1,245.7	235.5	1,481.2
Property, plant and equipment, net	1,531.6	(69.4)	1,462.2
Goodwill	1,826.3	(127.0)	1,699.3
Other intangible assets, net	672.2	(1.5)	670.7
Deferred debt issuance costs, net of accumulated amortization of $28.4	42.6		42.6
Deferred income taxes	21.8	3.7	25.5
Other assets	41.2	(0.1)	41.1
Total assets	$ 5,381.4	$ 41.2	$ 5,422.6
LIABILITIES AND STOCKHOLDER S EQUITY			
Current liabilities:			
Accounts payable	$ 271.2	$ (24.5)	$ 246.7
Income taxes payable	7.6	5.4	13.0
Accrued compensation	91.8	(7.8)	84.0
Restructuring liability	13.8		13.8
Accrued expenses and other current liabilities	211.2	(4.9)	206.3
Deferred income taxes	4.6		4.6
Long-term debt, current portion	107.3		107.3
Total current liabilities	707.5	(31.8)	675.7
Long-term debt	2,447.7		2,447.7
Pension and related liabilities	382.3	(0.8)	381.5
Deferred income taxes	84.6	(3.9)	80.7
Other liabilities	160.0		160.0
Total liabilities	3,782.1	(36.5)	3,745.6
Minority interest	180.8		180.8
Stockholder s equity:			
Common stock ($0.01 par value, 1,000,000 shares authorized, 382,000 shares issued and outstanding)			
Paid-in capital	1,005.4		1,005.4
Accumulated other comprehensive income	346.0	(23.6)	322.4
Retained earnings	67.1	101.3(b)	168.4
Total stockholder s equity	1,418.5	77.7	1,496.2
Total liabilities and stockholder s equity	$ 5,381.4	$ 41.2	$ 5,422.6

Notes to Unaudited Pro Forma Condensed Balance Sheet

1. Pro Forma Assumptions and Adjustments

We have elected to assume that we will use the estimated net proceeds of $302.5 million for general corporate purposes, which may include potential selective acquisitions, other investment opportunities and debt repayments. As a result, and in accordance with SEC guidance, we have assumed no interest income on these cash proceeds. However, we do expect to generate additional earnings through the use of these cash proceeds.

(a) Represents proceeds of $315.0 million plus an estimated working capital adjustment of $1.0 million, less estimated fees and expenses of $9.8 million associated with the sale and taxes of $3.7 million.

(b) This represents the net gain on the sale, including $3.7 million of tax charges and estimated fees and expenses of $9.8 million associated with the sale. In addition, an estimated working capital adjustment of $1.0 million is included in our estimated gross proceeds, which is subject to a potential post-closing adjustment. The effects of the gain were not reflected, however, in the pro forma statements of operations as the adjustments are non-recurring in nature. We do not expect the transaction to have any U.S. federal tax effect as a result of net operating losses and valuation allowances.

ROCKWOOD SPECIALTIES GROUP, INC. AND SUBSIDIARIES

Unaudited Pro Forma Condensed Statement of Operations

for the Nine Months Ended September 30, 2007

(Dollars in millions)

	Rockwood Historical	Adjustments	Pro Forma As Adjusted
Net sales	$ 2,476.4	$ (147.2)	$ 2,329.2
Cost of products sold	1,691.4	(109.4)	1,582.0
Gross profit	785.0	(37.8)	747.2
Selling, general and administrative expenses	474.6	(24.3)	450.3
Restructuring charges, net	8.9	(0.4)	8.5
Gain on sale of assets	(5.3)	0.4	(4.9)
Operating income	306.8	(13.5)	293.3
Other income (expenses):			
Interest expense	(158.7)		(158.7)
Interest income	11.0	(0.9)	10.1
Loss on early extinguishment of debt	(19.4)	0.3	(19.1)
Refinancing expenses	(0.9)		(0.9)
Foreign exchange gain, net	11.3		11.3
Other, net	(0.1)		(0.1)
Other income (expenses), net	(156.8)	(0.6)	(157.4)
Income from continuing operations before taxes and minority interest	150.0	(14.1)	135.9
Income tax provision	61.9	(2.4)	59.5
Income from continuing operations before minority interest	88.1	(11.7)	76.4
Minority interest in continuing operations	(6.2)		(6.2)
Net income from continuing operations	81.9	(11.7)	70.2
Income from discontinued operations, net of tax (a)	0.5		0.5
Gain on sale of discontinued operations, net of tax (a)	115.7		115.7
Minority interest in discontinued operations (a)	(0.1)		(0.1)
Net income	$ 198.0	$ (11.7)	$ 186.3

Notes to Unaudited Pro Forma Condensed Statements of Operations

1. Pro Forma Assumptions and Adjustments

We have elected to assume that we will use the estimated net proceeds of $302.5 million for general corporate purposes, which may include potential selective acquisitions, other investment opportunities and debt repayments. As a result, and in accordance with SEC guidance, we have assumed no interest income on these cash proceeds. However, we do expect to generate additional earnings through the use of these cash proceeds.

(a) Discontinued operations relates to the Groupe Novasep subsidiary which was sold in January 2007.

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ROCKWOOD SPECIALTIES GROUP, INC. AND SUBSIDIARIES

Unaudited Pro Forma Condensed Statement of Operations

for the Year Ended December 31, 2006

(Dollars in millions)

	Rockwood Historical	Adjustments	Pro Forma As Adjusted
Net sales	$ 2,975.2	$ (187.0)	$ 2,788.2
Cost of products sold	2,045.2	(137.4)	1,907.8
Gross profit	930.0	(49.6)	880.4
Selling, general and administrative expenses	584.6	(30.5)	554.1
Impairment charges	2.2		2.2
Restructuring charges, net	5.2	(0.3)	4.9
Gain on sale of assets	(0.2)	(0.1)	(0.3)
Operating income	338.2	(18.7)	319.5
Other income (expenses):			
Interest expense	(195.7)	(2.0)	(197.7)
Foreign exchange gain, net	8.6		8.6
Other, net	1.8		1.8
Other income (expenses), net	(185.3)	(2.0)	(187.3)
Income from continuing operations before taxes and minority interest	152.9	(20.7)	132.2
Income tax provision	72.6	(6.9)	65.7
Net income from continuing operations	80.3	(13.8)	66.5
Income from discontinued operations, net of tax (a)	27.9		27.9
Minority interest in discontinued operations (a)	(5.2)		(5.2)
Net income	$ 103.0	$ (13.8)	$ 89.2

Notes to Unaudited Pro Forma Condensed Statements of Operations

1. Pro Forma Assumptions and Adjustments

We have elected to assume that we will use the estimated net proceeds of $302.5 million for general corporate purposes, which may include potential selective acquisitions, other investment opportunities and debt repayments. As a result, and in accordance with SEC guidance, we have assumed no interest income on these cash proceeds. However, we do expect to generate additional earnings through the use of these cash proceeds.

(a) Discontinued operations relates to the Groupe Novasep subsidiary which was sold in January 2007.

(d) Exhibits.

Exhibit No.	Description
2.1	Stock Purchase Agreement dated as of October 7, 2007 by and between Rockwood Specialties Group, Inc. and OM Group, Inc.
99.1	Press Release dated January 2, 2008.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrants have duly caused this report to be signed on their behalf by the undersigned hereunto duly authorized.

Rockwood Holdings, Inc.

By:	/s/ Michael W. Valente	
	Name:	Michael W. Valente
	Title:	Assistant Secretary

Rockwood Specialties Group, Inc.

By:	/s/ Michael W. Valente	
	Name:	Michael W. Valente
	Title:	Assistant Secretary

Dated: January 7, 2008

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Directors and Executive Officers

Robin Adler (8)

2,410,000 18.64 2,410,000 14.24

Howard D. Marshall (9)

2,465,000 19.07 2,465,000 14.56

Tim F. Moriarty (10)

429,000 3.30 429,000 2.53

Craig Z. Foster (11)

305,000 2.36 305,000 1.80

James P. Moniz (12)

	87,602	*	87,602	*
Richard L. Dissly (13)				
	85,000	*	85,000	*
Juan A. Benitez (14)				
	34,995	*	34,995	*
Stephen G. Newberry (15)				
	29,995	*	29,995	*
Eugene R. White (16)				
	11,250	*	11,250	*
Victor A. Hebert				
	5,000	*	5,000	*
All directors and executive officers as a group (10 persons)				
	5,862,842	44.49%	5,862,842	34.13%

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* Less than 1% of Nextest s outstanding common stock.

(1) Includes 46,000 shares owned by minor children.

(2) These shares are held by the following funds: 924,125 shares are held by Needham Capital Partners III, L.P., 97,625 shares are held by Needham Capital Partners IIIA, L.P., 178,250 shares are held by Needham Capital Partners III (Bermuda), L.P. and the address for each is 445 Park Avenue, New York, New York, 10022. Needham Capital Management, LLC (NCM) is the general partner of Needham Capital Partners III, L.P. and Needham Capital Partners IIIA, L.P. Needham Capital Management (Bermuda), LLC (NCMB) is the general partner of Needham Capital Partners III (Bermuda), L.P. As managing members of NCM and NCMB, George A. Needham, Thomas P. Shanahan and John J. Prior, Jr. may be deemed to beneficially own the shares controlled by Needham Capital Partners III, L.P., Needham Capital Partners IIIA, L.P. and Needham Capital Partners III (Bermuda), L.P. Messrs. Needham, Shanahan and Prior, Jr. disclaim beneficial ownership of the shares controlled by Needham Capital Partners III, L.P., Needham Capital Partners IIIA, L.P. and Needham Capital Partners III (Bermuda), L.P.

(3) These shares are held by the following funds: 306,341 shares are held by Seligman New Technologies Fund II, Inc., 180,300 shares are held by Seligman Technologies Venture Fund LLC, and 513,359 shares are held by Seligman Communications and Information Fund, Inc., and the address for each is 100 Park Avenue, New York, New York 10017. Mr. William C. Morris, as the owner of a majority of the outstanding voting securities of J.&W. Seligman & Co. Incorporated (JWS), may be deemed to beneficially own the shares controlled by JWS. An affiliate of this stockholder, Seligman Advisors, Inc., is registered as limited purpose broker-dealers with the NASD. This selling stockholder purchased the shares being registered for resale in the ordinary course of businesses and at the time of the purchase, the selling stockholder had no agreements or understandings, directly or indirectly, with any person to distribute the securities.

(4) The address of this selling stockholder is 225 Arizona Avenue, Suite 200, Santa Monica, CA 90401.

(5) The address of this selling stockholder is 4 World Financial Center, 23rd Floor, New York, NY 10080. Merrill Lynch, Pierce, Fenner & Smith Incorporated is the most significant registered broker-dealers with the NASD affiliated with this selling stockholder. This selling stockholder is also affiliated with other smaller broker dealers. Merrill Lynch, Pierce, Fenner & Smith Incorporated is an underwriter in this offering. This selling stockholder purchased the shares being registered for resale in the ordinary course of businesses and at the time of the purchase, the selling stockholder had no agreements or understandings, directly or indirectly, with any person to distribute the securities.

(6) The address of this selling stockholder is 1105 Spruce Street, Boulder, CO 80302.

(7) The address of this selling stockholder is 2325 Orchard Parkway, San Jose, CA 95131.

(8) Includes 40,000 shares subject to exercisable option, and 20,000 shares owned by minor children.

(9) Includes 40,000 shares subject to exercisable option.

(10) Includes 6,000 shares owned by minor child and 100,000 shares subject to exercisable options.

(11) Includes 35,000 shares subject to exercisable option.

(12) Includes 10,000 shares of restricted stock which will vest upon completion of the offering, and 32,500 shares subject to exercisable option.

(13) Includes 5,000 shares subject to exercisable option.

(14) Includes 12,750 shares subject to exercisable option.

(15) Includes 12,750 shares subject to exercisable option.

(16) Includes 11,250 shares subject to exercisable option.

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DESCRIPTION OF CAPITAL STOCK

Upon the closing of this offering, our authorized capital stock, after giving effect to the amendment and restatement of our certificate of incorporation, will consist of 140,000,000 shares of common stock, $0.001 par value and 10,000,000 shares of preferred stock, $0.001 par value.

Common Stock

As of December 31, 2005, there were 12,886,928 shares of common stock that were held of record by approximately 185 stockholders after giving effect to the conversion of our preferred stock into common stock. There will be 16,886,928 shares of common stock outstanding, assuming no exercise of the underwriters overallotment option and no exercise of outstanding options, after giving effect to the sale of the shares of common stock offered by this prospectus.

Each holder of common stock is entitled to one vote for each share on all matters submitted to a vote of the stockholders, including the election of directors and each holder does not have cumulative voting rights. Accordingly, the holders of a majority of the shares of common stock entitled to vote in any election of directors can elect all of the directors standing for election, if they so choose.

Subject to preferences that may be applicable to any then outstanding preferred stock, holders of common stock are entitled to receive ratably those dividends, if any, as may be declared from time to time by the board of directors out of legally available funds. In the event of our liquidation, dissolution or winding up, holders of common stock will be entitled to share ratably in the net assets legally available for distribution to stockholders after the payment of all of our debts and other liabilities and the satisfaction of any liquidation preference granted to the holders of any outstanding shares of preferred stock.

Holders of common stock have no preemptive or conversion rights or other subscription rights and there are no redemption or sinking fund provisions applicable to the common stock. The rights, preferences and privileges of the holders of common stock are subject to, and may be adversely affected by, the rights of the holders of shares of any series of preferred stock, which we may designate in the future.

Preferred Stock

Upon the closing of this offering, the board of directors will be authorized, subject to any limitations prescribed by law, without stockholder approval, to issue up to an aggregate of 10,000,000 shares of preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions granted to or imposed upon the preferred stock, including voting rights, dividend rights, conversion rights, redemption privileges and liquidation preferences. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of holders of any preferred stock that may be issued in the future. Issuance of preferred stock, while providing flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of delaying, deferring or preventing a change in control of Nextest. We have no present plans to issue any shares of preferred stock.

Issuances of preferred stock, while providing desirable flexibility in connection with possible acquisitions and for other corporate purposes, may have the effect of delaying, deferring or preventing a change in control of Nextest without further action by the stockholders. The issuance of preferred stock with voting and conversion rights may also adversely affect the voting power of the holders of common stock. In certain circumstances, an issuance of preferred stock could have an effect of decreasing the market price of our common stock.

All outstanding shares of preferred stock will be converted to common stock upon the completion of this offering, and we currently have no plans to issue any other shares of preferred stock.

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Registration Rights

After this offering, the holders of approximately 2.7 million shares of common stock will be entitled to rights to cause us to register the sale of such shares under the Securities Act. These shares are referred to as registrable securities. Specifically, commencing twelve months after the closing of this offering holders of at least 50% of the registrable securities may require us to prepare and file a registration statement under the Securities Act at our expense covering at least 25% of the registrable securities then outstanding.

Under these demand registration rights, we are required to use our reasonable efforts to cause the shares requested to be included in the registration statement, subject to customary conditions and limitations. We are not obligated to effect more than one of these demand registrations. Once we become eligible to file a registration statement on Form S-3, the holders of the registrable securities may require us to register for a public offering of shares of registrable securities on a registration statement on Form S-3, if such registration will generate anticipated aggregate net proceeds of at least $1,000,000, and may participate in a registration by us, subject to specific conditions and limitations. Registration rights terminate no later than four years after this offering. Registration of these shares under the Securities Act would result in these shares, other than shares purchased by our affiliates, becoming freely tradable without restriction under the Securities Act.

Effect of Certain Provisions of our Certificate of Incorporation and Bylaws and the Delaware Anti-Takeover Statute

Certificate of Incorporation and Bylaws

Some provisions of Delaware law and our amended and restated certificate of incorporation and bylaws contain provisions that could make the following transactions more difficult:

- acquisition of us by means of a tender offer;
- acquisition of us by means of a proxy contest or otherwise; or
- removal of our incumbent officers and directors.

These provisions, summarized below, are expected to discourage coercive takeover practices and inadequate takeover bids and to promote stability in our management. These provisions are also designed to encourage persons seeking to acquire control of us to first negotiate with our board of directors.

Undesignated Preferred Stock. The ability to authorize undesignated preferred stock makes it possible for our board of directors to issue one or more series of preferred stock with voting or other rights or preferences that could impede the success of any attempt to change control of Nextest. These and other provisions may have the effect of deferring hostile takeovers or delaying changes in control or management of our company.

Stockholder Meetings. Our charter documents provide that a special meeting of stockholders may be called only by the chairman of the board, by our president, by a resolution adopted by a majority of our board of directors, or by holders of not less than 20% of our common stock.

Requirements for Advance Notification of Stockholder Nominations and Proposals. Our bylaws establish advance notice procedures with respect to stockholder proposals and the nomination of candidates for election as directors, other than nominations made by or at the direction of the board of directors or a committee of the board of directors.

Elimination of Stockholder Action by Written Consent. Our amended and restated certificate of incorporation eliminates the right of stockholders to act by written consent without a meeting.

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Board of Directors. Our restated Certificate of Incorporation and bylaws will provide that, subject to any rights of holders of preferred stock to elect additional directors under specified circumstances, the number of directors will be fixed from time to time exclusively by resolution by the board of directors. In addition, subject to any rights of holders of preferred stock, newly created directorships resulting from any increase in the number of directors and any vacancies on the board of directors resulting from death, resignation, disqualification, removal or other cause will be filled by the affirmative vote of a majority of the remaining directors then in office, even if less than a quorum, and not by the stockholders. No decrease in the number of directors constituting the board of directors will shorten the term of any incumbent director. Subject to the rights of holders of preferred stock, generally any director may be removed from office only for cause by the affirmative vote of the holders of at least a majority of our outstanding common stock.

Delaware Anti-Takeover Statute

We are subject to Section 203 of the Delaware General Corporation Law. This law prohibits a publicly-held Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder unless:

prior to the date of the transaction, the board of directors of the corporation approved either the business combination or the transaction which resulted in the stockholder becoming an interested stockholder;

upon consummation of the transaction which resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, excluding for purposes of determining the number of shares outstanding those shares owned by persons who are directors and also officers and by employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer; or

on or subsequent to the date of the transaction, the business combination is approved by the board of directors and authorized at an annual or special meeting of stockholders, and not by written consent, by the affirmative vote of at least two-thirds of the outstanding voting stock which is not owned by the interested stockholder.

Section 203 defines business combination to include:

any merger or consolidation involving the corporation and the interested stockholder;

any sale, transfer, pledge or other disposition of 10% or more of our assets involving the interested stockholder;

in general, any transaction that results in the issuance or transfer by us of any of our stock to the interested stockholder; or

the receipt by the interested stockholder of the benefit of any loans, advances, guarantees, pledges or other financial benefits provided by or through the corporation.

In general, Section 203 defines an interested stockholder as an entity or person beneficially owning 15% or more of the outstanding voting stock of the corporation and any entity or person affiliated with or controlling or controlled by the entity or person.

Transfer Agent and Registrar

The transfer agent and registrar for our common stock is Computershare Trust Company, NA.

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SHARES ELIGIBLE FOR FUTURE SALE

Prior to this offering, there has been no public market for our common stock. Future sales of substantial amounts of our common stock in the public market could adversely affect prevailing market prices. Furthermore, a large number of our outstanding shares of common stock will not be available for sale shortly after this offering because of contractual and legal restrictions on resale as described below. Sales of substantial amounts of our common stock in the public market after these restrictions lapse, or the perception that these sales may occur, could depress the prevailing market price of our common stock and limit our ability to raise equity capital in the future.

Upon completion of this offering, we will have outstanding an aggregate of 16,886,928 shares of common stock, based upon the shares outstanding as of December 31, 2005, assuming no exercise of the underwriters overallotment option and no exercise of outstanding options prior to completion of this offering. Of the total outstanding shares, the 5,400,000 shares sold in this offering will be freely tradable without restriction or further registration under the Securities Act, except that any shares held by our affiliates, as that term is defined under the Securities Act, may generally only be sold in accordance with Rule 144 of the Securities Act.

Sales of Restricted Shares

The remaining 11,486,928 shares of common stock held by existing stockholders were issued and sold by us in reliance on exemptions from the registration requirements of the Securities Act. All of these shares will be subject to lock-up agreements under which the holders have agreed not to offer, sell or otherwise dispose of any of the shares of common stock owned by them for a period of 180 days after the date of this prospectus. Merrill Lynch & Co. may, in its sole discretion, at any time and without prior notice or announcement, release all or any portion of the shares subject to lock-up agreements. The following table presents the number of shares that will be eligible for sale pursuant to Rule 144(k), Rule 144 and Rule 701 after the completion of this offering, 180 days after completion of the offering and 180+ days after completion of the offering, when all shares will be eligible for sale.

	Rule 144(k)	Rule 144	Rule 701	Total
Completion of the offering				
180 days after completion of the offering	2,440,392	8,577,399	389,545	11,407,336
180+ days after completion of the offering	2,440,392	8,656,991	389,545	11,486,928

Stock Options

After the completion of this offering, we intend to file a registration statement on Form S-8 under the Securities Act to register all of the shares of common stock subject to issuance of options outstanding or reserved for future issuance under our 1998 Plan, 2006 Plan and the Purchase Plan. Based upon the number of shares subject to outstanding options as of December 31, 2005 and the shares reserved for issuance under our 1998 Plan, 2006 Plan and Purchase Plan, the registration statement on Form S-8 would cover approximately 3.9 million shares. Shares registered under that registration statement will generally be available for sale in the open market immediately after the 180 day lock-up agreements expire.

Registration Rights

After this offering, the holders of an aggregate of approximately 2.7 million shares of our common stock will have the right to require us to register these shares under the Securities Act under certain circumstances. After registration, the shares will be freely tradable without restriction under the Securities Act. For more information regarding these registration rights, see Description of Capital Stock Registration Rights .

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Rule 144

In general, under Rule 144 as currently in effect, beginning 180 days after the date of this prospectus, a person who has beneficially owned restricted securities for at least one year and is not an affiliate would be entitled to sell in broker s transactions or to market makers, within any three-month period, a number of shares that does not exceed the greater of:

- 1% of the number of shares of common stock then outstanding (which will equal approximately 168,869 shares immediately after this offering); or

- the average weekly trading volume in the common stock on the Nasdaq National Market during the four calendar weeks preceding the filing of a notice on Form 144 with respect to the sale.

Sales under Rule 144 are generally subject to the availability of current public information about Nextest.

Rule 144(k)

Under Rule 144(k), a person who is not deemed to have been our affiliate at any time during the 90 days preceding a sale, and who has beneficially owned the shares proposed to be sold for at least two years, is entitled to sell these shares without having to comply with the manner of sale, public information, volume limitation or notice filing provisions of Rule 144. Therefore, unless otherwise restricted, 144(k) shares may be sold immediately upon the completion of this offering. Affiliates must always sell pursuant to Rule 144, even after the applicable holding periods have been satisfied.

Rule 701

In general, under Rule 701, any of our employees, directors, officers, consultants or advisors who purchase shares from us in connection with a compensatory stock or option plan or other written agreement before the effective date of this offering is entitled to sell his or her shares 90 days after the effective date of this offering, unless otherwise restricted, in reliance on Rule 144, without having to comply with the holding period of Rule 144 and, in the case of non-affiliates, without having to comply with the public information, volume limitation or notice filing provisions of Rule 144.

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UNDERWRITING

Merrill Lynch, Pierce, Fenner & Smith Incorporated, Cowen & Co., LLC and Needham & Company, LLC are acting as representatives of each of the underwriters named below. Subject to the terms and conditions set forth in a purchase agreement among us, the selling stockholders and the underwriters, we and the selling stockholders have agreed to sell to the underwriters, and each of the underwriters has agreed, severally and not jointly, to purchase from us and the selling stockholders, the number of shares of common stock set forth opposite its name below.

Underwriter	Number of Shares
Merrill Lynch, Pierce, Fenner & Smith Incorporated	
Needham & Company, LLC	
Cowen & Co., LLC	
Total	5,400,000

Subject to the terms and conditions set forth in the purchase agreement, the underwriters have agreed, severally and not jointly, to purchase all of the shares sold under the purchase agreement if any of these shares are purchased. If an underwriter defaults, the purchase agreement provides that the purchase commitments of the nondefaulting underwriters may be increased or the purchase agreement may be terminated.

We and the selling stockholders have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act, or to contribute to payments the underwriters may be required to make in respect of those liabilities.

The underwriters are offering the shares, subject to prior sale, when, as and if issued to and accepted by them, subject to approval of legal matters by their counsel, including the validity of the shares, and other conditions contained in the purchase agreement, such as the receipt by the underwriters of officers certificates and legal opinions. The underwriters reserve the right to withdraw, cancel or modify offers to the public and to reject orders in whole or in part.

Commissions and Discounts

The representatives have advised us that they propose initially to offer the shares to the public at the public offering price set forth on the cover page of this prospectus and to dealers at that price less a concession not in excess of $ per share. The underwriters may allow, and the dealers may reallow, a discount not in excess of $ per share to other dealers. After the offering, the public offering price, concession and discount may be changed.

The following table shows the public offering price, underwriting discount and proceeds, before expenses to us and the selling stockholders. The information assumes either no exercise or full exercise by the underwriters of their overallotment options.

	Per Share	Without Option	With Option
Public offering price	$	$	$
Underwriting discount	$	$	$
Proceeds, before expenses, to Nextest Systems	$	$	$
Proceeds, before expenses, to Selling Stockholders	$	$	$

The total expenses of the offering, not including the underwriting discount, are estimated at $ and are payable by us.

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Overallotment Option

We have granted an option to the underwriters to purchase up to 600,000 additional shares and the selling stockholders have granted an option to the underwriters to purchase up to 210,000 additional shares at the public offering price, less the underwriting discount. The underwriters may exercise their options for 30 days from the date of this prospectus solely to cover any overallotments. If the underwriters exercise their options, each will be obligated, subject to conditions contained in the purchase agreement, to purchase a number of additional shares proportionate to that underwriter s initial amount reflected in the above table.

No Sales of Similar Securities

We and the selling stockholders, our executive officers and directors and holders of our outstanding common stock have agreed not to sell or transfer any common stock or securities convertible into, exchangeable for exercisable for, or repayable with common stock, for 180 days after the date of this prospectus without first obtaining the written consent of Merrill Lynch, except for the shares being sold in this offering. Specifically, we and these other persons have agreed not to directly or indirectly:

- offer, pledge, sell or contract to sell any common stock;
- sell any option or contract to purchase any common stock;
- purchase any option or contract to sell any common stock;
- grant any option, right or warrant for the sale of any common stock;
- lend or otherwise dispose of or transfer any common stock; and
- enter into any swap or other agreement that transfers, in whole or in part, the economic consequences of ownership of any common stock whether any such swap or transaction is to be settled by delivery of shares or other securities, in cash or otherwise.

Quotation on the Nasdaq National Market

Our shares will be quoted on the Nasdaq National Market under the symbol NEXT .

The underwriters do not intend to confirm sales of the shares to any accounts over which they exercise discretionary authority.

Before this offering, there has been no public market for our common stock. The initial public offering price will be determined through negotiations among us, the selling stockholders and the underwriters. In addition to prevailing market conditions, the factors to be considered in determining the initial public offering price are:

- the valuation multiples of publicly traded companies that the underwriters believe to be comparable to us;
- our financial information;
- the history of, and the prospects for, our company and the industry in which we compete;
- an assessment of our management, its past and present operations, and the prospects for, and timing of, our future revenues;
- the present state of our development; and
- the above factors in relation to market values and various valuation measures of other companies engaged in activities similar to ours.

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An active trading market for the shares may not develop. It is also possible that after the offering the shares will not trade in the public market at or above the initial public offering price.

Because we may be deemed to have a conflict of interest with Cowen & Co., LLC, the offering will be conducted in accordance with Conduct Rule 2720 of the National Association of Securities Dealers, Inc. This rule requires that the public offering price of an equity security be no higher than the price recommended by a qualified independent underwriter which has participated in the preparation of the registration statement and performed its usual standard of due diligence with respect to that registration statement. Although affiliates of Needham & Company, LLC own an aggregate of 2,400,000 shares, or 28.2% of our outstanding preferred stock, in determining conflict of interest issues, the Conduct Rules of the NASD include only those shares in which the underwriter has an economic interest. As determined by the Conduct Rules of the NASD, Needham & Company, LLC (together with its affiliates) has an economic interest in approximately 2.0% of our outstanding preferred stock and is eligible to act as a qualified independent underwriter. Needham & Company, LLC has agreed to act as qualified independent underwriter for the offering. The price of the shares will be no higher than that recommended by Needham & Company, LLC. For a further discussion, see Risk Factors The underwriters may have a conflict of interest in connection with this offering.

Price Stabilization, Short Positions and Penalty Bids

Until the distribution of the shares is completed, SEC rules may limit underwriters and selling group members from bidding for and purchasing our common stock. However, the representatives may engage in transactions that stabilize the price of the common stock, such as bids or purchases to peg, fix or maintain that price.

The underwriters may purchase and sell our common stock in the open market. These transactions may include short sales, stabilizing transactions and purchases to cover positions created by short sales. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in the offering. Covered short sales are sales made in an amount not greater than the underwriters option to purchase additional shares in the offering. The underwriters may close out any covered short position by either exercising their option to purchase additional shares or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the overallotment option. Naked short sales are any sales in excess of such option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the common shares in the open market after pricing that could adversely affect investors who purchase in the offering. Stabilizing transactions consist of various bids for or purchases of shares of common stock made by the underwriters in the open market prior to the completion of the offering.

Similar to other purchase transactions, the underwriters purchases to cover the syndicate short sales may have the effect of raising or maintaining the market price of our common stock or preventing or retarding a decline in the market price of the common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market.

The representatives may also impose a penalty bid on underwriters and selling group members. This means that if the representatives purchase shares in the open market to reduce the underwriter s short position or to stabilize the price of such shares, they may reclaim the amount of the selling concession from the underwriters and selling group members who sold those shares. The imposition of a penalty bid may also affect the price of the shares in that it discourages resales of those shares.

Neither we nor any of the underwriters make any representation or prediction as to the direction or magnitude of any effect that the transactions described above may have on the price of our common stock. In addition, neither we nor any of the representatives make any representation that the representatives will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

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Passive Market Making

In connection with this offering, underwriters and selling group members may engage in passive market making transactions in the common stock on the Nasdaq National Market in accordance with Rule 103 of Regulation M under the Securities Exchange Act of 1934 during a period before the commencement of offers or sales of common stock and extending through the completion of the distribution. A passive market maker must display its bid at a price not in excess of the highest independent bid of that security. However, if all independent bids are lowered below the passive market maker s bid, that bid must then be lowered when specified purchase limits are exceeded.

Electronic Offer, Sale and Distribution of Shares

Merrill Lynch will be facilitating Internet distribution for this offering to certain of its Internet subscription customers. Merrill Lynch intends to allocate a limited number of shares for sale to its online brokerage customers. An electronic prospectus is available on the Internet Web site maintained by Merrill Lynch. Other than the prospectus in electronic format, the information on the Merrill Lynch Web site is not a part of this prospectus.

Other Relationships

Cowen & Co., LLC has provided us with investment banking advisory services in the past, for which Cowen & Co., LLC has received customary fees. Some of the underwriters and their affiliates may in the future engage in investment banking and other commercial dealings in the ordinary course of business with us for which they will receive customary fees and commissions. Affiliates of Needham & Company, LLC, Cowen & Co., LLC and Merrill Lynch, which are acting as underwriters in this offering, purchased an aggregate of 2,400,000 shares, 1,028,000 shares and 800,000 shares each of our Series B Preferred. Further, Eugene R. White, who has been a member of our board of directors since December 2001, is also a member of the board of directors of Needham & Company, LLC.

LEGAL MATTERS

The validity of the common stock being offered by this prospectus will be passed upon for us by Heller Ehrman LLP, San Francisco, California which has acted as our counsel in connection with this offering. The underwriters have been represented by Morrison & Foerster LLP, Palo Alto, California. Victor A. Hebert, a member of Heller Ehrman LLP and the corporate secretary of Nextest, beneficially owns 5,000 shares of our capital stock, on an as converted basis.

EXPERTS

The consolidated financial statements as of June 30, 2004 and 2005 and for each of the three years in the period ended June 30, 2005 included in this prospectus have been so included in reliance on the report of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

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WHERE YOU CAN FIND ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form S-1 (including exhibits and schedules) under the Securities Act, with respect to the shares of common stock offered by us and the selling stockholders in this offering. This prospectus, which constitutes a part of the registration statement, does not contain all of the information set forth in the registration statement; some items are contained in exhibits to the registration statement as permitted by the rules and regulations of the SEC. With respect to each document filed with the SEC as an exhibit to the registration statement, reference is made to the exhibit for a more complete description of the matter involved. When we complete this offering, we will also be required to file annual, quarterly and special reports, proxy statements and other information with the SEC.

You can read our SEC filings, including the registration statement, over the Internet at the SEC s web site at www.sec.gov. You may also read and copy any document we file with the SEC at its public reference facility at 450 Fifth Street, N.W., Washington, D.C. 20549. You may also obtain copies of the document at prescribed rates by writing to the Public Reference Section of the SEC at 450 Fifth Street, N.W., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the operation of the public reference facilities.

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NEXTEST SYSTEMS CORPORATION

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The reincorporation and the one for two reverse stock split described in Note 13 to the consolidated financial statements have not been consummated at March 2, 2006. When they have been consummated, we will be in a position to furnish the following report:

To the Board of Directors and Stockholders of

Nextest Systems Corporation

In our opinion, the accompanying consolidated balance sheets and related consolidated statements of operations, of stockholders equity and of cash flows present fairly, in all material respects, the financial position of Nextest Systems Corporation and its subsidiaries at June 30, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended June 30, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Notes 1 and 6 to the consolidated financial statements, in November 2006, the holders of the Company s Series B mandatorily redeemable convertible preferred stock have the right, if a majority of them elect to do so, to require the Company to redeem all the Series B preferred stock outstanding at its estimated redemption value at that date. As further discussed in Note 1 to the consolidated financial statements, the Company s ability to meet its obligation to the Series B preferred stockholders is dependant upon, among other things, raising additional capital.

/s/ PricewaterhouseCoopers LLP

San Jose, California

August 18, 2005, except for Note 13,

which is as of March 2, 2006

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NEXTEST SYSTEMS CORPORATION

CONSOLIDATED BALANCE SHEETS

(in thousands, except share data)

	June 30, 2004	June 30, 2005	December 31, 2005 (Unaudited)	Pro Forma Stockholders Equity at December 31, 2005 (Unaudited) (See Note 1)
ASSETS				
Current assets:				
Cash and cash equivalents	$ 5,026	$ 10,474	$ 16,896	
Short-term investments	5,001			
Accounts receivable, net of allowances of $159 at June 30, 2004, $157 at June 30, 2005 and $157 (unaudited) at December 31, 2005 (including balances due from a related party, see Note 11)	10,536	12,836	9,299	
Inventory	19,218	13,150	21,355	
Deferred tax assets	2,809	2,835	3,100	
Prepaid expenses and other current assets	1,118	298	660	
Total current assets	43,708	39,593	51,310	
Property and equipment, net	3,179	3,750	3,615	
Restricted cash	517	417	317	
Deferred tax assets	705	975	1,824	
Other assets	1,033	1,080	491	
Total assets	$ 49,142	$ 45,815	$ 57,557	
LIABILITIES, MANDATORILY REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY				
Current liabilities:				
Accounts payable	$ 6,786	$ 3,499	$ 7,584	
Accrued liabilities	5,278	3,100	4,490	
Deferred income	755	3,792	2,077	
Customer deposits	360	761	2,647	
Income tax payable	2,000	218	2,073	
Total current liabilities	15,179	11,370	18,871	
Deferred income	328	380	366	
Accrued rent	334	239	174	
Total liabilities	15,841	11,989	19,411	
Commitments and contingencies (Note 4)				
Series B Mandatorily Redeemable Convertible Preferred Stock:				
	26,441	30,784	33,785	$

$2.50 par value; 8,000,000 shares authorized; 8,000,000 shares issued and outstanding at June 30, 2004, June 30, 2005, and December 31, 2005 (unaudited) actual, and 0 (unaudited) pro forma (Series B liquidation preference of $40,000,000)				
Stockholders equity:				
Series A Convertible Preferred Stock: $3.00 par value; 500,000 shares authorized; 500,000 shares issued and outstanding at June 30, 2004, June 30, 2005 and December 31, 2005 (unaudited) actual, and 0 (unaudited) pro forma (Series A liquidation preference of $1,500,000)	1,490	1,490	1,490	
Common Stock: $0.001 par value				
Authorized: 140,000,000 shares;				
Issued and outstanding: 8,707,521 and 8,762,046 shares at June 30, 2004 and 2005, respectively and 8,624,178 (unaudited) actual, 12,886,928 (unaudited) pro forma at December 31, 2005, respectively	9	9	9	13
Additional paid in capital	4,421	3,434	4,739	40,010
Deferred stock-based compensation	(2,015)	(863)	(1,877)	(1,877)
Notes receivable from stockholders	(1,028)	(1,028)		
Retained earnings	3,983			
Total stockholders equity	6,860	3,042	4,361	$ 38,146
Total liabilities, mandatorily redeemable convertible preferred stock and stockholders equity	$ 49,142	$ 45,815	$ 57,557	

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

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NEXTEST SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except share and per share data)

	Years Ended June 30,			Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Net revenue:					
Products	$ 13,386	$ 42,076	$ 45,477	$ 26,145	$ 34,848
Services	2,212	2,374	2,970	1,305	1,782
Total net revenue (including net revenue from sales to a related party, see Note 11)	15,598	44,450	48,447	27,450	36,630
Cost of revenue:					
Products	10,416	20,535	25,029	13,512	17,781
Services	477	584	498	264	599
Total cost of revenue	10,893	21,119	25,527	13,776	18,380
Gross profit	4,705	23,331	22,920	13,674	18,250
Operating expenses:					
Research and development	4,456	6,351	6,657	3,194	3,752
Sales, general and administrative	8,046	13,117	17,067	7,923	9,769
Total operating expenses	12,502	19,468	23,724	11,117	13,521
Income (loss) from operations	(7,797)	3,863	(804)	2,557	4,729
Interest and other income, net:					
Interest and other income (expense), net	267	229	213	103	231
Interest expense	(163)	(31)	(60)	(30)	(58)
Interest and other income, net	104	198	153	73	173
Income (loss) before income taxes	(7,693)	4,061	(651)	2,630	4,902
Income tax (provision) benefit	920	2,190	339	(905)	(1,601)
Net income (loss)	(6,773)	6,251	(312)	1,725	3,301
Accretion of Series B preferred stock redemption value	(1,600)	(4,047)	(4,343)	(2,507)	(3,001)
Amount allocated to participating Series A preferred stockholders		(90)			(45)

Net income (loss) available to common stockholders	$ (8,373)	$ 2,114	$ (4,655)	$ (782)	$ 255
Basic and diluted net income (loss) per share available to common stockholders:					
Net income (loss) per common share, basic	$ (1.07)	$ 0.25	$ (0.54)	$ (0.09)	$ 0.03
Net income (loss) per common share, diluted	$ (1.07)	$ 0.22	$ (0.54)	$ (0.09)	$ 0.03
Weighted average number of shares used in per share calculations, basic	7,815,822	8,312,113	8,663,287	8,630,473	8,649,233
Weighted average number of shares used in per share calculations, diluted	7,815,822	9,457,404	8,663,287	8,630,473	9,485,590
Unaudited pro forma net income (loss) per share:					
Pro forma net income (loss) per share, basic			$ (0.02)		$ 0.26
Pro forma net income (loss) per share, diluted			$ (0.02)		$ 0.24
Pro forma shares used in per share calculation, basic			12,926,037		12,911,983
Pro forma shares used in per share calculation, diluted			12,926,037		13,748,340

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

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NEXTEST SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands, except share data)

	Series A Convertible Preferred Stock		Common Stock		Additional Paid In Capital	Deferred Stock-Based Compensation	Notes Receivable from Stockholders	Retained Earnings	Total Stockholders Equity
	Shares	Amount	Shares	Amount					
Balance at June 30, 2002	500,000	$ 1,490	8,235,017	$ 8	$ 1,403	$ (14)	$ (1,051)	$ 10,152	$ 11,988
Issuance of common stock upon exercise of options			70,050		1				1
Amortization of deferred stock-based compensation						14			14
Accretion of Series B mandatorily redeemable convertible preferred stock								(1,600)	(1,600)
Interest on notes receivable from stockholders							(55)		(55)
Repayment of interest on notes receivable from stockholders							55		55
Net loss								(6,773)	(6,773)
Balance at June 30, 2003	500,000	1,490	8,305,067	8	1,404		(1,051)	1,779	3,630
Issuance of common stock upon exercise of options			402,454	1	111				112
Deferred stock-based compensation					2,906	(2,906)			
Amortization of deferred stock-based compensation						891			891
Accretion of Series B mandatorily redeemable convertible preferred stock								(4,047)	(4,047)
Interest on notes receivable from stockholders							(55)		(55)
Repayment of principal and interest on notes receivable from stockholders							78		78
Net income								6,251	6,251
Balance at June 30, 2004	500,000	1,490	8,707,521	9	4,421	(2,015)	(1,028)	3,983	6,860
Issuance of common stock upon exercise of options			54,525		14				14
Deferred stock-based compensation					(329)	329			
Amortization of deferred stock-based compensation						823			823
Accretion of Series B mandatorily redeemable convertible preferred stock					(672)			(3,671)	(4,343)
Interest on notes receivable from stockholders							(55)		(55)
							55		55

Repayment of interest on notes receivable from stockholders									
Net loss								(312)	(312)
Balance at June 30, 2005	500,000	$ 1,490	8,762,046	$ 9	$ 3,434	$ (863)	$ (1,028)	$	$ 3,042

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

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NEXTEST SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

(in thousands, except share data)

(Continued)

	Series A Convertible Preferred Stock		Common Stock		Additional Paid In	Deferred Stock-Based	Notes Receivable from	Retained	Total Stockholders
	Shares	Amount	Shares	Amount	Capital	Compensation	Stockholders	Earnings	Equity
Balance at June 30, 2005	500,000	$ 1,490	8,762,046	$ 9	$ 3,434	$ (863)	$ (1,028)	$	$ 3,042
Issuance of common stock under restricted stock agreement (unaudited)			7,500		71	(71)			
Issuance of common stock upon exercise of options (unaudited)			25,550		32				32
Deferred stock-based compensation (unaudited)					1,907	(1,907)			
Amortization of deferred stock-based compensation (unaudited)						964			964
Accretion of Series B mandatorily redeemable convertible preferred stock (unaudited)					(60)			(2,941)	(3,001)
Interest on notes receivable from stockholders (unaudited)							(10)		(10)
Repayment of interest on notes receivable from stockholders (unaudited)							33		33
Repurchase of common stock (unaudited) (See Note 5)			(170,918)		(645)		1,005	(360)	
Net income for the six months ended December 31, 2005 (unaudited)								3,301	3,301
Balance at December 31, 2005 (unaudited)	500,000	$ 1,490	8,624,178	$ 9	$ 4,739	$ (1,877)	$	$	$ 4,361

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

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NEXTEST SYSTEMS CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Years Ended June 30,			Six Months Ended December 31,	
	2003	**2004**	**2005**	**2004**	**2005**
				(Unaudited)	**(Unaudited)**
Cash flows from operating activities:					
Net income (loss)	$ (6,773)	$ 6,251	$ (312)	$ 1,725	$ 3,301
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:					
Depreciation and amortization	475	557	1,076	478	643
Provision for inventory write-downs	1,692	585	1,954	1,086	362
Amortization of stock-based compensation	14	891	823	470	964
Deferred taxes provision (benefit)	2,223	(3,514)	(296)	(655)	(1,114)
Interest on notes receivable from stockholders	(55)	(55)	(55)	(27)	(10)
Interest on short-term investments	(39)	(54)	(50)	(31)	
Changes in current assets and liabilities:					
Accounts receivable	(928)	(5,149)	(2,300)	1,405	3,537
Inventory	731	(12,796)	2,771	(85)	(8,930)
Income tax receivable	(2,519)	3,027			
Prepaid expenses and other current assets	112	(853)	820	191	(362)
Other assets	(2)	(43)	(47)	(4)	17
Accounts payable	732	5,146	(3,287)	(4,653)	4,085
Accrued liabilities	395	3,662	(2,272)	(1,337)	1,325
Income taxes payable	755	280	(1,783)	(161)	2,427
Deferred income	652	(500)	3,089	1,126	(1,729)
Customer deposits	1,560	(1,200)	401	(233)	1,886
Net cash provided by (used in) operating activities	(975)	(3,765)	532	(705)	6,402
Cash flows from investing activities:					
Purchases of property and equipment	(182)	(2,128)	(304)	(195)	(145)
Purchases of short-term investments	(16,025)	(15,075)	(6,000)	(6,000)	
Sales and maturities of short-term investments	11,037	15,155	11,051	8,030	
Changes in restricted cash	92	100	100	100	100
Net cash provided by (used in) investing activities	(5,078)	(1,948)	4,847	1,935	(45)
Cash flows from financing activities:					
Proceeds from exercise of options	1	112	14	14	32
Repayment of principal and interest on notes receivable from stockholders	55	78	55	17	33

Net cash provided by financing activities	56	190	69	31	65
Net increase (decrease) in cash and cash equivalents	(5,997)	(5,523)	5,448	1,261	6,422
Cash and cash equivalents at beginning of period	16,546	10,549	5,026	5,026	10,474
Cash and cash equivalents at end of period	$ 10,549	$ 5,026	$ 10,474	$ 6,287	$ 16,896
Supplementary cash flow information:					
Cash paid for income taxes	$ 3	$ 1,066	$ 1,996	$ 1,721	$ 279
Refunds received for income taxes	$ 1,382	$ 3,049	$ 257	$	$ 3
Non-cash financing activities:					
Extinguishment of principal on notes receivable from stockholders (see Note 5)	$	$	$	$	$ 1,005

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

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 The Company and Basis of Presentation:

The Company

Nextest Systems Corporation (the Company), was incorporated in California in November 1997 and is engaged in the design, development manufacturing, sale and service of automatic test equipment (ATE) for the semiconductor industry.

The semiconductor industry is characterized by rapid technological change, competitive pricing pressures and cyclical market patterns. The Company s financial results are affected by a wide variety of factors, including general economic conditions worldwide, economic conditions specific to the semiconductor industry and in addition, the semiconductor market has historically been cyclical and subject to significant economic downturns at various times. Historically a small number of customers have accounted for a significant portion of the Company s revenue. The Company may experience significant period-to-period fluctuations in future operating results due to the factors mentioned above or other factors. Such factors could negatively impact the Company s cash flows from operations and liquidity.

The Company s future financing requirements will depend on many factors, including its rate of revenue growth, the price received for its products and services, the timing and extent of spending to support product development efforts, the expansion of sales and marketing activities, the timing of introductions of new products and enhancement to existing products, the cost of ensuring access to adequate manufacturing capacity, and the continuing market acceptance of its products. The Company believes that current cash balances and future cash flows from operations will be sufficient to meet its anticipated cash needs for operations for the next twelve months. In the event of liquidation, dissolution or winding up of the Company, holders of the Company s common stock may not receive any proceeds due to liquidation preferences of the Company s preferred stockholders. In November 29, 2006, the holders of the Series B redeemable convertible preferred stock have an option to have their shares redeemed at an estimated redemption value of $41.2 million (unaudited), as determined on December 31, 2005. If the Company completes an initial public offering of its common stock for greater than $25 million and a price not less than $10.00 per share by the redemption date, the Series B redeemable convertible preferred stock will automatically convert to common stock. However, if this offering does not take place prior to the Series B stockholders optional redemption in November 29, 2006, the Company will likely have to find an alternative source of capital to redeem the shares or obtain an extension of the redemption date from the Series B stockholders. Failure to consummate an initial public offering, raise additional capital or modify the redemption date could have a material adverse effect on the Company s ability to achieve its intended business objectives (see Note 6).

Fiscal periods

The Company reports results of operations on the basis of 52 or 53 week periods, ending on the last Saturday in June of each fiscal year. Fiscal years 2003, 2004, and 2005 ended on June 28, 2003, June 26, 2004, and June 25, 2005, respectively. Fiscal years 2003, 2004, and 2005 were each comprised of 52 weeks. For presentation purposes, the accompanying consolidated financial statements refer to the fiscal year end of each respective year as June 30. The periods for the six months ended December 31, 2004 and 2005 actually ended December 25, 2004 and December 24, 2005, respectively, and each included 26 weeks.

Basis of consolidation

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries (see Note 9). All material intercompany balances and transactions have been eliminated.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Foreign currency translation

The U.S. dollar is the functional currency for the Company s wholly-owned subsidiaries. Assets and liabilities that are not denominated in the functional currency are remeasured into U.S. dollars and the resulting gains or losses are included in Interest and other income, net. Such gains or losses have not been material for any period presented.

Use of estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities (inventory valuation, accounts receivable valuation, accrued warranty and fair values of common and preferred stock, etc.) and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of net revenue and expenses during the reporting period. Significant estimates in these consolidated financial statements include allowances for doubtful accounts receivable, inventory write-downs, estimates for future cash flows and economic useful lives of property and equipment, asset impairments, certain accrued liabilities, income tax contingencies and deferred tax valuation allowances and valuations of common and preferred stock. Actual results could differ from those estimates.

Unaudited interim results

The accompanying consolidated balance sheet at December 31, 2005 and related consolidated statements of operations and of cash flows for the six months ended December 31, 2004 and 2005, are unaudited. The interim financial statements have been prepared on the same basis as the annual financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments, necessary to state fairly the Company s results of operations and cash flows for the six months ended December 31, 2004 and 2005. The results for the six months ended December 31, 2005 are not necessarily indicative of the results to be expected for the year ending June 30, 2006 or for any other interim period or for any other future year.

Unaudited pro forma stockholders equity

Upon consummation of the offering contemplated by this prospectus, all of the Series B mandatorily redeemable convertible preferred stock and Series A convertible preferred stock outstanding will automatically convert to 4,262,750 shares of common stock, based on the shares of preferred stock outstanding at December 31, 2005. Unaudited pro forma stockholders equity, as adjusted for the assumed conversion of the mandatorily redeemable convertible preferred stock and redeemable convertible preferred stock, is set forth on the accompanying consolidated balance sheet. See Note 12 for discussion of unaudited pro forma earnings per share giving effect to this conversion.

Revenue recognition

The Company recognizes revenue from product sales when persuasive evidence of an arrangement exists, delivery has occurred, title has passed, the selling price is fixed or determinable and collection of the resulting receivable is reasonably assured. Delivery generally occurs when the product is delivered to a common carrier and shipping terms are FOB shipping point. Acceptance occurs once it is demonstrated that the product meets the Company s final test specifications and is delivered to a common carrier. When the arrangement with the customer includes future obligations or is contingent on obtaining customer acceptance (generally a new customer or a new product to an existing customer), revenue is deferred and recognized only when these obligations have been met or customer acceptance has been received. The Company s product sales consist

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

primarily of the sale of equipment. If the Company provides services (primarily extended warranty and maintenance service) along with the product, which are considered as multiple deliverables, such services are accounted for separately in accordance with EITF 00-21, Revenue Arrangements with Multiple Deliverables. For arrangements with multiple deliverables, the Company recognizes revenue for the delivered items if the delivered items have value to the customer on a stand-alone basis and the fair value of undelivered items can be reliably determined. The Company allocates total consideration, which is fixed and determinable, to separate deliverables, consisting of separate units of accounting based on the fair values of these units of accounting as determined by reference to the ordinary selling price of these units when they are sold on a stand-alone basis. Thereafter, depending on the nature of the deliverables comprising a unit of accounting, and the corresponding revenue recognition conventions, the Company recognizes revenue when all revenue recognition criteria are met.

The Company s customers do not have general rights of return. The substantial majority of the Company s sales are directly to end customers. The Company does not recognize revenue on evaluation units it may consign to its customers until a purchase order is placed by the customer and all other conditions of the Company s revenue recognition policy are met, as discussed above.

The Company recognizes revenue from fixed-price support or maintenance contracts, including extended warranty contracts, and short-term rental contracts, ratably over the contractual period and recognizes the costs associated with these contracts as incurred. Rental revenues are included as a component of product sales and have been immaterial to date. Revenue for out-of-warranty repairs and not under service contracts is recognized when the repaired product is delivered to a common carrier.

Deferred product revenue relates to shipped but not yet accepted product and unearned revenue for extended warranty and is reported net of its related cost of revenue in the caption Deferred Income in the accompanying consolidated balance sheet.

Shipping and handling cost

Shipping and handling charged to customers are recorded as revenue. These costs are included in the company s cost of revenue. Such charges were not significant in any of the periods presented.

Advertising

The Company expenses advertising costs as incurred. Advertising costs were $166,000, $347,000, $695,000, $563,000 (unaudited) and $610,000 (unaudited) for the years ended June 30, 2003, 2004 and 2005, and the six months ended December 31, 2004 and December 31, 2005, respectively.

Research and development

Research and development costs consist primarily of compensation and related costs for personnel as well as costs related to materials, outside contractors, equipment depreciation and other engineering overhead costs. All research and development costs are expensed as incurred.

Cash and cash equivalents

The Company considers all highly liquid investments with an original maturity of three months or less on the date of purchase to be cash equivalents. The Company deposits all of its cash and cash equivalents with two high credit quality financial institutions.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Short-term investments

The Company considers marketable securities with remaining maturities at the time of purchase greater than three months and that are expected to be realized within one year from the balance sheet date as short-term investments. Marketable securities consist of debt securities that are classified as available-for-sale and are reported at fair value in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities with net unrealized gains and losses reported within stockholders equity. There were no unrealized gains and losses at June 30, 2005 and 2004. Realized gains or losses on sale or maturity of securities are determined based on specific identification and are included in interest and other income, net. Short-term investments at June 30, 2004 consisted entirely of auction rate securities which when purchased had auction-rate reset dates within 90 days of the purchase date. Such auctions are assumed to occur as scheduled, but there can be no assurance that such auctions will occur. There were no short-term investments at June 30, 2005 and December 31, 2005 (unaudited).

Restricted cash

Restricted cash as of June 30, 2004 was $512,000 and as of June 30, 2005 was $412,000 and as of December 31, 2005 (unaudited) was $312,000, which is held for purposes of supporting an irrevocable standby letter of credit. The standby letter of credit is held as collateral for the lease of the 1901 Monterey Road facility. This letter of credit and its restricted cash balance are reduced annually by $100,000 in November. In addition, $5,000 is held as collateral for the Company s Visa/MasterCard Merchant Account at June 30, 2004 and 2005 and December 31, 2005 (unaudited).

Fair value of financial instruments

The carrying amounts of the Company s financial instruments, which include cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued liabilities approximate their fair values due to their short maturities and/or market-consistent interest rates.

The Company s Series B mandatorily redeemable preferred stock is being accreted to its estimated fair value at its redemption date. As a private company, the estimated fair value of the Series B Preferred shares at its redemption date is determined by the Board of Directors. In determining fair value, the Board of Directors considers a number of factors, including:

- the fair value of the Company s common stock (See Note 7 for discussion),
- contemporaneous or retrospective valuations performed by valuation specialists,

dividend, conversion, redemption and liquidation preferences of the Series B Preferred shares.

Concentration of credit risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents, short-term investments and accounts receivable. The Company deposits are primarily in checking and money market accounts with reputable financial institutions. Deposits held with financial institutions may exceed the amount of insurance provided on such deposits. The Company s accounts receivable are derived from U.S. dollar denominated revenue earned from customers located primarily in the North America, Europe and Asia. The Company performs on-going credit evaluations of its customers financial condition. While the Company generally does not require collateral, in certain circumstances it may require a

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

customer to provide an irrevocable letter of credit and/or a significant cash prior to shipment. The Company assesses collectibility of its accounts receivable and provides a valuation allowance for its estimate of uncollectible amounts. The Company had no significant write-offs or recoveries during the years ended June 30, 2003, 2004, 2005 and during the six months ended December 31, 2004 (unaudited) and December 31, 2005 (unaudited).

The following table sets forth sales to customers comprising 10% or more of the Company s total revenue for the periods indicated:

	Years Ended June 30,			Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Customer					
Atmel	17%	21%	34%	51%	%
SanDisk	39	26	16	17	26
Hynix					40
Amkor		14			
Samsung			19		11

The following table sets forth accounts receivable from customers comprising 10% or more of the Company s total accounts receivable balance at the period ends indicated:

	June 30,		December 31,
	2004	2005	2005
			(Unaudited)
Customer			
Atmel	24%	%	16%
Hynix		45	
SanDisk	14		36
Intel	15		
Samsung	12	28	
Lattice			10

Inventories

Inventory is stated at the lower of standard cost (which approximates actual cost on a first-in, first-out basis), or market. Due to changing market conditions, estimated future requirements, age of the inventories on-hand and our introduction of new products, the Company regularly reviews inventory quantities on-hand and records a provision to write-down excess and obsolete inventory to its estimated net realizable value. A significant increase in the demand for the Company s products could result in a short-term increase of inventory purchases while a significant decrease in demand could result in an increase in the provisions for excess inventory quantities on-hand. In addition, the Company s industry is subject to technological change, new product development and product technological obsolescence that could result in an increase in the amount of obsolete inventory quantities on-hand. When the Company records a provision for excess and obsolete inventory, a new cost basis for the inventory is created. Recoveries of previously written-down inventory are recognized only when the related inventory is sold and revenue has been recognized.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Inventory provisions for the years ended June 30, 2003, 2004 and 2005 were $1.7 million, $0.6 million and $2.0 million respectively. Recoveries resulting from sales of previously written-down inventory for the years ended June 30, 2003, 2004 and 2005 were none, $1.5 million and $0.6 million, respectively. Inventory provisions for the six months ended December 31, 2004 and December 31, 2005 were $1.1 million (unaudited) and $0.4 million (unaudited), respectively. Recoveries resulting from sales of previously written-down inventory for the six months ended December 31, 2004 and December 31, 2005 were $0.2 million (unaudited) and $0.3 million (unaudited), respectively.

Certain components used in the Company s products are purchased from a single or a limited group of suppliers. Although all single or limited group sourced components are currently available in adequate amounts, shortages of such components could develop in the future. The Company typically does not have written supply agreements and purchases these components through individual purchase orders.

Inventory held at customers represents evaluation units that have been consigned to potential customers for evaluation and test purposes (usually less than one year). There is no contractual obligation for the Company s customers to purchase these evaluation units. Returned units are added to inventory and subsequently sold to other customers. Costs of refurbishing such inventory have historically been insignificant. Net revenue from sales of evaluation units directly from inventory held at customers was approximately $107,000, $1,539,000 and $90,000 for the years ended June 30, 2003, 2004 and 2005, respectively and $50,000 (unaudited) and $23,000 (unaudited) for the six months ended December 31, 2004 and 2005, respectively. Gross margins on these sales were consistent with the overall gross margins in those periods.

Field service inventory represents spare parts used by the service department to support warranty and service activities and is not held for resale to our customers. This inventory generally must be maintained regardless of whether the systems they support are in the Company s existing product offering or whether they are used to support products. The Company records a provision to services cost of revenue for field service inventory that it deems to be excess or obsolete to write it down to its estimated net realizable value.

Property and equipment

Property and equipment, including leasehold improvements are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization is calculated using the straight-line method over the estimated useful lives of the related assets.

The depreciation and amortization periods of property and equipment are as follows:

Demonstration equipment	5 years
Computer and test equipment	5 years
Computer software	3 years
Furniture and fixtures	7 years

Leasehold improvements	Shorter of the estimated useful life or remaining term of lease

Demonstration equipment consists primarily of Company-owned test systems used to allow its customers to observe and test the systems operations and functionality. Depreciation of demonstration equipment is included in selling, general and administrative expense. Generally, the Company does not offer its demonstration equipment for sale to its customers, however if a unit is sold, the Company s policy is to transfer the asset back into inventory. When revenue is recognized the depreciated cost basis of the equipment is recorded as cost of revenue.

Maintenance and repairs are charged to expense as incurred, and improvements and betterments are capitalized. When assets are retired or otherwise disposed of, the cost and accumulated depreciation and

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

amortization are removed from the accounts and any resulting gain or loss is reported in Other income or loss in the period realized.

The Company reviews property and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable. Recoverability is measured by comparison of the carrying amount to the future undiscounted net cash flows, which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of these assets exceeds the fair value of the assets. There have been no impairments of long-lived assets through June 30, 2005 and December 31, 2005 (unaudited).

Income taxes

The Company accounts for income taxes under the liability method whereby the expected future tax consequences of temporary differences between the book and tax basis of assets and liabilities are recognized as deferred tax assets and liabilities, using enacted tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is provided if it is more likely than not that a portion or the entire deferred tax asset will not be realized.

In addition, the Company s calculation of their tax liabilities involves dealing with uncertainties in the application of complex tax regulations. The Company is subject to income tax audits in all of the jurisdictions in which it operates and, as a result, must also assess exposures to any potential issues arising from current or future audits of current and prior year s tax returns. Accordingly, the Company must assess such potential exposure and, where necessary, provide a reserve to cover any expected loss. To the extent that the Company establishes a reserve, its provision for income taxes would be increased. If the Company ultimately determines that payment of these amounts is unnecessary, it reverses the liability and recognizes a tax benefit during the period in which it determines that the liability is no longer necessary. The Company records an additional charge in its provision for taxes in the period in which it determines that the recorded tax liability is less than the Company s original estimate.

Warranty

The Company generally warrants its product against defect, in material, and workmanship and non-conformance to the Company s specification for a period of twelve months. The Company s warranty provision is based on the Company s best estimate, considering historical experiences with similar products as well as other assumptions that are considered reasonable under the circumstances. A provision for the estimated cost of warranty is recorded as a cost of revenue and is included in accrued liabilities when the related revenue is recognized (in thousands).

Balance at June 30, 2003	$ 232
Accrual for warranties issued	638

Settlements made	(448)
Balance at June 30, 2004	422
Accrual for warranties issued	457
Settlements made	(509)
Balance at June 30, 2005	370
Accrual for warranties issued (unaudited)	348
Settlements made (unaudited)	(185)
Balance at December 31, 2005 (unaudited)	$ 533

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Stock-based compensation

At June 30, 2004 and 2005 and December 31, 2005, the Company has one stock-based compensation plan. The Company accounts for stock-based employee compensation arrangements in accordance with provisions of Accounting Principles Board Opinion (APB) No. 25, Accounting for Stock Issued to Employees , and related Interpretations. Under APB 25, when the exercise price of the Company s stock options is less than the fair value of the underlying shares on the date of grant, compensation expense is recognized. The following table illustrates the effect on net income (loss) and basic and diluted net income (loss) per share available to common stockholders if the Company had applied the fair value recognition provisions of FASB No. 123, Accounting for Stock-Based Compensation , to stock-based employee compensation (in thousands, except per share data).

	Years Ended June 30,			Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Net income (loss), as reported	$ (6,773)	$ 6,251	$ (312)	$ 1,725	$ 3,301
Add: Stock-based employee compensation expense included in net income (loss), net of related tax	14	868	769	445	671
Deduct: Stock-based employee compensation expense determined under fair value based method for all awards, net of related tax	(181)	(993)	(1,059)	(579)	(713)
Pro forma net income (loss)	$ (6,940)	$ 6,126	$ (602)	$ 1,591	$ 3,259
Basic net income (loss) per share available to common stockholders:					
As reported	$ (1.07)	$ 0.25	$ (0.54)	$ (0.09)	$ 0.03
Pro forma	$ (1.09)	$ 0.24	$ (0.57)	$ (0.11)	$ 0.02
Diluted net income (loss) per share available to common stockholders:					
As reported	$ (1.07)	$ 0.22	$ (0.54)	$ (0.09)	$ 0.03
Pro forma	$ (1.09)	$ 0.21	$ (0.57)	$ (0.11)	$ 0.02

Stock-based compensation expense, including amounts to non-employees, was included in the following statement of operations categories (in thousands):

	Years Ended June 30,			Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Cost of revenue	$	$ 133	$ 121	$ 70	$ 95
Research and development		205	259	157	353
Sales, general and administrative	14	553	443	243	516
Total	$ 14	$ 891	$ 823	$ 470	$ 964

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Through April 16, 2004, the date of the Company s original 2004 filing with the Securities and Exchange Commission (SEC) related to its original proposed initial public offering, the Company used the minimum value method to estimate the fair value of options granted to employees. Options granted subsequent to April 16, 2004 were valued using the Black-Scholes valuation model with estimated volatility of 90%. The fair value of the Company s stock-based compensation awards granted to employees was estimated using the following weighted average assumptions:

	Years Ended June 30,			Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Dividend yield	None	None	None	None	None
Risk-free interest rate	3.07%	2.75%-3.65%	3.18%-3.84%	3.18%-3.44%	3.96%-4.36%
Expected life (in years)	5.0	5.0	3.8	3.6	2.6

The reduction in the expected life of the options granted in the year ended June 30, 2005 and the six months ended December 31, 2004 and 2005 (unaudited) reflected the impact of issuing options with shorter vesting periods. The weighted average fair value of stock options granted in fiscal year 2003, 2004 and 2005, was $0.14, $4.72 and $5.40, respectively. The weighted average fair value of stock options granted in the six months ended December 31, 2004 and 2005 (unaudited) was $6.19 (unaudited) and $3.67 (unaudited), respectively.

The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123, Emerging Task Force Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services (EITF 96-18) and Financial Accounting Standards Board Interpretation No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans (FIN 28).

Net income (loss) per share

Basic net income (loss) available to common stockholders per share is computed by dividing the net income (loss) available to common stockholders by the weighted-average common shares outstanding for the period. The net income (loss) available to common stockholders is calculated by deducting the accretion of the estimated redemption fair value of the Series B mandatorily redeemable convertible preferred stock and dividends allocable to the Series A convertible preferred stockholders from net income (loss) to determine the net income (loss) available to common stockholders.

Diluted net income (loss) available to common stockholders per share is computed giving effect to all potentially dilutive common stock, including options and common stock subject to repurchase using the treasury stock method and all convertible securities using the if-converted method to the extent it is dilutive.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following table sets forth the computation of basic and diluted net income (loss) attributable to common stockholders per share (in thousands, except share and per share data):

	Years Ended June 30,			Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Numerators:					
Net income (loss)	$ (6,773)	$ 6,251	$ (312)	$ 1,725	$ 3,301
Accretion of Series B preferred stock redemption value (1)	(1,600)	(4,047)	(4,343)	(2,507)	(3,001)
Net income allocated to participating Series A preferred stockholders (2)		(90)			(45)
Net income (loss) available to common stockholders Basic	$ (8,373)	$ 2,114	$ (4,655)	$ (782)	$ 255
Net income (loss) allocated to participating preferred stockholders					
Net income (loss) available to common stockholders Diluted	$ (8,373)	$ 2,114	$ (4,655)	$ (782)	$ 255
Denominators:					
Weighted-average common shares outstanding	8,261,192	8,497,953	8,741,557	8,726,050	8,691,009
Unvested common shares subject to repurchase	(445,370)	(185,840)	(78,270)	(95,577)	(41,776)
Weighted-average shares Basic	7,815,822	8,312,113	8,663,287	8,630,473	8,649,233
Dilutive effect of employee stock options		959,451			794,705
Dilutive effect of unvested common shares subject to repurchase		185,840			41,652
Weighted-average shares Dilutive	7,815,822	9,457,404	8,663,287	8,630,473	9,485,590
Net income (loss) per common share Basic	$ (1.07)	$ 0.25	$ (0.54)	$ (0.09)	$ 0.03
Net income (loss) per common share Diluted	$ (1.07)	$ 0.22	$ (0.54)	$ (0.09)	$ 0.03

(1) Income is not allocated to the Series B preferred stockholders because the accretion of the estimated redemption value of the Series B preferred stock is greater than its original price plus cumulative dividends.

(2) No allocation was made to the Series A preferred stockholders in periods with net losses, as such an allocation would have been antidilutive in the fiscal years 2003 and 2005 and the six months ended December 31, 2004.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following outstanding mandatorily redeemable convertible preferred stock and convertible preferred stock, common stock options and unvested common stock were excluded from the computation of diluted net income per share as they had an antidilutive effect:

	Years Ended June 30,			Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Series B mandatorily redeemable convertible preferred stock (assuming conversion, using appropriate conversion ratio, to common shares)	4,000,000	4,000,000	4,000,000	4,000,000	4,000,000
Series A convertible preferred stock (assuming conversion, using appropriate conversation ratio, to common shares)	262,750	262,750	262,750	262,750	262,750
Unvested common shares subject to repurchase	252,500		52,500	77,500	7,500
Stock options	1,234,054	29,750	1,390,225	1,363,275	808,500

Comprehensive income

Other comprehensive income is defined as the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources. There was no difference between the Company s net income (loss) and its comprehensive income (loss) for the years ended June 30, 2003, 2004, 2005 and for the six month period ended December 31, 2004 (unaudited) and 2005 (unaudited).

Recent accounting pronouncements

In November 2004, the FASB issued SFAS 151, *Inventory Costs an amendment of ARB No. 43, Chapter 4.* The Statement clarified the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). The Statement requires that those items be recognized as current period charges regardless of whether they meet the criterion of so abnormal as previously stated in Paragraph 5 of ARB No. 43, Chapter 43. In addition, the Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005 on a prospective basis. The adoption of this standard did not have a material impact on its consolidated financial statements.

In December 2004, the FASB issued SFAS 123 (revised 2004), *Shared Based Payment.* The Statement is a revision of FASB 123 and supersedes APB No. 25. The Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for good or services or incurs liabilities in exchange of goods or services that are based on the fair value of the entity s equity instruments. It focuses primarily on accounting for transactions in which an entity obtains employee services in share-based payment transactions. The Statement requires an entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award over the period during which an employee is required to provide service for the award. The grant-date fair value of employee share options and similar instruments must be estimated using option-pricing models adjusted for the unique characteristics of those instruments unless observable market prices for the same of similar instruments are available. In addition, the Statement requires an entity to measure the cost of employee services received in exchange for an award of liability instruments based on its current fair value and that the fair value of that award will be remeasured subsequently at each reporting date through the settlement date. The effective date of this

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Statement for the Company is for the first interim period beginning after the filing of this registration statement. The Company will implement this standard using the modified prospective method. The adoption of SFAS No. 123(R) will have an adverse impact on the Company s results of operations. Based on the Company s preliminary estimates, future compensation cost to be recognized for all granted but unvested stock options as of December 31, 2005 resulting from the implementation of SFAS No. 123(R) is as follows (in thousands of dollars):

	Amount
	(unaudited)
January-June 2006	$ 920
Fiscal 2007	1,129
Fiscal 2008	599
Fiscal 2009	255
Fiscal 2010	69
Fiscal 2011	11
Total	$ 2,983

In March 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 107, which provides guidance on the implementation of Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment. In particular, SAB No. 107 provides key guidance related to valuation methods (including assumptions such as expected volatility and expected term), the accounting for income tax effects of share-based payment arrangements upon adoption of SFAS No. 123(R), the modification of employee share options prior to the adoption of SFAS No. 123(R), the classification of compensation expense, capitalization of compensation cost related to share-based payment arrangements, first-time adoption of SFAS No. 123(R) in an interim period, and disclosures in Management s Discussion and Analysis subject to the adoption of SFAS No. 123(R). The Company will apply the principles of SAB 107 in conjunction with the adoption of SFAS No. 123(R).

In December 2004, the FASB issued SFAS 153, *Exchanges of Nonmonetary Assets.* The Statement is an amendment of APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The Company believes that the adoption of this standard will have no material impact on its consolidated financial statements.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections.* The Statement replaces APB Opinion No. 20, *Accounting Changes* and FASB 3, *Reporting Accounting Changes in Interim Financial Statements* and changes the requirements for the accounting for and reporting of a change in accounting principle. This Statement applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. The effective date of this Statement for the Company is for the first fiscal year beginning after December 15, 2005. The adoption of this standard will not have a material impact on the Company s consolidated financial statements.

In March 2005, the FASB issued FASB Interpretation No. 47 (FIN 47), Accounting for Conditional Asset Retirement Obligations. FIN 47 clarifies that the term conditional asset retirement obligation as used in FASB Statement No. 143, Accounting for Asset Retirement Obligations , refers to a legal obligation to perform an asset retirement activity in which the timing and (or) method of settlement are conditional on a future event that may or may not be within the control of the entity. The obligation to perform the asset retirement activity is

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

unconditional even though uncertainty exists about the timing and (or) method of settlement. Uncertainty about the timing and (or) method of settlement of a conditional asset retirement obligation should be factored into the measurement of the liability when sufficient information exists. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation. The effective date of this Statement for the Company is for the first fiscal year beginning after December 15, 2005. The Company is currently evaluating what impact, if any, this statement will have on its financial statements.

Withdrawal of Initial Public Offering (IPO)

On January 26, 2005, the Company formally withdrew its initial efforts to complete an IPO. At June 30, 2004, the Company had recorded $767,000 of prepaid expenses related to the IPO that it wrote off in the third quarter of its fiscal year 2005 in addition to $131,000 of other IPO related expenses incurred during fiscal year 2005.

Note 2 Balance Sheet Components (in thousands):

	June 30,		December 31,
	2004	2005	2005
			(Unaudited)
Inventory:			
Raw materials	$ 14,719	$ 6,879	$ 10,454
Work-in-progress	2,000	1,578	3,463
Inventory held at customers	1,171	2,558	2,708
Field service inventory	740	944	1,240
Finished goods	588	1,191	3,490
	$ 19,218	$ 13,150	$ 21,355

	June 30,		December 31,
	2004	2005	2005
			(Unaudited)
Property and equipment, net:			
Demonstration equipment	$ 890	$ 1,152	$ 1,102
Computer and test equipment	1,221	2,864	3,261

Computer software	518	557	732
Furniture and fixtures	33	42	42
Leasehold improvements	1,373	1,791	1,793
Construction in progress	842	118	21
	4,877	6,524	6,951
Less: Accumulated depreciation and amortization	(1,698)	(2,774)	(3,336)
	$ 3,179	$ 3,750	$ 3,615

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Depreciation expense was $475,000, $557,000 and $1,076,000 for the years ended June 30, 2003, 2004 and 2005, respectively. Depreciation expense was $478,000 (unaudited) and $643,000 (unaudited) for the six months ended December 31, 2004 and 2005, respectively.

	June 30,		December 31,
	2004	2005	2005
			(Unaudited)
Accrued liabilities:			
Payroll and related expenses	$ 1,534	$ 1,269	$ 1,782
Accrued liability for inventory in-transit	962	116	686
Professional fees	882	116	125
Accrued warranty	422	370	533
Other accrued expenses	1,478	1,229	1,364
	$ 5,278	$ 3,100	$ 4,490

Note 3 Income Taxes:

The Company s income (loss) before income taxes is all U.S. source income (loss). The provision (benefit) for income taxes consists of the following (in thousands):

	Years Ended June 30,		
	2003	2004	2005
Current:			
Federal	$ (3,213)	$ 1,236	$ (80)
State	48	(53)	(3)
Foreign	22	141	40
	(3,143)	1,324	(43)
Deferred:			
Federal	1,446	(2,184)	48
State	777	(1,330)	(344)
Foreign			

	2,223	(3,514)	(296)
Total provision (benefit) for income taxes	$ (920)	$ (2,190)	$ (339)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The difference between the actual tax rate and the U.S. statutory tax rate is as follows:

	Years Ended June 30,		
	2003	**2004**	**2005**
Federal income tax provision (benefit) calculated using U.S. statutory tax rate	(35.0)%	35.0 %	(35.0)%
State tax, net of federal benefit	(5.1)	1.6	(34.6)
Foreign tax	0.3	4.9	(1.3)
Research and development credit	(1.3)	(12.1)	(23.5)
Export tax benefit	(7.6)	(4.0)	(3.3)
Deferred stock-based compensation		7.2	37.1
Meals and entertainment	0.2	0.6	6.4
Changes in tax reserves	(4.4)		2.1
Other	(4.5)	(1.1)	
Change in deferred tax valuation allowance	45.4	(86.0)	
Total effective tax rate	(12.0)%	(53.9)%	(52.1)%

Deferred tax assets and liabilities consist of the following (in thousands):

	June 30,	
	2004	**2005**
Deferred tax assets:		
Research and development credits	$ 308	$ 594
Alternative minimum tax credits		40
Net operating loss carryforwards	197	113
Depreciation and amortization	183	160
Accruals, reserves and other	2,826	2,903
Net deferred tax assets	$ 3,514	$ 3,810

As of June 30, 2003, the Company recorded a valuation allowance of $3.5 million covering all of its deferred tax assets because management determined it was more likely than not that the assets would not be realized. During the fiscal year ended June 30, 2004, the Company determined that based on the Company s return to profitability as evidenced by pre-tax income and forecasted profitability for the foreseeable future as supported by a significant increase in backlog and recent sales growth, as well as an improvement in the overall market outlook for the Company s products, that it was more likely than not that the deferred tax assets would be realized. Therefore, the valuation allowance of $3.5 million established in the fiscal year ended June 30, 2003 was reversed. The Company has determined that based upon continued taxable income in the fiscal year ended June 30, 2005 and forecasted profitability for the foreseeable future as supported by the Company s fiscal year ended June 30, 2005 results and the September 30, 2005 backlog it remains more likely than not that the deferred tax asset will be realized. The deferred tax asset is primarily comprised of reversing temporary differences related mainly to inventory write-downs, depreciation and accrued expenses.

At June 30, 2005, the Company had state net operating loss carryforwards of approximately $3.7 million available to reduce future state taxable income. The carryforward begins to expire in 2014, if not utilized. In addition, the Company has research and development tax credit carryforwards of approximately $914,000 for state tax purposes at June 30, 2005. The tax credit carryforward will be carried forward indefinitely until utilized.

Under the Internal Revenue Code Section 382, the amounts of and benefits from net operating loss carryforwards and tax credits may be impaired or limited in certain circumstances. Events which cause

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

limitations in the amount of net operating losses and tax credits that the Company may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50%, as defined, over a three year period.

Note 4 Commitments and Contingencies:

Lease Commitments

Future minimum lease payments under non-cancelable operating leases have various expiration dates through 2010. In May 2004, the Company leased approximately 19,240 square feet of space in San Jose, California, which the Company uses for receiving, shipping and warehousing activities. The lease term is 54 months with aggregate payments of $556,000. The Company also leases office spaces in Arizona, Oregon, Japan, Korea, Thailand, the Philippines, China, United Kingdom and Italy for sales and services. Rent expense for the years ended June 30, 2003, 2004 and 2005 was $1,103,000, $1,153,000 and $1,358,000, respectively. Rent expense for six months ended December 31, 2004 and 2005 was $627,000 (unaudited) and $704,000 (unaudited), respectively. Future minimum lease payments as of December 31, 2005 (unaudited) under noncancelable operating leases are as follows (in thousands):

January June 2006	$ 721
Fiscal 2007	1,401
Fiscal 2008	665
Fiscal 2009	69
Fiscal 2010 and thereafter	13
	$ 2,869

Purchase commitments

There were no non-cancelable purchase commitments that exceeded twelve months at June 30, 2005 or December 31, 2005 (unaudited).

Contingencies

The Company, as permitted under California law and in accordance with their By-laws, has indemnification obligations to their officers and directors for certain events or occurrences, subject to certain limits, while they were serving at the Company s request in such capacity. The maximum amount of potential future indemnification is unlimited; however, there have been no claims to date and the Company has a Director and Officer Insurance Policy that enables them to recover a portion of any future amounts paid. As a result of the insurance policy coverage, the Company believes the fair value of these indemnification agreements is minimal.

The Company s sales agreements indemnify their customers for any expenses or liability resulting from claimed infringements of patents, trademarks or copyrights of third parties. The terms of these indemnification agreements are generally perpetual any time after execution of the agreement. The maximum amount of potential future indemnification is unlimited. However, to date, the Company has not paid any claims or been required to defend any lawsuits with respect to any claim.

From time to time, the Company may have certain contingent liabilities that arise in the ordinary course of its business activities. The Company accrues contingent liabilities when it is probable that future expenditures will be made and such expenditures can be reasonably estimated. In the opinion of management, there are no

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

pending claims of which the outcome is expected to result in a material adverse effect in the financial position, results of operations or cash flows of the Company.

Line of Credit

Since April 29, 2005, the Company has a maximum $10,000,000 revolving credit facility based on certain qualifying accounts receivable with a financial institution that expires on April 29, 2007, bearing interest at the bank s prime rate plus 0.25% per annum. The interest rate at June 30, 2005 was 6.25%. The agreement, which is collateralized by the assets of the Company, contains a minimum net worth covenant and other restrictions. The commitment fee is $12,500 per annum for the initial $5,000,000 credit facility and an additional $12,500 for the next $5,000,000 credit facility. As of June 30, 2005 and December 31, 2005 (unaudited), there have been no borrowings under the line of credit and the Company was in compliance with the covenant and other restrictions.

Note 5 Common Stock:

The Company s Articles of Incorporation authorize the Company to issue 85,000,000 shares of no par value Common Stock. At June 30, 2005 and December 31,2005, there were 52,500 and 41,020 (unaudited) shares, respectively, subject to repurchase. As of December 31, 2005 (unaudited), the Company has reserved shares of common stock for future issuance as follows:

Series A Preferred Stock	262,750
Series B Preferred Stock	4,000,000
Stock options	2,375,809
	6,638,559

Restricted Stock Purchase Agreements

During the years ended June 30, 2003, 2004 and 2005, the Company did not issue common stock under any restricted stock purchase agreement. During the fiscal years 2001 and 2002, the Company sold 262,500 and 25,000 shares of its common stock to employees and directors of the Company under agreements which provide for repurchase of shares by the Company at the stock s original purchase price ranging from $3.00 to $4.50 per share, respectively. This purchase price represented the estimated fair value of those shares at the purchase date. The weighted average prices of restricted stock issued in fiscal 2001 and 2002 were $3.58 and $4.50 per share, respectively. Shares are released from the repurchase option cumulatively on the dates set forth on each individual s Restricted Stock Purchase Agreement. The Company may repurchase shares that are still subject to the right of repurchase if any of the following events take place: (1) termination of continuous employment or (2) involuntary transfer to creditors or to any other person or entity of all or any part of the shares still subject to the repurchase option at the time of the transfer.

As consideration for the purchase of a portion of these shares the Company accepted promissory notes totaling $1,027,500 from certain officers, directors and employees. These promissory notes accrue interest at a rate of 4% to 6% per annum and are payable in full in 2006. All of these notes are full recourse and are collateralized by the individual s personal assets including the related shares purchased. One of the notes limits the personal liability to 30% of the face value of the instrument and as a result, variable accounting is required until such time that the underlying restricted shares have vested or the loan is repaid. Due to the increased fair value of the underlying common stock, the Company recorded a charge of approximately $124,000, $73,000 and $10,000 (unaudited) during the fiscal year ended June 30, 2004 and 2005 and the six months ended December 31, 2005, respectively. On

NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

September 21, 2005, these notes were extinguished in exchange for the holders returning to the Company 170,918 shares with a fair value of $5.88 per share as determined by the Board of Directors (see Note 1). These shares were retired and added back to the shares available for future grants under the Company s stock option plan.

Restricted Stock Issuance (unaudited)

In the years ended June 30, 2003, 2004 and 2005, and in the six months ended December 31, 2004, the Company did not issue any new restricted stock. In the six months ended December 31, 2005, the Company issued 7,500 restricted shares with a fair value of $9.50 per share and recorded deferred stock-based compensation of $71,000. This grant vests over five years with 20% annual cliff vesting. The expense will be recognized over the requisite service period.

Dividend Restrictions

All dividends on Common Stock are restricted until all dividend preferences of the Series A Convertible Preferred Stock and Series B Mandatorily Redeemable Convertible Preferred stock have been satisfied (see Note 6).

Note 6 Convertible Preferred Stock:

At December 31, 2003, the Company had authorized 15,000,000 shares of preferred stock, of which 500,000 shares, issued in January 2001 and 8,000,000 shares, issued in November and December 2001 were designated as Series A Convertible Preferred Stock (Series A), and Series B Mandatorily Redeemable Convertible Preferred Stock (Series B), respectively. The Series A and Series B are collectively referred to as Preferred Stock.

The Series A and Series B have the following characteristics:

Voting

The holders of the preferred stock are entitled to vote, together with the holders of common stock, on all matters submitted to stockholders for a vote. Each preferred stockholder is entitled to the number of votes equal to the number of shares of common stock into which each preferred share is convertible at the time of such vote.

The holders of Series B voting as a single class shall be entitled to elect one member of the board of directors.

The Company must obtain affirmative vote or written consent from the majority of the holders of the Series A and 75% of the holders of Series B in order to alter the rights or privileges of each respective series of preferred stock, amend articles of incorporation and increase or decrease the authorized number of each respective series of preferred stock.

Dividends

The holders of the Series A are entitled to receive, when and if declared by the Board of Directors and out of funds legally available, noncumulative dividends at an annual rate of 6% per annum. The holders of Series B are entitled to receive, when and if declared by the Board of Directors, cumulative dividends at an annual rate of 8% per annum. Dividends are payable in preference and priority to any payment of any dividend on common stock, until all declared dividends on the Series A and Series B have been paid. Through December 31, 2005 (unaudited), no dividends have been declared or paid by the Company.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Liquidation preference

In the event of any liquidation, dissolution or winding up of the Company, including a sale, lease, assignment, transfer, conveyance or disposal of substantially all of the assets, a merger, acquisition or other transaction or series of related transactions in which more than 50% of the outstanding voting power of this Company is disposed, the assets of the Company shall be distributed to the Series B to receive the greater of an amount of $5.00 per share, plus any declared but unpaid dividends prior to and in preference to any distribution to the holders of Series A, and common stock or the amount per share that would have been payable had each share of Series B been converted to common stock on the effective date of such liquidation event. Should the Company s legally available assets be insufficient to satisfy the Series B liquidation preferences, then all the funds will be distributed to the holders of Series B ratably. Solely in the event of any ordinary liquidation, dissolution or winding up of the Company, and only after the satisfaction of all Series B preferences, the holders of Series A are entitled to receive an amount of $3.00 per share, plus any declared but unpaid dividends prior to and in preference to any distribution to the holders of common stock. Should the Company s legally available assets be insufficient to satisfy the Series A ordinary liquidation preferences, then all legally available funds will be distributed to the holders of Series A in proportion to their holdings. The remaining assets, if any, shall be distributed ratably among the holders of common stock.

Conversion

Each share of Series A and Series B, at the option of the holder, is convertible into a number of fully paid shares of common stock as determined by dividing the respective preferred stock issue price by the conversion price in effect at the time. The conversion price of Series A and Series B is $5.71 and $5.00 per share, respectively, and is subject to adjustment in accordance with antidilution provisions contained in the Company s Articles of Incorporation. Conversion is automatic for both Series A and Series B upon the earlier of the closing of a firm commitment underwritten public offering in which the aggregate proceeds raised exceed $25,000,000 and in the case of Series B only a per share price of not less than $10.00. Upon the sale, lease or transfer of substantially all the Company s assets including a merger or an acquisition in which more than 50% of the outstanding voting power is disposed all Series A is automatically converted to common stock. At June 30, 2005 and December 31, 2005 (unaudited), 4,262,750 shares of the Company s common stock were reserved for issuance upon the conversion of the Series A and Series B Preferred Stock. At the current conversion prices, Series A and Series B are convertible to common as follows: Series A, 1.05 common shares for each 2 preferred shares and Series B, 1 common share for each 2 preferred shares.

Redemption

If the Series B is not converted to common stock prior to written notice of at least a majority of the holders of Series B, at any time not less than 60 days prior to the fourth anniversary of the Series B original issue date (November 29, 2001), the Company shall redeem all the Series B Preferred at a price equal to the greater of the fair value of the Series B, as determined by the Board of Directors, including a director elected by the holders of Series B, or the original Series B issue price for each share of Series B, plus all declared but unpaid dividends thereon. In December 2004, the Series B stockholders agreed to extend the mandatory redemption date to November 29, 2006. At June 30, 2005, the Company recorded cumulative charges to its retained earnings of $10,251,000 and $672,000 to its paid-in capital related to the accretion of the Series B to its estimated redemption value using the effective interest method. At December 31, 2005, the Company recorded cumulative charges to its retained earnings of $13,192,000 (unaudited) and $732,000 (unaudited) to its paid-in capital related to the accretion of the Series B to its estimated redemption value. If Series B Preferred remains outstanding until its extended redemption date (November 29, 2006), its estimated minimum redemption value will be $41,200,000, as determined on December 31, 2005 (unaudited). This amount may change based on changes in the fair value of the Series B.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Registration Rights

The Company and the holders of Series B entered into an Information and Registration Rights Agreement on November 27, 2001. Among other things, the agreement provides that upon receipt of notice of demand to effect registration with respect to all or a part of the registrable securities (4,000,000 common shares after conversion) from holders aggregating at least 50% of the Series B stockholders, the Company must employ all reasonable efforts in good faith to cause such registration statement to become effective and maintain such effectiveness for 180 days. The notice of demand to effect registration may be made at any time after the earlier of (a) four years after the date of the agreement or (b) twelve months after the closing of the Company s qualified initial public offering of shares of common stock pursuant to a registration statement. The agreement does not provide for any liquidated damages by the Company to the Series B holders if the Company is unable to complete the registration or maintain such effectiveness for 180 days.

Note 7 Stock Option Plan:

In January 1998, the Company adopted the 1998 Equity Incentive Plan (the Plan). The Plan provides for the granting of restricted stock and stock options to employees, directors and consultants of the Company. Options granted under the Plan may be either incentive stock options or nonqualified stock options. Incentive stock options (ISO) may be granted only to Company employees. Nonqualified stock options (NSO) may be granted to Company employees, directors and consultants. The Company had reserved 3,000,000 shares of Common Stock for issuance under the Plan. In January 2000, the Company amended the Plan to increase the number of shares authorized to be issued under the Plan to 5,000,000 shares. In March 2004, the Company again amended the Plan to increase the number of shares authorized to be issued under the Plan to 6,000,000 shares.

Options under the Plan may be granted for periods of up to ten years and at prices no less than 85% of the estimated fair value of the shares on the date of grant as determined by the Board of Directors, provided, however, that (i) the exercise price of an ISO and NSO shall not be less than 100% and 85% of the estimated fair value of the shares on the date of grant, respectively, and (ii) the exercise price of an ISO and NSO granted to a 10% stockholder shall not be less than 110% of the estimated fair value of the shares on the date of grant, respectively. To date, options granted generally vest cumulatively, as to 20% of the optioned shares on each anniversary date until all of the optioned shares have vested.

In October 2000, the Company granted options, which included 20,000 options to purchase Common Stock to certain non-employees consultants under the Plan. These options were valued at the date of grant based on Black-Scholes pricing model with the following assumptions: expected life of 10 years, risk-free interest rate of 5.66%, no dividends during the expected term and volatility of 90%. The Company recognized a deferred charge of $42,000 at the date of grant and compensation expense of $14,000 in connection with these options during each of the fiscal years 2001, 2002 and 2003.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Activity under the Plan is as follows:

	Shares Available for Grant	Number of Shares Outstanding	Weighted Average Exercise Prices
Balances at June 30, 2002	815,841	949,129	$ 1.16
Options granted	(356,400)	356,400	1.00
Options cancelled	1,425	(1,425)	1.98
Options exercised		(70,050)	0.02
Balances at June 30, 2003	460,866	1,234,054	1.16
Options authorized	1,000,000		
Options granted	(575,875)	575,875	1.76
Options cancelled	11,975	(11,975)	2.18
Options exercised		(402,454)	0.28
Balances at June 30, 2004	896,966	1,395,500	1.68
Options granted	(151,250)	151,250	8.74
Options cancelled	102,000	(102,000)	1.62
Options exercised		(54,525)	0.28
Balances at June 30, 2005	847,716	1,390,225	2.50
Options granted (unaudited)	(697,275)	697,275	6.30
Restricted stock granted (unaudited) (see Note 5)	(7,500)		
Restricted stock repurchased (unaudited) (see Note 5)	170,918		
Options cancelled (unaudited)	30,200	(30,200)	1.26
Options exercised (unaudited)		(25,550)	1.22
Balances at December 31, 2005 (unaudited)	344,059	2,031,750	$ 3.84

Total options at June 30, 2005 are comprised as follows:

Range of Exercise Price	Options Outstanding at June 30, 2005			Options Exercisable at June 30, 2005	
	Number Outstanding	Weighted Average Remaining Contractual	Weighted Average Exercise Price	Number Outstanding	Weighted Average Exercise Price

		Life (in Years)			
$ 0.02	183,550	4.53	$ 0.02	163,550	$ 0.02
1.00	459,550	7.62	1.00	122,640	1.00
1.10	160,000	3.33	1.10	40,000	1.10
2.00	144,475	8.68	2.00	31,995	2.00
3.00	159,700	5.40	3.00	140,300	3.00
4.50	118,450	6.70	4.50	74,100	4.50
7.60	46,250	9.57	7.60		7.60
10.00	118,250	9.14	10.00	29,750	10.00
	1,390,225	6.69	$ 2.50	602,335	$ 2.13

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Total options at December 31, 2005 (unaudited) are comprised as follows:

	Options Outstanding at December 31, 2005			Options Exercisable at December 31, 2005	
Range of Exercise Price	**Number Outstanding**	**Weighted Average Remaining Contractual Life (in Years)**	**Weighted Average Exercise Price**	**Number Outstanding**	**Weighted Average Exercise Price**
$ 0.02	182,350	4.03	$ 0.02	182,350	$ 0.02
1.00	410,300	7.16	1.00	180,700	1.00
1.10	160,000	2.83	1.10	80,000	1.10
2.00	143,975	8.19	2.00	42,195	2.00
3.00	155,700	4.90	3.00	153,700	3.00
4.50	118,450	6.21	4.50	75,050	4.50
5.00	32,050	9.72	5.00	4,100	5.00
5.88	574,825	9.74	5.88	113,375	5.88
7.60	46,250	9.07	7.60	700	7.60
9.50	90,250	9.99	9.50		9.50
10.00	117,600	8.64	10.00	43,550	10.00
	2,031,750	7.41	$ 3.84	875,720	$ 2.61

Stock-based compensation

The Company uses the intrinsic-value method prescribed in APB No. 25 in accounting for its stock-based compensation arrangements with employees. Stock-based compensation expense is recognized for employee stock option grants in those instances in which the fair value of the underlying common stock is greater than the exercise price of the stock options at the date of grant. The Company recorded deferred stock-based compensation related to options issued to employees of $2,589,000, none and $1,950,000 (unaudited), in respect to stock options granted during fiscal years ended June 30, 2004 and 2005 and the six months ended December 31, 2005, respectively, of which $767,000, $750,000 and $954,000 (unaudited) has been amortized to stock-based compensation expense during the fiscal years ended June 30, 2004 and 2005 and the six months ended December 31, 2005, respectively. These amounts have been determined, net of recoveries for forfeitures, on an accelerated basis over the vesting period of the individual options, in accordance with FASB Interpretation No. 28. In the year end June 30, 2005, the Company recorded a $263,000 reduction in deferred stock-based compensation related to forfeitures as well as $2,000 (unaudited) in the six months ended December 31, 2005. Stock-based compensation expense was as follows (in thousands):

Years Ended June 30,

				Six Months Ended December 31,	
	2003	2004	2005	2004	2005
				(Unaudited)	(Unaudited)
Stock options to employees and nonemployees	$ 14	$ 767	$ 750	$ 424	$ 954
Restricted stock (see note 5)		124	73	46	10
Total	$ 14	$ 891	$ 823	$ 470	$ 964

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

During the years ended June 30, 2004 and 2005 and the six months ended December 31, 2005 (unaudited), the Company granted options with exercise prices as follows:

Date of Grant	Number of options granted (in thousands)	Weighted Average Exercise Price	Weighted Average Fair Value of common stock per share	Intrinsic Value per share
October 22, 2003	161	$ 1.00	$ 5.30	$ 4.30
October 22, 2003	240	1.10	5.30	4.20
January 21, 2004	51	2.00	6.80	4.80
March 23, 2004	94	2.00	8.60	6.60
April 21, 2004	30	10.00	10.00	
July 2, 2004	28	10.00	10.00	
October 27, 2004	58	10.00	10.00	
October 29, 2004	4	10.00	10.00	
January 19, 2005	46	7.60	7.60	
April 25, 2005	15	4.50	4.50	
July 27, 2005 (unaudited)	5	5.00	5.34	0.34
September 21, 2005 (unaudited)	26	5.00	5.88	0.88
September 21, 2005 (unaudited)*	555	5.88	9.35	3.47
September 30, 2005 (unaudited)	20	5.88	5.88	
December 22, 2005 (unaudited)	91	9.50	9.50	

The intrinsic value per share at the date of grant is being recorded as compensation expense over the applicable vesting period, using the multiple option vesting method.

* These options reflect the exercise price and fair value of the Company s common stock as determined on their modification date, December 21, 2005, as discussed below.

Modification of Stock Options (unaudited)

On September 21, 2005, the Company granted options to the Company s employees and directors to purchase 581,000 shares of the Company s common stock. Such options had an exercise price of $5.00 per share as compared to the then current fair value of the common stock of $5.88 per share. To address the impact on these grantees arising from the recently enacted American Job Creation Act, specifically IRC Section 409A, in December 2005, the Company modified 555,000 of such options to increase their exercise price to $5.88, the fair value at the time of grant. This one-time modification resulted in incremental deferred stock-based compensation of $1,438,000, based on the weighted average fair value of the Company s common stock being $9.35 on the date of modification.

As a private company, the fair value of the Company s common stock is determined by the Board of Directors. In determining fair value of its common stock, the Board of Directors considers a number of factors, including:

- recent transactions in the Company s common stock with third parties, if any,

- contemporaneous or retrospective valuations performed by valuation specialists. With respect to options granted in the twelve month period ended December 31, 2005, the Board of Directors obtained contemporaneous valuations performed by valuation specialists for all options granted except for those granted in January and April 2005 and certain options granted in September 2005. As

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

a result of the modification discussed above, substantially all options granted in September 2005 were remeasured based on the fair value of the Company s common stock at the date of the modification (December 2005) based upon a contemporaneous valuation performed by valuation specialists. In determining the fair value of the Company s common stock for all other options granted in the twelve month period ended December 31, 2005, the Board of Directors used a contemporaneous valuation prepared by management which followed substantially the same methodology used by the valuation specialists,

key milestones achieved in the Company s business, including forecasted revenues and cash flows, product development, and market acceptance,

values ascribed to comparable publicly traded companies in the Company s industry,

current and long-term prospects for the semiconductor equipment industry, including forecasted capital expenditures by the Company s significant customers; and

other economic and business factors.

This valuation requires significant judgment and is subject to change in future periods based on the above factors.

Note 8 Employment Benefit Plan:

In 1998, the Company adopted a defined contribution retirement plan (the Plan), which qualifies under Section 401(k) of the Internal Revenue Code of 1996. The Plan covers essentially all U.S. employees. Eligible employees may make voluntary contributions to the Plan up to statutory annual limitations and the Company is allowed to make discretionary contributions. The Company has made no discretionary contributions to date.

Note 9 Subsidiary Companies:

In November 2003, the Company formed a subsidiary called Nextest Systems Europe S.R.L. . The primary purpose of the subsidiary is to provide consulting services relating to ATE for the semiconductor industry and related products.

In March 2004, the Company formed a subsidiary called Nextest Systems (Philippines) Corporation . The primary purpose of the subsidiary is to engage in the trade or business of test systems development and integration in the semiconductor industry.

In November 2004, the Company formed a subsidiary called Nextest Systems UK LTD . The primary purpose of the subsidiary is to provide pre-sale and post-sale engineering support and services.

In December 2004, the Company formed a subsidiary called Nextest Systems France S.A.R.L. . The primary purpose of the subsidiary is to provide pre-sale and post-sale engineering support and services.

In December 2004, the Company formed Nextest Systems (Thailand) Ltd. . The primary purpose of the subsidiary is to provide pre-sale and post-sale engineering support and services.

In January 2005, the Company formed Nextest Systems Japan K.K. . The primary purpose of the subsidiary is to provide pre-sale and post-sale engineering support and services.

In February 2005, the Company formed Nextest Systems Korea Co., Ltd. . The primary purpose of the subsidiary is to provide pre-sale and post-sale engineering support and services.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 10 Segment And Geographic Information:

The Company operates in one segment, designing, manufacturing and marketing of automated test equipment for the semiconductor industry. This determination was reached upon review of the structure of the Company s internal organization, the financial information that the Company s chief operating decision maker uses to make decisions about operating matters, such as resource allocations and performance assessment and the structure of discrete financial information available. All products and services are marketed in the geographic regions in which the Company operates.

Within the Company s one operating segment, two revenue-generating activities have been identified for purposes of external reporting: products and services. Both products and services share a similar customer base and economic environment and share internal operating resources and assets. The Company does not internally report profitability for each of these revenue-generating activities. Decisions are based on the combined impact of the decisions on the results of products and services. Therefore, while the Company has been reporting net revenue and cost of revenues for the products and services separately, the Company does not consider these revenue-generating activities to constitute separate operating segments.

The Company markets its products and related services to customers mainly through a direct sales force. Net revenue is attributed to geographic areas based on the country to which product is shipped or its first in-use county, if known. The Company s net revenue by geographic regions was (in thousands):

	Year Ended June 30,						Six Months Ended December 31,			
	2003		2004		2005		2004		2005	
							(Unaudited)		(Unaudited)	
North America, Primarily United States	$ 5,819	37.3%	$ 17,043	38.3%	$ 20,107	41.5%	$ 15,189	55.3%	$ 5,334	14.5%
Asia/Pacific										
Korea	704	4.5	5,707	12.8	10,149	21.0	213	0.8	19,103	52.2
Taiwan	6,294	40.4	3,877	8.7	1,074	2.2	493	1.8	5,757	15.7
Thailand	1,515	9.7	3,215	7.2	2,332	4.8	1,739	6.3	936	2.6
People s Republic of China	176	1.1	5,409	12.2	8,577	17.7	5,644	20.5	4,728	12.9
Philippines	468	3.0	6,122	13.8	1,053	2.2	568	2.1	188	0.5
Other	243	1.6	476	1.1	488	1.0	486	1.8	44	0.1
Total Asia Pacific	9,400	60.3	24,806	55.8	23,673	48.9	9,143	33.3	30,756	84.0
Europe, Middle East and Africa (EMEA)	379	2.4	2,601	5.9	4,667	9.6	3,118	11.4	540	1.5

	$ 15,598	100.0%	$ 44,450	100.0%	$ 48,447	100.0%	$ 27,450	100.0%	$ 36,630	100.0%

Over 89% of the Company s long-lived assets are located in the United States.

Note 11 Related Party Transactions:

At June 30, 2004 and June 30, 2005, the Company held non-recourse promissory notes from one executive, one non-executive employee and three directors totaling $1,027,500. The notes were issued in connection with the purchase of shares of common stock in October 2000, January 2001, March 2001 and April 2002. On September 21, 2005, these notes were extinguished and a total bonus payment of $117,000 (unaudited) that was approved by the Board of Directors was paid to the directors and an executive and $48,000 (unaudited) to one non-executive employee to reimburse them for the tax consequences related to the repurchase of their restricted common stock to extinguish their non-recourse promissory notes (see Note 5). The bonus was recognized in the accompanying consolidated statement of operations as sales, general and administrative expense.

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The affiliated funds of the underwriters of this current initial public offering invested an aggregate of $10,570,000 in the Series B Mandatorily Redeemable Convertible Preferred Stock financing in November 2001.

The Company sells its products to one of its Series A stockholders which management believes are at terms comparable to arms length transactions based on prices charged in comparison to other unrelated customers. Total sales to the stockholder were $2,642,000, $9,506,000, $16,502,000 in the fiscal years ended June 30, 2003, 2004 and 2005, respectively, and $13,863,000 (unaudited) and $2,683,000 (unaudited) for the six month period ended December 31, 2004 and December 31, 2005, respectively. The balance due from the stockholder was $2,617,000, $657,000 and $1,555,000 (unaudited) at June 30, 2004 and 2005 and December 31, 2005, respectively. This Series A stockholder s ownership represents less than 2.0% of the common stock, Series A and Series B preferred stock, as converted, outstanding at December 31, 2005 (unaudited) and it does not have the right to appoint a member to the Company s Board of Directors and has no active involvement in the day to day management or direction of Company policies.

Note 12 Unaudited Pro Forma Net Income (Loss) Per Share Attributable To Common Stockholders:

Pro forma basic and diluted net income (loss) per share have been computed to give effect to the automatic conversion of the mandatorily redeemable cumulative convertible preferred stock and convertible preferred stock to common stock that will occur upon the closing of the Company s initial public offering (using the as-converted method) for the fiscal year ended June 30, 2005 and the six months ended December 31, 2005, as if the closing occurred at the beginning of fiscal 2005. The numerator excludes the accretion of the Series B redemption value of $4,343,000 and $3,001,000 during the fiscal year ended June 30, 2005 and the six months ended December 31, 2005, respectively as well as allocation of income to Series A participating stockholders of $45,000 in the six month period ended December 31, 2005. The following table sets forth the computation of the unaudited pro forma basic and diluted net income per share:

	Year Ended June 30, 2005	Six Months Ended December 31, 2005
	(Unaudited)	(Unaudited)
Numerator:		
Net income (loss)	$ (312,000)	$ 3,301,000
Denominator:		
Weighted average common shares outstanding	8,741,557	8,691,009
Less: Unvested common shares subject to repurchase	(78,270)	(41,776)
Add: Adjustments to reflect the weighted average effect of the assumed conversion of Series A and B preferred stock from the date of issuance	4,262,750	4,262,750
Total shares used in computing basic pro forma net income per common share	12,926,037	12,911,983
Add: Adjustments to reflect the effect of the assumed exercise/vesting of:		
Employee stock options outstanding		794,705

Unvested common shares subject to repurchase		41,652
Total shares used in computing diluted pro forma net income per common share	12,926,037	13,748,340
Unaudited pro forma net income (loss) per common share:		
Basic	$ (0.02)	$ 0.26
Diluted	$ (0.02)	$ 0.24

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NEXTEST SYSTEMS CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 13 Subsequent Events:

Reincorporation

The Company intends to reincorporate in Delaware prior to the effective date of its initial public offering. All references to share amounts have been retroactively restated in the accompanying financial statements to give effect to the reincorporation. Subsequent to the proposed reincorporation, the Company will be authorized to issue 140,000,000 shares of $0.001 par value common stock and 10,000,000 shares of $0.001 par value preferred stock. Further, the Board of Directors will have the authority to issue undesignated preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions thereof.

Reverse Stock Split

On February 14, 2006, the Board of Directors authorized a 1 for 2 reverse split of the Company s common stock to become effective prior to completion of its public offering. The accompanying historical financial statements have been restated to reflect this reverse stock split.

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Through and including , 2006 (the 25th day after the date of this prospectus), all dealers effecting transactions in these securities, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers obligations to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

5,400,000 Shares

Common Stock

PROSPECTUS

Merrill Lynch & Co.

Cowen & Company

Needham & Company, LLC

, 2006

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PART II

Information Not Required In Prospectus

Item 13. Other Expenses of Issuance and Distribution.

The following table sets forth all expenses to be paid by Nextest, other than the underwriting discounts and commissions payable by Nextest in connection with the sale of the common stock being registered. Except for the underwriting discounts, no portion of these expenses will be borne by the selling stockholders. All amounts shown are estimates except for the registration fee and the NASD filing fee.

	Amount to be Paid
Registration fee	$ 10,632
NASD filing fee	8,500
Nasdaq National Market	5,000
Blue sky qualification fees and expenses	5,000
Printing and engraving expenses	150,000
Legal fees and expenses	350,000
Accounting fees and expenses	600,000
Transfer agent and registrar fees	5,000
Miscellaneous expenses	50,868
TOTAL:	$ 1,185,000

Item 14. Indemnification of Officers and Directors.

Section 145 of the Delaware General Corporation Law permits indemnification of officers, directors and other corporate agents under certain circumstances and subject to certain limitations. Our amended and restated certificate of incorporation and bylaws provide that we will indemnify our directors, officers, employees and agents to the full extent permitted by Delaware General Corporation Law, including in circumstances in which indemnification is otherwise discretionary under Delaware law. In addition, we have entered into separate indemnification agreements with our directors and executive officers which would require us, among other things, to indemnify them against certain liabilities which may arise by reason of their status or service (other than liabilities arising from willful misconduct of a culpable nature). The indemnification provisions in our amended and restated certificate of incorporation and bylaws and the indemnification agreements to be entered into between us and our directors and executive officers may be sufficiently broad to permit indemnification of our directors and executive officers for liabilities (including reimbursement of expenses incurred) arising under the Securities Act. We also intend to maintain director and officer liability insurance, if available on reasonable terms, to insure our directors and officers against the cost of defense, settlement or payment of a judgment under certain circumstances. In addition, the underwriting agreement filed as Exhibit 1.1 to this Registration Statement provides for indemnification by the underwriters of us and our officers and directors for certain liabilities arising under the Securities Act, or otherwise.

Item 15. Recent Sales of Unregistered Securities.

From February 7, 2003 through February 6, 2006, we have sold and issued an aggregate of 1,317,900 options to purchase shares of common stock to our directors, employees and consultants at exercise prices ranging from $1.00 to $10.00 and 532,529 shares of common stock have been issued pursuant to the exercise of options for aggregate proceeds of $158,269.

The sales of the above securities were deemed to be exempt from registration pursuant to either Section 4(2) of the Securities Act as transactions by an issuer not involving a public offering or Rule 701 promulgated under the Securities Act as transactions pursuant to compensatory benefit plans approved by the

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registrant s board of directors. The recipients of securities in each of these transactions represented their intention to acquire the securities for investment only and not with view to or for sale in connection with any distribution thereof and appropriate legends were affixed to the share certificates and instruments issued in such transactions. All recipients either received adequate information about the registrant or had adequate access, through their relationship with us, to information about us. There were no underwriters employed in connection with any of the transactions set forth in Item 15.

Item 16. Exhibits and Financial Statement Schedules.

(A) EXHIBITS

Exhibit Number	Description of Document
1.1*	Form of Underwriting Agreement
3.1	Amended and Restated Articles of Incorporation, as amended and currently in effect
3.2	Bylaws currently, as amended and in effect
3.3	Form of Amended and Restated Certificate of Incorporation (to be effective at closing)
3.4	Form of Amended and Restated Bylaws (to be effective at closing)
4.1*	Specimen Common Stock Certificate
4.2	Information and Registration Rights Agreement by and among Nextest Systems Corporation and certain holders of preferred stock, dated as of November 27, 2001
5.1*	Opinion of Heller Ehrman LLP
10.1	Nextest Systems Corporation 1998 Equity Incentive Plan, as amended
10.2	Form of Option Agreement under Nextest Systems Corporation 1998 Equity Incentive Plan
10.3	Nextest Systems Corporation 2006 Equity Incentive Plan
10.4*	Form of Option Agreement under Nextest Systems Corporation 2006 Equity Incentive Plan
10.5	Nextest Systems Corporation 2006 Employee Stock Purchase Plan
10.6*	Form of Indemnification Agreement
10.7	Lease Agreement dated October 16, 2000 by and between Lawrence L. Reece Trust and the Company
10.8	Lease Agreement dated April 8, 2004 by and between Wilson Hui, Theresa Hui, Yen Hui, Yenny Chuong and James Chuong and the Company
21.1	Subsidiaries of Nextest Systems Corporation
23.1	Consent of PricewaterhouseCoopers LLP, independent registered public accounting firm
23.2*	Consent of Heller Ehrman LLP (included in Exhibit 5.1)
24.1	Power of Attorney (included on page II-4)

* To be filed by amendment
Previously filed

(B) FINANCIAL STATEMENT SCHEDULE

Schedules not listed above have been omitted because the information required to be set forth therein is not applicable or is shown in the financial statements or notes thereto.

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Item 17. Undertakings.

The undersigned Registrant hereby undertakes to provide to the Underwriters at the closing specified in the Underwriting Agreement certificates in such denominations and registered in such names as required by the Underwriters to permit prompt delivery to each purchaser.

Insofar as indemnification for liabilities arising under the Securities Act may be permitted to directors, officers and controlling persons of the Registrant pursuant to the foregoing provisions described in Item 14 of this Registration Statement or otherwise, the Registrant has been advised that in the opinion of the Commission such indemnification is against public policy as expressed in the Securities Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the Registrant of expenses incurred or paid by a director, officer, or controlling person of the Registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the Registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Securities Act and will be governed by the final adjudication of such issue.

The undersigned Registrant hereby undertakes that:

(1) For purposes of determining any liability under the Securities Act, the information omitted from the form of Prospectus filed as part of this Registration Statement in reliance upon Rule 430A and contained in a form of prospectus filed by the Registrant pursuant to Rule 424(b)(1) or (4) or 497(h) under the Securities Act shall be deemed to be part of this Registration Statement as of the time it was declared effective; and

(2) For the purpose of determining any liability under the Securities Act, each post-effective amendment that contains a form of Prospectus shall be deemed to be a new Registration Statement relating to the securities offered therein and the Offering of such securities at the time shall be deemed to be the initial bona fide offering thereof.

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this Amendment No. 3 to Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in San Jose, California, on the 2nd day of March, 2006.

NEXTEST SYSTEMS CORPORATION

By: /s/ ROBIN ADLER

Robin Adler

Chief Executive Officer

Pursuant to the requirements of the Securities Act, this Registration Statement has been signed by the following persons in the capacities and on the dates indicated:

Signature	Title	Date
/s/ ROBIN ADLER Robin Adler	Chief Executive Officer and Chairman (Principal Executive Officer)	March 2, 2006
/s/ JAMES P. MONIZ James P. Moniz	Chief Financial Officer (Principal Financial and Accounting Officer)	March 2, 2006
/s/ HOWARD MARSHALL Howard Marshall	Director	March 2, 2006
/s/ JUAN A. BENITEZ* Juan A. Benitez	Director	March 2, 2006
/s/ STEPHEN G. NEWBERRY* Stephen G. Newberry	Director	March 2, 2006
/s/ RICHARD L. DISSLY* Richard L. Dissly	Director	March 2, 2006
/s/ EUGENE R. WHITE* Eugene R. White	Director	March 2, 2006

*By:	/s/ Robin Adler
	Robin Adler
	Attorney-in-Fact

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EXHIBIT INDEX

Exhibit Number	Description of Document
1.1*	Form of Underwriting Agreement
3.1	Amended and Restated Articles of Incorporation, as amended and currently in effect
3.2	Bylaws currently, as amended and in effect
3.3	Form of Amended and Restated Certificate of Incorporation (to be effective at closing)
3.4	Form of Amended and Restated Bylaws (to be effective at closing)
4.1*	Specimen Common Stock Certificate
4.2	Information and Registration Rights Agreement by and among Nextest Systems Corporation and certain holders of preferred stock, dated as of November 27, 2001
5.1*	Opinion of Heller Ehrman LLP
10.1	Nextest Systems Corporation 1998 Equity Incentive Plan, as amended
10.2	Form of Option Agreement under Nextest Systems Corporation 1998 Equity Incentive Plan
10.3	Nextest Systems Corporation 2006 Equity Incentive Plan
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