SYNOPSYS INC
Form 10-Q
September 08, 2010
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 20549**

# FORM 10-Q

**(MARK ONE)**

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

**FOR THE QUARTERLY PERIOD ENDED JULY 31, 2010**

**OR**

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

**FOR THE TRANSITION PERIOD FROM TO**

**COMMISSION FILE NUMBER: 0-19807**

# SYNOPSYS, INC.

**(Exact name of registrant as specified in its charter)**

| **DELAWARE** | **56-1546236** |
|---|---|
| **(State or other jurisdiction of** | **(I.R.S. Employer** |
| **incorporation or organization)** | **Identification Number)** |

**700 EAST MIDDLEFIELD ROAD**

**MOUNTAIN VIEW, CA 94043**

**(Address of principal executive offices, including zip code)**

**(650) 584-5000**

**(Registrant s telephone number, including area code)**

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

| | |
|---|---|
| Large accelerated filer x | Accelerated filer ¨ |
| Non-accelerated filer ¨ (Do not check if a smaller reporting company) | Smaller reporting company ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

As of September 3, 2010, there were 148,561,589 shares of the registrant s common stock outstanding.

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**SYNOPSYS, INC.**

**QUARTERLY REPORT ON FORM 10-Q**

**FOR THE FISCAL QUARTER ENDED JULY 31, 2010**

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## PART I. FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

**SYNOPSYS, INC.**

**UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS**

**(in thousands, except par value amounts)**

| | July 31, 2010 | October 31, 2009 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 883,441 | $ 701,613 |
| Short-term investments | 326,384 | 466,713 |
| Total cash, cash equivalents and short-term investments | 1,209,825 | 1,168,326 |
| Accounts receivable, net of allowances of $2,760 and $3,587, respectively | 148,582 | 127,010 |
| Deferred income taxes | 72,022 | 73,453 |
| Income taxes receivable | 26,568 | 51,191 |
| Prepaid and other current assets | 38,977 | 43,820 |
| Total current assets | 1,495,974 | 1,463,800 |
| Property and equipment, net | 139,102 | 146,910 |
| Goodwill | 1,002,531 | 932,691 |
| Intangible assets, net | 118,061 | 96,810 |
| Long-term deferred income taxes | 264,874 | 205,396 |
| Other long-term assets | 94,107 | 93,247 |
| Total assets | $ 3,114,649 | $ 2,938,854 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | $ 240,407 | $ 255,095 |
| Accrued income taxes | 2,736 | 5,508 |
| Deferred revenue | 593,911 | 553,990 |
| Total current liabilities | 837,054 | 814,593 |
| Long-term accrued income taxes | 101,731 | 157,354 |
| Other long-term liabilities | 92,082 | 88,002 |
| Long-term deferred revenue | 33,972 | 34,739 |
| Total liabilities | 1,064,839 | 1,094,688 |
| Stockholders equity: | | |
| Preferred Stock, $0.01 par value: 2,000 shares authorized; none outstanding | | |
| Common Stock, $0.01 par value: 400,000 shares authorized; 147,537 and 146,945 shares outstanding, respectively | 1,475 | 1,469 |
| Capital in excess of par value | 1,527,034 | 1,500,166 |
| Retained earnings | 758,727 | 574,980 |
| Treasury stock, at cost: 9,728 and 10,326 shares, respectively | (213,637) | (228,618) |
| Accumulated other comprehensive loss | (23,789) | (3,831) |

| | | |
|---|---|---|
| Total stockholders equity | 2,049,810 | 1,844,166 |
| Total liabilities and stockholders equity | $ 3,114,649 | $ 2,938,854 |

See accompanying notes to unaudited condensed consolidated financial statements.

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**SYNOPSYS, INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(in thousands, except per share amounts)**

| | Three Months Ended July 31, | | Nine Months Ended July 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| Revenue: | | | | |
| Time-based license | $ 286,563 | $ 285,622 | $ 847,710 | $ 860,613 |
| Upfront license | 14,650 | 17,751 | 47,811 | 46,129 |
| Maintenance and service | 35,716 | 41,804 | 109,681 | 115,025 |
| Total revenue | 336,929 | 345,177 | 1,005,202 | 1,021,767 |
| Cost of revenue: | | | | |
| License | 43,996 | 44,173 | 130,140 | 128,288 |
| Maintenance and service | 14,697 | 17,410 | 46,475 | 48,037 |
| Amortization of intangible assets | 8,050 | 8,452 | 24,736 | 24,153 |
| Total cost of revenue | 66,743 | 70,035 | 201,351 | 200,478 |
| Gross margin | 270,186 | 275,142 | 803,851 | 821,289 |
| Operating expenses: | | | | |
| Research and development | 105,649 | 104,989 | 319,931 | 305,792 |
| Sales and marketing | 83,812 | 77,973 | 242,791 | 237,877 |
| General and administrative | 27,371 | 27,735 | 81,937 | 83,608 |
| In-process research and development | | 400 | | 1,000 |
| Amortization of intangible assets | 2,561 | 2,956 | 8,339 | 9,683 |
| Total operating expenses | 219,393 | 214,053 | 652,998 | 637,960 |
| Operating income | 50,793 | 61,089 | 150,853 | 183,329 |
| Other (expense) income, net | (3,046) | 5,384 | 8,109 | 17,928 |
| Income before provision for income taxes | 47,747 | 66,473 | 158,962 | 201,257 |
| Provision (benefit) for income taxes | 8,420 | 19,037 | (52,700) | 53,104 |
| Net income | $ 39,327 | $ 47,436 | $ 211,662 | $ 148,153 |
| Net income per share: | | | | |
| Basic | $ 0.27 | $ 0.33 | $ 1.43 | $ 1.04 |
| Diluted | $ 0.26 | $ 0.32 | $ 1.40 | $ 1.02 |
| Shares used in computing per share amounts: | | | | |
| Basic | 148,006 | 144,138 | 147,909 | 143,093 |
| Diluted | 151,106 | 146,063 | 151,459 | 144,699 |

See accompanying notes to unaudited condensed consolidated financial statements.

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**SYNOPSYS, INC.**

**UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(in thousands)**

| | Nine Months Ended July 31, | |
|---|---|---|
| | **2010** | **2009** |
| Cash flow from operating activities: | | |
| Net income | $ 211,662 | $ 148,153 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization and depreciation | 71,772 | 74,581 |
| Stock compensation | 45,214 | 42,799 |
| Allowance for doubtful accounts | (851) | 2,735 |
| Write-down of long-term investments | 468 | 6,333 |
| Gain on sale of investments | (3,114) | (610) |
| Deferred income taxes | (31,297) | 15,801 |
| In-process research and development | | 1,000 |
| Net changes in operating assets and liabilities, net of acquired assets and liabilities: | | |
| Accounts receivable | (19,181) | 10,690 |
| Other current assets | (7,497) | 4,915 |
| Other long-term assets | (2,470) | (7,071) |
| Accounts payable and accrued liabilities | (21,270) | (62,358) |
| Income taxes | (31,445) | 1,004 |
| Deferred revenue | 32,153 | (62,723) |
| Net cash provided by operating activities | 244,144 | 175,249 |
| Cash flows from investing activities: | | |
| Proceeds from sales and maturities of short-term investments | 352,124 | 223,994 |
| Purchases of short-term investments | (209,564) | (310,323) |
| Purchases of long-term investments | | (671) |
| Purchases of property and equipment | (27,593) | (24,634) |
| Cash paid for acquisitions and intangible assets, net of cash acquired | (137,681) | (48,248) |
| Capitalization of software development costs | (2,116) | (2,228) |
| Net cash used in investing activities | (24,830) | (162,110) |
| Cash flows from financing activities: | | |
| Principal payments on capital leases | (3,609) | (1,675) |
| Proceeds from credit facilities | | 1,279 |
| Payment on credit facility | | (260) |
| Issuances of common stock | 87,241 | 28,237 |
| Purchases of treasury stock | (125,257) | |
| Net cash (used in) provided by financing activities | (41,625) | 27,581 |
| Effect of exchange rate changes on cash and cash equivalents | 4,139 | 3,929 |
| Net change in cash and cash equivalents | 181,828 | 44,649 |
| Cash and cash equivalents, beginning of period | 701,613 | 577,632 |
| Cash and cash equivalents, end of period | $ 883,441 | $ 622,281 |

See accompanying notes to unaudited condensed consolidated financial statements.

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**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1. Description of Business**

Synopsys, Inc. (Synopsys or the Company) is a world leader in electronic design automation (EDA) supplying the global electronics market with software, intellectual property (IP) and services used in semiconductor design, verification and manufacturing. The Company delivers technology-leading semiconductor design and verification platforms and integrated circuit (IC) manufacturing related products to the global electronics market, enabling the development and production of complex systems-on-chips (SoCs). In addition, the Company provides IP, system-level solutions and design services to simplify the design process and accelerate time-to-market for its customers, and software and services that help customers prepare and optimize their designs for manufacturing.

**Note 2. Summary of Significant Accounting Policies**

The Company has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Pursuant to these rules and regulations, the Company has condensed or omitted certain information and footnote disclosures it normally includes in its annual consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP). In management s opinion, the Company has made all adjustments necessary to fairly present its financial position, results of operations and cash flows. The Company s interim period operating results do not necessarily indicate the results that may be expected for any other interim period or for the full fiscal year. These financial statements and accompanying notes should be read in conjunction with the consolidated financial statements and notes thereto in Synopsys Annual Report on Form 10-K for the fiscal year ended October 31, 2009 filed with the SEC on December 18, 2009.

To prepare financial statements in conformity with GAAP, management must make estimates and assumptions that affect the amounts reported in the unaudited condensed consolidated financial statements and accompanying notes. Actual results could differ from these estimates and may result in material effects on the Company s operating results and financial position.

*Principles of Consolidation.* The unaudited condensed consolidated financial statements include the accounts of Synopsys and all of its subsidiaries. All significant intercompany accounts and transactions have been eliminated.

*Fiscal Year End.* The Company s fiscal year ends on the Saturday nearest to October 31. The Company s third quarter of fiscal 2010 ended on July 31, 2010. Fiscal 2010 and fiscal 2009 are both 52-week fiscal years. For presentation purposes, the unaudited condensed consolidated financial statements and accompanying notes refer to the closest calendar month end.

*Basis of Presentation.* Certain immaterial amounts within net cash used in operating activities and within total revenue in prior year unaudited condensed consolidated financial statements have been reclassified to conform to the current year presentation. These reclassifications had no impact on net cash used in operating activities and total revenue.

*Subsequent Events.* The Company has evaluated subsequent events for the purpose of this Quarterly Report on Form 10-Q.

**Note 3. Fair Value Measures**

Accounting Standard Codification (ASC) 820-10, *Fair Value Measurements and Disclosures*, defines fair value, establishes guidelines and enhances disclosures for fair value measurements.

The accounting guidance requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The accounting guidance also establishes a fair value hierarchy based on the independence of the source and objective evidence of the inputs used. There are three fair value hierarchies based upon the level of inputs that are significant to fair value measurement:

**Level 1** Observable inputs that reflect quoted prices (unadjusted) for identical instruments in active markets;

**Level 2** Observable inputs other than quoted prices included in Level 1 for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-driven valuations in which all significant inputs and significant value drivers are observable in active markets; and

**Level 3** Unobservable inputs to the valuation derived from fair valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

On a recurring basis, the Company measures fair value of its assets and liabilities which include cash equivalents, short-term investments, marketable equity securities, a non-qualified deferred compensation plan, foreign currency derivative contracts and contingent consideration associated with business combinations.

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SYNOPSYS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s cash equivalents, short-term investments, and marketable equity securities are classified within Level 1 or Level 2 because they are valued using quoted market prices in an active market or alternative independent pricing sources and models utilizing market observable inputs.

The Company s non-qualified deferred compensation plan assets consist of money market and mutual funds invested in domestic and international marketable securities. During fiscal 2009, the deferred compensation plan assets were classified within Level 2 as the assets were invested in funds with indirectly observable market prices. During the first quarter of fiscal 2010, the deferred compensation plan assets were transferred to mutual funds that are directly observable in active markets and are therefore classified within Level 1.

The Company s foreign currency derivative contracts are classified within Level 2 because these contracts were not actively traded and the valuation inputs are based on quoted prices and market observable data of similar instruments.

During the second quarter of fiscal 2010, the Company recorded a liability for contingent consideration of $7.8 million arising from a business combination (see Note 5 for further details). The fair value of the contingent consideration was determined at the acquisition date using the income approach based on the net present value of estimated payments. The contingent consideration was classified within Level 3 as the management assumptions for the valuation included discount rates and estimated probabilities of achievement of certain technical milestones which are unobservable in the market. As of July 31, 2010, the assumptions for the valuation did not materially change.

***Assets and Liabilities Measured at Fair Value on a Recurring Basis***

Assets and liabilities measured at fair value on a recurring basis are summarized below as of July 31, 2010:

| | | Fair Value Measurement Using | | |
|---|---|---|---|---|
| **Description** | **Total** | **Quoted Prices in Active Markets for Identical Assets (Level 1)** | **Significant Other Observable Inputs (Level 2)** | **Significant Unobservable Inputs (Level 3)** |
| | | (in thousands) | | |
| **Assets** | | | | |
| Cash equivalents: | | | | |
| Money market funds | $ 640,940 | $ 640,940 | $ | $ |
| Short-term investments: | | | | |
| Municipal securities | 326,384 | | 326,384 | |
| Prepaid and other current assets: | | | | |
| Foreign currency derivative contracts | 1,129 | | 1,129 | |
| Other long-term assets: | | | | |
| Deferred compensation plan assets | 77,412 | 77,412 | | |
| **Total assets** | $ 1,045,865 | $ 718,352 | $ 327,513 | $ |
| **Liabilities** | | | | |
| Accounts payable and accrued liabilities: | | | | |
| Foreign currency derivative contracts | $ 11,458 | $ | $ 11,458 | $ |
| Contingent consideration | 2,865 | | | 2,865 |
| Other long-term liabilities: | | | | |
| Contingent consideration | 4,935 | | | 4,935 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **Total liabilities** | $ | 19,258 | $ | | $ | 11,458 | $ | 7,800 |

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**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Assets and liabilities measured at fair value on a recurring basis are summarized below as of October 31, 2009:

| Description | Total | Fair Value Measurement Using<br>Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| | (in thousands) | | | |
| **Assets** | | | | |
| Cash equivalents: | | | | |
| Money market funds | $ 461,068 | $ 461,068 | $ | $ |
| Short-term investments: | | | | |
| Municipal securities | 466,713 | | 466,713 | |
| Other current assets: | | | | |
| Foreign currency derivative contracts | 12,019 | | 12,019 | |
| Other long-term assets: | | | | |
| Marketable equity securities (1) | 2,140 | 2,140 | | |
| Deferred compensation plan assets | 73,968 | | 73,968 | |
| **Total assets** | $ 1,015,908 | $ 463,208 | $ 552,700 | $ |
| **Liabilities** | | | | |
| Accounts payable and accrued liabilities: | | | | |
| Foreign currency derivative contracts | $ 846 | $ | $ 846 | $ |
| **Total liabilities** | $ 846 | $ | $ 846 | $ |

(1) During the fiscal year ended October 31, 2009, the Company recorded a $0.9 million other-than-temporary impairment charge in other (expense) income, net, due to the decline of the stock price of a public company in its long-term investment portfolio. This investment was subsequently sold during the nine months ended July 31, 2010 and a gain of $2.1 million was recorded in other (expense) income, net.

Equity investments in privately-held companies are accounted for under the cost method of accounting. These equity investments (also called non-marketable equity securities) are classified within Level 3 as they are valued using significant unobservable inputs or data in an inactive market, and the valuation requires management judgment due to the absence of market price and inherent lack of liquidity. The non-marketable equity securities are measured and recorded at fair value when an event or circumstance which impacts the fair value of these securities indicates other-than-temporary decline in value has occurred. The following table presents the non-marketable equity securities that were measured and recorded at fair value within long-term assets and the loss recorded during the following periods:

| | Balance as of July 31, 2010 | Significant Unobservable Inputs (Level 3) | Total (losses) during three months ended July 31, 2010 | Total (losses) during nine months ended July 31, |
|---|---|---|---|---|

| | | | | 2010 |
|---|---|---|---|---|
| | | (in thousands) | | |
| Non-marketable equity securities | $ 452 | $ 452 | $ (468) | $ (468) |

The Company recognized a $0.5 million other-than-temporary charge in one of its investments during the three and nine months ended July 31, 2010. The fair value of this investment was calculated using the income approach.

| | Balance as of July 31, 2009 | Significant Unobservable Inputs (Level 3) | Total (losses) during three months ended July 31, 2009 | Total (losses) during nine months ended July 31, 2009 |
|---|---|---|---|---|
| | | (in thousands) | | |
| Non-marketable equity securities | $ 3,206 | $ 3,206 | $ (3,374) | $ (5,464) |

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SYNOPSYS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company identified impairment indicators in these investments and calculated the fair value by determining what a willing buyer would pay to purchase the securities using a financial model based on business enterprise value and calculating its liquidity preference. The inputs to the financial model were based on cash flow projections.

**Note 4. Financial Assets and Liabilities**

*Cash, Cash Equivalents and Investments.* Short-term investments have been classified as available-for-sale securities. Cash, cash equivalents and investments are detailed as follows:

| | Cost | Gross Unrealized Gains | Gross Unrealized Losses Less Than 12 Months | Gross Unrealized Losses 12 Months or Longer | Estimated Fair Value[(1)] |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Balance at July 31, 2010 | | | | | |
| Classified as current assets: | | | | | |
| Non-interest bearing cash (U.S. and International) | $ 33,338 | $ | $ | $ | $ 33,338 |
| Money market funds (U.S.) | 240,839 | | | | 240,839 |
| Cash deposits and money market funds (International) | 609,264 | | | | 609,264 |
| Municipal securities | 324,613 | 1,779 | (8) | | 326,384 |
| | 1,208,054 | 1,779 | (8) | | 1,209,825 |
| Classified as non-current assets: | | | | | |
| Non-marketable equity securities | 7,360 | | | | 7,360 |
| Total | $ 1,215,414 | $ 1,779 | $ (8) | $ | $ 1,217,185 |

| | Cost | Gross Unrealized Gains | Gross Unrealized Losses Less Than 12 Months | Gross Unrealized Losses 12 Months or Longer | Estimated Fair Value (1) |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Balance at October 31, 2009 | | | | | |
| Classified as current assets: | | | | | |
| Non-interest bearing cash (U.S. and International) | $ 40,390 | $ | $ | $ | $ 40,390 |
| Money market funds (U.S.) | 141,418 | | | | 141,418 |
| Cash deposits and money market funds (International) | 519,805 | | | | 519,805 |
| Municipal securities | 463,966 | 2,827 | (80) | | 466,713 |
| | 1,165,579 | 2,827 | (80) | | 1,168,326 |
| Classified as non-current assets: | | | | | |
| Marketable and non-marketable equity securities | 8,002 | 1,796 | | | 9,798 |

| Total | $ 1,173,581 | $ 4,623 | $ (80) | $ | $ 1,178,124 |
|---|---|---|---|---|---|

(1) See Note 3 for further discussion on fair values of money market funds, municipal securities, and non-marketable equity securities.
As of July 31, 2010, the stated maturities of the Company s short-term investments are $87.4 million within one year, $129.6 million within one to five years, $37.0 million within five to ten years and $72.4 million after ten years. Actual maturities differ from the stated maturities because borrowers may have the right to call or prepay these obligations. Accordingly, these investments are classified as available-for-sale and are recorded on the balance sheet at fair market value with unrealized gains or losses, net of tax, reported as a component of accumulated other comprehensive loss. The cost of securities sold is based on the specific identification method and realized gains and losses are included in other (expense) income, net. Realized gains and losses on sales of short-term investments have not been material in any period presented.

*Derivatives.* In accordance with ASC 815, *Derivatives and Hedging*, the Company recognizes derivative instruments as either assets or liabilities in the unaudited condensed consolidated financial statements at fair value and provides qualitative and quantitative disclosures about such derivatives.

**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company operates internationally and is exposed to potentially adverse movements in foreign currency exchange rates. The Company enters into hedges in the form of foreign currency forward contracts to reduce its exposure to foreign currency rate changes on non-functional currency denominated forecasted transactions and balance sheet positions including: (1) certain assets and liabilities, (2) shipments forecasted to occur within approximately one month, (3) future billings and revenue on previously shipped orders, and (4) certain future intercompany invoices denominated in foreign currencies.

The duration of forward contracts ranges from one month to 19 months, the majority of which are short term. The Company does not use foreign currency forward contracts for speculative or trading purposes. The Company enters into foreign exchange forward contracts with high credit quality financial institutions that are rated A or above and to date has not experienced nonperformance by counterparties. Further, the Company anticipates continued performance by all counterparties to such agreements.

The assets or liabilities associated with the forward contracts are recorded at fair value in other current assets or other current liabilities in the unaudited condensed consolidated balance sheet. The accounting for gains and losses resulting from changes in fair value depends on the use of the foreign currency forward contract and whether it is designated and qualifies for hedge accounting.

***Cash Flow Hedging Activities***

Certain foreign exchange forward contracts are designated and qualify as cash flow hedges. These contracts have durations of one year or less, except for forward contracts denominated in British pound, Canadian dollar, Chinese yuan, Euro, Indian rupee, Japanese yen and Taiwan dollar, which can have durations of up to 19 months. Certain forward contracts are rolled over periodically to capture the full length of exposure to the Company s foreign currency risk, which can be up to three years. To receive hedge accounting treatment, all hedging relationships are formally documented at the inception of the hedge and the hedges must be highly effective in offsetting changes to future cash flows on the hedged transactions. The effective portion of gains or losses resulting from changes in fair value of these hedges is initially reported, net of tax, as a component of accumulated other comprehensive loss, or OCI, in stockholders equity and reclassified into revenue or operating expenses, as appropriate, at the time the hedged transactions affect earnings.

Hedging effectiveness is evaluated monthly using spot rates, with any gain or loss caused by hedging ineffectiveness recorded in other (expense) income, net. The premium/discount component of the forward contracts is recorded to other (expense) income, net and is not included in evaluating hedging effectiveness.

***Non-designated Hedging Activities***

The Company s foreign exchange forward contracts that are used to hedge non-functional currency denominated balance sheet assets and liabilities are not designated as hedging instruments. Accordingly, any gains or losses from changes in the fair value of the forward contracts are recorded in other (expense) income, net. The gains and losses on these forward contracts generally offset the gains and losses associated with the underlying assets and liabilities, which are also recorded in other (expense) income, net. The duration of the forward contracts for hedging the Company s balance sheet exposure is approximately one month.

The Company also has certain foreign exchange forward contracts for hedging certain international revenue and expenses that are not designated as hedging instruments. Accordingly, any gains or losses from changes in the fair value of the forward contracts are recorded in other (expense) income, net. The gains and losses on these forward contracts generally offset the gains and losses associated with the foreign currency in operating income. The duration of these forward contracts is usually less than one year. The overall goal of the Company s hedging program is to minimize the impact of currency fluctuations on its net income over its fiscal year.

During the three and nine months ended July 31, 2010, $3.0 million and $4.5 million of losses, respectively, and during the three and nine months ended July 31, 2009, $1.7 million and $7.8 million of gains, respectively, were recorded in other (expense) income, net due to changes in the fair values of non-designated forward contracts. As of July 31, 2010, the Company had a total gross notional amount of $435.2 million of short-term foreign currency forward contracts outstanding with net fair values of ($10.3) million. As of October 31, 2009, the Company had a total gross notional amount of $525.4 million of short-term foreign currency forward contracts outstanding with net fair values of $11.2 million. The notional amounts for derivative instruments provide one measure of the transaction volume outstanding as of July 31, 2010 and October 31,

2009, respectively, and do not represent the amount of the Company s exposure to market gain or loss. The Company s exposure to market gain or loss will vary over time as a function of currency exchange rates. The amounts ultimately realized upon settlement of these financial instruments, together with the gains and losses on the underlying exposures, will depend on actual market conditions during the remaining life of the instruments.

**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following represents the unaudited condensed consolidated balance sheet location and amount of derivative instrument fair values segregated between designated and non-designated hedge instruments:

| | Fair Values of derivative instruments designated as hedging instruments | Fair Values of derivative instruments not designated as hedging instruments |
|---|---|---|
| | (in thousands) | |
| As of July 31, 2010 | | |
| Other current assets | $ 1,129 | $ |
| Other current liabilities | $ 11,181 | $ 277 |
| As of October 31, 2009 | | |
| Other current assets | $ 10,273 | $ 1,746 |
| Other current liabilities | $ 846 | $ |

The following table represents the unaudited condensed consolidated statement of operations location and amount of gains and losses on derivative instrument fair values for designated hedge instruments, net of tax:

| | Location of gain(loss) recognized in OCI on derivatives | Amount of gain (loss) recognized in OCI on derivatives (effective portion) | Location of gain(loss) reclassified from OCI | Amount of gain (loss) reclassified from OCI (effective portion) |
|---|---|---|---|---|
| | | (in thousands) | | |
| Three months ended July 31, 2010 | | | | |
| Foreign exchange contracts | Revenue | $ (3,644) | Revenue | $ 703 |
| Foreign exchange contracts | Operating expenses | (3,413) | Operating expenses | (236) |
| Total | | $ (7,057) | | $ 467 |
| Three months ended July 31, 2009 | | | | |
| Foreign exchange contracts | Revenue | $ 2,373 | Revenue | $ 1,896 |
| Foreign exchange contracts | Operating expenses | 9,899 | Operating expenses | (2,849) |
| Total | | $ 12,272 | | $ (953) |
| Nine months ended July 31, 2010 | | | | |
| Foreign exchange contracts | Revenue | $ (2,565) | Revenue | $ 1,601 |
| Foreign exchange contracts | Operating expenses | (9,783) | Operating expenses | 2,615 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total | | $ | (12,348) | | $ | 4,216 |
| Nine months ended July 31, 2009 | | | | | | |
| Foreign exchange contracts | Revenue | $ | 4,486 | Revenue | $ | 4,216 |
| Foreign exchange contracts | Operating expenses | | 10,384 | Operating expenses | | (13,553) |
| Total | | $ | 14,870 | | $ | (9,337) |

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SYNOPSYS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table represents the ineffective portion and the portion excluded from effectiveness testing of the hedge gains (losses) for derivative instruments designated as hedging instruments, which are recorded in other (expense) income, net:

| | Amount of gain (loss) recognized in income statement on derivatives (ineffective portion)[1] | Amount of gain (loss) recognized in income statement on derivatives (excluded from effectiveness testing)[2] |
|---|---|---|
| Three months ended July 31, 2010 | | |
| Foreign exchange contracts | $ 320 | $ (892) |
| Three months ended July 31, 2009 | | |
| Foreign exchange contracts | $ 41 | $ (36) |
| Nine months ended July 31, 2010 | | |
| Foreign exchange contracts | $ 278 | $ (1,051) |
| Nine months ended July 31, 2009 | | |
| Foreign exchange contracts | $ 3 | $ 3,008 |

(1) The ineffective portion includes forecast inaccuracies.
(2) The portion excluded from effectiveness includes the discount earned or premium paid for the contracts.

**Note 5. Business Combinations**

Effective for fiscal 2010, the Company adopted new accounting guidance, ASC 805, Business Combinations. During the nine months ended July 31, 2010, the Company completed several acquisitions and preliminarily allocated the total purchase consideration of $146.9 million to the assets acquired and liabilities assumed based on their respective fair values at the acquisition dates, resulting in total goodwill of $66.4 million. These acquisitions are not considered material individually or in the aggregate to the Company s unaudited condensed consolidated balance sheet and results of operations. The unaudited condensed consolidated financial statements include the operating results of the acquired businesses from their respective acquisition dates.

Acquired identifiable intangible assets totaling $51.5 million are being amortized over their respective useful lives ranging from two to nine years. The purchase consideration includes contingent consideration of $10.0 million payable upon the achievement of certain technology milestones over three years. The contingent consideration was recorded as a liability at its estimated fair value determined based on the net present value of estimated payments of $7.8 million on the acquisition date and will be remeasured quarterly during the three-year contingency period with changes in its fair value recorded in the Company s statements of operations. The change in the fair value upon remeasurement was immaterial for the three and nine months ended July 31, 2010.

***Other***

During the nine months ended July 31, 2010, the Company paid $3.1 million upon the achievement of certain milestones related to prior fiscal year acquisitions.

**Note 6. Goodwill and Intangible Assets**

Goodwill as of July 31, 2010 consisted of the following:

| | | (in thousands) |
|---|---|---|
| Balance at October 31, 2009 | $ | 932,691 |
| Additions [1] | | 66,410 |
| Other adjustments[2] | | 3,430 |
| Balance at July 31, 2010 | $ | 1,002,531 |

(1) Additions relate to purchase acquisitions as described in Note 5.
(2) Adjustments relate to prior fiscal year acquisitions.

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**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Intangible assets as of July 31, 2010 consisted of the following:

| | Gross Assets | Accumulated Amortization (in thousands) | Net Assets |
|---|---|---|---|
| Core/developed technology | $ 182,491 | $ 108,567 | $ 73,924 |
| Customer relationships | 85,120 | 52,322 | 32,798 |
| Contract rights intangible | 11,400 | 7,925 | 3,475 |
| Covenants not to compete | 2,200 | 1,810 | 390 |
| Trademarks and trade names | 2,700 | 1,340 | 1,360 |
| In-process research and development (IPRD)[1] | 2,825 | | 2,825 |
| Capitalized software development costs [2] | 8,128 | 4,839 | 3,289 |
| Total | $ 294,864 | $ 176,803 | $ 118,061 |

(1) IPRD is classified as an indefinite-lived intangible asset until the project is completed or abandoned.
(2) During the first quarter of fiscal 2010, the Company retired fully amortized assets of $5.8 million.

Intangible assets as of October 31, 2009 consisted of the following:

| | Gross Assets | Accumulated Amortization (in thousands) | Net Assets |
|---|---|---|---|
| Core/developed technology | $ 146,266 | $ 85,355 | $ 60,911 |
| Customer relationships | 73,120 | 45,715 | 27,405 |
| Contract rights intangible | 8,100 | 5,661 | 2,439 |
| Covenants not to compete | 2,200 | 1,247 | 953 |
| Trademarks and trade names | 2,700 | 911 | 1,789 |
| Capitalized software development costs | 11,755 | 8,442 | 3,313 |
| Total | $ 244,141 | $ 147,331 | $ 96,810 |

Amortization expense related to intangible assets consisted of the following:

| | Three Months Ended July 31, | | Nine Months Ended July 30, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Core/developed technology | $ 7,710 | $ 7,502 | $ 23,212 | $ 21,889 |
| Customer relationships | 2,088 | 2,597 | 6,607 | 8,514 |
| Contract rights intangible | 589 | 950 | 2,264 | 2,478 |

| | | | | |
|---|---|---|---|---|
| Covenant not to compete | 88 | 212 | 563 | 521 |
| Trademark and trade names | 136 | 147 | 429 | 434 |
| Capitalized software development costs [1] | 741 | 742 | 2,223 | 2,196 |
| Total | $ 11,352 | $ 12,150 | $ 35,298 | $ 36,032 |

(1) Amortization of capitalized software development costs is included in cost of license revenue in the unaudited condensed consolidated statements of operations.

The following table presents the estimated future amortization of intangible assets:

| **Fiscal Year** | **(in thousands)** |
|---|---|
| Remainder of fiscal 2010 | $ 10,877 |
| 2011 | 37,313 |
| 2012 | 26,766 |
| 2013 | 17,655 |
| 2014 | 10,943 |
| 2015 and thereafter | 11,682 |
| IPRD (to be amortized upon project completion or written off upon abandonment) | 2,825 |
| Total | $ 118,061 |

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**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 7. Liabilities**

*Accounts Payable and Accrued Liabilities.* Accounts payable and accrued liabilities consist of:

| | July 31, 2010 | October 31, 2009 |
|---|---|---|
| | (in thousands) | |
| Payroll and related benefits | $ 166,455 | $ 189,719 |
| Other accrued liabilities | 58,021 | 45,734 |
| Accounts payable | 11,245 | 10,136 |
| Facility restructuring charge[1] | 3,125 | 4,538 |
| Prior fiscal year acquisition related costs | 1,561 | 4,968 |
| Total | $ 240,407 | $ 255,095 |

(1) Loss on the closure of a facility obtained through a prior fiscal year acquisition.

*Other Long-term Liabilities.* Other long-term liabilities consist of:

| | July 31, 2010 | October 31 2009 |
|---|---|---|
| | (in thousands) | |
| Deferred compensation liability | $ 77,412 | $ 69,709 |
| Other long-term liabilities | 14,670 | 18,293 |
| Total | $ 92,082 | $ 88,002 |

**Note 8. Credit Facility**

On October 20, 2006, the Company entered into a five-year, $300.0 million senior unsecured revolving credit facility providing for loans to the Company and certain of its foreign subsidiaries. The amount of the facility may be increased by up to an additional $150.0 million through the fourth year of the facility. The facility contains financial covenants requiring the Company to maintain a minimum leverage ratio and specified levels of cash, as well as other non-financial covenants. The facility terminates on October 20, 2011. Borrowings under the facility bear interest at the greater of the administrative agent s prime rate or the federal funds rate plus 0.50%; however, the Company has the option to pay interest based on the outstanding amount at Eurodollar rates plus a spread between 0.50% and 0.70% based on a pricing grid tied to a financial covenant. In addition, commitment fees are payable on the facility at rates between 0.125% and 0.175% per year based on a pricing grid tied to a financial covenant. As of July 31, 2010, the Company had no outstanding borrowings under this credit facility and was in compliance with all the covenants.

**Note 9. Comprehensive Income**

The following table presents the components of comprehensive income:

| | Three Months Ended July 31, | | Nine Months Ended July 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Net income | $ 39,327 | $ 47,436 | $ 211,662 | $ 148,153 |
| Change in unrealized (losses) gains on investments, net of tax of $43 and $1,102, for the three and nine months ended July 31, 2010, respectively, and of ($111) and ($1,447) for each of the same periods in fiscal 2009, respectively | (66) | 169 | (1,670) | 2,193 |
| Deferred (losses) gains on cash flow hedges, net of tax of $1,461 and $1,940, for the three and nine months ended July 31, 2010, respectively, and of ($3,013) and ($3,079) for each of the same periods in fiscal 2009, respectively | (7,321) | 12,272 | (12,570) | 14,870 |
| Reclassification adjustment on deferred (gains) losses on cash flow hedges, net of tax of $474 and $2,095, for the three and nine months ended July 31, 2010, respectively, and of ($138) and ($1,846) for each of the same periods in fiscal 2009, respectively | (468) | 912 | (4,216) | 9,333 |
| Foreign currency translation adjustment | (126) | 4,367 | (1,502) | 1,012 |
| Total | $ 31,346 | $ 65,156 | $ 191,704 | $ 175,561 |

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**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 10. Stock Repurchase Program**

On September 3, 2009, the Company s Board of Directors (Board) replenished the Company s stock repurchase program such that the Company is authorized to purchase up to $500.0 million of its common stock. Originally approved in 2002, the stock repurchase program has been periodically replenished to $500.0 million. The Company repurchases shares to offset dilution caused by ongoing stock issuances from existing plans for equity compensation awards, acquisitions, and when management believes it is a good use of cash. Repurchases are transacted in accordance with Rule 10b-18 of the Securities Exchange Act of 1934 (Exchange Act) and may be made through any means including, but not limited to, open market purchases, plans executed under Rule 10b5-1(c) of the Exchange Act and structured transactions.

During the three and nine months ended July 31, 2010, the Company purchased 3.5 million shares at an average price of $21.58 per share and 5.8 million shares at an average price of $21.76 per share, respectively, for an aggregate purchase price of $75.0 million and $125.3 million, respectively. There were no stock repurchases during the three and nine months ended July 31, 2009. During the three and nine months ended July 31, 2010, approximately 1.2 million and 6.4 million shares, respectively, were reissued from treasury stock for employee stock compensation purposes. During the three and nine months ended July 31, 2009, approximately 0.2 million and 2.5 million shares, respectively, were reissued from treasury stock for employee stock compensation purposes. As of July 31, 2010, $374.7 million remained available for future purchases under the program.

**Note 11. Stock Compensation**

The Company determines the fair value of stock based awards in the form of stock options, employee stock purchases under the Employee Stock Purchase Plan (ESPP), restricted stock, and restricted stock units on the grant date. The value of awards expected to vest is recognized as expense over the applicable service periods. The Company uses the straight-line attribution method to recognize stock compensation costs over the service period of the award. The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options and employee stock purchase plan awards in accordance with ASC 718, *Compensation Stock Compensation.* The Black-Scholes option-pricing model incorporates various subjective assumptions including expected volatility, expected term and interest rates. The expected volatility for both stock options and stock purchase rights under the ESPP is estimated by a combination of implied volatility for publicly traded options of the Company s common stock with a term of six months or longer and the historical stock price volatility over the estimated expected term of the Company s stock awards. The expected term of the Company s stock awards is based on historical experience.

As of July 31, 2010, there was $80.3 million of unamortized share-based compensation expense which is expected to be amortized over a weighted-average period of approximately 2.7 years. The intrinsic values of options exercised during the three and nine months ended July 31, 2010 were $5.7 million and $18.7 million, respectively. The intrinsic values of options exercised during the three and nine months ended July 31, 2009 were $0.5 million and $2.2 million, respectively.

The compensation cost recognized in the unaudited condensed consolidated statements of operations for these stock compensation arrangements was as follows:

| | Three Months Ended July 31, | | Nine Months Ended July 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Cost of license | $ 1,585 | $ 1,640 | $ 5,116 | $ 5,013 |
| Cost of maintenance and service | 490 | 536 | 1,531 | 1,626 |
| Research and development expense | 6,366 | 5,994 | 19,863 | 18,166 |
| Sales and marketing expense | 3,030 | 2,964 | 9,544 | 9,224 |
| General and administrative expense | 3,043 | 2,861 | 9,160 | 8,770 |
| Stock compensation expense before taxes | 14,514 | 13,995 | 45,214 | 42,799 |

| | | | | |
|---|---|---|---|---|
| Income tax benefit | (3,327) | (3,163) | (10,363) | (9,673) |
| Stock compensation expense after taxes | $ 11,187 | $ 10,832 | $ 34,851 | $ 33,126 |

**Note 12. Net Income per Share**

The Company computes basic net income per share by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted net income per share reflects the dilution of potential common shares outstanding such as stock options and unvested restricted stock units and awards during the period using the treasury stock method.

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SYNOPSYS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The table below illustrates the weighted-average common shares used to calculate basic net income per share with the weighted-average common shares used to calculate diluted net income per share:

| | Three Months Ended July 31, | | Nine Months Ended July 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Numerator: | | | | |
| Net income | $ 39,327 | $ 47,436 | $ 211,662 | $ 148,153 |
| Denominator: | | | | |
| Weighted-average common shares for basic net income per share | 148,006 | 144,138 | 147,909 | 143,093 |
| Dilutive effect of common share equivalents from equity-based compensation | 3,100 | 1,925 | 3,550 | 1,606 |
| Weighted-average common shares for diluted net income per share | 151,106 | 146,063 | 151,459 | 144,699 |

Diluted net income per share excludes 12.2 million and 11.0 million of anti-dilutive stock options and unvested restricted stock units and awards, respectively, for the three and nine months ended July 31, 2010, and 20.0 million and 19.2 million of anti-dilutive stock options and unvested restricted stock units and awards for the three and nine months ended July 31, 2009, respectively. While these stock options and unvested restricted stock units and awards were anti-dilutive for the respective periods, they could be dilutive in the future.

**Note 13. Segment Disclosure**

ASC 280, *Segment Reporting,* requires disclosures of certain information regarding operating segments, products and services, geographic areas of operation and major customers. Segment reporting is based upon the management approach, i.e., how management organizes the Company s operating segments for which separate financial information is (1) available and (2) evaluated regularly by the Chief Operating Decision Maker (CODM) in deciding how to allocate resources and in assessing performance. Synopsys CODMs are the Company s Chief Executive Officer and Chief Operating Officer.

The Company provides software and hardware products and consulting services in the electronic design automation software industry. The Company operates in a single segment. In making operating decisions, the CODMs primarily consider consolidated financial information, accompanied by disaggregated information about revenues by geographic region. Specifically, the CODMs consider where individual seats or licenses to the Company s products are used in allocating revenue to particular geographic areas. Revenue is defined as revenues from external customers. Goodwill is not allocated since the Company operates in one reportable segment.

The following table presents the revenues related to operations by geographic areas:

| | Three Months Ended July 31, | | Nine Months Ended July 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Revenue: | | | | |
| United States | $ 165,841 | $ 169,553 | $ 489,112 | $ 495,611 |
| Europe | 45,245 | 47,587 | 136,482 | 148,022 |
| Japan | 61,261 | 65,791 | 187,504 | 202,969 |

| | | | | |
|---|---|---|---|---|
| Asia-Pacific and other | 64,582 | 62,246 | 192,104 | 175,165 |
| Consolidated | $ 336,929 | $ 345,177 | $ 1,005,202 | $ 1,021,767 |

Geographic revenue data for multi-region, multi-product transactions reflect internal allocations and is therefore subject to certain assumptions and to the Company s methodology.

One customer accounted for more than ten percent of the Company s consolidated revenue for the three and nine months ended July 31, 2010 and 2009, respectively.

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SYNOPSYS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 14. Other (expense) income, net**

The following table presents the components of other (expense) income, net:

| | Three Months Ended July 31, | | Nine Months Ended July 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | | |
| Interest income | $ 1,315 | $ 2,364 | $ 4,545 | $ 8,788 |
| (Loss) gain on assets related to deferred compensation plan | (2,165) | 6,134 | 3,662 | 5,615 |
| Foreign currency exchange (loss) gain | (1,234) | (18) | (1,201) | 5,694 |
| Write-down of long-term investments | (468) | (3,374) | (468) | (6,333) |
| Other (expense) income, net | (494) | 278 | 1,571 | 4,164 |
| Total | $ (3,046) | $ 5,384 | $ 8,109 | $ 17,928 |

**Note 15. Taxes**

***Effective Tax Rate***

The Company estimates its annual effective tax rate at the end of each fiscal quarter. The Company considers estimations of annual pre-tax income, the geographic mix of pre-tax income and the Company s interpretations of tax laws and possible outcomes of audits.

The following table presents the provision (benefit) for income taxes and the effective tax rates:

| | Three Months Ended July 31, | | Nine Months Ended July 31, | |
|---|---|---|---|---|
| | 2010 | 2009 | 2010 | 2009 |
| | (in thousands) | | (in thousands) | |
| Income before income taxes | $ 47,747 | $ 66,473 | $ 158,962 | $ 201,257 |
| Provision (benefit) for income tax | $ 8,420 | $ 19,037 | $ (52,700) | $ 53,104 |
| Effective tax rate | 17.6% | 28.6% | (33.2)% | 26.4% |

The Company s effective tax rate for the three and nine months ended July 31, 2010 is lower than the statutory federal income tax rate of 35% primarily due to its non-U.S. operations, which are taxed at lower rates, as well as IRS settlement related adjustments partially offset by state taxes and non-deductible stock compensation. The effective tax rate decreased in the three months ended July 31, 2010, as compared to the same period in fiscal 2009, primarily due to IRS settlement related adjustments and the tax effect of the expiration of a statute of limitations in the prior fiscal year, partially offset by the expiration of the federal research and experimentation credit on December 31, 2009. The effective tax rate decreased in the nine months ended July 31, 2010, as compared to the same period in fiscal 2009, primarily due to reaching the final settlement with the IRS for fiscal years 2002 through 2004. See IRS Examinations below, for further information regarding the IRS settlement.

The timing of the resolution of income tax examinations is highly uncertain as well as the amounts and timing of various tax payments that are part of the settlement process. This could cause large fluctuations in the balance sheet classification of current and non-current assets and liabilities. The Company believes that in the next twelve months it is reasonably possible that the statute of limitations on certain state and foreign income and withholding taxes will expire, and that certain federal and foreign transfer pricing issues could be effectively settled. Given the uncertainty as to ultimate settlement terms, the timing of payment and the impact of such settlements on other uncertain tax positions, the

range of the estimated potential decrease in underlying unrecognized tax benefits is between $0 and $20 million.

The Company files income tax returns in the United States, including various state and local jurisdictions. Its subsidiaries file tax returns in various foreign jurisdictions, including Ireland, Hungary, Taiwan and Japan. The Company remains subject to income tax examinations in the United States, Hungary and Taiwan for fiscal years after 2005, and in Ireland and Japan for fiscal years after 2004. See *IRS Examinations* below, for the status of our current federal income tax audits.

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**SYNOPSYS, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In March 2010, in a case between Xilinx, Inc. and the IRS, the U.S. Court of Appeals for the Ninth Circuit issued a decision affirming an earlier U.S. Tax Court ruling that stock option compensation does not need to be included in the costs shared under a cost sharing arrangement. In July 2010 the IRS announced that it would acquiesce to the result of the Xilinx decision, and issued an Action on Decision (AOD) in August 2010. As a result of this announcement, the Company reversed previously recorded liabilities of $5.2 million and recorded a credit to additional paid-in capital in the third quarter of 2010.

***IRS Examinations***

The Company is regularly audited by the IRS.

In July 2008, the IRS completed its field examination of fiscal years 2002-2004 and issued a Revenue Agent s Report (RAR) in which it contested the Company s tax deduction for payments made in connection with litigation between Avant! Corporation and Cadence Design Systems, Inc. In addition, the IRS asserted that the Company was required to make an additional transfer pricing adjustment with a wholly owned non-U.S. subsidiary as a result of the Company s acquisition of Avant! in 2002. The IRS also proposed adjustments to the Company s transfer pricing arrangements with its foreign subsidiaries, deductions for foreign trade income and certain temporary differences.

In the second quarter of fiscal 2009, the Company reached a tentative settlement with the Examination Division of the IRS that would resolve this matter. The settlement was subject to further review and approval within the federal government, including the Joint Committee on Taxation of the U.S. Congress (Joint Committee). The Company was notified of such approval on January 4, 2010. As a result of the settlement, the Company owed additional taxes of approximately $51 million (including interest) which will be fully offset by future tax benefits over the next seven years. Certain refund claims of approximately $35 million are owed to the Company as a result of the settlement. In October 2009, the Company made a prepayment of $19 million to the IRS which is expected to cover the remaining additional taxes arising from the audit of fiscal years 2002-2004. This final settlement resulted in a decrease in the Company s tax expense for the first quarter of fiscal 2010 of approximately $91.6 million, which is due to the release of previously established tax liabilities of $67.8 million, principally related to the acquisition of Avant! Corporation in 2002, as well as a release of a valuation allowance of $21.6 million for foreign tax credits which were utilized in connection with the settlement. The total decrease in unrecognized tax benefits was approximately $86.8 million of which $67.8 million has been reflected in the effective tax rate while the remaining $19.0 million is reflected in accrued income taxes. In the third quarter of 2010, the Company recorded an additional $2.7 million adjustment with respect to the settlement, primarily due to reductions of its interest liability approved by the IRS as a result of netting of certain refund claims against taxes owed.

As a result of the IRS settlement, the Company s net deferred tax assets increased by $55.4 million. The change is due primarily to increases in its deferred tax assets of $72.3 million for certain costs that have been capitalized for tax purposes and will be amortized in future periods, partially offset by a decrease to deferred tax assets of $25.2 million, due to use of the Company s foreign tax credit carryover, net of the reversal of a valuation allowance.

The IRS has commenced an audit of the Company s fiscal years 2006-2008 as well as certain returns filed by Synplicity, Inc. prior to its acquisition by the Company in May 2008. As of July 31, 2010, no adjustments have been proposed.

**Note 16. Contingencies**

The Company is subject to routine legal proceedings, as well as demands, claims and threatened litigation that arise in the normal course of its business. The ultimate outcome of any litigation is uncertain and unfavorable outcomes could have a negative impact on the Company s financial position and results of operations.

**Note 17. Effect of New Accounting Pronouncements**

The effect of recent accounting pronouncements has not changed from the Company s Annual Report on Form 10-K for the fiscal year ended October 31, 2009.

**Note 18. Subsequent Events**

On September 2, 2010, the Company acquired all outstanding shares of Virage Logic Corporation (Virage), including certain unvested equity awards. The Company paid $12.00 per share for each outstanding share of Virage common stock for a total of approximately $312 million.

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

*This Quarterly Report on Form 10-Q, and in particular the following discussion, includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 (the Securities Act) and Section 21E of the Securities Exchange Act of 1934 (the Exchange Act). These statements include but are not limited to statements concerning: our business, product and platform strategies, expectations regarding previous and future acquisitions; completion of development of our unfinished products, or further development or integration of our existing products; continuation of current industry trends towards vendor consolidation; expectations regarding our license mix; expectations regarding customer interest in more highly integrated tools and design flows; expectations of the success of our intellectual property, design for manufacturing and system-level design initiatives; expectations concerning recent completed acquisitions; expectations that our cash, cash equivalents and short-term investments and cash generated from operations will satisfy our business requirements for the next 12 months; and our expectations of our future liquidity requirements. The words may, will, could, would, anticipate, expect, intend, believe, continue, or the negatives of these terms, or other comparable terminology and similar expressions identify these forward-looking statements. However, these words are not the only means of identifying such statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Our actual results could differ materially from those projected in the forward-looking statements as a result of a number of factors, risks and uncertainties, including, without limitation, those identified below in Part II, Item 1A of this Form 10-Q. The information included herein is given as of the filing date of this Form 10-Q with the Securities and Exchange Commission (SEC) and future events or circumstances could differ significantly from these forward-looking statements. Accordingly, we caution readers not to place undue reliance on these statements. Unless required by law, we undertake no obligation to update publicly any forward-looking statements. All subsequent written or oral forward-looking statements attributable to our company or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. Readers are urged to carefully review and consider the various disclosures made in this report and in other documents we file from time to time with the SEC that attempt to advise interested parties of the risks and factors that may affect our business.*

*The following summary of our financial condition and results of operations should be read together with our unaudited condensed consolidated financial statements and the related notes thereto contained in Part I, Item 1 of this report and with our audited consolidated financial statements and the related notes thereto contained in our Annual Report on Form 10-K for the fiscal year ended October 31, 2009, filed with the SEC on December 18, 2009.*

*Fiscal Year End. Our fiscal year ends on the Saturday nearest to October 31. Our third quarter of fiscal 2010 ended on July 31, 2010. Fiscal 2010 and fiscal 2009 are both 52-week fiscal years. For presentation purposes, this Form 10-Q, including the unaudited condensed consolidated financial statements and accompanying notes, refers to the applicable calendar month end.*

***Overview***

*Business Summary*

Synopsys is a world leader in the electronic design automation (EDA) market. We supply software, IP and services for semiconductor design, verification and manufacturing. We develop and license the complex software that engineers use to design integrated circuits, also known as chips. We offer a broad portfolio of highly integrated solutions that simplify the chip and system-level design process, enable the development and production of electronic products, and accelerate time-to-market for our customers.

Our customers are generally large semiconductor and electronics manufacturers. Our solutions help them overcome the challenge of developing increasingly advanced electronics products while reducing their design and manufacturing costs. While our products are an important part of our customers development process, our customers research and development budget and spending decisions may be impacted by their business outlook and their willingness to invest in new and increasingly complex chip designs. The recent global recession intensified the cost and investment challenges for our customers.

Despite the recent global recession, we have maintained profitability and positive cash flow on an annual basis in recent years. We achieved these results not only because of our solid execution, leading technology and strong customer relationships, but also because of our recurring revenue business model. Under this model, a substantial majority of our customers pay for their licenses over time and we typically recognize this recurring revenue over the life of the contract, which averages approximately three years. Recurring revenue generally represents more than 90% of our total revenue. The revenue we recognize in a particular period generally results from selling efforts in prior periods rather than the current period. We typically enter each quarter with greater than 90% of our revenue for that particular quarter already committed from our customers, providing for stability and predictability of results.

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Although our customers in the semiconductor industry have experienced revenue growth in 2010, they still remain cautious and focused on their costs, including in their research and development budgets. In addition, increased spending by our customers with us may not immediately affect our revenue results, due to our revenue business model. While we are still cautious about the magnitude and sustainability of an economic recovery, our business outlook is positive given our strong financials, diligent expense management, and acquisition strategy.

We will continue to monitor market conditions and may make adjustments to our business in the event that the recent revenue growth experienced by the semiconductor industry is irregular or not sustained. We expect to continue to explore both organic and inorganic growth opportunities. In particular, we may continue to acquire companies or technology that can contribute to the strategic, operational and financial performance of our business. We believe that the combination of our solid financials, leading technology and strong customer relationships will help us successfully execute our strategies.

*Financial Performance Summary for the Three Months Ended July 31, 2010*

- Our net income decreased by $8.1 million, or 17%, from $47.4 million to $39.3 million compared to the same period in fiscal 2009. The decrease was primarily due to a decrease in upfront license revenue, maintenance and service revenue and an increase in sales and marketing expense for variable compensation driven by timing of shipments. The decrease was partially offset by a lower tax provision.

- Total revenue decreased by $8.3 million due to lower maintenance and service revenues compared to the same period in fiscal 2009.

- We continued to derive over 90% of our total revenue from time-based license revenue and maintenance and service revenue in fiscal 2010 and fiscal 2009.

***Critical Accounting Policies and Estimates***

Our discussion and analysis of our financial results under the heading Result of Operations below are based on our unaudited condensed consolidated financial statements, which we have prepared in accordance with U.S. generally accepted accounting principles. In preparing these financial statements, we make assumptions, judgments and estimates that can affect the reported amounts of assets, liabilities, revenues and expenses and net income. On an on-going basis, we evaluate our estimates based on historical experience and various other assumptions we believe are reasonable under the circumstances. Our actual results may differ from these estimates.

The accounting policies that most frequently require us to make assumptions, judgments and estimates, and therefore are critical to understanding our results of operations, are:

- Revenue recognition;

- Income taxes;

- Valuation of stock-based compensation; and

- Valuation of intangible assets.

We describe our revenue recognition policy below. Our other critical accounting policies and estimates are discussed in Part II, Item 7 *Management s Discussion and Analysis of Financial Condition and Results of Operations* of our Annual Report on Form 10-K for the fiscal year ended October 31, 2009, filed with the SEC on December 18, 2009.

*Revenue Recognition*

We recognize revenue from software licenses and related maintenance and service revenue and, to a lesser extent, from hardware sales, in accordance with ASC 985-605, *Software Revenue Recognition* and ASC 605-25, *Multiple Element Arrangements*. Software license revenue consists of fees associated with the licensing of our software. Maintenance and service revenue consists of maintenance fees associated with perpetual and term licenses and professional service fees. Hardware revenue consists of Field Programmable Gate Array (FPGA) board-based products.

With respect to software licenses, we utilize three license types:

*Technology Subscription Licenses (TSLs)* are time-based licenses for a finite term, and generally provide the customer limited rights to receive, or to exchange certain quantities of licensed software for, unspecified future technology. We bundle and do not charge separately for post-contract customer support (maintenance) for the term of the license.

*Term Licenses* are also for a finite term, but do not provide the customer any rights to receive, or to exchange licensed software for, unspecified future technology. Customers purchase maintenance separately for the first year and may renew annually for the balance of the term. The annual maintenance fee is typically calculated as a percentage of the net license fee.

*Perpetual Licenses* continue as long as the customer renews maintenance plus an additional 20 years. Perpetual licenses do not provide the customer any rights to receive, or to exchange licensed software for, unspecified future technology. Customers purchase maintenance separately for the first year and may renew annually.

For the three software license types, we recognize revenue as follows:

*TSLs.* We typically recognize revenue from TSL fees (which include bundled maintenance) ratably over the term of the license period, or as customer installments become due and payable, whichever is later. Revenue attributable to TSLs is reported as time-based license revenue in the unaudited condensed consolidated statement of operations.

*Term Licenses.* We recognize revenue from term licenses in full upon shipment of the software if payment terms require the customer to pay at least 75% of the license fee within one year from shipment and all other revenue recognition criteria are met. Revenue attributable to these term licenses is reported as upfront license revenue in the unaudited condensed consolidated statement of operations. For term licenses in which less than 75% of the license fee is payable within one year from shipment, we recognize revenue as customer payments become due and payable. Such revenue is reported as time-based license revenue in the unaudited condensed consolidated statement of operations.

*Perpetual Licenses.* We recognize revenue from perpetual licenses in full upon shipment of the software if payment terms require the customer to pay at least 75% of the license fee within one year from shipment and all other revenue recognition criteria are met. Revenue attributable to these perpetual licenses is reported as upfront license revenue in the unaudited condensed consolidated statement of operations. For perpetual licenses in which less than 75% of the license fee is payable within one year from shipment, we recognize revenue as customer installments become due and payable. Such revenue is reported as time-based license revenue in the unaudited condensed consolidated statement of operations.

From time to time, we also enter into arrangements in which portions of revenue are contingent upon the occurrence of uncertain future events, for example, royalty arrangements. We refer to this revenue as contingent revenue. Contingent revenue is recognized if and when the applicable event occurs. It is reported as time-based revenue in the unaudited condensed consolidated statement of operations. Historically, such arrangements resulted in approximately one percent of our total revenue; however, this may increase in the future.

We recognize revenue from hardware sales in full upon shipment if all other revenue recognition criteria are met. Revenue attributable to these hardware sales is reported as upfront license revenue in the unaudited condensed consolidated statement of operations. If a technology subscription license is sold together with the hardware, we recognize total revenue ratably over the term of the software license period, or as customer installments become due and payable, whichever is later. Revenue attributable to these hardware sales is reported as time-based license revenue in the unaudited condensed consolidated statement of operations.

We recognize revenue from maintenance fees ratably over the maintenance period to the extent cash has been received or fees become due and payable, and recognize revenue from professional services and training fees as such services are performed and accepted by the customer. Revenue attributable to maintenance, professional services and training is reported as maintenance and service revenue in the unaudited condensed consolidated statement of operations.

Our determination of fair value of each element in multiple element arrangements is based on vendor-specific objective evidence (VSOE). We limit our assessment of VSOE of fair value for each element to the price charged when such element is sold separately.

We have analyzed all of the elements included in our multiple-element software arrangements and have determined that we have sufficient VSOE to allocate revenue to the maintenance components of our perpetual and term license products and to professional services. Accordingly, assuming all other revenue recognition criteria are met, we recognize license revenue from perpetual and term licenses upon delivery using the residual method, we recognize revenue from maintenance ratably over the maintenance term, and we recognize revenue from professional services as milestones are met and accepted. We recognize revenue from TSLs ratably over the term of the license, assuming all other revenue recognition criteria are met, since there is not sufficient VSOE to allocate the TSL fee between license and maintenance services.

We make significant judgments related to revenue recognition. Specifically, in connection with each transaction involving our products, we must evaluate whether: (1) persuasive evidence of an arrangement exists, (2) delivery of software or services has occurred, (3) the fee for such software or services is fixed or determinable, and (4) collectability of the full license or service fee is probable. All four of these criteria must be met in order for us to recognize revenue with respect to a particular arrangement. We apply these revenue recognition criteria as follows:

*Persuasive Evidence of an Arrangement Exists.* Prior to recognizing revenue on an arrangement, our customary policy is to have a written contract, signed by both the customer and us or a purchase order from those customers that have previously negotiated a standard end-user license arrangement or purchase agreement.

*Delivery Has Occurred.* We deliver our products to our customers electronically or physically. For electronic deliveries, delivery occurs when we provide access to our customers to take immediate possession of the software by downloading it to the customer s hardware. For physical deliveries, the standard transfer terms are typically FOB shipping point. We generally ship our products or license keys promptly after acceptance of customer orders. However, a number of factors can affect the timing of product shipments and, as a result, timing of revenue recognition, including the delivery dates requested by customers and our operational capacity to fulfill product orders at the end of a fiscal quarter.

*The Fee is Fixed or Determinable.* Our determination that an arrangement fee is fixed or determinable depends principally on the arrangement s payment terms. Our standard payment terms for perpetual and term licenses require 75% or more of the license fee to be paid within one year. If the arrangement includes these terms, we regard the fee as fixed or determinable, and recognize all license revenue under the arrangement in full upon delivery (assuming all other revenue recognition criteria are met). If the arrangement does not include these terms, we do not consider the fee to be fixed or determinable and generally recognize revenue when customer installments are due and payable. In the case of a TSL, because of the right to exchange products or receive unspecified future technology and because VSOE for maintenance services does not exist for a TSL, we recognize revenue ratably over the term of the license, but not in advance of when customers installments become due and payable.

*Collectability is Probable.* We judge collectability of the arrangement fees on a customer-by-customer basis pursuant to our credit review policy. We typically sell to customers with whom we have a history of successful collection. For a new customer, or when an existing customer substantially expands its commitments to us, we evaluate the customer s financial position and ability to pay and typically assign a credit limit based on that review. We increase the credit limit only after we have established a successful collection history with the customer. If we determine at any time that collectability is not probable under a particular arrangement based upon our credit review process or the customer s payment history, we recognize revenue under that arrangement as customer payments are actually received.

*Revenue Background*

We generate our revenue from the sale of software licenses, maintenance and professional services and to a small extent, hardware products. Under current accounting rules and policies, we recognize revenue from orders we receive for software licenses, services and hardware products at varying times. In most instances, we recognize revenue on a TSL software license order over the license term and on a term or perpetual software license order in the quarter in which the license is delivered. Substantially all of our current time-based licenses are TSLs with an average license term of approximately three years. Revenue on maintenance orders is recognized ratably over the maintenance period (normally one year). Revenue on professional services orders generally is recognized upon completion and customer acceptance of contractually agreed milestones. Revenue on hardware product orders is recognized generally in full in the quarter that the product is shipped.

Our revenue in any fiscal quarter is equal to the sum of our time-based license, upfront license, maintenance and professional service and hardware revenue for the period. We derive time-based license revenue in any quarter largely from TSL orders received and delivered in prior quarters and to a smaller extent due to contracts in which revenue is recognized as customer installments become due and payable and from contingent revenue arrangements. We derive upfront license revenue directly from term and perpetual license and hardware product orders mostly booked and shipped during the quarter. We derive maintenance revenue in any quarter largely from maintenance orders received in prior quarters since our maintenance orders generally yield revenue ratably over a term of one year. We also derive professional service revenue primarily from orders received in prior quarters, since we recognize revenue from professional services when those services are delivered and accepted, not when they are booked. Our license revenue is sensitive to the mix of TSLs and perpetual or term licenses delivered during a reporting period. A TSL order typically yields lower current quarter revenue but contributes to revenue in future periods. For example, a

$120,000 order for a three-year TSL shipped on the last day of a quarter typically generates no revenue in that quarter, but $10,000 in each of the twelve succeeding quarters. Conversely, perpetual and term licenses with greater than 75% of the license fee due within one year from shipment typically generate current quarter revenue but no future revenue (e.g., a $120,000 order for a perpetual license generates $120,000 in revenue in the quarter the product is shipped, but no future revenue). Additionally, revenue in a particular quarter may also be impacted by perpetual and term licenses in which less than 75% of the license fees is payable within one year from shipment as the related revenue will be recognized as revenue in the period when customer payments become due and payable.

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Our customer arrangements are complex, involving hundreds of products and various license rights, and our customers bargain with us over many aspects of these arrangements. For example, they often demand a broader portfolio of solutions, support and services and seek more favorable terms such as expanded license usage, future purchase rights and other unique rights at an overall lower total cost. No single factor typically drives our customers buying decisions, and we compete on all fronts to serve customers in a highly competitive EDA market. Customers generally negotiate the total value of the arrangement rather than just unit pricing or volumes.

***Results of Operations***

*Total Revenue*

| | July 31, | | Dollar | % |
|---|---|---|---|---|
| | 2010 | 2009 | Change | Change |
| | | (dollars in millions) | | |
| Three months ended | $ 336.9 | $ 345.2 | $ (8.3) | (2)% |
| Nine months ended | $ 1,005.2 | $ 1,021.8 | $ (16.6) | (2)% |

In general, fluctuations in revenue are primarily due to customer requirements including payment terms and the timing of contract renewals.

The decrease in total revenue for the three months ended July 31, 2010 compared to the same period in fiscal 2009 was primarily due to lower upfront license revenue of $3.1 million and lower maintenance and service revenue of $6.1 million.

The decrease in total revenue for the nine months ended July 31, 2010 compared to the same period in fiscal 2009 was primarily due to lower time based revenue of $12.9 million, and lower maintenance and service revenue of $5.3 million.

The fluctuations in revenue for each type of revenue are explained below.

Beginning in fiscal 2010, we included contingent revenue as time-based revenue. As a result, $1.2 million and $7.1 million in contingent revenue were reclassified from upfront license to time-based license revenue for the three and nine months ended July 31, 2009 to conform to fiscal 2010 presentation. This reclassification had no impact on total revenue.

*Time-Based License Revenue*

| | July 31, | | Dollar | % |
|---|---|---|---|---|
| | 2010 | 2009 | Change | Change |
| | | (dollars in millions) | | |
| Three months ended | $ 286.6 | $ 285.6 | $ 1.0 | <1% |
| Percentage of total revenue | 85% | 83% | | |
| Nine months ended | $ 847.7 | $ 860.6 | $ (12.9) | (1)% |
| Percentage of total revenue | 84% | 84% | | |

Time-based license revenue for the three and nine months ended July 31, 2010 compared to the same period in fiscal 2009 was relatively flat. Revenue changes were primarily due to customer requirements including payment terms and the timing of contract renewals.

*Upfront License Revenue*

| | July 31, | | Dollar | % |
|---|---|---|---|---|
| | 2010 | 2009 | Change | Change |
| | | (dollars in millions) | | |
| Three months ended | $ 14.7 | $ 17.8 | $ (3.1) | (17) % |
| Percentage of total revenue | 4% | 5% | | |

| | | | | |
|---|---|---|---|---|
| Nine months ended | $ 47.8 | $ 46.1 | $ 1.7 | 4% |
| Percentage of total revenue | 5% | 5% | | |

Changes in upfront license revenue are generally attributable to fluctuations in customer license requirements which can drive the amount of upfront revenue in any particular period.

The decrease in upfront license revenue for the three months ended July 31, 2010 compared to the same period in fiscal 2009 was primarily due to a decrease in revenue from upfront term licenses.

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The increase in upfront license revenue for the nine months ended July 31, 2010 compared to the same period in fiscal 2009 was primarily attributable to an increase in revenue from perpetual licenses due to customer requirements.

*Maintenance and Service Revenue*

| | July 31, 2010 | July 31, 2009 | Dollar Change | % Change |
|---|---|---|---|---|
| | | (dollars in millions) | | |
| Three months ended | | | | |
| Maintenance revenue | $ 19.9 | $ 21.0 | $ (1.1) | (5)% |
| Professional services and other revenue | 15.8 | 20.8 | (5.0) | (24)% |
| Total maintenance and services revenue | $ 35.7 | $ 41.8 | $ (6.1) | (15)% |
| Percentage of total revenue | 11% | 12% | | |
| Nine months ended | | | | |
| Maintenance revenue | $ 59.0 | $ 63.3 | $ (4.3) | (7)% |
| Professional services and other revenue | 50.7 | 51.7 | (1.0) | (2)% |
| Total maintenance and services revenue | $ 109.7 | $ 115.0 | $ (5.3) | (5)% |
| Percentage of total revenue | 11% | 11% | | |

Maintenance revenue decreased in the three and nine months ended July 31, 2010 compared to the same periods in fiscal 2009 primarily due to the timing of renewals of maintenance contracts.

Professional services and other revenue decreased in the three and nine months ended July 31, 2010 compared to the same period in fiscal 2009, primarily due to a decrease in customer demand for professional services and a decrease in the number of large contracts completed in fiscal 2010.

***Events Affecting Cost of Revenues and Operating Expenses***

*Functional Allocation of Operating Expenses.* We allocate certain human resource programs, information technology and facility expenses among our functional income statement categories based on headcount within each functional area. Annually, or upon a significant change in headcount (such as a workforce reduction, realignment or acquisition) or other factors, management reviews the allocation methodology and expenses included in the allocation pool.

*Acquisition Expenses.* During the nine months ended July 31, 2010, we made certain acquisitions that were not considered material to our unaudited condensed consolidated financial statements. Beginning in fiscal 2010, the costs arising from such acquisitions are expensed in the period when they are incurred as required by the new accounting standards. Acquisition costs include contract terminations, professional service fees, severance costs for employee terminations and other directly related charges. Prior to fiscal 2010, such costs were recorded as purchase consideration. Our period over period comparisons have been affected to a limited extent by this change in the treatment of acquisition costs and have been included in our analysis in the following paragraphs.

***Cost of Revenue***

| | July 31, 2010 | July 31, 2009 | Dollar Change | % Change |
|---|---|---|---|---|
| | | (dollars in millions) | | |
| Three months ended | | | | |
| Cost of license revenue | $ 44.0 | $ 44.2 | $ (0.2) | <(1)% |
| Cost of maintenance and service revenue | 14.7 | 17.4 | (2.7) | (16)% |

| | | | | |
|---|---|---|---|---|
| Amortization of intangible assets | 8.0 | 8.4 | (0.4) | (5)% |
| Total | $ 66.7 | $ 70.0 | $ (3.3) | (5)% |
| Percentage of total revenue | 20% | 20% | | |
| Nine months ended | | | | |
| Cost of license revenue | $ 130.2 | $ 128.3 | $ 1.9 | 1% |
| Cost of maintenance and service revenue | 46.5 | 48.0 | (1.5) | (3)% |
| Amortization of intangible assets | 24.7 | 24.2 | 0.5 | 2% |
| Total | $ 201.4 | $ 200.5 | $ 0.9 | <1% |
| Percentage of total revenue | 20% | 20% | | |

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We divide cost of revenue into three categories: cost of license revenue, cost of maintenance and service revenue, and amortization of intangible assets. We segregate expenses directly associated with consulting and training services from cost of license revenue associated with internal functions providing license delivery and post-customer contract support services. We then allocate these group costs between cost of license revenue and cost of maintenance and service revenue based on license and maintenance and service revenue reported. Our cost of revenue includes a high percentage of fixed costs and does not generally fluctuate with our revenues.

*Cost of license revenue.* Cost of license revenue includes costs related to products sold and software licensed, allocated operating costs related to product support and distributions costs, royalties paid to third party vendors, and the amortization of capitalized research and development costs associated with software products which have reached technological feasibility.

*Cost of maintenance and service revenue.* Cost of maintenance and service revenue includes operating costs related to maintain the infrastructure necessary to operate our services and training organization, and costs associated with the delivery of our consulting services, such as, hotline and on-site support, production services and documentation of maintenance updates.

*Amortization of intangible assets.* Amortization of acquired intangible assets, which is included in cost of revenue and operating expenses, includes the amortization of core/developed technology, contract rights trademarks, trade names, customer relationships, covenants not to compete and other intangibles related to acquisitions.

The decrease in cost of revenue in the three months ended July 31, 2010 compared to the same period in fiscal 2009 was primarily due to decreases of $1.0 million in the fair value of our deferred compensation plan obligation, $1.2 million in personnel related costs from lower consulting services and $1.0 million in material costs. These decreases were offset by an increase of $1.0 million in functionally allocated expenses driven by increased headcount from our current and prior year acquisitions.

The slight increase in cost of revenue for the nine months ended July 31, 2010 compared with the same period in fiscal 2009 was primarily due to employee related costs driven by increased headcount from our current and prior year acquisitions.

***Operating Expenses***

*Research and Development*

| | July 31, | | Dollar | % |
|---|---|---|---|---|
| | **2010** | **2009** | **Change** | **Change** |
| | | **(dollars in millions)** | | |
| Three months ended | $ 105.6 | $ 105.0 | $ 0.6 | 1% |
| Percentage of total revenue | 31% | 30% | | |
| Nine months ended | $ 319.9 | $ 305.8 | $ 14.1 | 5% |
| Percentage of total revenue | 32% | 30% | | |

Research and development expense in the three months ended July 31, 2010 compared to the same period in fiscal 2009 was relatively flat. The increases in personnel related costs of $2.8 million and $1.3 million in functionally allocated expenses as a result of headcount increases primarily from our current and prior year acquisitions were partially offset by the decrease of $3.9 million in the fair value of our deferred compensation plan obligation.

The increase in research and development expense for the nine months ended July 31, 2010 compared with the same period in fiscal 2009 was primarily due to increases of $12.1 million in personnel related costs and $4.9 million in functionally allocated expenses, as a result of headcount increases primarily from our current and prior year acquisitions.

*Sales and Marketing*

| | July 31, | | Dollar | % |
|---|---|---|---|---|
| | **2010** | **2009** | **Change** | **Change** |
| | | **(dollars in millions)** | | |

| | | | | |
|---|---|---|---|---|
| Three months ended | $ 83.8 | $ 78.0 | $ 5.8 | 7% |
| Percentage of total revenue | 25% | 23% | | |
| Nine months ended | $ 242.8 | $ 237.9 | $ 4.9 | 2% |
| Percentage of total revenue | 24% | 23% | | |

The increase in sales and marketing expenses for the three months ended July 31, 2010 compared to the same period in fiscal 2009 was primarily due to an increase of $8.7 million in variable compensation driven by timing of shipments based on contract requirements, offset by a decrease of $2.5 million in the fair value of our deferred compensation plan obligation.

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The increase in sales and marketing expenses for the nine months ended July, 31, 2010 compared to the same period in fiscal 2009 was primarily due to an increase of $13.4 million in variable compensation driven by timing of shipments based on contract requirements, offset by a decrease of $4.8 million of other sales and marketing expenses including expenses related to employee conferences and consulting services.

*General and Administrative*

| | July 31, | | Dollar | % |
|---|---|---|---|---|
| | 2010 | 2009 | Change | Change |
| | | (dollars in millions) | | |
| Three months ended | $ 27.4 | $ 27.7 | $ (0.3) | (1)% |
| Percentage of total revenue | 8% | 8% | | |
| Nine months ended | $ 81.9 | $ 83.6 | $ (1.7) | (2)% |
| Percentage of total revenue | 8% | 8% | | |

General and administrative expenses for the three months ended July 31, 2010 compared to the same period in fiscal 2009 were flat. The decrease of $3.3 million in functionally allocated expenses, driven by reduced headcount, and $1.2 million in the fair value of our deferred compensation plan obligation were partially offset by an increase of $1.1 million in loss on exit of a capital lease transaction, an increase of $1.0 million in facility costs and an increase of $2.2 million in acquisition related costs.

The decrease in general and administrative expenses for the nine months ended July 31, 2010 compared to the same period in fiscal 2009 was primarily due to a $8.9 million decrease in functionally allocated expenses driven by reduced headcount, and partially offset by an increase of $1.1 million in loss upon exit of a capital lease obligation, an increase of $2.6 million in facility costs and an increase of $5.9 million in acquisition related costs.

*Amortization of Intangible Assets*

| | July 31, | | Dollar | % |
|---|---|---|---|---|
| | 2010 | 2009 | Change | Change |
| | | (dollars in millions) | | |
| Three months ended | | | | |
| Included in cost of revenue | $ 8.0 | $ 8.4 | $ (0.4) | (5)% |
| Included in operating expenses | 2.6 | 3.0 | (0.4) | (13)% |
| Total | $ 10.6 | $ 11.4 | $ (0.8) | (7)% |
| Percentage of total revenue | 3% | 3% | | |
| Nine months ended | | | | |
| Included in cost of revenue | $ 24.7 | $ 24.2 | $ 0.5 | 2% |
| Included in operating expenses | 8.3 | 9.7 | (1.4) | (14)% |
| Total | $ 33.0 | $ 33.9 | $ (0.9) | (3)% |
| Percentage of total revenue | 3% | 3% | | |

The decrease in amortization of intangible assets was due to certain intangible assets acquired in prior years becoming fully amortized. See Note 6 to Notes to *Unaudited Condensed Consolidated Financial Statements* for a schedule of future amortization amounts.

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***Other (expense) income, net***

| | July 31, 2010 | July 31, 2009 | Dollar Change | % Change |
|---|---|---|---|---|
| | (dollars in millions) | | | |
| Three months ended | | | | |
| Interest income | $ 1.3 | $ 2.4 | $ (1.1) | (46)% |
| (Loss) gain on assets related to deferred compensation plan | (2.2) | 6.1 | (8.3) | (136)% |
| Foreign currency exchange (loss) gain | (1.2) | | (1.2) | (100)% |
| Write-down of long-term investments | (0.5) | (3.4) | 2.9 | (85)% |
| Other (expense) income, net | (0.4) | 0.3 | (0.7) | (233)% |
| Total | $ (3.0) | $ 5.4 | $ (8.4) | (156)% |
| Nine months ended | | | | |
| Interest income | $ 4.5 | $ 8.8 | $ (4.3) | (49)% |
| Gain on assets related to deferred compensation plan | 3.7 | 5.6 | (1.9) | (34)% |
| Foreign currency exchange (loss) gain | (1.2) | 5.7 | (6.9) | (121)% |
| Write-down of long-term investments | (0.5) | (6.3) | 5.8 | (92)% |
| Other income, net | 1.6 | 4.1 | (2.5) | (61)% |
| Total | $ 8.1 | $ 17.9 | $ (9.8) | (55)% |

Other (expense) income, net, decreased during the three and nine months ended July 31, 2010, compared to the same periods in fiscal 2009 primarily due to a decrease in foreign currency exchange gains due to currency fluctuations, a decrease in interest income and a decrease in the fair market value of investments in our non-qualified deferred compensation plan. These decreases were offset by fewer write-downs of long-term investments as compared to the same period in fiscal 2009.

***Taxes***

See Note 15 of the *Notes to Unaudited Condensed Consolidated Financial Statements*.

***Liquidity and Capital Resources***

Our sources of cash, cash equivalents and short-term investments are funds generated from our business operations and funds that may be drawn down under our credit facility.

The following sections discuss changes in our balance sheet and cash flows, and other commitments on our liquidity and capital resources during the nine months ended July 31, 2010.

*Cash and Cash Equivalents and Short-Term Investments*

| | July 31, 2010 | October 31, 2009 | Dollar Change | % Change |
|---|---|---|---|---|
| | (dollars in millions) | | | |
| Cash and cash equivalents | $ 883.4 | $ 701.6 | $ 181.8 | 26% |
| Short-term investments | 326.4 | 466.7 | (140.3) | (30)% |
| Total | $ 1,209.8 | $ 1,168.3 | $ 41.5 | 4% |

During the nine months ended July 31, 2010, our primary sources and uses of cash consisted of (1) cash provided by operating activities of $244.1 million, (2) proceeds from sales and maturities of short-term investments of $352.1 million, (3) purchases of investments of $209.6 million, (4) cash paid for acquisitions and intangibles assets, net of cash acquired of $137.7 million, (5) proceeds from exercises of stock options of $87.2 million, and (6) repurchases of common stock of $125.3 million.

We hold our cash, cash equivalents and short-term investments in the United States and in foreign accounts, primarily in Ireland, Bermuda, and Japan. As of July 31, 2010, we held an aggregate of $584.4 million in cash, cash equivalents and short-term investments in the United States and an aggregate of $625.4 million in foreign accounts. Funds in foreign accounts are generated from revenue outside North America. At present, such foreign funds are considered to be indefinitely reinvested in foreign countries to the extent of indefinitely reinvested foreign earnings.

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*Cash Flows*

| | July 31, 2010 | July 31, 2009 | Dollar Change | % Change |
|---|---|---|---|---|
| | (dollars in millions) | | | |
| Nine months ended | | | | |
| Cash provided by operating activities | $ 244.1 | $ 175.2 | $ 68.9 | 39% |
| Cash used in investing activities | (24.8) | (162.1) | 137.3 | (85)% |
| Cash (used in) provided by financing activities | (41.6) | 27.6 | (69.2) | (251)% |

*Cash provided by operating activities.* Cash provided by operations is dependent primarily upon the payment terms of our license agreements. To be classified as upfront revenue, we require that 75% of a term or perpetual license fee be paid within the first year. Conversely, payment terms for TSLs are generally extended and the license fee is typically paid either quarterly or annually in even increments over the term of the license. Accordingly, we generally receive cash from upfront license revenue much sooner than from time-based license revenue.

Cash provided by operating activities increased in the nine months ended July 31, 2010 compared to same period in fiscal 2009 primarily due to increased cash received from customers as a result of timing of billings, decreased bonus and commission payments and lower payments to vendors.

*Cash used in investing activities.* The decrease in cash used in investing activities in the nine months ended July 31, 2010 compared to same period in fiscal 2009 primarily relates to an increase in the sale of short-term investments in preparation for our acquisition of Virage Logic Corporation, offset by cash paid for acquisitions.

*Cash (used in) provided by financing activities.* The decrease in cash from financing activities in the nine months ended July 31, 2010 compared to same period in fiscal 2009 primarily relates to common stock repurchases under our stock repurchase program, partially offset by issuance of our common stock under our stock compensation plans. See Note 10 of *Notes to Unaudited Condensed Consolidated Financial Statements* for details of our stock repurchase program.

Cash used in or provided by our activities may fluctuate in future periods as a result of a number of factors, including timing of our billings and collections, our operating results, the timing and amount of tax and other liability payments and cash used in any future acquisitions and stock repurchases.

*Accounts Receivable, net*

| July 31, 2010 | October 31, 2009 | Dollar Change | % Change |
|---|---|---|---|
| (dollars in millions) | | | |
| $ 148.6 | $127.0 | | |