SYNOPSYS INC
Form 10-Q
September 06, 2006

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, 2006

OR

o 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 incorporation or organization)	(I.R.S. Employer 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 o

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

Large accelerated filer x Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

141,087,721 shares of Common Stock as of September 2, 2006

SYNOPSYS, INC.

QUARTERLY REPORT ON FORM 10-Q

JULY 31, 2006

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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, 2006	**October 31, 2005**
ASSETS		
Current assets:		
Cash and cash equivalents	$ 269,717	$ 404,436
Short-term investments	241,557	182,070
Total cash, cash equivalents and short-term investments	511,274	586,506
Accounts receivable, net	110,875	100,178
Deferred income taxes	89,704	195,501
Income taxes receivable	46,254	48,370
Prepaid expenses and other current assets	23,118	16,924
Total current assets	781,225	947,479
Property and equipment, net	164,278	170,195
Long-term investments	4,616	8,092
Goodwill	744,493	728,979
Intangible assets, net	113,595	142,519
Long-term deferred income taxes	188,890	82,384
Other assets	68,284	61,828
Total assets	$ 2,065,381	$ 2,141,476
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 195,279	$ 231,359
Accrued income taxes	163,973	169,632
Deferred revenue	428,607	415,689
Total current liabilities	787,859	816,680
Deferred compensation and other liabilities	75,566	63,841
Long-term deferred revenue	45,417	42,019
Total liabilities	908,842	922,540
Stockholders equity:		
Preferred Stock, $0.01 par value; 2,000 shares authorized; none outstanding		
Common Stock, $0.01 par value; 400,000 shares authorized; 140,409 and 145,897 shares outstanding, respectively	1,404	1,459
Additional paid-in capital	1,307,569	1,263,952
Retained earnings	175,667	171,108
Treasury stock, at cost; 16,769 and 11,259 shares, respectively	(315,402)	(199,482)
Deferred stock compensation		(2,100)
Accumulated other comprehensive loss	(12,699)	(16,001)
Total stockholders equity	1,156,539	1,218,936
Total liabilities and stockholders equity	$ 2,065,381	$ 2,141,476

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, 2006	2005	Nine Months Ended July 31, 2006	2005
Revenue:				
Time-based license	$ 224,782	$ 188,742	$ 645,309	$ 550,807
Upfront license	14,418	16,171	48,744	44,152
Maintenance and service	38,008	46,537	118,123	142,134
Total revenue	277,208	251,450	812,176	737,093
Cost of revenue:				
License (1)	32,665	25,357	95,304	73,611
Maintenance and service (1)	16,201	17,837	49,678	53,335
Amortization of intangible assets	6,579	16,214	21,733	72,278
Total cost of revenue	55,445	59,408	166,715	199,224
Gross margin	221,763	192,042	645,461	537,869
Operating expenses:				
Research and development (1)	93,972	82,679	275,111	237,658
Sales and marketing (1)	81,171	83,573	245,460	249,462
General and administrative (1)	26,692	25,602	84,845	76,371
In-process research and development			800	5,700
Amortization of intangible assets	6,775	7,804	21,247	24,481
Total operating expenses	208,610	199,658	627,463	593,672
Operating income (loss)	13,153	(7,616)	17,998	(55,803)
Other income, net	2,421	37,200	9,745	47,227
Income (loss) before income taxes	15,574	29,584	27,743	(8,576)
Income tax provision (benefit)	8,024	12,290	13,121	(6,573)
Net income (loss)	$ 7,550	$ 17,294	$ 14,622	$ (2,003)
Net income (loss) per share:				
Basic	$ 0.05	$ 0.12	$ 0.10	$ (0.01)
Diluted	$ 0.05	$ 0.12	$ 0.10	$ (0.01)
Shares used in computing per share amounts:				
Basic	142,538	143,830	143,629	144,899
Diluted	143,964	145,668	145,662	144,899

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(1)Includes stock based compensation expense as follows:				
Cost of license revenue	1,594	64	4,544	151
Cost of maintenance and service	778	34	2,362	80
Research and development expense	6,832	307	21,367	972
Sales and marketing expense	3,977	144	12,409	420
General and administrative expense	2,420	103	7,253	167

See accompanying notes to unaudited condensed consolidated financial statements

SYNOPSYS, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

	Nine Months Ended July 31, 2006	2005
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	$ 14,622	$ (2,003)
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization and depreciation	85,546	138,129
Stock based compensation	47,935	1,790
In-process research and development	800	5,700
Deferred income taxes	3,832	(22,058)
Write-down of long-term investments	1,336	2,564
Provision for or (recovery) of doubtful accounts	(125)	(3,594)
Net change in deferred gains and losses on cash flow hedges	(777)	(13,995)
(Gain) loss on sale of short-term investments	(17)	323
Net changes in operating assets and liabilities, net of acquired assets and liabilities:		
Accounts receivable	(9,337)	47,825
Income taxes receivable	33	61
Prepaid expenses and other current assets	(5,220)	9,647
Other assets	(3)	(9,317)
Accounts payable and accrued liabilities	(41,684)	(2,268)
Accrued income taxes	(6,086)	(5,481)
Deferred revenue	15,027	37,851
Deferred compensation and other liabilities	261	9,681
Net cash provided by operating activities	106,143	194,855
CASH FLOWS FROM INVESTING ACTIVITIES:		
Cash paid for acquisitions, net of cash received	(20,850)	(171,420)
Proceeds from sale and maturities of short-term investments	221,311	252,417
Sale of long-term investments	248	
Purchases of short-term investments	(281,126)	(200,256)
Purchases of long-term investments	(1,539)	
Purchases of property and equipment	(34,129)	(34,728)
Capitalization of software development costs	(2,342)	(2,215)
Net cash used in investing activities	(118,427)	(156,202)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuances of common stock	43,139	24,421
Purchases of treasury stock	(169,544)	(88,385)
Proceeds from credit facility		75,000
Payments on credit facility		(75,000)
Net cash used in financing activities	(126,405)	(63,964)
Effect of exchange rate changes on cash and cash equivalents	3,970	(1,444)
Net decrease in cash and cash equivalents	(134,719)	(26,755)
Cash and cash equivalents, beginning of period	404,436	346,709
Cash and cash equivalents, end of period	$ 269,717	$ 319,954

See accompanying notes to unaudited condensed consolidated financial statements.

SYNOPSYS, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

Synopsys, Inc. (the Company) has prepared the accompanying unaudited condensed consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (the Commission). 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 generally accepted accounting principles (GAAP). In management s opinion, the Company has made all adjustments (consisting only of normal, recurring adjustments, except as otherwise indicated) 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, 2005 on file with the Commission.

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 material effects on the Company s operating results and financial position may result.

Certain immaterial amounts in prior year financial statements have been reclassified to conform to the current year presentation. In particular, the Company has reclassified prior year share-based compensation charges into the related functional classifications in the condensed consolidated statements of operations, statements of cash flows and in Note 2. In addition, the Company reclassified prior year compensation charges relating to the Company s deferred compensation plans from other income (expense), net, into the related functional classifications in the condensed consolidated statements of operations. These reclassifications had no impact on net income (loss) for each of the reporting periods presented.

The Company has adopted a fiscal year ending on the Saturday nearest to October 31. The Company s third fiscal quarter ended on the Saturday nearest to July 31 (i.e., July 29). Fiscal 2005 and 2006 are both 52-week years. Fiscal 2007 will be a 53-week fiscal year. For presentation purposes, the unaudited condensed consolidated financial statements and accompanying notes refer to the applicable calendar month end.

2. SHARE-BASED COMPENSATION

Adoption of SFAS 123(R)

On November 1, 2005, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), which requires the measurement and recognition of compensation expense based on estimated fair value for all share-based payment awards including stock options, employee stock purchases under employee stock purchase plans, non-vested share awards (such as restricted stock) and stock appreciation rights. SFAS 123(R) supersedes SFAS 123 Accounting for Stock-Based Compensation (SFAS 123). The Company elected the modified prospective application method, under which prior periods are not restated for comparative purposes to reflect the impact of SFAS 123(R). The modified prospective transition method requires that share-based compensation expense be recorded for (a) any share-based payments granted through, but not yet vested as of October 31, 2005 based on the grant-date fair value estimated in accordance with the pro forma provisions of SFAS 123, and (b) any share-based payments granted or modified subsequent to October 31, 2005, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R).

Prior to November 1, 2005, the Company accounted for its share-based compensation plans using the intrinsic value method under the recognition and measurement provisions of Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees and related guidance. Under the intrinsic value method, the Company did not recognize any significant amount of stock-based compensation expense in the Company s consolidated statements of operations, as options granted under those plans had an exercise price equal to the market value on the date of grant.

The adoption of SFAS 123(R) has had a material effect on the Company s reported financial results since October 31, 2005. The Company recorded approximately $15.6 million and $47.9 million of share-based compensation expense during the three and nine months ended July 31, 2006, respectively.

The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options and employee stock purchase plans awards under SFAS 123(R) which is consistent with that used for pro forma disclosures under SFAS 123, prior to the adoption of SFAS 123(R). The Black-Scholes option-pricing model is subject to certain limitations, since it was developed for use in estimating the fair value of short lived exchange-traded options that have no vesting restrictions and are fully transferable. In addition, the Black-Scholes option-pricing model incorporates various and highly subjective assumptions including expected volatility, expected term and interest rates. The expected volatility is based on historical volatility of the Company s common stock over the most recent period commensurate with the estimated expected term of the Company s stock options. The expected term of the Company s stock options are based on its historical experience.

The assumptions used to estimate the fair value of stock options granted under our stock option plans and stock purchase rights granted under our employee stock purchase plans for the three and nine months ended July 31, 2006 and 2005 are as follows:

	Three Months Ended		**Nine Months Ended**	
Options	**July 31, 2006**	**July 31, 2005**	**July 31, 2006**	**July 31, 2005**
Volatility	39.98% - 40.92%	48.61%	39.98% - 43.47%	48.61% - 53.98%
Expected term (years)	3.8%	5.0	3.8	5.0
Risk free interest rate	4.93% - 5.03%	3.86%	4.29% - 5.03%	3.60% - 3.99%
Expected dividend yield	0%	0%	0%	0%
Weighted average grant date fair value	$ 7.27	$ 8.03	$ 8.01	$ 8.45
ESPP				
Volatility	21.62% - 40.33%	53.98%	21.62% - 51.54%	28.57% - 53.98%
Expected term (years)	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0	0.5 - 2.0
Risk free interest rate	4.69% - 4.75%	2.68%	3.00% - 4.75%	2.68%
Expected dividend yield	0%	0%	0%	0%
Weighted average grant date fair value	$ 7.96	$ 6.43	$ 6.87	$ 6.42

Prior to the adoption of SFAS 123(R), the Company provided the disclosures required under SFAS 148. The following table illustrates the effect on net income (loss) and net income (loss) per share, net of tax effects, for the three and nine months ended July 31, 2005 if the Company had applied the fair value recognition provisions of SFAS 123 to share-based awards.

	Three Months Ended July 31, 2005	**Nine Months Ended July 31, 2005**
	(in thousands, except per share amounts)	
Net income (loss)	$ 17,294	$ (2,003)
Add: Share-based employee compensation expense included in reported net income (loss), as reported under APB 25, net of related tax effects	265	960
Deduct: Total share-based employee compensation expense determined under the fair value based method for all awards, net of related tax effects	(28,741)	(69,327)
Pro-forma net loss under SFAS 123	$ (11,182)	$ (70,370)
Net income (loss) per share:		
Basic and diluted - as reported	$ 0.12	$ (0.01)
Basic and diluted - pro forma	$ (0.08)	$ (0.49)

As of July 31, 2006, $86.9 million of total unrecognized compensation cost related to stock awards is expected to be recognized over a weighted-average period of 1.7 years. The total intrinsic values of options exercised in the third quarter of fiscal 2006 and fiscal 2005 were $0.9 million and $3.7 million, respectively, and $8.3 million and $5.3 million for the nine months ended July 31, 2006 and 2005, respectively.

In March 2005, the Commission issued Staff Accounting Bulletin No. 107 (SAB 107), which provided supplemental implementation guidance for SFAS 123(R). SAB 107 requires share-based compensation to be classified in the same expense line items as cash compensation. Accordingly, the Company recorded share-based compensation as follows for the three and nine months ended July 31, 2006 and 2005 (in thousands):

	Three Months Ended July 31,		Nine Months Ended July 31,	
(in thousands, except per share amounts)	**2006**	**2005**	**2006**	**2005**
Cost of license	$ 1,594	$ 64	$ 4,544	$ 151
Cost of maintenance and service	778	34	2,362	80
Research and development expense	6,832	307	21,367	972
Sales and marketing expense	3,977	144	12,409	420
General and administrative expense	2,420	103	7,253	167
Share-based compensation expense before taxes	15,601	652	47,935	1,790
Income tax benefit	(3,424)	(168)	(10,520)	(610)
Share-based compensation expense after taxes	$ 12,177	$ 484	$ 37,415	$ 1,180
Effect on net income per share:				
Basic	$ 0.09	$	$ 0.26	$
Diluted	$ 0.08	$	$ 0.26	$

Prior to the adoption of SFAS 123(R), the Company presented deferred compensation as a separate component of stockholders equity. In accordance with the provisions of SFAS 123(R), on November 1, 2005, the Company reclassified the balance in deferred compensation to additional paid-in capital on its balance sheet.

The Company included all tax benefits for deductions resulting from the exercise of stock options as operating cash flows in its statement of cash flows prior to the adoption of SFAS 123(R). SFAS 123(R) requires the cash flows resulting from the tax benefits for tax deductions in excess of the compensation expense recorded for those options (excess tax benefits) to be classified as cash from financing activities. Under SFAS 123(R), the Company uses the straight-line attribution method to recognize share-based compensation costs over the service period of the award. To calculate the excess tax benefits available for use in offsetting future tax shortfalls as of the date of implementation, the Company follows the alternative transition method discussed in Financial Accounting Standards Board (FASB) Staff Position No. 123(R)-3. There was no material impact to the Company s financial statements upon adoption of the alternative transition method in the third quarter of fiscal 2006. The Company has not recorded any excess tax benefits during fiscal 2006.

Stock Benefit Plans

Employee Stock Purchase Plan

Under the Company s Employee Stock Purchase Plan and International Employee Stock Purchase Plan (collectively, the ESPP), employees are granted the right to purchase shares of common stock at a price per share that is 85% of the lesser of the fair market value of the shares at (i) the beginning of a rolling two-year offering period or (ii) the end of each semi-annual purchase period, subject to a plan limit on the number of shares that may be purchased in a purchase period. During the nine months ended July 31, 2006 and 2005, the Company issued 1,303,811 and 998,229 shares, respectively, under the ESPP at average per share prices of $13.67 and $13.43, respectively. As of July 31, 2006, 6,524,223 shares of common stock were reserved for future issuance under the ESPP.

Stock Option Plans

2006 Employee Equity Incentive Plan

On April 25, 2006, the Company s stockholders approved the 2006 Employee Equity Incentive Plan (the 2006 Employee Plan), which provides for the grant of incentive stock options, non-statutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, and other forms of equity compensation as determined by the plan administrator. The 2006 Employee Plan also provides the ability to grant performance stock awards and performance cash awards. The terms and conditions of each type of award are set forth in the 2006 Employee Plan. The Company expects

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that options granted under this plan will have a term of seven years. As of July 31, 2006, an aggregate of 439,100 stock options were outstanding under this plan.

As a result of the stockholders approval of the 2006 Employee Plan, the Company s 1992 Stock Option Plan, 1998 Non-Statutory Stock Option Plan and 2005 Assumed Stock Option Plan (collectively, the Prior Plans) have been terminated as to future grants. Should any options currently outstanding under such plans and plans assumed by the Company in acquisitions (36,354,186 options as of July 31, 2006) expire unexercised, they shall become available for future grant under the 2006 Employee Plan.

An aggregate of 47,497,248 shares are reserved for issuance under the 2006 Employee Plan (inclusive of the options previously granted under the Prior Plans and options assumed by the Company in acquisitions). An aggregate of 10,418,232 shares were available for future issuance under the 2006 Employee Plan as of July 31, 2006.

1992 Stock Option Plan

Under the Company s 1992 Stock Option Plan (the 1992 Plan), 38,866,356 shares of common stock were originally authorized for issuance. Pursuant to the 1992 Plan, the Board of Directors (the Board) could grant either incentive or non-qualified stock options to purchase shares of common stock to employees or consultants, excluding non-employee directors at not less than 100% of the fair market value of those shares on the grant date. Stock options granted under the 1992 Plan generally vest over a period of four years and expire seven to ten years from the date of grant. The 1992 Plan was terminated as to future grants in connection with approval of the 2006 Employee Plan. As of July 31, 2006, 8,957,395 stock options remained outstanding under this plan.

Under the 1992 Plan, in December 2005 and January 2006, certain executive officers of the Company were granted an aggregate of 420,000 stock options the vesting of which is contingent upon the Company meeting certain operating margin performance goals in fiscal years 2006 and 2007. These stock options have exercise prices equal to the fair market value of the underlying common stock on the date of grant, contingently vest over two years and have a term of seven years. Share-based compensation expense is being recorded assuming that performance goals will be achieved.

1998 Non-Statutory Stock Option Plan

Under the Company s 1998 Non-Statutory Stock Option Plan (the 1998 Plan), 50,295,546 shares of common stock were originally authorized for issuance. Pursuant to the 1998 Plan, the Board could grant nonqualified stock options to employees or consultants, excluding executive officers. Exercisability, option price and other terms were determined by the Board but the option price could not be less than 100% of the fair market value of those shares on the grant date. Stock options granted under the 1998 Plan generally vest over a period of four years and expire seven to ten years from the date of grant. The 1998 Plan was terminated as to future grants in connection with approval of the 2006 Employee Plan. As of July 31, 2006, 24,303,467 stock options remained outstanding under this plan.

2005 Assumed Stock Option Plan

Under the Company s 2005 Assumed Stock Option Plan (formerly, the Nassda Corporation 2001 Stock Option Plan, the 2005 Plan), an aggregate of 3,427,529 shares of common stock were originally authorized for issuance. Pursuant to the 2005 Plan, the Compensation Committee of the Board or its designee could grant nonqualified stock options to employees or consultants of the Company who either were (i) not employed by the Company or any of its subsidiaries on May 11, 2005 or (ii) providing services to Nassda Corporation (or any subsidiary corporation thereof) prior to May 11, 2005. Exercisability, option price and other terms were determined by the Board but the option price could not be less than 100% of the fair market value of those shares on the grant date. Stock options granted under the 2005 Plan generally vest over a period of four years and expire seven to ten years from the date of grant. The 2005 Plan was terminated as to future grant in connection with approval of the 2006 Employee Plan. As of July 31, 2006, 1,265,065 stock options remained outstanding under this plan.

2005 Non-Employee Directors Equity Incentive Plan

On May 23, 2005, the Company s stockholders approved the 2005 Non-Employee Directors Equity Incentive Plan (the 2005 Directors Plan) and the reservation of 300,000 shares of common stock for issuance there under. The Directors Plan provides for annual equity awards to non-employee directors in the form of either stock options or restricted stock. Stockholders approved a 450,000 share increase in the number of shares reserved for issuance under the Directors Plan on April 25, 2006. The Company issued non-employee directors an aggregate of 34,512 shares of restricted stock at market value with an aggregate value of approximately $0.8 million in April 2006. An aggregate of 76,572 shares of

restricted stock were granted under the plan as of July 31, 2006. The share-based compensation expense related to these shares will be amortized over the vesting period of three years. As of July 31, 2006, 673,428 shares of common stock were reserved for future grant under the Directors Plan.

1994 Non-Employee Directors Stock Option Plan

An aggregate of 1,080,162 stock options remained outstanding under the Company s 1994 Non-Employee Directors Stock Option Plan as of July 31, 2006, which expired as to future grants in October 2004.

Plans Assumed in Acquisitions

The Company has assumed certain option plans in connection with business combinations with respect to stock options outstanding at the time of such business combinations. Generally, the options granted under these plans have terms similar to the Company s own options. The exercise prices of such options have been adjusted to reflect the relative exchange ratios. No shares are reserved for future grant under these plans, although should such options be canceled or expire unexercised, they shall become available for future grant under the 2006 Employee Plan. As of July 31, 2006, an aggregate of 1,828,259 such options were outstanding.

The following table summarizes stock option activity during the three and nine months ended July 31, 2006 under all plans:

(in thousands, except per share and life amounts)	Options Available for Grant (1)	Options Outstanding	Weighted Average Exercise Price per Share	Weighted-Average Remaining Contractual Life (In Years)	Aggregate Intrinsic Value (2)
Balance at October 31, 2005	13,012	36,491	$ 19.92		
Granted	(3,992)	3,992	$ 20.99		
Exercised		(653)	$ 15.97		
Canceled	592	(865)	$ 21.66		
Balance at January 31, 2006	9,612	38,965	$ 20.06	5.41	$ 110,037
Options reserved for grant	359		$		
Granted	(363)	363	$ 22.24		
Exercised		(651)	$ 15.61		
Canceled	693	(401)	$ 20.48		
Balance at April 30, 2006	10,301	38,276	$ 20.15	5.17	$ 105,118
Granted	(443)	443	$ 19.49		
Exercised		(286)	$ 19.74		
Canceled	560	(560)	$ 20.80		
Balance at July 31, 2006	10,418	37,873	$ 20.16	4.94	$ 22,857
Vested and expected to vest at July 31, 2006		37,359	$ 20.18	4.92	$ 22,634
Exercisable at July 31, 2006		27,594	$ 20.58	4.51	$ 18,409

(1) Excludes 673,428 shares reserved for future issuance under the 2005 Non-Employee Directors Equity Incentive Plan, which may be issued as restricted stock or stock options.

(2) The aggregate intrinsic value in the preceding table represents the total pretax intrinsic value, based on the Company s closing stock price of $17.78 as of July 31, 2006, which would have been received by the option holders had all option holders exercised their options as of that date.

The following table summarizes significant ranges of outstanding and exercisable options as of July 31, 2006.

	Options Outstanding			**Exercisable Options**		
Range of Exercise Prices	**Number Outstanding (in thousands)**	**Weighted-Average Remaining Contractual Life (In Years)**	**Weighted-Average Exercise Price**	**Number Exercisable (in thousands)**	**Weighted-Average Remaining Contractual Life (In Years)**	**Weighted-Average Exercise Price**
$0.05 - $16.13	6,563	4.67	$ 14.85	5,618	4.32	$ 14.80
$16.14 - $17.16	4,343	5.16	$ 17.07	1,892	4.66	$ 17.01
$17.17 - $18.08	3,947	5.02	$ 17.70	2,251	4.64	$ 17.77
$18.09 - $19.75	5,206	3.80	$ 19.13	4,451	3.44	$ 19.22
$19.76 - $21.10	5,188	6.25	$ 20.75	1,822	5.99	$ 20.49
$21.10 - $24.93	8,224	4.88	$ 22.94	7,397	4.68	$ 23.04
$24.94 - $30.00	3,510	4.71	$ 27.99	3,358	4.58	$ 27.98
$30.00 and over	892	6.06	$ 31.40	805	5.93	$ 31.28
	37,873	4.94	$ 20.16	27,594	4.51	$ 20.58

The following table summarizes unvested restricted stock activity for the three and nine months ended July 31, 2006.

(in thousands, except per share amounts)	**Number of Shares**	**Weighted-Average Grant Date Fair Value**
Unvested shares at October 31, 2005	36	$ 17.83
Granted		$
Vested	(3)	$ 17.83
Forfeited		$
Unvested shares at March 31, 2006	33	$ 17.83
Granted	35	$ 21.73
Vested	(4)	$ 17.83
Forfeited		$
Unvested shares at April 30, 2006	64	$ 19.94
Granted		$
Vested	(6)	$ 19.59
Forfeited		$
Unvested shares at July 31, 2006	58	$ 19.98

3. BUSINESS COMBINATIONS

Acquisition of Virtio Corporation, Inc. (Virtio)

The Company acquired Virtio on May 15, 2006 in an all-cash transaction.

Reasons for the Acquisition. The Company believes that its acquisition of Virtio will expand its presence in electronic system level design. The Company expects the combination of the Company s System Studio solution with Virtio s virtual prototyping technology will help accelerate systems to market by giving software developers the ability to begin code development earlier than with prevailing methods. The acquisition also puts the Company in a unique position to provide an integrated implementation, verification and intellectual property solution to speed up hardware and software development. The results of operations of Virtio are included in the Company s accompanying unaudited condensed consolidated statement of operations since the date of the acquisition. The Company does not consider the acquisition of Virtio to be material to its results of operations, and therefore is not presenting pro forma statements of operations for the three and nine months ended July 31, 2006 and 2005.

Purchase Price. The Company paid $9.1 million in cash at close for the outstanding shares of Virtio, of which $0.9 million has been deposited with an escrow agent and which will be paid to the former stockholders of Virtio pursuant to the terms of an escrow agreement. In addition, the Company had a prior investment in Virtio for $1.7 million. The total purchase consideration consisted of:

	(in thousands)
Cash paid	$ 9,076
Prior investment in Virtio	1,664
Acquisition-related costs	713
Total purchase price	$ 11,453

Acquisition-related costs of $0.7 million consist primarily of legal, tax and accounting fees, estimated facilities closure costs and employee termination costs. As of July 31, 2006, the Company had paid $0.2 million of the acquisition-related costs. The $0.5 million balance remaining at July 31, 2006 primarily consists of professional and tax-related service fees and facilities closure costs.

Under the agreement with Virtio, the Company has also agreed to pay up to $4.3 million over three years to the former stockholders based upon achievement of certain sales milestones. This contingent consideration is considered to be additional purchase price and will be an adjustment to goodwill when and if payment is made. Additionally, the Company has also agreed to pay $0.9 million in employee retention bonuses which will be recognized as compensation expense over the service period of the applicable employees.

Assets Acquired. The Company has performed a preliminary valuation and allocated the total purchase consideration to the assets and liabilities acquired, including identifiable intangible assets based on their respective fair values on the acquisition date. The Company acquired $2.5 million of intangible assets consisting of $1.9 million in existing technology, $0.4 million in customer relationships and $0.2 million in non-compete agreements to be amortized over five to seven years. Additionally, the Company acquired assets of $0.6 million and assumed liabilities of $1.5 million.

Goodwill, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired in the merger was $9.9 million, will neither be amortized nor deductible for tax purposes. Goodwill resulted primarily from the Company s expectation of synergies from the integration of Virtio s technology with the Company s technology and operations.

Acquisition of HPL Technologies, Inc. (HPL)

The Company acquired HPL on December 7, 2005 in an all-cash transaction.

Reasons for the Acquisition. The Company believes that the acquisition of HPL will help solidify the Company s position as a leading electronic design automation vendor in design for manufacturing (DFM) software and will give the Company a comprehensive design-to-silicon flow that links directly into the semiconductor manufacturing process. Integrating HPL s yield management and test chip technologies into the Company s industry-leading DFM portfolio is also expected to enable customers to increase their productivity and improve profitability in the design and manufacture of advanced semiconductor devices. The results of operations of HPL are included in the Company s accompanying unaudited condensed consolidated statement of operations since the date of the acquisition. The Company does not consider the acquisition of HPL to be material to its results of operations, and therefore is not presenting pro forma statements of operations for the three and nine months ended July 31, 2006 and 2005.

Purchase Price. The Company paid $11.0 million in cash on December 7, 2005 for all outstanding shares of HPL. In addition, the Company had a prior investment in HPL for $1.9 million. The total purchase consideration consisted of:

	(in thousands)
Cash paid	$ 11,001
Prior investment in HPL	1,872
Acquisition-related costs	2,831
Total purchase price	$ 15,704

Acquisition-related costs of $2.8 million consist primarily of legal, tax and accounting fees of $1.6 million, $0.3 million of estimated facilities closure costs and other directly related charges, and $0.9 million in employee termination

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costs. As of July 31, 2006, the Company had paid $2.2 million of the acquisition related costs, of which $1.1 million were for professional services costs, $0.2 million were for facilities closure costs and $0.9 million were for employee termination costs. The $0.6 million balance remaining at July 31, 2006 consists of professional and tax-related service fees and facilities closure costs.

Assets Acquired. The Company acquired $8.5 million of intangible assets consisting of $5.1 million in core developed technology, $3.2 million in customer relationships and $0.2 million in backlog to be amortized over two to four years. Approximately $0.8 million of the purchase price represents the fair value of acquired in-process research and development projects that have not yet reached technological feasibility and have no alternative future use. Accordingly, the amount was immediately expensed and included in the Company s condensed consolidated statement of operations for the first quarter of fiscal year 2006. Additionally, the Company acquired assets of $7.6 million and assumed liabilities of $10.2 million.

Goodwill, representing the excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired in the merger was $9.0 million, will be neither amortized nor deductible for tax purposes. Goodwill resulted primarily from the Company s expectation of synergies from the integration of HPL s technology with the Company s technology and operations.

4. GOODWILL AND INTANGIBLE ASSETS

The Company s aggregate goodwill as of July 31, 2006 consist of:

	(in thousands)
Balance at October 31, 2005	$ 728,979
HPL goodwill(1)	9,043
Virtio goodwill	9,879
Adjustments(2)	(3,408)
Balance at July 31, 2006	$ 744,493

Intangible assets as of July 31, 2006 consist of:

	Gross Assets	Accumulated Amortization (in thousands)	Net Assets
Customer relationships	$ 140,540	$ 88,136	$ 52,404
Acquired core/developed technology	323,511	274,946	48,565
Contract rights/backlog	66,070	62,495	3,575
Other intangibles(3)	8,883	5,336	3,547
Covenants not to compete	12,944	11,215	1,729
Capitalized software development costs	13,327	9,552	3,775
Trademarks and trade names	18,007	18,007	
Total intangible assets	$ 583,282	$ 469,687	$ 113,595

Intangible assets as of October 31, 2005 consist of:

	Gross Assets	Accumulated Amortization (in thousands)	Net Assets
Customer relationships	$ 136,940	$ 70,125	$ 66,815
Acquired core/developed technology	314,975	256,413	58,562
Contract rights /backlog	65,870	60,528	5,342
Other intangibles	7,883	3,051	4,832
Covenants not to compete	12,744	9,074	3,670
Capitalized software development costs	10,587	7,331	3,256
Trademarks and trade names	18,007	17,965	42
Total intangible assets	$ 567,006	$ 424,487	$ 142,519

Total amortization expense related to intangible assets is set forth in the table below:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005	2006	2005
		(in thousands)		
Customer relationships	$ 6,039	$ 5,819	$ 18,011	$ 16,728
Acquired core/developed technology	5,585	13,740	18,533	60,093
Contract rights/backlog	519	2,441	1,967	12,087
Other intangibles	740	654	2,285	2,000
Covenants not to compete	472	847	2,141	2,373
Capitalized software development costs(4)	769	691	2,221	2,041
Trademarks and trade names		517	42	3,518
Total amortization expense	$ 14,124	$ 24,709	$ 45,200	$ 98,840

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(1) During the second quarter of fiscal year 2006, the Company completed the valuation analysis of HPL s tangible and intangible assets as well as a net operating loss study. As a result of the analysis, goodwill was decreased by $0.5 million from the amount reported in the first quarter of fiscal year 2006. The net operating loss study resulted in $4.5 million decrease to goodwill and an equal and offsetting increase to net deferred tax assets from the amount reported in the first quarter of fiscal year 2006. In addition, during the third quarter of fiscal year 2006, the Company decreased HPL goodwill by $0.3 million primarily related to tax adjustments.

(2) Primarily relates to a $3.9 million correction of deferred tax liabilities related to intangible assets acquired in fiscal year 2005, offset by adjustments to tax liabilities and merger costs.

(3) Represents an increase of $1.0 million upon payment of additional consideration, upon reaching certain milestones, due as a result of an acquisition of assets in fiscal 2005.

(4) Amortization of capitalized software development is included in cost of license in the condensed consolidated statements of operations.

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

	(in thousands)
Three months ending October 31, 2006	$ 13,960
Fiscal Year	
2007	49,514
2008	30,955
2009	14,246
2010	3,553
2011 and thereafter	1,367
Total estimated future amortization of intangible assets	$ 113,595

5. STOCK REPURCHASE PROGRAM

The Company is authorized to repurchase up to $500 million of its common stock under a stock repurchase program previously established by the Company s Board in 2001. The stock repurchase program had been renewed and replenished up to the $500 million maximum annually through December 2004. During the three and nine months ended July 31, 2006, the Company repurchased approximately 3.7 million shares at an average price of $19.01 per share and 8.4 million shares at an average price of $20.14 per share, respectively, for a total repurchase of $169.5 million during the nine month period. During the three and nine months ended July 31, 2005, the Company repurchased approximately 0.2 million shares at an average price of approximately $16.65 per share and 5.1 million shares at an average price of approximately $17.20 per share, respectively, for a total purchase of $88.4 million during the nine month period. As of July 31, 2006, $267.1 million remained available for further purchases under the program.

6. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities consist of:

	July 31 2006 (in thousands)	October 31, 2005
Payroll and related benefits	$ 125,466	$ 157,915
Acquisition-related costs	3,137	6,616
Other accrued liabilities	52,193	54,772
Accounts payable	14,483	12,056
Total accounts payable and accrued liabilities	$ 195,279	$ 231,359

7. CREDIT FACILITY

In April 2004, the Company entered into a three-year, $250.0 million senior unsecured revolving credit facility. This facility contains financial covenants requiring that the Company maintain a minimum leverage ratio and specified levels of cash, as well as other non-financial covenants. The facility terminates on April 28, 2007. 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 Euro dollar rates plus a spread between 0.80% and 1.125% based on a pricing grid tied to a financial covenant. In addition, commitment fees are payable on the facility at rates between 0.20% and 0.25% per annum based on a pricing grid tied to a financial covenant. As of July 31, 2006, the Company had no outstanding borrowings under this credit facility and was in compliance with all covenants.

8. COMPREHENSIVE INCOME (LOSS)

The following table sets forth the components of comprehensive income (loss), net of tax:

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005 (in thousands)	2006	2005
Net income (loss)	$ 7,550	$ 17,294	$ 14,622	$ (2,003)
Unrealized gain (loss) on investments, net of tax effect of $125 and $96 for the three and nine months ended July 31, 2006, respectively, and of $(783) and $(647) for each of the same periods in fiscal 2005, respectively	199	(1,061)	(143)	(847)
Correction of error in accounting for certain hedging transactions, net of tax effect of $1,150 for the nine months ended July 31, 2005(1)				(1,808)
Deferred gain (loss) on cash flow hedges, net of tax effect of $353 and $524 for three and nine months ended July 31, 2006, respectively, and $1,682 and $446 for each of the same periods in fiscal 2005, respectively	(663)	(2,250)	(967)	(360)
Reclassification adjustment on deferred gain (loss) on cash flow hedges, net of tax effect of $(61) and $(334) for the three and nine months ended July 31, 2006, respectively, and $62 and $3,546 for each of the same periods in fiscal 2005, respectively	86	(97)	380	(6,524)
Foreign currency translation adjustment	2,949	(1,754)	4,032	(4,209)
Total comprehensive income (loss)	$ 10,121	$ 12,132	$ 17,924	$ (15,751)

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(1) See Note 12 for further explanation.

9. NET INCOME (LOSS) PER SHARE

In accordance with Statement of Financial Accounting Standards No. 128, Earnings per Share (SFAS 128), the Company computes basic income (loss) per share by dividing net income (loss) available to common shareholders by the weighted average number of common shares outstanding during the period (excluding the dilutive effect of stock options and unvested restricted stock). Diluted income per share reflects the dilution of potential common shares outstanding during the period using the treasury stock method. In computing diluted income (loss) per share, the Company adjusts the share count by assuming options are exercised and that the Company repurchases shares with the proceeds of these hypothetical exercises along with the tax benefit resulting from the hypothetical option exercises. The Company further assumes that any unamortized share-based compensation is also used to repurchase shares. For shares issuable under the ESPP, the Company uses the average stock price and average ESPP withholdings to determine the incremental shares to be repurchased.

Diluted net income per share excludes anti-dilutive options and unvested restricted stock totaling 27.5 million and 28.8 million shares for the three months ended July 31, 2006 and 2005, respectively, and 24.1 million and 29.4 million shares for the nine months ended July 31, 2006 and 2005, respectively. While these options and unvested restricted stock were anti-dilutive for the respective periods, they could be dilutive in the future.

The table below reconciles the weighted-average number of common shares used to calculate basic net income per share to the weighted-average number of common shares used to calculate diluted net income per share.

	Three Months Ended July 31,		**Nine Months Ended July 31,**	
	2006	**2005**	**2006**	**2005**
		(in thousands)		
Weighted-average common shares for basic net income (loss) per share	142,538	143,830	143,629	144,899
Weighted-average dilutive stock options, stock purchase rights and restricted stock outstanding under the treasury stock method	1,426	1,838	2,033	
Weighted-average common shares for diluted net income (loss) per share	143,964	145,668	145,662	144,899

10. SEGMENT DISCLOSURE

Statement of Financial Accounting Standards No. 131, Disclosures about Segments of an Enterprise and Related Information (SFAS 131), requires disclosures of certain information regarding operating segments, products and services, geographic areas of operation and major customers. SFAS 131 reporting is based upon the management approach. Under this method, management organizes the Company s operating segments for which separate financial information is both available and evaluated regularly by the Chief Operating Decision Maker (CODM) in deciding how to allocate resources and in assessing performance. The Company s CODMs are the Company s Chief Executive Officer and Chief Operating Officer. In making operating decisions, the CODMs primarily consider consolidated financial information, accompanied by disaggregated information about revenues by geographic region and product platform. The CODMs have determined that the Company operates in a single segment.

Revenue and net property and equipment, related to operations in the United States and other geographic areas were:

	Three Months Ended July 31,		**Nine Months Ended July 31,**	
	2006	**2005**	**2006**	**2005**
		(in thousands)		
Revenue:				
United States	$ 138,841	$ 127,947	$ 412,000	$ 376,748
Europe	46,493	39,796	130,187	116,426
Japan	45,058	39,804	136,007	126,629
Asia Pacific and Other	46,816	43,904	133,982	117,290
Consolidated	$ 277,208	$ 251,450	$ 812,176	$ 737,093

	July 31, 2006 (in thousands)	October 31, 2005
Property and equipment, net:		
United States	$ 139,686	$ 146,885
Other	24,592	23,310
Consolidated	$ 164,278	$ 170,195

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

For management reporting purposes, the Company organizes its products and services into five distinct groups: Galaxy Design Platform, Discovery Verification Platform, Intellectual Property, Design for Manufacturing and Professional Service & Other. The Company includes revenue from companies or products it has acquired during the periods covered from the acquisition date through the end of the relevant periods. For presentation purposes, the Company allocates software maintenance revenue to the products to which those support services relate.

	Three Months Ended July 31,		Nine Months Ended July 31,	
	2006	2005 (in thousands)	2006	2005
Revenue:				
Galaxy Design Platform	$ 142,757	$ 138,943	$ 426,932	$ 416,596
Discovery Verification Platform	72,316	54,007	197,794	156,755
Intellectual Property	22,187	17,663	59,894	51,711
Design for Manufacturing	28,697	28,162	89,582	76,725
Professional Service & Other	11,251	12,675	37,974	35,306
Consolidated	$ 277,208	$ 251,450	$ 812,176	$ 737,093

One customer accounted for more than ten percent of the Company s consolidated revenue in the three and nine months ended July 31, 2006 and 2005.

11. DEFERRED COMPENSATION PLAN

The Company maintains the Synopsys Deferred Compensation Plan (the Deferred Plan), which permits eligible employees to defer up to 50% of their annual cash base compensation and up to 100% of their annual cash variable compensation. Distributions from the Deferred Plan are generally payable upon termination of employment over five to 15 years or as a lump sum payment at the option of the employee. Since the inception of the Deferred Plan, the Company has not made any matching or discretionary contributions to the Deferred Plan. There are no Deferred Plan provisions that provide for any guarantees or minimum return on investments. Undistributed amounts under the Deferred Plan are subject to the claims of the Company s creditors. As of July 31, 2006 and October 31, 2005, the invested amounts under the Deferred Plan total to $60.6 million and $54.0 million, respectively, and are recorded as long-term other assets on the Company s balance sheet. As of July 31, 2006 and October 31, 2005, the Company has recorded $63.3 million and $56.5 million, respectively, as a long-term liability to recognize undistributed deferred compensation due to employees.

12. OTHER INCOME (EXPENSE), NET

The following table presents a summary of other income (expense) components:

	Three Months Ended July 31 2006	2005	Nine Months Ended July 31, 2006	2005
		(in thousands)		
Interest income, net	$ 3,687	$ 2,555	$ 10,031	$ 6,328
(Loss) on sale of investments, including write-downs	(5)		(1,355)	(2,599)
Foreign currency exchange (loss) gain	(166)	153	(414)	2,477
Foreign currency exchange gain from disallowed hedges				2,958
Investment (loss) income from deferred compensation plan assets, net	(978)	877	2,992	2,880
Other (1)	(117)	33,615	(1,509)	35,183
Total	$ 2,421	$ 37,200	$ 9,745	$ 47,227

(1) For the three and nine months ended July 31, 2006, these amounts are comprised primarily of $0.7 million and $2.0 million, respectively, in premiums paid on foreign exchange forward contracts. For the three and nine months ended July 31, 2005, the amount included a $33 million litigation settlement relating to the acquisition of Nassda Corporation.

In the first quarter of fiscal 2005, the Company re-evaluated its interpretation of certain provisions of Statement of Financial Accounting Standards No. 133, Accounting for Derivatives and Hedging (SFAS 133), resulting in the discovery of an error in the application of the standard to certain prior year foreign currency hedge transactions. The effect of the error was not material in any prior period and did not impact the economics of the Company s hedging program. To correct the error, the Company reclassified the remaining $3.0 million related to the disallowed hedges from accumulated other comprehensive loss to other income in the nine months ended July 31, 2005.

13. INCOME TAXES

Effective Tax Rate

The Company estimates its annual effective tax rate at the end of each quarterly period. The Company s estimate takes into account estimations of annual pre-tax income (loss), the geographic mix of pre-tax income (loss) and the Company s interpretations of tax laws and possible outcomes of audits.

The following table presents the provision for income taxes and the effective tax rates for the three and nine months ended July 31, 2006 and July 31, 2005:

	Three Months Ended July 31, 2006	2005	Nine Months Ended July 31, 2006	2005
	(dollars in millions)			
Income (loss) before income taxes	$ 15.6	$ 29.6	$ 27.7	$ (8.6)
Provision for income tax	$ 8.0	$ 12.3	$ 13.1	$ (6.6)
Effective tax rate	51.5 %	41.5 %	47.3 %	76.7 %

The provision for income taxes for the three months ended July 31, 2006 includes a net tax expense of $1.0 million primarily due to a change in estimate relating to federal and state research and experimentation credits. In addition, the provision for income taxes for the nine months ended July 31, 2006 includes a tax expense of $1.8 million relating to state and foreign taxes in the second quarter of fiscal year 2006.

As a result of a change in U.S. tax rules, in the third quarter of fiscal year 2006, the Company changed its tax accounting method on its tax return for fiscal year 2005 with respect to the current portion of deferred revenue to follow the

recognition of revenue under generally accepted accounting principles. This accounting method change, as well as other adjustments made to the Company s taxable income upon the filing of the fiscal year 2005 tax return, resulted in an increase in the Company s net operating loss (NOL) carryforwards. Since the Company does not expect to use these NOL s within one year, the Company reclassified deferred tax assets of approximately $108 million from current to non-current in the third quarter of fiscal year 2006.

In the third quarter of fiscal year 2006, the Company recorded a net decrease to additional paid in capital of approximately $2.2 million. The decrease is primarily due to two tax adjustments: the withdrawal of an incorrect state refund claim made in 2005 relating to stock option deductions claimed for foreign employees and an overstatement in 2005 of the excess tax benefit realized from exercises of stock options assumed in certain acquisitions.

In May 2006, the Tax Increase Prevention and Reconciliation Act of 2005 (the Act) was enacted. The Act provides a three-year exception to U.S. taxation of certain foreign intercompany income. The provisions of the Act will first apply to the Company for its fiscal year 2007. Management is in the process of evaluating the impact of these rules to its provision for income taxes.

Tax Effects of Stock Awards. In November 2005, FASB issued a Staff Position (FSP) on FAS 123(R)-3, Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards. Effective upon issuance, this FSP describes an alternative transition method for calculating the tax effects of stock based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock based compensation, and to determine the subsequent impact on the APIC pool and the statement of cash flows of the tax effects of employee share-based compensation awards that are outstanding upon adoption of SFAS 123(R). The Company elected to use the alternative transition method in the third quarter of fiscal year 2006. The impact of this election on the first two quarters of fiscal year 2006 was not material.

IRS Revenue Agent s Report. On June 8, 2005, the Company received a Revenue Agent s Report (RAR) in which the Internal Revenue Service (IRS) proposed to assess a net tax deficiency for fiscal years 2000 and 2001 of approximately $476.8 million, plus interest. Interest accrues on the amount of any deficiency finally determined until paid, and compounds daily at the federal underpayment rate, which adjusts quarterly.

This proposed adjustment primarily relates to transfer pricing transactions between the Company and a wholly-owned foreign subsidiary. The proposed adjustment for fiscal years 2000 and 2001 is the total amount relating to these transactions asserted under the IRS theories.

On July 13, 2005, the Company filed a protest to the proposed deficiency with the IRS, which caused the matter to be referred to the Appeals Office of the IRS. Resolution of this matter could take a considerable time, possibly years. The Company strongly believes the proposed IRS adjustments and resulting proposed deficiency are inconsistent with applicable tax laws, and that the Company thus has meritorious defenses to these proposals. Accordingly, the Company will continue to challenge these proposed adjustments vigorously. While it believes the IRS asserted adjustments are not supported by applicable law, the Company believes it is probable it will be required to make additional payments in order to resolve this matter. However, based on the Company s analysis to date, the Company believes it has adequately provided for this matter. If the Company determines its provision for this matter to be inadequate or the Company is required to pay a significant amount of additional U.S. taxes and applicable interest in excess of its provision for this matter, its results of operations and financial condition could be materially and adversely affected.

In the third quarter of 2006, the IRS started an examination of the Company s federal income tax returns for the years 2002 through 2004.

14. RELATED PARTY TRANSACTIONS

Andy D. Bryant, Intel Corporation s Executive Vice President and Chief Financial and Enterprise Services Officer, served on the Company s Board of Directors from January 1999 to May 2005. Revenue derived from Intel Corporation and its subsidiaries in the aggregate accounted for approximately 11% and 12% of the Company s total revenue for the three and nine months ended July 31, 2006, respectively, and approximately 12% and 13% of the Company s total revenue for the three and nine months ended July 31, 2005. Management believes all transactions between the two parties were carried out on an arm s length basis.

15. SUBSEQUENT EVENTS

On August 16, 2006, the Company closed its acquisition of SIGMA-C Software AG, a Munich-based company providing simulation software that allows semiconductor manufacturers and their suppliers to develop and optimize process sequences for optical lithography, e-beam lithography and next-generation lithography technologies, in an all-cash transaction for an aggregate of $20.5 million.

16. EFFECT OF NEW ACCOUNTING PRONOUNCEMENTS

In February 2006, the Financial Accounting Standards Board issued Statement No. 155 Accounting for Certain Hybrid Financial Instruments (SFAS 155), which amends SFAS No. 133 Accounting for Derivative Instruments and Hedging Activities, and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS 155 provides a fair value measurement option for certain hybrid financial instruments containing an embedded derivative that would otherwise require bifurcation. It is effective for the fiscal years beginning after September 15, 2006. The adoption of SFAS 155 is not expected to have a material effect on the Company s condensed consolidated financial position, results of operations or cash flows.

In June 2006, the FASB issued FASB Interpretation Number 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). The interpretation contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109. The first step is to evaluate the tax position for recognition by determining whether it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions are effective for the Company beginning in the first quarter of fiscal year 2008. The Company has not determined the impact this interpretation will have on its condensed consolidated financial statements in fiscal year 2008.

For the effect of other new accounting pronouncements, reference is made to Item 8. Note 13. Effect of New Accounting Pronouncements contained in Part II of the Company s Annual Report on Form 10-K for the fiscal year ended October 31, 2005. The Company has not adopted any new accounting pronouncements since October 31, 2005 except for SFAS 123(R). See Note 2 above.

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

The following discussion 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 Item 1 of this report. This discussion contains 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 the risk factors set forth under the caption Factors That May Affect Future Results. 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. The information included herein is as of the filing date of this Form 10-Q with the Securities and Exchange Commission (SEC); future events or circumstances could differ significantly from these forward-looking statements. Accordingly, we caution readers not to place undue reliance on these statements.

Overview

Synopsys, Inc. (Synopsys) is a world leader in electronic design automation (EDA) software and related services for semiconductor design. We deliver technology-leading semiconductor design and verification software platforms and integrated circuit (IC) manufacturing software products to the global electronics market enabling the development and production of complex systems-on-chips (SoCs). In addition, we provide intellectual property (IP) and design services to simplify the design process and accelerate time-to-market for our customers. Finally, we provide software and services that help customers prepare and optimize their designs for manufacturing.

Business Environment

We generate substantially all of our revenue from customers in the semiconductor and electronics industries. Our customers typically fund purchases of our software and services largely out of their research and development (R&D) budgets and, to a lesser extent, their manufacturing and capital budgets. As a result, our customers business outlook and willingness to invest in new and increasingly complex chip designs heavily influence our business.

Since the 2000 through 2002 semiconductor downturn and subsequent recovery, our customers have focused significantly on expense reductions, including their R&D budgets. This expense outlook has affected us in a number of ways. First, some customers have reduced their overall level of EDA expenditures by decreasing their level of EDA tool purchases, using older generations of product or by not renewing maintenance services. Second, customers bargain more intensely on pricing and payment terms, which has affected revenues industry-wide. For example, customers desire to conserve cash by paying for licenses over time resulted in a shift of our license mix to an almost completely ratable model in the fourth quarter of fiscal 2004, in which substantially more revenue is recognized over time rather than at the time of shipment. This shift adversely affected our total revenue in fiscal 2004 and 2005. Third, customers are beginning to seek to consolidate their EDA purchases with fewer suppliers in order to lower their overall cost of ownership while at the same time meeting new technology challenges. This has increased competition among EDA vendors.

Recognizing that our customers will continue to spend cautiously and will work to aggressively contain costs, we are intensely focused on improving our customers overall economics of design by providing more fully integrated design solutions and offering customers the opportunity to consolidate their EDA spending with us. Over the long term, we believe EDA industry spending growth will continue to depend on growth in semiconductor R&D spending and on continued growth in the overall semiconductor market. The Semiconductor Industry Association has forecasted modest growth in semiconductor revenues for the remainder of 2006 and into 2007 and we believe semiconductor R&D spending will grow as well. However, we cannot currently predict whether this outlook will contribute to higher EDA industry spending.

We are under no obligation (and expressly disclaim any obligation) to update or alter any of the information contained in this Overview, whether as a result of new information, future events or otherwise, except to the extent required by law.

Product Developments for the Three Months Ended July 31, 2006

During the third quarter of fiscal 2006, we announced or introduced a number of new products and related developments, including:

- Availability of our NanoTime next-generation transistor-level static timing analysis solution designed to deliver concurrent timing and signal integrity analysis to address emerging custom circuit design challenges.

- Availability of our PrimeYield tool suite built for 65 nanometer and smaller technology nodes that integrates design with manufacturing by predicting design-induced mechanisms that threaten manufacturing tolerances and by providing automated correction guidance to upstream implementation tools.

- Release of a new version of our Sentaurus TCAD product that adds significant process and device modeling capabilities for accelerated development of advanced technologies.

- Demonstration of the industry s first commercially available controller based on the Certified Wireless USB specification designed to minimize power consumption and reduce overall design cost and risk for designers seeking to add Certified Wireless USB technology to their design.

- Availability of DesignWare USB 2.0 nanoPHY IP for a leading foundry s 90 nanometer low-power process, helping lower risk and enable more predictable manufacturing results for designers using that process.

Financial Performance for the Three Months Ended July 31, 2006

- Revenue was $277.2 million, up 10% from $251.5 million in the same quarter last year, primarily due to an increase in time-based revenue from orders booked in prior periods which more than offset a decrease in service revenue during the current quarter.

- Time-based license revenue increased 19% from $188.7 million in the third quarter of fiscal 2005 to $224.8 million in the current quarter, primarily reflecting the continuation of our almost completely ratable license model for an additional four quarters combined with increased business levels in earlier quarters.

- Upfront license revenue decreased 11% from $16.2 million in the third quarter of fiscal 2005 to $14.4 million in the current quarter due primarily to normal fluctuations in customer demand for upfront licenses.

- We derived approximately 6% of our software license revenue from upfront licenses and 94% from time-based licenses in the current quarter, versus approximately 8% and 92%, respectively, in the same quarter last year, within our target range for ratable license revenue.

- Maintenance revenue declined by 24% from $32.9 million in the third quarter of fiscal 2005 to $25.1 million in the current quarter primarily as a result of the decrease in upfront licenses (which reduces new maintenance orders since maintenance is purchased separately with upfront licenses) and by non-renewal of maintenance by some of our existing perpetual license customers. Professional service and other revenue, at $12.9 million, decreased 5% from $13.6 million in the third quarter of fiscal 2005 due to the timing of customer acceptance of services performed under ongoing contracts.

- Net income was $7.6 million compared to net income of $17.3 million in the third quarter of fiscal 2005, primarily due to a large litigation settlement received in the prior period and commencement of recognition of

share-based compensation expense in fiscal 2006, partially offset by increased time-based revenue in the current period.

- We repurchased approximately 3.7 million shares of our common stock at an average price of approximately $19 per share for a total of approximately $70.5 million.

- Operating cash flow decreased 46% from $194.9 million in the nine months ended July 31, 2005 to $106.1 million in the current period primarily due to increased vendor, bonus and commission and other payments compared to the same period in fiscal year 2005.

Acquisitions in the Three Months Ended July 31, 2006

During the quarter, we completed our acquisition of Virtio Corporation, a creator of virtual platforms for embedded software development, for total cash payments of $9.1 million, which will help us provide an integrated implementation, verification and IP solution to speed up hardware and software development. See Note 3 to *Notes to Unaudited Condensed Consolidated Financial Statements*.

Critical Accounting Policies and Estimates

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires our management to make judgments and estimates that affect the amounts reported in our financial statements and accompanying notes. Our management believes that we consistently apply these judgments and estimates and the financial statements and accompanying notes fairly represent all periods presented. However, any differences between these judgments and estimates and actual results could have a material impact on our statement of operations and financial condition. Critical accounting policies and estimates, as defined by the SEC, are those that are most important to the portrayal of our financial condition and results of operations and require the most difficult and subjective judgments and estimates of matters that are inherently uncertain. Our critical accounting policies and estimates are those governing: (1) revenue recognition; (2) valuation of intangible assets and goodwill; (3) income taxes and; (4) share-based compensation. We describe our revenue recognition and share-based compensation policies below. Our remaining 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, 2005, filed with the SEC on January 12, 2006.

Revenue Recognition. We recognize revenue from software licenses and maintenance and service revenue. 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.

We have designed and implemented revenue recognition policies in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended by SOP 98-9, Modification of SOP 97-2, Software Revenue Recognition With Respect to Certain Transactions.

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

- *Technology Subscription Licenses (TSLs)*, are 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 revenue in the income statement.

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- *Term Licenses*. We recognize the term license fee in full upon shipment of the software if payment terms require the customer to pay at least 75% of the term 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 income statement. For term licenses in which less than 75% of the term license fee is due within one year from shipment, we recognize revenue as customer installments become due and payable. Such revenue is reported as time-based revenue in the income statement.

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

In addition, we recognize revenue from maintenance fees associated with term and perpetual licenses ratably over the maintenance period and recognizes revenue from professional service and training fees as such services are performed and accepted by the customer. Revenue attributable to maintenance, professional services and training is reported as service revenue in the income statement.

We allocate revenue on software transactions (referred to as arrangements) involving multiple elements (i.e. a license element and a maintenance element) to each element based on the relative fair values of the elements. 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 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 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 in accordance with SOP 98-9, we recognize revenue from maintenance ratably over the maintenance term, and we recognize revenue from professional services as the related services are performed 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: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) its fee is fixed or determinable, and (iv) collectibility is probable. We apply these criteria as discussed below.

- *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 volume purchase agreement.

- *Delivery Has Occurred*. We deliver software to our customers physically or electronically. For physical deliveries, the standard transfer terms are typically FOB shipping point. For electronic deliveries, delivery occurs when we provide the customer access codes, or keys, that allow the customer to take immediate possession of the software on its hardware. We generally ship our software products 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 upfront software license orders at the end of a 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 require 75% or more of the arrangement fee to be paid within one year. Where these terms apply, we regard the fee as fixed or determinable, and recognize license revenue in full upon delivery (assuming all other revenue recognition criteria are met). If the payment terms do not meet this standard, which we refer to as extended payment 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, we recognize revenue ratably even if the fee is fixed or determinable, due to the fact that VSOE for maintenance services does not exist for a TSL and due to revenue recognition criteria relating to arrangements that include rights to receive unspecified future technology.

- *Collectibility is Probable*. To recognize revenue, we must judge collectibility of the arrangement fees, which we do 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 collectibility is not probable based upon its credit review process or the customer s payment history, we recognize revenue on a cash-collected basis.

Valuation of Share-Based Compensation. Effective November 1, 2005, we adopted the provisions of Statement of Financial Accounting Standards No. 123(R), Share-Based Payment (SFAS 123(R)). SFAS 123(R) establishes standards for accounting for transactions in which an entity exchanges its equity instruments, such as stock options, stock purchase rights, restricted stock or restricted stock units, for goods or services, such as the services of the entity s employees. SFAS 123(R) also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity s equity instruments or that may be settled by the issuance of those equity instruments. SFAS 123(R) eliminates the ability to account for share-based compensation transaction using the intrinsic value method under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and generally requires instead that these transactions be accounted for using a fair-value based method. Accordingly, we measure share-based compensation cost at the grant date, based on the fair value of the award, and recognize the expense over the employee s requisite service period using the modified prospective method. The measurement of share-based compensation cost is based on several criteria including, but not limited to, the valuation model used and associated input factors such as expected term of the award, stock price volatility, dividend rate, risk free interest rate and award cancellation rate. These input factors are subjective and are determined using management s judgment. If a difference arises between the assumptions used in determining share-based compensation cost and the actual factors which become known over time, we may change the input factors used in determining share-based compensation costs. These changes impact future awards and may materially impact our results of operations in the period and future periods the changes are made.

Results of Operations

Revenue Background

We generate our revenue from the sale of software licenses, maintenance and professional services. Under current accounting rules and policies, we recognize revenue from orders we receive for software licenses and services at varying times. In general, we recognize revenue on a time-based software license order quarterly over the license term and on an upfront term or perpetual software license order in the quarter in which the license is shipped. Substantially all of our current time-based licenses are TSLs with an average license term of approximately three years. Maintenance orders generally generate revenue ratably over the maintenance period (normally one year). Professional service orders generally generate revenue upon completion and customer acceptance of contractually agreed milestones. A more complete description of our revenue recognition policy can be found above under *Critical Accounting Policies and Estimates*.

Our revenue in any fiscal quarter is equal to the sum of our time-based license, upfront license, maintenance and professional service revenue for the period. We derive time-based license revenue in any quarter almost entirely from TSL orders received and delivered in prior quarters. We

derive upfront license revenue directly from upfront term and perpetual license orders 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 almost entirely 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 very sensitive to the mix of time-based and upfront licenses delivered during the quarter. 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, upfront licenses generate current quarter revenue but no future revenue (e.g., a $120,000 order for an upfront license generates $120,000 in revenue in the quarter the product is shipped, but no future revenue). TSLs also result in a shift of maintenance revenue to time-based license revenue since maintenance is included in revenue reported for TSLs, while maintenance on upfront orders is charged and reported separately.

License Order Mix

The percentage of upfront licenses we book each quarter is driven by a number of factors, including customer demand, preferred customer payment terms and customer-requested ship dates. Prior to August 2000, substantially all of our license revenue was upfront. Beginning in August 2000, when we introduced TSLs, we shifted our target license order mix to approximately 75% TSLs and 25% upfront licenses, based on our expectations of total orders and our assessment of the demand for upfront licenses. We substantially maintained this mix from this date through fiscal 2003. However, as a result of reduced customer demand for upfront licenses as noted above in *Business Environment*, we shifted to an almost completely time-based license model in the fourth quarter of fiscal 2004. Our actual license order mix for the last eight fiscal quarters is set forth below.

	Q3-2006	Q2-2006	Q1-2006	Q4-2005	Q3-2005	Q2-2005	Q1-2005	Q4-2004
Time-based licenses	94 %	92 %	94 %	96 %	92 %	94 %	97 %	93 %
Upfront licenses	6 %	8 %	6 %	4 %	8 %	6 %	3 %	7 %

In certain cases, our time-based and upfront license agreements provide the customer the right to re-mix a portion of the software initially licensed for other specified Synopsys products. The customer s re-mix of product, when allowed under the license arrangement, does not alter the timing of recognition of the license fees paid by the customer. In these cases the customer does not need to obtain a new license and pay additional license fees to use the additional products. As a result, these arrangements could result in reduced revenue compared to licensing the individual products separately. However, we believe providing our customers re-mix rights assists in broader adoption of our products.

Total Revenue

	JULY 31 2006	2005	DOLLAR CHANGE	% CHANGE
	(dollars in millions)			
Three months ended	$ 277.2	$ 251.5	$ 25.7	10 %
Nine months ended	$ 812.2	$ 737.1	$ 75.1	10 %

The increases in total revenue for the current periods compared to the comparable periods in fiscal 2005 was due primarily to increased time-based license orders booked in prior periods which continue to contribute revenue over their license term.

Time-based License