

SYNOPSIS INC
Form 10-Q
September 13, 2007

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

FOR THE QUARTERLY PERIOD ENDED JULY 31, 2007

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

SYNOPSIS, INC.

(Exact name of registrant as specified in its charter)

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DELAWARE

(State or other jurisdiction of
incorporation or organization)

56-1546236

(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 (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

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

Accelerated filer

Non-accelerated filer

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

Yes No

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

144,922,335 shares of Common Stock as of September 12, 2007

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SYNOPSIS, INC.
QUARTERLY REPORT ON FORM 10-Q
JULY 31, 2007
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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

SYNOPSIS, INC.
 UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except par value amounts)

| | July 31, 2007 | October 31, 2006 |
|---|------------------|---------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 435,854 | \$ 330,759 |
| Short-term investments | 358,368 | 241,963 |
| Total cash, cash equivalents and short-term investments | 794,222 | 572,722 |
| Accounts receivable, net | 204,787 | 122,584 |
| Deferred income taxes | 112,445 | 112,342 |
| Income taxes receivable | 43,665 | 42,538 |
| Prepaid expenses and other assets | 51,348 | 44,304 |
| Total current assets | 1,206,467 | 894,490 |
| Property and equipment, net | 128,739 | 140,660 |
| Goodwill | 752,955 | 735,643 |
| Intangible assets, net | 79,807 | 106,144 |
| Long-term deferred income taxes | 197,039 | 206,254 |
| Other assets | 90,039 | 74,631 |
| Total assets | \$ 2,455,046 | \$ 2,157,822 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and accrued liabilities | \$ 232,014 | \$ 234,149 |
| Accrued income taxes | 188,164 | 191,349 |
| Deferred revenue | 568,838 | 445,598 |
| Total current liabilities | 989,016 | 871,096 |
| Deferred compensation and other liabilities | 81,511 | 69,889 |
| Long-term deferred revenue | 66,564 | 53,670 |
| Total liabilities | 1,137,091 | 994,655 |
| Stockholders' equity: | | |
| Preferred Stock, \$0.01 par value: 2,000 shares authorized; none outstanding | | |
| Common Stock, \$0.01 par value: 400,000 shares authorized; 143,634 and 140,568 shares outstanding, respectively | 1,436 | 1,406 |
| Capital in excess of par value | 1,363,458 | 1,316,252 |
| Retained earnings | 249,097 | 170,743 |
| Treasury stock, at cost: 13,589 and 16,619 shares, respectively | (292,322) | (312,753) |
| Accumulated other comprehensive loss | (3,714) | (12,481) |
| Total stockholders' equity | 1,317,955 | 1,163,167 |
| Total liabilities and stockholders' equity | \$ 2,455,046 | \$ 2,157,822 |

See accompanying notes to unaudited condensed consolidated financial statements.

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SYNOPSIS, INC.
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
 (in thousands, except per share amounts)

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|------------|-------------------|------------|
| | July 31, | | July 31, | |
| | 2007 | 2006 | 2007 | 2006 |
| Revenue: | | | | |
| Time-based license | \$ 251,389 | \$ 224,782 | \$ 746,091 | \$ 645,309 |
| Upfront license | 18,981 | 14,418 | 47,108 | 48,744 |
| Maintenance and service | 33,728 | 38,008 | 104,037 | 118,123 |
| Total revenue | 304,098 | 277,208 | 897,236 | 812,176 |
| Cost of revenue: | | | | |
| License | 37,092 | 32,665 | 107,269 | 95,304 |
| Maintenance and service | 15,763 | 16,201 | 47,459 | 49,678 |
| Amortization of intangible assets | 5,536 | 6,579 | 17,455 | 21,733 |
| Total cost of revenue | 58,391 | 55,445 | 172,183 | 166,715 |
| Gross margin | 245,707 | 221,763 | 725,053 | 645,461 |
| Operating expenses: | | | | |
| Research and development | 94,365 | 93,972 | 282,205 | 275,111 |
| Sales and marketing | 95,417 | 81,171 | 264,237 | 245,460 |
| General and administrative | 24,177 | 26,692 | 76,405 | 84,845 |
| In-process research and development | 2,100 | | 2,100 | 800 |
| Amortization of intangible assets | 6,650 | 6,775 | 19,938 | 21,247 |
| Total operating expenses | 222,709 | 208,610 | 644,885 | 627,463 |
| Operating income | 22,998 | 13,153 | 80,168 | 17,998 |
| Other income, net | 10,829 | 2,421 | 38,431 | 9,745 |
| Income before income taxes | 33,827 | 15,574 | 118,599 | 27,743 |
| Provision for income taxes | 8,972 | 8,024 | 29,122 | 13,121 |
| Net income | \$ 24,855 | \$ 7,550 | \$ 89,477 | \$ 14,622 |
| Net income per share: | | | | |
| Basic | \$ 0.17 | \$ 0.05 | \$ 0.62 | \$ 0.10 |
| Diluted | \$ 0.17 | \$ 0.05 | \$ 0.60 | \$ 0.10 |
| Shares used in computing per share amounts: | | | | |
| Basic | 143,820 | 142,538 | 143,626 | 143,629 |
| Diluted | 149,709 | 143,964 | 149,283 | 145,662 |

See accompanying notes to unaudited condensed consolidated financial statements.

SYNOPSIS, INC.
 UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

| | Nine Months Ended July 31, | |
|--|-------------------------------|------------|
| | 2007 | 2006 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$ 89,477 | \$ 14,622 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Amortization and depreciation | 77,844 | 85,546 |
| Share-based compensation | 46,674 | 47,935 |
| In-process research and development | 2,100 | 800 |
| Deferred income taxes | 14,966 | 3,833 |
| Provision for doubtful accounts | (330) | (125) |
| Net change in deferred gains and losses on cash flow hedges | 1,661 | (1,491) |
| Write-down of long-term investments | | 1,336 |
| (Gain) on sale of land | (4,284) | |
| Loss (gain) on sale of short and long-term investments | 8 | (17) |
| Net changes in operating assets and liabilities, net of acquired assets and liabilities: | | |
| Accounts receivable | (80,511) | (9,337) |
| Prepaid expenses and other current assets | (11,555) | (4,473) |
| Other assets | 317 | (3) |
| Accounts payable and accrued liabilities | (8,255) | (41,685) |
| Accrued income taxes | (3,313) | (6,086) |
| Deferred revenue | 135,279 | 15,027 |
| Deferred compensation and other liabilities | 254 | 261 |
| Net cash provided by operating activities | 260,332 | 106,143 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Cash paid for acquisitions and intangible assets, net of cash acquired | (34,120) | (20,850) |
| Proceeds from sales and maturities of short-term investments | 209,167 | 221,311 |
| Proceeds from sales of long-term investments | | 248 |
| Purchases of short-term investments | (328,419) | (281,126) |
| Purchases of long-term investments | (4,620) | (1,539) |
| Purchases of property and equipment | (36,429) | (34,129) |
| Proceeds from sale of land | 26,298 | |
| Capitalization of software development costs | (2,106) | (2,342) |
| Net cash used in investing activities | (170,229) | (118,427) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Issuances of common stock | 151,653 | 43,139 |
| Repurchases of common stock | (140,789) | (169,544) |
| Net cash provided by (used in) financing activities | 10,864 | (126,405) |
| Effect of exchange rate changes on cash and cash equivalents | 4,128 | 3,970 |
| Net increase (decrease) in cash and cash equivalents | 105,095 | (134,719) |
| Cash and cash equivalents, beginning of period | 330,759 | 404,436 |
| Cash and cash equivalents, end of period | \$ 435,854 | \$ 269,717 |

See accompanying notes to unaudited condensed consolidated financial statements.

SYNOPSIS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Description of Business

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Synopsys, Inc. (Synopsys or the Company) is a provider of electronic design automation (EDA) software for semiconductor design companies. The Company delivers technology-leading semiconductor design and verification platforms and integrated circuit (IC) manufacturing products to the global electronics market, enabling the development and production of complex systems-on-chips (SoCs). In addition, the Company provides: intellectual property (IP) and design services to simplify the design process and accelerate time-to-market for our customers; and software and services that help customers prepare and optimize their designs for manufacturing.

Note 2. Summary of Significant Accounting Policies

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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 U.S. 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, 2006 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 may result in material effects on the Company's operating results and financial position.

Principles of Consolidation. The consolidated financial statements include the accounts of the Company and all of its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Fiscal Year End. The Company has adopted a fiscal year ending on the Saturday nearest to October 31. The Company's third fiscal quarter ended on August 4, 2007. Fiscal 2007 is a 53-week fiscal year and as a result, the nine months ended July 31, 2007 had 40 weeks. Fiscal 2006 was a 52-week year. For presentation purposes, the unaudited condensed consolidated financial statements and accompanying notes refer to the applicable calendar month end.

Note 3. Share-based Compensation

Accounting for Share-based Compensation

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, stock appreciation rights, restricted stock awards and restricted stock units.

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). 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 employee stock purchase plan (ESPP) is estimated by a combination of implied volatility for publicly traded options of the Company's stock with a term of six months or longer and the historical stock price volatility over the estimated expected term of the Company's share-based awards. The expected term of the Company's share-based awards is based on historical experience.

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The assumptions used to estimate the fair value of stock options granted and employee stock purchases granted under the Company's stock option plans and ESPP for the three and nine months ended July 31, 2007 and 2006 are as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|--------------------|-----------------|-------------------|-----------------|
| | July 31, 2007 | 2006 | July 31, 2007 | 2006 |
| Options | | | | |
| Volatility | 30.04% - 31.06% | 39.98% - 40.92% | 30.04% - 32.11% | 39.98% - 43.47% |
| Expected term (years) | 4.3 | 3.8 | 4.3 | 3.8 |
| Risk-free interest rate | 4.47% - 5.00% | 4.93% - 5.03% | 4.35% - 5.00% | 4.29% - 5.03% |
| Expected dividend yield | 0% | 0% | 0% | 0% |
| Weighted average grant date fair value | \$8.74 | \$7.27 | \$8.58 | \$8.01 |
| ESPP | | | | |
| Volatility | 19.61% - 44.85% | 21.62% - 40.33% | 19.61% - 44.85% | 21.62% - 51.54% |
| Expected term (years) | 0.5 - 2.0 | 0.5 - 2.0 | 0.5 - 2.0 | 0.5 - 2.0 |
| Risk-free interest rate | 3.58% - 5.09% | 4.69% - 4.75% | 3.58% - 5.09% | 3.00% - 4.75% |
| Expected dividend yield | 0% | 0% | 0% | 0% |
| Weighted average grant date fair value | \$6.43 | \$7.96 | \$6.43 | \$6.87 |

Restricted stock units were granted as part of the Company's new hire and annual incentive compensation program starting in fiscal 2007. During the first nine months of fiscal 2007, 1.3 million restricted stock units were granted under the 2006 Employee Equity Incentive Plan (Employee Plan) with a weighted average grant date fair value of \$26.85 per share. Restricted stock units are valued based on the closing price of the Company's stock on the grant date. In general, restricted stock units vest over three to four years and are subject to the employees' continuing service to the Company. Each restricted stock unit grant reduces the number of shares available for future grants by 1.36 shares and each restricted stock unit cancellation increases shares available for future grants by 1.36 shares under the Employee Plan.

As of July 31, 2007, there was \$86.0 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, 2007 were \$9.2 million and \$56.8 million, respectively. The intrinsic values of options exercised during the three and nine months ended July 31, 2006 were \$0.9 million and \$8.3 million, respectively.

The share-based compensation expense recorded in the unaudited condensed consolidated statement of operations for these share-based compensation arrangements was as follows:

| (in thousands, except per share amounts) | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------|-------------------|-----------|
| | July 31, 2007 | 2006 | July 31, 2007 | 2006 |
| Cost of license | \$ 1,916 | \$ 1,594 | \$ 5,388 | \$ 4,544 |
| Cost of maintenance and service | 701 | 778 | 2,054 | 2,362 |
| Research and development expense | 6,334 | 6,832 | 16,936 | 21,367 |
| Sales and marketing expense | 3,978 | 3,977 | 13,289 | 12,409 |
| General and administrative expense | 3,181 | 2,420 | 9,007 | 7,253 |
| Share-based compensation expense before taxes | 16,110 | 15,601 | 46,674 | 47,935 |
| Income tax benefit | (3,671) | (3,424) | (10,637) | (10,520) |
| Share-based compensation expense after taxes | \$ 12,439 | \$ 12,177 | \$ 36,037 | \$ 37,415 |

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 followed the alternative transition method discussed in Financial Accounting Standards Board (FASB) Staff Position No. 123(R)-3. The Company has not recorded any excess tax benefits during fiscal years 2007 and 2006.

Note 4. Stock Repurchase Program

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The Company is authorized to purchase up to \$500.0 million of its common stock under a stock repurchase program originally established by the Company's Board of Directors (Board) in December 2004. The Company repurchases shares to offset dilution caused by ongoing stock issuances such as existing employee stock option plans, existing stock purchase plans and acquisitions and, also when management believes it is a good use of cash. Repurchases are transacted in accordance with Rule 10b-18 under the Securities Exchange Act of 1934 (Exchange Act) through open market purchases, plans executed under Rule 10b5-1 under the Exchange Act, and structured transactions.

In May 2007, the Company entered into a structured repurchase transaction for a portion of its third quarter repurchase activity, with a prepayment of \$40.0 million in exchange for shares at a pre-determined price. Under the terms of the agreement, there is no requirement to return any portion of the prepayment or requirement for the Company to deliver additional funds. If the average market price of the common stock over the term of the transaction was below the pre-determined price, the Company would receive additional shares of the Company. The prepayment was recorded as treasury stock on the Company's balance sheet at payment date. Shares were excluded from the number of shares outstanding as of the date of each delivery of shares. The transaction was completed during the three months ended July 31, 2007.

During the three and nine months ended July 31, 2007, the Company purchased 2.2 million shares at an average price of \$27.05 per share, and 5.3 million shares at an average price of \$26.70 per share, respectively. During the three and nine months ended July 31, 2006, the Company purchased 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. The aggregate purchase prices were \$140.8 million and \$169.5 million in the nine months ended July 31, 2007 and 2006, respectively. During the three and nine months ended July 31, 2007, approximately 1.1 million and 8.3 million shares were reissued respectively, for employee share-based compensation requirements. During the three and nine months ended July 31, 2006, approximately 0.3 million and 2.7 million shares were reissued, respectively, for employee share-based compensation requirements. On March 22, 2007 the Board replenished the stock repurchase program to \$500.0 million. As of July 31, 2007, \$440.6 million remained available for future purchases under the program.

Note 5. Business Combinations

The Company does not consider the following acquisitions to be material to its results of operations and is therefore not presenting proforma statements of operations for the nine months ended July 31, 2007. The unaudited condensed consolidated financial statements include the operating results of each business from the date of acquisition. The acquisitions were accounted for in accordance with SFAS 141.

ArchPro Design Automation, Inc. (ArchPro)

The Company acquired ArchPro on June 14, 2007.

ArchPro's technologies enable engineers to address power management challenges in multi-voltage designs from chip architecture to Register Transfer Language (RTL) and gate-level design. These technologies allow verification of modern power management techniques such as power gating, substrate biasing, dynamic voltage and frequency scaling. The Company believes that this acquisition will help the Company enhance its power management verification technologies.

The Company paid \$12.9 million in cash on June 14, 2007 for the outstanding shares of ArchPro. The total purchase consideration consisted of:

| | (in thousands) | |
|---------------------------|----------------|--------|
| Cash paid | \$ | 12,921 |
| Acquisition-related costs | | 1,651 |
| Total purchase price | \$ | 14,572 |

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Acquisition-related costs of \$1.7 million consist primarily of legal, tax and accounting fees, estimated facilities closure costs and employee termination costs. As of July 31, 2007, the Company had paid \$0.3 million of the acquisition-related costs and has a remaining balance of \$1.4 million.

Under the agreement, the Company agreed to pay up to an additional \$4.0 million over three years to the former ArchPro shareholders based upon achievement of certain booking and product milestones. This contingent consideration is considered to be additional purchase price.

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 \$1.8 million of intangible assets consisting of \$1.4 million in existing technology, \$0.2 million in customer relationships and \$0.2 million in backlog to be amortized over two to five years. Additionally, the Company acquired tangible assets of \$1.2 million and assumed liabilities of \$0.6 million.

The in-process research and development (IPRD) expense related to the ArchPro acquisition was \$2.1 million. ArchPro had several projects in process at the time of acquisition which will be completed over a period of approximately two years.

Goodwill, representing the excess of the purchase price over the fair value of net tangible and identifiable intangible assets acquired in the merger was \$8.9 million and will not be amortized and is not deductible for tax purposes. Goodwill primarily resulted from Synopsys expectation of synergies from the integration of ArchPro's technology with the Company's technology and operations.

The Company also recorded a net deferred tax asset of \$1.9 million and an income tax payable contingency of \$0.7 million from this transaction.

Mosaid Technologies, Inc. (Mosaid)

The Company acquired certain assets and intellectual property of Mosaid on July 30, 2007.

Mosaid is a developer and licensor of semiconductor Intellectual Property (IP). The integration of Mosaid's double data rate memory controller and its semiconductor IP products into the Company's DesignWare IP portfolio will further expand the breadth of the Company's standards-based connectivity IP solutions.

The Company paid \$13.3 million in cash on July 30, 2007. The Company retained \$2.0 million to be paid within a year, per the holdback agreement. The total purchase consideration consisted of:

| | (in thousands) |
|---------------------------|-----------------------|
| Cash paid | \$ 13,310 |
| Holdback payable | 2,000 |
| Acquisition-related costs | 252 |
| Total purchase price | \$ 15,562 |

Acquisition-related costs of \$0.3 million consist primarily of legal, tax and accounting fees.

Assets Acquired. The Company has performed a preliminary valuation and allocated the total purchase consideration to the tangible assets acquired based on their respective fair values on the acquisition date and allocated the remaining amount to goodwill of \$14.6 million. The tangible assets acquired were accounts receivable of \$1.4 million and deferred revenue of \$0.4 million. The Company intends to complete the valuation during the fourth quarter and place a value on the intangible assets acquired and amortize such assets over the determined useful life.

Goodwill, representing the excess of the purchase price over the fair value of tangible assets acquired in the merger was \$14.6 million and will not be amortized and is deductible for tax purposes. Goodwill will be adjusted for the value of intangible assets acquired. Goodwill primarily resulted from the Company's expectation of synergies from the integration of Mosaid's technology with the Company's technology and operations.

Note 6. Goodwill and Intangible Assets

Goodwill as of July 31, 2007 consisted of the following:

| | (in thousands) |
|-----------------------------|----------------|
| Balance at October 31, 2006 | \$ 735,643 |
| ArchPro acquisition | 8,851 |
| Mosaïd acquisition | 14,553 |
| Adjustments(1) | (6,092) |
| Balance at July 31, 2007 | \$ 752,955 |

(1) Includes income tax related adjustments of \$5.3 million and adjustments due to a reduction of merger costs of \$0.8 million, all relating to prior acquisitions.

Intangible assets as of July 31, 2007 consisted of the following:

| | Gross Assets | Accumulated Amortization (in thousands) | Net Assets |
|--|--------------|---|------------|
| Customer relationships | \$ 142,250 | \$ 112,290 | \$ 29,960 |
| Core/developed technology | 104,855 | 62,087 | 42,768 |
| Contract rights intangible | 6,300 | 4,608 | 1,692 |
| Other intangibles | 8,383 | 7,796 | 587 |
| Covenants not to compete | 3,390 | 2,792 | 598 |
| Trademarks and trade names | 200 | 40 | 160 |
| Capitalized software development costs | 16,864 | 12,822 | 4,042 |
| Total | \$ 282,242 | \$ 202,435 | \$ 79,807 |

Intangible assets as of October 31, 2006 consisted of the following:

| | Gross Assets | Accumulated Amortization (in thousands) | Net Assets |
|--|--------------|---|------------|
| Customer relationships | \$ 142,050 | \$ 93,880 | \$ 48,170 |
| Core/developed technology | 94,455 | 47,769 | 46,686 |
| Contract rights intangible | 6,100 | 3,042 | 3,058 |
| Other intangibles | 8,383 | 5,576 | 2,807 |
| Covenants not to compete | 3,390 | 1,944 | 1,446 |
| Trademarks and trade names | 200 | 10 | 190 |
| Capitalized software development costs | 14,113 | 10,326 | 3,787 |
| Total | \$ 268,691 | \$ 162,547 | \$ 106,144 |

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Total amortization expense related to intangible assets consisted of the following:

| | Three Months Ended July 31, 2007 | | Nine months Ended July 31, 2007 | |
|---|--|-----------|---------------------------------------|-----------|
| | 2006 | 2006 | 2006 | 2006 |
| | (in thousands) | | | |
| Customer relationships | \$ 6,141 | \$ 6,039 | \$ 18,410 | \$ 18,011 |
| Core/developed technology | 4,479 | 5,585 | 14,318 | 18,533 |
| Contract rights intangible | 533 | 519 | 1,566 | 1,967 |
| Other intangibles | 740 | 740 | 2,220 | 2,285 |
| Covenants not to compete | 283 | 472 | 848 | 2,141 |
| Trademarks and trade names | 10 | | 30 | 42 |
| Capitalized software development costs(1) | 855 | 769 | 2,496 | 2,221 |
| Total | \$ 13,041 | \$ 14,124 | \$ 39,888 | \$ 45,200 |

(1) Amortization of capitalized software development costs 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) |
|-------------------|----------------|
| Fiscal Years: | |
| Remainder of 2007 | \$ 13,111 |
| 2008 | 37,437 |
| 2009 | 19,582 |
| 2010 | 7,143 |
| 2011 | 1,994 |
| Thereafter | 540 |
| Total | \$ 79,807 |

Note 7. Accounts Payable and Accrued Liabilities

Accounts payable and accrued liabilities consist of:

| | July 31, 2007 | October 31, 2006 |
|------------------------------|------------------|---------------------|
| | (in thousands) | |
| Payroll and related benefits | \$ 160,135 | \$ 159,823 |
| Acquisition related costs | 4,275 | 2,388 |
| Other accrued liabilities | 59,301 | 56,933 |
| Accounts payable | 8,303 | 15,005 |
| Total | \$ 232,014 | \$ 234,149 |

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, 2007, the Company had no outstanding borrowings under this credit facility and was in compliance with all the

covenants.

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Note 9. Comprehensive Income

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

| | Three Months Ended | | Nine months Ended | |
|--|--------------------|-----------|-------------------|-----------|
| | July 31, 2007 | 2006 | July 31, 2007 | 2006 |
| Net income | \$ 24,855 | \$ 7,550 | \$ 89,477 | \$ 14,622 |
| Unrealized gains (losses) on investments, net of tax of (\$1,000) and (\$1,049), for three and nine months ended July 31, 2007, respectively, and of \$125 and \$96 for each of the same periods in fiscal 2006, respectively. | 1,516 | 199 | 1,589 | (143) |
| Deferred (losses) gains on cash flow hedges, net of tax of \$144 and (\$363), for three and nine months ended July 31, 2007, respectively, and of \$353 and \$524 for each of the same periods in fiscal 2006, respectively. | (1,185) | (663) | 1,298 | (967) |
| Reclassification adjustment on deferred losses (gains) on cash flow hedges, net of tax of (\$184) and (\$349), for three and nine months ended July 31, 2007, respectively, and of (\$61) and (\$334) for each of the same periods in fiscal 2006, respectively. | 338 | 86 | 633 | 380 |
| Foreign currency translation adjustment | 1,447 | 2,949 | 5,247 | 4,032 |
| Total | \$ 26,971 | \$ 10,121 | \$ 98,244 | \$ 17,924 |

Note 10. Net Income per Share

In accordance with SFAS No. 128, *Earnings per Share* (SFAS 128), the Company computes basic income per share by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period, excluding unvested restricted stock units and awards. 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.

Diluted net income per share excludes 6.1 million and 27.5 million of anti-dilutive options and unvested restricted stock units and awards for the three months ended July 31, 2007 and 2006, respectively; and 6.1 million and 24.1 million of anti-dilutive options and unvested restricted stock units and awards for the nine months ended July 31, 2007 and 2006, respectively. While these options and unvested restricted stock units and awards were anti-dilutive for the respective periods, they could be dilutive in the future.

The table below reconciles 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 | | Nine months Ended | |
|--|--------------------|---------|-------------------|---------|
| | July 31, 2007 | 2006 | July 31, 2007 | 2006 |
| Weighted-average common shares for basic net income per share | 143,820 | 142,538 | 143,626 | 143,629 |
| Dilutive effect of common share equivalents from equity-based compensation | 5,889 | 1,426 | 5,657 | 2,033 |
| Weighted-average common shares for diluted net income per share | 149,709 | 143,964 | 149,283 | 145,662 |

Note 11. Segment Disclosure

SFAS 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, i.e., how management organizes the Company's operating segments for which separate financial information is available and 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 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

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revenue to particular geographic areas. Revenue is defined as revenues from external customers. Goodwill is not allocated since the Company operates in one reportable operating segment.

Revenue related to operations in the United States and other geographic areas were:

| | Three Months Ended July 31, 2007 | | Nine months Ended July 31, 2007 | |
|------------------------|--|------------|---------------------------------------|------------|
| | (in thousands) | | | |
| | 2007 | 2006 | 2007 | 2006 |
| Revenue: | | | | |
| United States | \$ 151,576 | \$ 138,841 | \$ 447,377 | \$ 412,000 |
| Europe | 47,688 | 46,493 | 140,969 | 130,187 |
| Japan | 48,596 | 45,058 | 145,186 | 136,007 |
| Asia-Pacific and other | 56,238 | 46,816 | 163,704 | 133,982 |
| Total | \$ 304,098 | \$ 277,208 | \$ 897,236 | \$ 812,176 |

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.

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 Services and Other. The Company includes revenue from companies or products the Company has acquired during a period from the acquisition date through the end of the relevant periods. The following table summarizes the revenue attributable to these groups:

| | Three Months Ended July 31, 2007 | | Nine Months Ended July 31, 2007 | |
|---------------------------------|--|------------|---------------------------------------|------------|
| | (in thousands) | | | |
| | 2007 | 2006 | 2007 | 2006 |
| Revenue: | | | | |
| Galaxy Design Platform | \$ 144,716 | \$ 142,757 | \$ 439,202 | \$ 426,932 |
| Discovery Verification Platform | 80,997 | 72,316 | 235,321 | 197,794 |
| Intellectual Property | 25,046 | 22,187 | 73,384 | 59,894 |
| Design for Manufacturing | 38,526 | 28,697 | 105,522 | 89,582 |
| Professional Services & Other | 14,813 | 11,251 | 43,807 | 37,974 |
| Total | \$ 304,098 | \$ 277,208 | \$ 897,236 | \$ 812,176 |

One customer accounted for more than ten percent of the Company's total revenue in the three and nine months ended July 31, 2007 and 2006.

Note 12. Other Income, Net

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

| | Three Months Ended July 31, 2007 | | Nine months Ended July 31, 2007 | |
|---|--|----------|---------------------------------------|-----------|
| | (in thousands) | | | |
| | 2007 | 2006 | 2007 | 2006 |
| Interest income, net | \$ 6,708 | \$ 3,687 | \$ 17,514 | \$ 10,031 |
| Income (loss) on assets related to executive deferred compensation plan | 3,279 | (978) | 7,913 | 2,992 |
| Other (1) | 842 | (288) | 13,004 | (3,278) |
| Total | \$ 10,829 | \$ 2,421 | \$ 38,431 | \$ 9,745 |

(1) Includes litigation settlement of \$12.5 million in the nine months ended July 31, 2007 from Magma Design Automation, Inc.

Note 13. 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, 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 for income taxes and the effective tax rates for the three months and nine months ended July 31, 2007 and 2006:

| | Three Months Ended | | Nine months Ended | |
|----------------------------|------------------------|-----------|-------------------|-----------|
| | July 31, 2007 | 2006 | July 31, 2007 | 2006 |
| | (dollars in thousands) | | | |
| Income before income taxes | \$ 33,827 | \$ 15,574 | \$ 118,599 | \$ 27,743 |
| Provision for income tax | 8,972 | 8,024 | 29,122 | 13,121 |
| Effective tax rate | 26.5 | % 51.5 | % 24.6 | % 47.3 |

The Company's effective tax rate for the three and nine months ended July 31, 2007 is lower than the statutory federal income tax rate of 35% primarily due to the tax impact of non-U.S. operations, which are taxed at lower rates, and research and development credits, partially offset by state taxes and non-deductible stock option compensation expense recorded under SFAS 123(R). The effective tax rate decreased in the three and nine months ended July 31, 2007, as compared to the same periods in fiscal 2006, primarily due to a reduction in foreign withholding tax liabilities, the benefit of a new exception to current U.S. taxation of certain foreign intercompany income and the extension of the federal research and development tax credit. The 2007 third quarter provision includes the effect of certain state tax audit settlements and additional tax provisions on foreign earnings, partially offset by an increase in the Company's federal and state research and development tax credits for 2006.

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. This proposed adjustment primarily relates to transfer pricing transactions between the Company and a wholly-owned foreign subsidiary. The Company strongly believes the proposed IRS adjustment and resulting proposed deficiency are inconsistent with applicable tax laws, and that the Company thus has meritorious defenses to this proposed IRS adjustment.

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. The appeals process began during the second quarter of fiscal 2007 and continues with an objective to reach a final resolution of the matter at the Appeals level. The Company believes it is probable that it will be required to make some additional payments in order to resolve this matter, but believes it has already adequately provided for this matter. If the Company reaches a final written settlement with the Appeals division and thereby determines that the provision for this matter is overstated or understated and thus requires adjustment, the Company's results of operations and financial condition could be materially affected. Final resolution of this matter could take considerable time.

In the third quarter of fiscal year 2006, the IRS started an examination of the Company's federal income tax returns for the fiscal years 2002 through 2004. As of July 31, 2007, the examination is still in progress and no adjustments have been proposed by the IRS which would require an adjustment to the tax provision.

Note 14. Contingencies

See the disclosure in Note 13 above regarding the IRS Revenue Agent's Report.

Other Proceedings

The Company is also subject to other 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.

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Note 15. Effect of New Accounting Pronouncements

In September 2006, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, (SAB 108). SAB 108 addresses the process and diversity in practice of quantifying misstatements and provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The SEC staff believes that registrants should quantify errors using both a balance sheet (iron curtain) and an income statement (rollover) approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. In the year of adoption, SAB 108 allows a one-time cumulative effect transition adjustment for errors that were not previously deemed material, but are material under the guidance in SAB 108. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. The Company will be required to adopt the provisions of SAB 108 by the end of fiscal 2007. The Company is currently evaluating the requirements of SAB 108 and the potential impact upon adoption. Historically, the Company has evaluated uncorrected differences utilizing the rollover approach. Although the Company believes its prior period assessments of uncorrected differences utilizing the rollover approach and the conclusions reached regarding its quantitative and qualitative assessments of such uncorrected differences were appropriate, the Company expects that, due to the analysis required in SAB 108, certain historical uncorrected differences during fiscal 1999 through fiscal 2004 related to share-based compensation and fixed assets, will be corrected upon adoption.

The Company will adopt SAB 108 in the fourth quarter of fiscal 2007. It estimates that the historical uncorrected differences related to fiscal 1999 through fiscal 2004 will be approximately \$11 to \$15 million. However, the Company is continuing to evaluate the impact of adopting SAB 108 and, as a result, the actual adjustment could be higher or lower than the estimate as a result of quantification of known immaterial errors or identification of additional immaterial errors.

In June 2006, the FASB issued FASB Interpretation No. 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 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. In May 2007, the FASB issued Staff Position No. FIN 48-1 (FSP FIN 48-1), *Definition of Settlement in FASB Interpretation No. 48*, which amended FIN 48 to provide guidance about how an enterprise should determine whether a tax position is effectively settled for the purpose of recognizing previously unrecognized tax benefits. Under FSP FIN 48-1, a tax position could be effectively settled on completion of an examination by a taxing authority if certain other conditions are satisfied. 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 the Company's consolidated financial position and results of operations in fiscal year 2008.

In February 2007, the Financial Accounting Standards Board issued Statement No. 159, *the Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 expands the use of fair value measurement to report all financial instruments at fair value. Its objective is to improve financial reporting by allowing entities to use fair value measurement for financial instruments in periods subsequent to adoption without using the complex hedging-accounting provisions. Under SFAS 159, entities may measure specified financial instruments at fair value on an instrument-by-instrument basis, with changes in fair value recognized in earnings at each subsequent reporting period. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The requirements are effective for the Company beginning in the first quarter of fiscal 2009. The Company is currently evaluating the impact, if any, SFAS 159 may have on the Company's consolidated financial position and results of operations.

For the effect of the recent accounting pronouncements, references are made to Note 14 of *Notes To Consolidated Financial Statements* contained in Part II, Item 8 of the Company's Annual Report on Form 10-K for the fiscal year ended October 31, 2006.

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 Part I, 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 in Part II, Item 1A below.

Overview

Business Environment

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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 in their R&D budgets. This expense outlook has affected us in a number of ways. First, some customers have reduced their EDA expenditures by decreasing their level of EDA tool purchases, using older generations of EDA products 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, 2005 and 2006. Third, some customers are consolidating 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 during 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.

Financial Performance for the Three Months Ended July 31, 2007

- Total revenue was \$304.1 million, up 10% from \$277.2 million in the third quarter of fiscal 2006. This increase is attributable to increased bookings of ratable license orders in prior periods which increase time-based revenue recognized in later periods, reflecting the shift of the license model in the fourth quarter of fiscal 2004.
- Time-based licenses revenue of \$251.4 million, up 12% from \$224.8 million in the third quarter of fiscal 2006, is attributable to increased bookings of ratable license orders in prior periods which increase time-based revenue recognized in later periods.
- Upfront license revenue of \$19.0 million, up 32% from \$14.4 million in the third quarter of fiscal 2006, reflects fluctuation in customer license type requirements.
- We derived approximately 93% of our revenue from time-based licenses and maintenance and service and 7% from upfront licenses in the current quarter versus 94% and 6%, respectively, in the same quarter of last year. This reflects our highly ratable license model.
- Maintenance revenue was \$16.8 million, down 33% from \$25.1 million in the third quarter of fiscal 2006. This decrease is primarily attributable to the transition of our ratable license model (which reduces new

maintenance orders as maintenance is included with time-based licenses and thus not billed separately). The decline is also attributable, to a lesser extent, by the non-renewal of maintenance by some of our existing perpetual license customers. Professional services and other revenue of \$16.9 million in the third quarter of fiscal 2007 increased 31% from \$12.9 million in the same period of fiscal 2006 primarily from the timing of customer acceptance of services performed under ongoing contracts.

- Net income was \$24.9 million compared to \$7.6 million in the third quarter of fiscal 2006. The increase is primarily due to increased bookings of ratable license orders in prior periods, which increased revenue in the current period, and cost control efforts.

- We repurchased approximately 2.2 million shares of our common stock at an average price of \$27.05 per share for approximately \$59.4 million.

- Net cash provided by operations increased 145% to \$260.3 million in the nine months ended July 31, 2007 from \$106.1 million in the nine months ended July 31, 2006. This increase is attributable mainly to higher net income, increased collections, a litigation settlement of \$12.5 million received from Magma during the second quarter of fiscal 2007, and decreased commission payments and payments to vendors due to timing of payments.

Critical Accounting Policies and Estimates

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We base the discussion and analysis of our financial condition and results of operations upon our unaudited condensed consolidated financial statements, which we prepare in accordance with U.S. generally accepted accounting principles. In preparing these financial statements, we must make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. 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 estimates and judgments, and therefore are critical to understanding our results of operations, are:

- Revenue recognition;
- Valuation of share-based compensation;
- Valuation of intangible assets; and
- Income taxes.

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, 2006, filed with the SEC on January 11, 2007.

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.

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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 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

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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 statement of operations.
- *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 statement of operations. 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. This revenue is reported as *time-based license revenue* in the statement of operations.
- *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 license revenue* in the statement of operations. 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 license revenue* in the statement of operations.

In addition, we recognize revenue from maintenance fees associated with term and perpetual licenses ratably over the maintenance period and recognize revenue from professional service and training fees as these 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 statement of operations.

Our determination of fair value of each element in multiple element arrangements is based on vendor-specific objective evidence (VSOE). VSOE for each element is based on the price charged when the 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, if 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 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: (1) persuasive evidence of an arrangement exists, (2) delivery of software or services has occurred, (3) the fee for the software or services is fixed or determinable, and (4) collectibility 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 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 license keys, that allow the customer to take immediate possession of the software by downloading it to the customer's hardware. We generally ship our software 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 future delivery dates as reflected in the agreements and our operational capacity to fulfill 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. 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, 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 exchange products or receive unspecified future technology.
- *Collectibility is Probable.* We judge collectibility 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 collectibility 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.

Valuation of Share-Based Compensation. Effective November 1, 2005, we adopted the provisions of SFAS 123(R) using the modified prospective method. 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 transactions 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 straight-line attribution 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, 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 future share-based compensation costs. Any of these changes could materially impact our results of operations in the period in which the changes are made and in periods thereafter.

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 applicable to different kinds of license arrangements, we recognize revenue from orders we receive for software licenses and services at varying times. In general, we recognize revenue on a time-based

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software license order over the license term and on an upfront term or perpetual software license order at the time the license is shipped. Substantially all of our current time-based licenses are technology subscription licenses, or TSLs, with an average license term of approximately three years, but can vary quarter-to-quarter depending on the license mix. Maintenance orders generally generate revenue ratably over the maintenance period (generally one year). Professional services 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 largely from TSL orders received and delivered in prior quarters. We derive upfront license revenue directly from upfront 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 services 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 ordered.

Our license revenue is 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 higher 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 TSLs, while maintenance on upfront orders is charged and reported separately.

Total Revenue

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| | July 31, 2007 (dollars in millions) | 2006 | Dollar Change | % Change | |
|--------------------|---|----------|------------------|-------------|---|
| Three months ended | \$ 304.1 | \$ 277.2 | \$ 26.9 | 10 | % |
| Nine months ended | \$ 897.2 | \$ 812.2 | \$ 85.0 | 10 | % |

Time-Based License Revenue

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| | July 31, 2007 (dollars in millions) | | 2006 | | Dollar Change | % Change |
|-----------------------------|---|-------|------|-------|------------------|-------------|
| Three months ended | \$ | 251.4 | \$ | 224.8 | \$ 26.6 | 12 % |
| Percentage of total revenue | | 83 % | | 81 % | | |
| Nine months ended | \$ | 746.1 | \$ | 645.3 | \$ 100.8 | 16 % |
| Percentage of total revenue | | 83 % | | 79 % | | |

The increase in total revenue and time-based revenue for the three and nine months ended July 31, 2007 compared to the same periods of fiscal 2006 was primarily due to (1) increasing bookings of time-based licenses, which are normally greater than one year, in prior periods which increased time-based revenue recognized in later periods, (2) the shift in the fourth quarter of fiscal 2004 in our license model to a highly ratable model under which ratable license orders in prior periods continue to contribute to time-based license revenue in later periods, and (3) with respect to the nine-month period, the fact that the first quarter of fiscal 2007 had 14 weeks compared to 13 weeks in the same quarter of fiscal 2006, resulting in one week's additional ratable revenue being recognized in the nine month period (the fourth quarter of fiscal 2007 is a 13 week quarter). As we reach maturity of our license model change to a model with substantially more ratable revenue, we expect that the model change itself will no longer contribute to the increases in total revenue or time-based revenue.

Upfront License Revenue

| | July 31, | | | Dollar | % |
|-----------------------------|------------------------------|-------------|--|---------------|---------------|
| | 2007 | 2006 | | Change | Change |
| | (dollars in millions) | | | | |
| Three months ended | \$ 19.0 | \$ 14.4 | | \$ 4.6 | 32 % |
| Percentage of total revenue | 6 % | 5 % | | | |
| Nine months ended | \$ 47.1 | \$ 48.7 | | \$ (1.6) | (3)% |
| Percentage of total revenue | 5 % | 6 % | | | |

The increase in the third quarter upfront license revenue was primarily due to changes in customer license type requirements in the quarter. For the nine months ended July 31, 2007, upfront license revenue did not change significantly which is consistent with our shift to our highly ratable model.

Maintenance and Services Revenue

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| | July 31, 2007 (dollars in millions) | 2006 | Dollar Change | % Change |
|---|---|----------|------------------|-------------|
| Three months ended | | | | |
| Maintenance revenue | \$ 16.8 | \$ 25.1 | \$ (8.3) | (33)% |
| Professional services and other revenue | 16.9 | 12.9 | 4.0 | 31 % |
| Total maintenance and services revenue | \$ 33.7 | \$ 38.0 | \$ (4.3) | (11)% |
| Percentage of total revenue | 11 | % 14 | % | |
| Nine months ended | | | | |
| Maintenance revenue | \$ 54.7 | \$ 80.8 | \$ (26.1) | (32)% |
| Professional services and other revenue | 49.3 | 37.3 | 12.0 | 32 % |
| Total maintenance and services revenue | \$ 104.0 | \$ 118.1 | \$ (14.1) | (12)% |
| Percentage of total revenue | 12 | % 15 | % | |

Our maintenance revenue has declined primarily due to our continued shift towards TSLs, which include maintenance with the license fee and thus generate no separately recognized maintenance revenue, and non-renewal of maintenance by certain customers on perpetual or other upfront licenses. In addition, some customers may choose in the future not to renew maintenance on upfront licenses for economic or other factors, which would also adversely affect future maintenance revenue.

Professional services and other revenue increased in the three and nine months ended July 31, 2007 compared to the same periods in fiscal 2006 due primarily to timing of customer acceptance of services performed under ongoing contracts.

Events Affecting Cost of Revenues and Operating Expenses

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Temporary Shutdown of Operations. During the nine months ended July 31, 2007 and 2006, respectively, we temporarily shut down our operations in North America for three days as a cost-saving measure, resulting in savings as follows (there were no shutdowns during the three months ended July 31, 2007 or 2006):

| | Nine months Ended | |
|----------------------------|--------------------------|-------------|
| | July 31, | 2006 |
| | 2007 | |
| | (in thousands) | |
| Cost of revenue | \$ 708 | \$ 705 |
| Research and development | 1,529 | 1,508 |
| Sales and marketing | 877 | 890 |
| General and administrative | 382 | 430 |
| Total | \$ 3,496 | \$ 3,533 |

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. Quarterly, or upon a significant change in headcount (such as a workforce reduction, realignment or acquisition) or other factors, management reviews the allocation methodology and the expenses included in the allocation pool.

53 Week Fiscal Year. Fiscal 2007 is a 53 week fiscal year. The nine months ended July 31, 2007 had 40 weeks, increasing cost of revenues and operating expenses in the period compared to a typical 39 week period.

Cost of Revenue

| | July 31, 2007 (dollars in millions) | 2006 | Dollar Change | % Change | |
|---|---|-----------------|------------------|-------------|----------|
| Three months ended | | | | | |
| Cost of license revenue | \$ 37.1 | \$ 32.7 | \$ 4.4 | 13 | % |
| Cost of maintenance and service revenue | 15.8 | 16.2 | (0.4) | (2) |)% |
| Amortization of intangible assets | 5.5 | 6.5 | (1.0) | (15) |)% |
| Total | \$ 58.4 | \$ 55.4 | \$ 3.0 | 5 | % |
| Percentage of total revenue | 19 | % | 20 | % | |
| Nine months ended | | | | | |
| Cost of license revenue | \$ 107.3 | \$ 95.3 | \$ 12.0 | 13 | % |
| Cost of maintenance and service revenue | 47.5 | 49.7 | (2.2) | (4) |)% |
| Amortization of intangible assets | 17.4 | 21.7 | (4.3) | (20) |)% |
| Total | \$ 172.2 | \$ 166.7 | \$ 5.5 | 3 | % |
| Percentage of total revenue | 19 | % | 21 | % | |

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 providing consulting and training from costs of revenue associated with internal functions which provide license delivery and post-customer contract support services. Management then allocates these consulting and training costs between cost of license revenue and cost of maintenance and service revenue based on license and service revenue reported during the quarter.

Cost of license revenue. Cost of license revenue includes costs associated with the sale and licensing of our software products, both time-based and upfront. Further, cost of license revenue includes the allocated cost of employee salary and benefits for providing software delivery, including software production costs, product packaging, and amortization of capitalized software development costs related to Synopsys products, documentation and royalties payable to third party vendors.

Cost of maintenance and service revenue. Cost of maintenance and service revenue includes employee salary and benefits for consulting professionals and associated costs to maintain the related infrastructure necessary to operate our services and training organization. Further, cost of maintenance and service revenue includes allocated costs of employee salary and benefits for providing customer services, such as hotline and on-site support, production services and documentation of maintenance updates.

Amortization of intangible assets. See *Amortization of Intangible Assets* below for information regarding the amount of amortization charged to cost of revenue for the relevant periods.

The increase in total cost of revenue for the three months ended July 31, 2007 is primarily due to an increase of \$2.8 million in compensation and employee benefits due to increased personnel costs as a result of the acquisitions of ArchPro during the third quarter of fiscal 2007, partially offset by a decrease of \$1.0 million in amortization of intangible assets as a result of intangible assets acquired in prior years becoming fully amortized. Additionally, there were increases in (1) royalty and other direct costs as a result of increased shipments, (2) share-based compensation expense, and (3) travel expenses due to increased support activities.

The increase in total cost of revenue for the nine months ended July 31, 2007 is primarily due to (1) an increase of \$8.5 million in compensation and employee benefits due to our increased personnel costs including the acquisition of ArchPro during the third quarter of fiscal 2007, (2) an increase of \$2.1 million in royalty and other direct costs as a result of increased shipments during fiscal 2007 as compared to the same period in fiscal 2006, and (3) the first quarter

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of fiscal 2007 having 14 weeks compared to 13 weeks in the same quarter of fiscal 2006. This increase was partially offset by a decrease of \$4.3 million in amortization of intangible assets as a result of intangible assets acquired in prior years becoming fully amortized. Additionally, there was also a reduction in human resources, information technology and facilities costs, allocated to this line item compared to the same period in fiscal 2006 as a result of decreased corporate-wide allocable expenses.

Operating Expenses

Research and Development

| | July 31, 2007 | | 2006 | Dollar Change | % Change |
|-----------------------------|------------------------------|---|-------------|--------------------------|---------------------|
| | (dollars in millions) | | | | |
| Three months ended | \$ 94.4 | | \$ 94.0 | \$ 0.4 | <1 % |
| Percentage of total revenue | 31 | % | 34 | % | |
| Nine months ended | \$ 282.2 | | \$ 275.1 | \$ 7.1 | 3 % |
| Percentage of total revenue | 31 | % | 34 | % | |

For the three months ended July 31, 2007, the increase was primarily due to an increase of \$3.4 million in research and development personnel and related costs due to our increased investment in personnel and as a result of the acquisitions in fiscal 2007 and late fiscal 2006, partially offset by a decrease of \$1.4 million in travel, entertainment and communications expenses. Additionally, there were decreases in expenses related to share-based compensation, facilities and depreciation, as well as human resources, information technology and facilities costs, allocated to this line item compared to the same period in fiscal 2006 as a result of decreased corporate-wide allocable expenses.

For the nine months ended July 31, 2007, the increase was primarily due to an increase of \$17.9 million in research and development personnel and related costs due to our increased investment in personnel and as a result of acquisitions in fiscal 2007 and fiscal 2006, and as a result of the first quarter of fiscal 2007 having 14 weeks compared to 13 weeks in the same quarter of fiscal 2006. This increase was partially offset by (1) a decrease of \$4.7 million in share-based compensation expense, (2) a decrease of \$2.7 million in expenses for travel, entertainment and communications, (3) a reduction of \$1.4 million in depreciation expense, and (4) a reduction of \$2.0 million in human resources, information technology and facilities costs allocated to this line item compared to the same period in fiscal 2006 as a result of decreased corporate-wide allocable expenses.

Sales and Marketing

| | July 31, 2007 | | 2006 | Dollar Change | % Change |
|-----------------------------|------------------------------|---|-------------|--------------------------|---------------------|
| | (dollars in millions) | | | | |
| Three months ended | \$ 95.4 | | \$ 81.2 | \$ 14.2 | 17 % |
| Percentage of total revenue | 31 | % | 29 | % | |
| Nine months ended | \$ 264.2 | | \$ 245.5 | \$ 18.8 | 8 % |
| Percentage of total revenue | 29 | % | 30 | % | |

For the three months ended July 31, 2007, the increase was primarily due to (1) an increase of \$14.2 million in variable compensation as a result of increased orders shipped, and (2) an increase of \$2.1 million in overall sales and marketing personnel related costs compared to the same period of fiscal 2006; partially offset by a reduction of \$1.0 million in human resources, information technology and facilities costs, allocated to this line item compared to the same period in fiscal 2006 as a result of decreased corporate-wide allocable expenses and reductions in communications, membership and subscription expenses due to lower spending.

For the nine months ended July 31, 2007, the increase was primarily due to (1) an increase of \$14.4 million in variable compensation as a result of increased orders shipped as compared to the same period in fiscal 2006, (2) an increase of \$8.4 million in sales and marketing personnel related costs primarily as a result of the first quarter of fiscal 2007 having 14 weeks compared to 13 weeks in the same quarter of fiscal 2006, and (3) an increase of \$1.3 million for costs related to sales meetings. This increase was partially offset by (1) a reduction of \$1.5 million for expenses related to communications, professional services, membership and subscriptions, and (2) a reduction of \$3.3 million in human resources, information technology and facilities costs, allocated to this line item compared to the same period in fiscal 2006 as a result of decreased corporate-wide allocable expenses. Additionally there were decreases in expenses related

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to marketing and communications and consultants for the nine months ended July 31, 2007 as compared to the same period in fiscal 2006.

General and Administrative

| | July 31, 2007 | | 2006 | | Dollar Change | | % Change |
|-----------------------------|--------------------------|---|-------------|---|--------------------------|--|---------------------|
| | (dollars in millions) | | | | | | |
| Three months ended | \$ 24.2 | | \$ 26.7 | | \$ (2.5) | | (9)% |
| Percentage of total revenue | 8 | % | 10 | % | | | |
| Nine months ended | \$ 76.4 | | \$ 84.8 | | \$ (8.4) | | (10)% |
| Percentage of total revenue | 8 | % | 10 | % | | | |

For the three months ended July 31, 2007, the decrease was primarily due to (1) a decrease of \$4.6 million in expenses related to professional services for litigation, Sarbanes-Oxley compliance, tax and audit matters, and (2) a decrease of \$1.2 million in depreciation expense as a result of older equipment being fully depreciated. This decrease was partially offset by (1) an increase of \$1.1 million in expenses related to facilities, and (2) a net increase of \$1.4 million in human resources, information technology and facilities costs, allocated to this line item compared to the same period in fiscal 2006.

For the nine months ended July 31, 2007, the decrease was primarily due to (1) a decrease of \$5.5 million in expenses related to professional services for litigation, Sarbanes-Oxley compliance, tax and audit matters, (2) a decrease of \$2.6 million in depreciation expense as a result of older equipment being fully depreciated, (3) a decrease of \$1.6 million in telecommunication and networking expenses, (4) a decrease of \$1.8 million in employee training, recruiting and other related costs, (5) a decrease of \$1.3 million in general and administrative personnel related costs, and (6) a gain of \$4.3 million, net of related expenses, for a land sale completed during the current quarter recorded as an offset to expense under this line. These decreases were offset by (1) an increase of \$1.2 million in share-based compensation expense, (2) an increase of \$1.3 million in expense related to facilities, and (3) a net increase of \$5.8 million in human resources, information technology and facilities costs, allocated to this line item compared to the same period in fiscal 2006.

Amortization of Intangible Assets

Amortization of intangible assets includes the amortization of the contract rights associated with certain executory contracts and the amortization of core/developed technology, trademarks, trade names, customer relationships, covenants not to compete and other intangibles related to acquisitions completed in prior years and in the three months ended July 31, 2007. Amortization expense is included in the unaudited condensed consolidated statements of operations as follows:

| | July 31, 2007 | | 2006 | | Dollar Change | | % Change |
|-----------------------------|--------------------------|---|-------------|---|--------------------------|--|---------------------|
| | (dollars in millions) | | | | | | |
| Three months ended | | | | | | | |
| Cost of revenue | \$ 5.5 | | \$ 6.5 | | \$ (1.0) | | (15)% |
| Operating expenses | 6.7 | | 6.8 | | (0.1) | | (1)% |
| Total | \$ 12.2 | | \$ 13.3 | | \$ (1.1) | | (8)% |
| Percentage of total revenue | 4 | % | 5 | % | | | |
| Nine months ended | | | | | | | |
| Cost of revenue | \$ 17.4 | | \$ 21.7 | | \$ (4.3) | | (20)% |
| Operating expenses | 19.9 | | 21.2 | | (1.3) | | (6)% |
| Total | \$ 37.3 | | \$ 42.9 | | \$ (5.6) | | (13)% |
| Percentage of total revenue | 4 | % | 5 | % | | | |

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For the three and nine months ended July 31, 2007, the decrease in amortization of intangible assets is primarily due to some of the intangible assets acquired in prior years becoming fully amortized in fiscal year 2006. See Note 6 to *Notes to Unaudited Condensed Consolidated Financial Statements* for a schedule of future amortization amounts.

In-Process Research and Development. We recorded a \$2.1 million IPRD charge related to our acquisition of ArchPro during the three and nine months ended July 31, 2007. We recorded a \$0.8 million IPRD charge related to our acquisition of HPL Technologies, Inc. in the nine months ended July 31, 2006. At the acquisition date, the projects associated with these IPRD efforts had not yet reached technological feasibility and had no alternative future use. Accordingly, the amounts were expensed on the acquisition date. These projects will be completed over a period of approximately two years.

Other Income, Net

| | July 31, 2007 (dollars in millions) | 2006 | Dollar Change | % | Change |
|---|---|---------------|------------------|------------|----------|
| Three months ended | | | | | |
| Interest income, net | \$ 6.7 | \$ 3.7 | \$ 3.0 | 81 | % |
| Income (loss) on assets related to executive deferred compensation plan | 3.3 | (1.0) | 4.3 | 430 | % |
| Other | 0.8 | (0.3) | 1.1 | 366 | % |
| Total | \$ 10.8 | \$ 2.4 | \$ 8.4 | 350 | % |
| Nine months ended | | | | | |
| Interest income, net | \$ 17.5 | \$ 10.0 | \$ 7.5 | 75 | % |
| Income (loss) on assets related to executive deferred compensation plan | 7.9 | 3.0 | 4.9 | 163 | % |
| Other | 13.0 | (3.3) | 16.3 | 494 | % |
| Total | \$ 38.4 | \$ 9.7 | \$ 28.7 | 296 | % |

Other income, net increased \$8.4 million during the three months ended July 31, 2007 compared to the same period in fiscal 2006, primarily due to increases in interest income and deferred compensation plan income. Other income, net increased \$28.7 million during the nine months ended July 31, 2007 compared to the same periods in fiscal 2006, primarily due to a \$12.5 million litigation settlement payment from Magma Design Automation, Inc.

Income Tax Rate

Effective Tax Rate

We estimate our annual effective tax rate at the end of each quarterly period. Our estimate takes into account estimations of annual pre-tax income (loss), the geographic mix of pre-tax income (loss) and our 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, 2007 and 2006:

| | Three Months Ended July 31, 2007 | | 2006 | | Nine months Ended July 31, 2007 | | 2006 | |
|----------------------------|--|---------|----------|---------|---------------------------------------|---|------|---|
| | (dollars in millions) | | | | | | | |
| Income before income taxes | \$ 33.8 | \$ 15.6 | \$ 118.6 | \$ 27.7 | | | | |
| Provision for income tax | \$ 9.0 | \$ 8.0 | \$ 29.1 | \$ 13.1 | | | | |
| Effective tax rate | 26.5 | % | 51.5 | % | 24.6 | % | 47.3 | % |

The effective tax rate for the three and nine months ended July 31, 2007 is lower than the statutory federal income tax rate of 35% primarily due to the tax impact of non-U.S. operations, which are taxed at lower rates, and research and development credits, partially offset by state taxes and non-deductible stock option compensation expense recorded under SFAS 123(R). The effective tax rate decreased in the three and nine months ended July 31, 2007, as compared to the same periods in fiscal 2006, primarily due to a reduction in foreign withholding tax liabilities, the benefit of a new exception to current U.S. taxation of certain foreign intercompany income and the extension of the federal research and

development tax credit. The 2007 third quarter provision includes the effect of certain state tax audit settlements and

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additional tax provisions on foreign earnings, partially offset by an increase in our federal and state research and development tax credits for 2006.

IRS Revenue Agent's Report. On June 8, 2005, we 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. This proposed adjustment primarily relates to transfer pricing transactions between Synopsys and a wholly-owned foreign subsidiary. We strongly believe the proposed IRS adjustment and resulting proposed deficiency are inconsistent with applicable tax laws, and that we thus have meritorious defenses to this proposed IRS adjustment.

On July 13, 2005, we filed a protest to the proposed deficiency with the IRS, which caused the matter to be referred to the Appeals Office of the IRS. The appeals process began during the second quarter of fiscal 2007 and continues with an objective to reach a final resolution of the matter at the Appeals level. We believe it is probable that we will be required to make some additional payments in order to resolve this matter, but we believe we have already adequately provided for this matter. If we reach a final written settlement with the Appeals division and thereby determine that the provision for this matter is overstated or understated and thus requires adjustment, our results of operations and financial condition could be materially affected. Final resolution of this matter could take considerable time.

In the third quarter of 2006, the IRS started an examination of our federal income tax returns for the years 2002 through 2004. As of July 31, 2007, the examination is still in progress, and no adjustments had been proposed by the IRS which would require an adjustment to the tax provision.

Effect of New Accounting Pronouncements

Please see Note 15 of *Notes to Unaudited Condensed Consolidated Financial Statements* for a description of the effect of new accounting pronouncements on Synopsys.

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 fiscal 2007.

Cash and Cash Equivalents and Short-Term Investments

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| | July 31, 2007 (dollars in millions) | October 31, 2006 | Dollar Change | % Change | |
|---------------------------|--|------------------|------------------|-------------|---|
| Cash and cash equivalents | \$ 435.8 | \$ 330.7 | \$ 105.1 | 32 | % |
| Short-term investments | 358.4 | 242.0 | 116.4 | 48 | % |
| Total | \$ 794.2 | \$ 572.7 | \$ 221.5 | 39 | % |

During the nine months ended July 31, 2007, our primary sources and uses of cash consisted of (1) cash provided by operating activities of \$260.3 million, (2) proceeds from issuance of common stock to employees of \$151.7 million, (3) proceeds from sales and maturities of short-term investments of \$209.2 million, (4) proceeds from sale of land of \$26.3 million, (5) repurchases of common stock of \$140.8 million, (6) purchases of investments of \$333.0 million, (7) purchases of property and equipment of \$36.4 million, and (8) cash paid for acquisitions and intangible assets of \$34.1 million.

Cash Flows

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| | Nine months Ended | | Dollar Change | % Change |
|---|-------------------|-------------|------------------|-------------|
| | July 31, 2007 | 2006 | | |
| Cash provided by operations | \$ 260.3 | \$ 106.1 | \$ 154.2 | 145 % |
| Cash used in investing activities | \$ (170.2) | \$ (118.4) | \$ (51.8) | (44)% |
| Cash provided by (used in) financing activities | \$ 10.9 | \$ (126.4) | \$ 137.3 | 109 % |

Cash provided by operating activities. Cash provided by operations is dependent primarily upon the payment terms of our license agreements. For an upfront license, we require that 75% of the license fee be paid within the first year. Conversely, payment terms for time-based licenses 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 licenses much sooner than for time-based licenses.

Cash provided by operating activities increased primarily due to increased collections, a litigation settlement of \$12.5 million received from Magma during the second quarter of fiscal 2007, and decreased commission payments and payments to vendors due to timing of payments compared to the same period in 2006.

Cash used in investing activities. The increase in cash used primarily relates to acquisitions, the timing of purchases and maturities of marketable securities, and our capital expenditures to support our growth, partially offset by cash received for the sale of land in San Jose for \$26.3 million, net of related fees.

Cash provided by (used in) financing activities. The increase in cash provided primarily relates to a higher amount of option exercises by employees and reduced stock repurchases under our stock repurchase program compared to the same period in fiscal 2006. See Note 4 of *Notes to Unaudited Condensed Consolidated Financial Statements* for details of the stock repurchase program.

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, 2007, we held an aggregate of \$584.9 million in cash, cash equivalents and short-term investments in the United States and an aggregate of \$209.3 million in foreign accounts.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in the 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.

Accounts Receivable, net

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| July 31, 2007 (dollars in millions) | | October 31, 2006 | | Dollar Change | | % Change | |
|--|-------|------------------|-------|------------------|------|-------------|---|
| \$ | 204.8 | \$ | 122.6 | \$ | 82.2 | 67 | % |

Our accounts receivable and Days Sales Outstanding (DSO) are primarily driven by our billing and collections activities. Our DSO was 61 days at July 31, 2007 and 39 days at October 31, 2006. The increase in accounts receivable and DSO primarily relates to a large billing to one customer that occurred late in the third quarter with subsequent payment terms.

Net Working Capital

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Working capital is comprised of current assets less current liabilities, as shown on our unaudited condensed consolidated balance sheets. As of July 31, 2007, our net working capital was \$217.5 million, compared to \$23.4 million as of October 31, 2006. The increase of \$194.1 million was primarily due to (1) an increase of \$105.1 million in cash and cash equivalents including proceeds from sale of land and the Magma litigation settlement, (2) an increase in short-term investments of \$116.4 million, (3) an increase in accounts receivable of \$82.2 million, (4) an increase in income taxes receivable and deferred taxes of \$1.2 million, (5) an increase in prepaid and other of \$7.0 million, (6) a decrease in income taxes payable of \$3.2 million, and (7) a decrease of \$2.1 million in accounts payable and other liabilities. This increase was partially offset by an increase in deferred revenue of \$123.2 million.

Other Sources of Liquidity and Commitments Revolving Credit Facility

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We have cash available through a \$300.0 million credit facility. As of July 31, 2007, we had no outstanding borrowings under this credit facility and were in compliance with all covenants. See Note 8 of *Notes to Unaudited Condensed Consolidated Financial Statements* for a description of our revolving credit facility.

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Contractual Obligations.

For contractual obligations, reference is made to the section in Item 7 in Part II in our Annual Report on Form 10-K for the fiscal year ended October 31, 2006, entitled *Contractual Obligations And Off-Balance Sheet Arrangements*. Our obligations have not changed materially since the date set forth in Item 7 of the Form 10-K.

We believe that our current cash, cash equivalents, short-term investments, cash generated from operations, and available credit under our credit facility will satisfy our business requirements for at least the next twelve months.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For financial market risks related to changes in interest rates and foreign currency exchange rates, reference is made to Item 7A *Quantitative and Qualitative Disclosure About Market Risk* contained in Part II of our Annual Report on Form 10-K for the fiscal year ended October 31, 2006. Our exposure to market risk has not changed materially since the dates set forth in Item 7A of the Form 10-K.

ITEM 4. CONTROLS AND PROCEDURES

(a) *Evaluation of Disclosure Controls and Procedures.* As of July 31, 2007 (the Evaluation Date), Synopsisys carried out an evaluation under the supervision and with the participation of Synopsisys management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Synopsisys disclosure controls and procedures (as such term is defined in Rules 13a-15 (e) and 15d-15 (e) under the Exchange Act). There are inherent limitations to the effectiveness of any system of disclosure controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable, not absolute, assurance of achieving their control objectives. Nonetheless, our Chief Executive Officer and Chief Financial Officer have concluded that, as of July 31, 2007, (1) Synopsisys disclosure controls and procedures were designed to provide reasonable assurance of achieving their objectives, and (2) Synopsisys disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the reports Synopsisys files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required, and that such information is accumulated and communicated to Synopsisys management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding its required disclosure.

(b) *Changes in Internal Controls.* There were no changes in Synopsisys internal control over financial reporting during the three months ended July 31, 2007 that have materially affected, or are reasonably likely to materially affect, Synopsisys internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

IRS Revenue Agent's Report

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On June 8, 2005, we 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. This proposed adjustment primarily relates to transfer pricing transactions between Synopsys and a wholly-owned foreign subsidiary. We strongly believe the proposed IRS adjustment and resulting proposed deficiency are inconsistent with applicable tax laws, and that we thus have meritorious defenses to this proposed IRS adjustment.

On July 13, 2005, we filed a protest to the proposed deficiency with the IRS, which caused the matter to be referred to the Appeals Office of the IRS. The appeals process began during the second quarter of fiscal 2007 and continues with an objective to reach a final resolution of the matter at the Appeals level. We believe it is probable that we will be required to make some additional payments in order to resolve this matter, but we believe we have already adequately provided for this matter. If we reach a final written settlement with the Appeals division and thereby determine that the provision for this matter is overstated or understated and thus requires adjustment, our results of operations and financial condition could be materially affected. Final resolution of this matter could take considerable time. We reported on this matter in our Annual Report on Form 10-K for the fiscal year ended October 31, 2006, as well as in our first two Quarterly Reports on Form 10-Q for fiscal 2007.

Other Proceedings

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We are also subject to other routine legal proceedings, as well as demands, claims and threatened litigation, that arise in the normal course of our business. The ultimate outcome of any litigation is uncertain and unfavorable outcomes could have a negative impact on our results of operations and financial condition. Regardless of outcome, litigation can have an adverse impact on Synopsys because of the defense costs, diversion of management resources and other factors.

ITEM 1A. RISK FACTORS

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended October 31, 2006, which have not materially changed other than as set forth below. Those risks, which could materially affect our business, financial condition or future results, are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Changes in, or interpretations of, accounting principles could result in unfavorable accounting charges or effects, including changes to our prior financial statements, which could cause our stock price to decline.

We prepare our consolidated financial statements in conformity with U.S. generally accepted accounting principles. These principles are subject to interpretation by the SEC and various bodies formed to interpret and create appropriate accounting principles. A change in these principles, or in our interpretations of these principles, can have a significant effect on our reported results and may retroactively affect previously reported results.

For example, in September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 addresses the process and diversity in practice of quantifying misstatements and provides interpretive guidance on the consideration of the effects of prior year misstatements in quantifying current year misstatements for the purpose of a materiality assessment. The SEC staff believes that registrants should quantify errors using both a balance sheet (iron curtain) and an income statement (rollover) approach and evaluate whether either approach results in quantifying a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. In the year of adoption, SAB 108 allows a one-time cumulative effect transition adjustment for errors that were not previously deemed material, but are material under the guidance in SAB 108. The guidance in SAB 108 must be applied to annual financial statements for fiscal years ending after November 15, 2006. Synopsys will be required to adopt the provisions of SAB 108 by the end of fiscal 2007. Synopsys is currently evaluating the requirements of SAB 108 and the potential impact upon adoption. Historically, Synopsys has evaluated uncorrected differences utilizing the rollover approach. Although Synopsys believes its prior period assessments of uncorrected differences utilizing the rollover approach and the conclusions reached regarding its quantitative and qualitative assessments of such uncorrected differences were appropriate, Synopsys expects that, due to the analysis required in SAB 108, certain historical uncorrected differences during fiscal 1999 through fiscal 2003 related to share-based compensation and fixed assets, will be corrected upon adoption.

We will adopt SAB 108 in the fourth quarter of fiscal 2007. We estimate that the historical uncorrected differences related to fiscal 1999 through fiscal 2004 will be approximately \$11 to \$15 million. However, we are continuing to evaluate the impact of adopting SAB 108 and, as a result, the actual adjustment could be higher or lower than the estimate as a result of quantification of known immaterial errors or identification of additional immaterial errors.

We received a letter dated February 5, 2007 from the Staff of the Division of Corporation Finance of the Securities and Exchange Commission with respect to our Annual Report on Form 10-K filed for the fiscal year ended October 31, 2006, and a follow-up letter on April 11, 2007. The SEC Staff letters related to our planned adoption of Staff Accounting Bulletin No. 108 and our expected correction of historical non-material uncorrected differences related to share-based compensation upon adoption of SAB 108. We responded to both of these letters and, on June 12, 2007, we received a letter from the SEC Staff stating that they have completed their review of our Form 10-K and related filings and have no further comments at this time.

We have received a Revenue Agent's Report from the Internal Revenue Service claiming a significant increase in our U.S. taxable income and the IRS started an examination of Synopsys' federal income tax returns for fiscal years 2002 through 2004. An adverse outcome, or an adjustment of our tax provisions generally, could have a material effect on our results of operations and financial condition.

On June 8, 2005, we 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. This proposed adjustment primarily relates to transfer pricing transactions between Synopsys and a wholly-owned foreign subsidiary. We strongly believe the proposed IRS adjustment and resulting proposed deficiency are inconsistent with applicable tax laws, and that we thus have meritorious defenses to this proposed IRS adjustment. On July 13, 2005, we filed a protest to the proposed deficiency with the IRS, which caused the matter to be referred to the Appeals Office of the IRS. The appeals process began during the second quarter of fiscal 2007 and continues with an objective to reach a final resolution of the matter at the Appeals level. We believe it is probable that we will be required to make some additional payments in order to resolve this matter, but we believe we have already adequately provided for this matter. If we reach a final written settlement with the Appeals division and thereby determine that the provision for this matter is overstated or understated and thus requires adjustment, our results of operations and financial condition could be materially affected. Final resolution of this matter could take considerable time.

In the third quarter of fiscal year 2006, the IRS started an examination of our federal income tax returns for the fiscal years 2002 through 2004. As of July 31, 2007, the examination is still in progress and no adjustments have been proposed by the IRS which would require an adjustment to the tax provision. If, based upon the status of this pending examination, we determine that we are required to pay a significant amount of U.S. taxes and applicable interest, our results of operations and financial condition could be materially affected.

From time to time we are subject to claims that our products infringe on third party intellectual property rights.

Under our customer agreements and other license agreements, we agree in many cases to indemnify our customers if our products infringe on a third party's intellectual property rights. As a result, we are from time to time subject to claims that our products infringe on these third party rights. For example, we recently settled a matter with Magma Design, Inc. in which both parties claimed patent infringement. As part of the settlement, Magma paid us an aggregate of \$12.5 million. However, we are also currently defending some of our customers against claims that their use of one of our products infringes on a patent held by a Japanese electronics company. We believe this claim is without merit and will continue to vigorously defend against it.

These types of claims can, however, result in costly and time-consuming litigation, require us to enter into royalty arrangements, subject us to damages or injunctions restricting our sale of products, require us to refund license fees to our customers or to forgo future payments or require us to redesign certain of our products, any one of which could materially and adversely affect our business, results of operations and financial condition.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The table below sets forth information regarding repurchases of Synopsys common stock by Synopsys during the three months ended July 31, 2007.

| Period (1) | TOTAL NUMBER OF SHARES PURCHASED | AVERAGE PRICE PAID PER SHARE | TOTAL NUMBER OF SHARES PURCHASED AS PART OF PUBLICLY ANNOUNCED PROGRAMS | MAXIMUM DOLLAR VALUE OF SHARES THAT MAY YET BE PURCHASED UNDER THE PROGRAMS |
|------------------------------------|---|------------------------------------|--|---|
| Month #1 | | | | |
| May 8, 2007 through June 9, 2007 | 1,926,874 | \$ 27.08637 | 1,926,874 | \$ 447,807,969.07 |
| Month #2 | | | | |
| June 10, 2007 through July 7, 2007 | 182,717 | \$ 26.91173 | 182,717 | \$ 442,890,738.01 |
| Month #3 | | | | |
| July 8 through August 4, 2007 | 86,400 | \$ 26.44845 | 86,400 | \$ 440,605,591.93 |
| Total | 2,195,991 | \$ 27.04674 | 2,195,991 | \$ 440,605,591.93 |

(1) All months shown are Synopsys fiscal months.

All shares were purchased pursuant to a \$500 million stock repurchase program approved by Synopsys Board of Directors and announced on December 1, 2004 which was replenished to \$500 million on March 22, 2007 and announced on March 27, 2007. Funds are available until expended or until the program is suspended by the Chief Financial Officer or the Board of Directors.

ITEM 6. EXHIBITS

- 3.1 Amended and Restated Certificate of Incorporation of Synopsys, Inc. (1)
 - 3.2 Restated Bylaws of Synopsys, Inc. (2)
 - 4.1 Reference is made to Exhibit 3.1 and 3.2.
 - 10.41 Form of Fiscal 2006 Executive Incentive Plan, as amended
 - 31.1 Certification of Chief Executive Officer as required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
 - 31.2 Certification of Chief Financial Officer as required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
 - 32.1 Certification of Chief Executive Officer and Chief Financial Officer as required by Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended and Section 1350 of Chapter 63 of Title 18 of the United States Code.
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- (1) Incorporated by reference to exhibit to Synopsis Quarterly Report on Form 10-Q for the quarterly period ended July 31, 2003.
- (2) Incorporated by reference to exhibit to Synopsis Current Report on Form 8-K filed with the Commission on September 12, 2006.

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SIGNATURES

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

SYNOPSIS, INC.

By:

/s/ Brian M. Beattie
Brian M. Beattie
Chief Financial Officer
(Principal Financial Officer)

Date: September 12, 2007

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