CADENCE DESIGN SYSTEMS INC
Form 10-Q
October 30, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 29, 2007

OR

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

For the transition period from _____to _____

Commission file number 0-15867

CADENCE DESIGN SYSTEMS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**77-0148231**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
2655 Seely Avenue, Building 5, San Jose, California	**95134**
(Address of Principal Executive Offices)	(Zip Code)

(408) 943-1234
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 _X_ 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 [_X_] 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 _X_

On September 29, 2007, 268,811,877 shares of the registrant s common stock, $0.01 par value, were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CADENCE DESIGN SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)
(Unaudited)

ASSETS

	September 29, 2007	December 30, 2006
Current Assets:		
Cash and cash equivalents	$ 935,587	$ 934,342
Short-term investments	15,654	24,089
Receivables, net of allowances of $2,499 and $3,804, respectively	278,200	238,438
Inventories	37,867	37,179
Prepaid expenses and other	111,554	77,957
Total current assets	1,378,862	1,312,005
Property, plant and equipment, net of accumulated depreciation of $612,206 and $615,768, respectively	332,519	354,575
Goodwill	1,311,087	1,267,579
Acquired intangibles, net	139,457	112,738
Installment contract receivables	221,520	149,584
Other assets	355,830	246,341
Total Assets	$ 3,739,275	$ 3,442,822

LIABILITIES AND STOCKHOLDERS EQUITY

	September 29, 2007	December 30, 2006
Current Liabilities:		
Convertible notes	$ 230,385	$ ----
Current portion of long-term debt	----	28,000
Accounts payable and accrued liabilities	241,737	259,790
Current portion of deferred revenue	241,318	260,275
Total current liabilities	713,440	548,065
Long-Term Liabilities:		
Long-term portion of deferred revenue	124,548	95,018
Convertible notes	500,000	730,385
Other long-term liabilities	448,439	370,063
Total long-term liabilities	1,072,987	1,195,466

Stockholders Equity:		
Common stock and capital in excess of par value	1,491,687	1,398,899
Treasury stock, at cost	(596,997)	(544,855)
Retained earnings	1,042,938	832,763
Accumulated other comprehensive income	15,220	12,484
Total stockholders equity	1,952,848	1,699,291
Total Liabilities and Stockholders Equity	$ 3,739,275	$ 3,442,822

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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CADENCE DESIGN SYSTEMS, INC.
CONDENSED CONSOLIDATED INCOME STATEMENTS
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
Revenue:				
Product	$ 273,799	$ 244,561	$ 775,496	$ 684,826
Services	31,225	34,262	95,963	99,798
Maintenance	95,900	87,325	285,611	268,251
Total revenue	400,924	366,148	1,157,070	1,052,875
Costs and Expenses:				
Cost of product	13,823	14,097	42,302	54,669
Cost of services	23,364	23,034	70,421	70,995
Cost of maintenance	15,217	15,604	45,635	47,514
Marketing and sales	97,163	97,499	297,924	289,064
Research and development	125,391	110,335	365,418	342,133
General and administrative	40,747	35,240	123,166	109,267
Amortization of acquired intangibles	4,739	4,606	13,661	17,982
Restructuring and other charges (credits)	(7,066)	(15)	(9,584)	(726)
Write-off of acquired in-process technology	2,678	----	2,678	900
Total costs and expenses	316,056	300,400	951,621	931,798
Income from operations	84,868	65,748	205,449	121,077
Interest expense	(2,849)	(2,959)	(9,373)	(9,880)
Other income, net	14,201	9,993	47,938	53,191
Income before provision for income taxes and cumulative effect of change in accounting principle	96,220	72,782	244,014	164,388
Provision for income taxes	23,488	30,722	67,265	70,579
Net income before cumulative effect of change in accounting principle	72,732	42,060	176,749	93,809
Cumulative effect of change in accounting principle, net of tax	----	----	----	418
Net income	$ 72,732	$ 42,060	$ 176,749	$ 94,227
Net income per share before cumulative effect of change in accounting principle:				

Basic	$	0.27	$	0.15	$	0.65	$	0.33
Diluted	$	0.24	$	0.14	$	0.60	$	0.30
Net income per share after cumulative effect of change in accounting principle:								
Basic	$	0.27	$	0.15	$	0.65	$	0.34
Diluted	$	0.24	$	0.14	$	0.60	$	0.30
Weighted average common shares outstanding basic		272,977		279,329		272,354		281,077
Weighted average common shares outstanding diluted		299,506		312,266		297,783		314,190

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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CADENCE DESIGN SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 29, 2007	Nine Months Ended September 30, 2006
Cash and Cash Equivalents at Beginning of Period	$ 934,342	$ 861,315
Cash Flows from Operating Activities:		
Net income	176,749	94,227
Adjustments to reconcile net income to net cash provided by operating activities:		
Cumulative effect of change in accounting principle	----	(418)
Depreciation and amortization	96,798	113,862
Stock-based compensation	78,828	80,437
Equity in loss from investments, net	2,504	900
Gain on investments, net	(16,608)	(25,600)
Gain on sale and leaseback of land and buildings	(12,606)	----
Write-down of investment securities	2,550	1,429
Write-off of acquired in-process technology	2,678	900
Non-cash restructuring and other charges (credits)	(7,106)	----
Tax benefit of call options	7,036	3,969
Deferred income taxes	4,848	13,697
Proceeds from the sale of receivables, net	163,549	131,404
Recoveries on trade accounts receivable and sales returns	(975)	(3,727)
Other non-cash items	8,525	4,157
Changes in operating assets and liabilities, net of effect of acquired businesses:		
Receivables	9,053	77,489
Installment contract receivables	(273,301)	(195,038)
Inventories	(681)	(2,777)
Prepaid expenses and other	(23,229)	(9,368)
Other assets	(2,027)	5,108
Accounts payable and accrued liabilities	(35,516)	(107,147)
Deferred revenue	9,411	13,275
Other long-term liabilities	18,448	19,714
Net cash provided by operating activities	208,928	216,493
Cash Flows from Investing Activities:		
Proceeds from sale of available-for-sale securities	6,271	5,542
Proceeds from sale of short-term investments	197	----
Proceeds from the sale of long-term investments	6,323	21,599
Proceeds from the sale of property, plant and equipment	46,500	----
Purchases of property, plant and equipment	(57,405)	(48,270)
Purchases of software licenses	----	(6,409)

Investment in venture capital partnerships and equity investments		(3,214)		(2,000)
Cash paid in business combinations and asset acquisitions, net of cash acquired, and acquisition of intangibles		(74,117)		(65,352)
Net cash used for investing activities		(75,445)		(94,890)
Cash Flows from Financing Activities:				
Principal payments on term loan		(28,000)		(99,000)
Tax benefit from employee stock transactions		20,727		7,556
Proceeds from issuance of common stock		249,006		126,315
Purchases of treasury stock		(384,151)		(258,384)
Other		8,558		----
Net cash used for financing activities		(133,860)		(223,513)
Effect of exchange rate changes on cash and cash equivalents		1,622		(1,895)
Increase (decrease) in cash and cash equivalents		1,245		(103,805)
Cash and Cash Equivalents at End of Period	$	935,587	$	757,510

The accompanying notes are an integral part of these Condensed Consolidated Financial Statements.

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CADENCE DESIGN SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE 1. BASIS OF PRESENTATION

The Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q have been prepared by Cadence Design Systems, Inc., or Cadence, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission, or the SEC. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. However, Cadence believes that the disclosures contained in this Quarterly Report comply with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, for a Quarterly Report on Form 10-Q and are adequate to make the information presented not misleading. These Condensed Consolidated Financial Statements are meant to be, and should be, read in conjunction with the Consolidated Financial Statements and the notes thereto included in Cadence s Annual Report on Form 10-K for the fiscal year ended December 30, 2006.

The unaudited Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q reflect all adjustments (which include only normal, recurring adjustments and those items discussed in these Notes) that are, in the opinion of management, necessary to state fairly the results for the periods presented. The results for such periods are not necessarily indicative of the results to be expected for the full fiscal year.

Preparation of the Condensed Consolidated Financial Statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Condensed Consolidated Financial Statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cadence adopted the provisions of Financial Accounting Standards Interpretation, or FIN, No. 48 Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109 on December 31, 2006, which was the first day of Cadence s 2007 fiscal year. FIN No. 48 prescribes a new recognition threshold and measurement attribute for the financial statement recognition and measurement of an income tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. Upon its adoption of FIN No. 48, Cadence applied the provisions of FIN No. 48 to all income tax positions. The cumulative effect of applying the provisions of FIN No. 48 have been reported as an adjustment to the opening balance of retained earnings or other appropriate components of equity or net assets in the Condensed Consolidated Balance Sheet as of the beginning of fiscal year 2007.

Cadence adopted the provisions of Emerging Issues Task Force, or EITF, Issue No. 06-03, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) on December 31, 2006, which was the first day of Cadence s 2007 fiscal year. EITF No. 06-03 allows companies to choose either the gross basis or net basis of income statement presentation for taxes collected from customers and remitted to governmental authorities and requires companies to disclose such policy. Cadence applies the net basis presentation for taxes collected from customers and remitted to governmental authorities.

NOTE 2. STOCK-BASED COMPENSATION

Cadence has equity incentive plans that provide for the grant to employees of stock-based awards, including stock options and restricted stock. In addition, the 1995 Directors Plan provides for the automatic grant of stock options to non-employee members of Cadence s Board of Directors. Cadence also has an employee stock purchase plan, or ESPP, which enables employees to purchase shares of Cadence common stock.

Stock-based compensation expense and the related income tax benefit recognized under Statement of Financial Accounting Standards, or SFAS, No. 123R, Share-Based Payment in the Condensed Consolidated

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Income Statements in connection with stock options, restricted stock and the ESPP for the three and nine months ended September 29, 2007 and September 30, 2006 were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
Stock options	$ 9,069	$ 11,354	$ 29,166	$ 38,216
Restricted stock	12,022	11,027	41,531	34,611
ESPP	3,028	1,892	8,131	7,610
Total stock-based compensation expense	$ 24,119	$ 24,273	$ 78,828	$ 80,437
Income tax benefit	$ 7,312	$ 7,738	$ 26,488	$ 24,969

Stock Options

The exercise price of each stock option granted under Cadence s employee equity incentive plans is equal to or greater than the market price of Cadence s common stock on the date of grant. Generally, option grants vest over four years, expire no later than ten years from the grant date and are subject to the employee s continuing service to Cadence. The options granted under the 1995 Directors Stock Option Plan vest one year from the date of grant. Options assumed in connection with acquisitions generally have exercise prices that differ from the fair value of Cadence s common stock on the date of acquisition and such options generally continue to vest under their original vesting schedules and expire on the original dates stated in the acquired company s option agreements. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. The weighted average grant date fair value of options granted and the weighted average assumptions used in the model for the three and nine months ended September 29, 2007 and September 30, 2006 were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
Dividend yield	None	None	None	None
Expected volatility	27.0%	24.1%	23.2%	24.6%
Risk-free interest rate	4.26%	4.59%	4.68%	4.83%
Expected life (in years)	4.4	5.3	4.4	5.4
Weighted average fair value of options granted	$ 6.41	$ 5.16	$ 5.14	$ 5.62

The computation of the expected volatility assumption used in the Black-Scholes pricing model for new grants is based on implied volatility. When establishing the expected life assumption, Cadence reviews annual historical employee exercise behavior with respect to option grants having similar vesting periods. The risk-free interest rate for the period within the expected term of the option is based on the yield of United States Treasury notes in effect at the time of grant. Cadence has not historically paid dividends; thus the expected dividend yield used in the calculation is zero.

Restricted Stock

The cost of restricted stock awards is determined using the fair value of Cadence s common stock on the date of the grant, and compensation expense is recognized over the vesting period. Generally, restricted stock awards vest

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over four years and are subject to the employee s continuing service to Cadence. The weighted average grant date fair values for the three and nine months ended September 29, 2007 and September 30, 2006 were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
Weighted average fair value of restricted stock granted	$ 20.65	$ 16.59	$ 20.59	$ 16.75

Cadence issues some of its restricted stock with performance-based vesting. The terms of these restricted stock grants are consistent with grants of restricted stock described above, with the exception that they vest not upon the mere passage of time, but upon the attainment of certain predetermined performance goals. Each period, Cadence estimates the most likely outcome of such performance goals and recognizes the related stock-based compensation expense. The amount of stock-based compensation expense recognized in any one period can vary based on the attainment or estimated attainment of the various performance goals. If such performance goals are not met, no compensation expense is recognized and any previously recognized compensation expense is reversed. Stock-based compensation expense related to these performance-based restricted stock grants for the three and nine months ended September 29, 2007 and September 30, 2006 was as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
Stock-based compensation expense related to performance-based grants	$ 3,291	$ 2,969	$ 13,713	$ 9,792

Cumulative effect of change in accounting principle, net of tax

During the nine months ended September 30, 2006, a non-cash benefit of approximately $0.4 million for estimated forfeitures of restricted stock previously expensed was recorded as of the SFAS No. 123R implementation date as a one-time cumulative effect of change in accounting principle, net of tax. Pursuant to Accounting Principles Board, or APB, No. 25, Accounting for Stock Issued to Employees, stock-based compensation expense was not previously reduced for estimated future forfeitures, but instead was reversed upon actual forfeiture.

Employee Stock Purchase Plan

Under the ESPP, substantially all employees may purchase Cadence s common stock at a price equal to 85 percent of the lower of the fair market value at the beginning of the applicable offering period or at the end of each applicable purchase period, in an amount up to 12% of their annual base earnings plus bonuses, subject to a limit in any calendar year of $25,000 worth of common stock. The offering periods under the ESPP that began prior to August 1, 2006 were concurrent 24-month offering periods. Each offering period was divided into four consecutive six-month purchase periods. All offering periods that started before August 1, 2006 continued until they were completed or until they were terminated as provided in the documents governing the ESPP. Participants in the ESPP remained in the 24-month offering periods until these offering periods were completed or until such participant withdrew from the ESPP, whichever was earlier. Effective August 1, 2006, offering periods under the ESPP are six months with a corresponding six month purchase period. New offerings begin on each February 1st and August 1st, and those offerings run consecutively rather than concurrently. Participants were converted to the six-month offering periods starting with the next offering period in which the participants enroll on or after August 1, 2006. Beginning with the August 1, 2007 offering period, all participants are participating in a six-month offering period and all 24-month offering periods have been completed. The purchase dates under the ESPP are January 31st and July 31st of each year.

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Shares of common stock issued under the ESPP for the three and nine months ended September 29, 2007 and September 30, 2006 were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands, except per share amounts)			
Cadence shares issued under the ESPP	1,279	1,812	3,200	3,640
Cash received from the exercise of purchase rights under the ESPP	$ 21,383	$ 20,831	$ 43,964	$ 41,619
Weighted average purchase price per share	$ 16.71	$ 11.49	$ 13.74	$ 11.43

Compensation expense is calculated using the fair value of the employees purchase rights under the Black-Scholes option pricing model. The weighted average grant date fair value of purchase rights granted under the ESPP and the weighted average assumptions used in the model for the three and nine months ended September 29, 2007 and September 30, 2006 were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
Dividend yield	None	None	None	None
Expected volatility	27.0%	24.1%	24.6%	24.0%
Risk-free interest rate	4.96%	5.18%	5.08%	4.89%
Expected life (in years)	0.5	0.5	0.5	1.1
Weighted average fair value of purchase rights granted	$ 5.01	$ 3.60	$ 4.74	$ 4.32

The computation of the expected volatility assumption used in the Black-Scholes pricing model for purchase rights is based on implied volatility. The expected life assumption is based on the average exercise date for the purchase periods in each offering period. The risk-free interest rate for the period within the expected life of the purchase right is based on the yield of United States Treasury notes in effect at the time of grant. Cadence has not historically paid dividends; thus the expected dividend yield is zero.

NOTE 3. INCOME TAXES

Cadence adopted the provisions of FIN No. 48 on December 31, 2006, which was the first day of Cadence s 2007 fiscal year. Cadence applies FIN No. 48 to each income tax position accounted for under SFAS No. 109, Accounting for Income Taxes, at each financial statement reporting date. This process involves the assessment of whether each income tax position is more likely than not of being sustained based on its technical merits. In making this assessment, Cadence must assume that the taxing authority will examine the income tax position and have full knowledge of all relevant information. For each income tax position that meets the more likely than not recognition threshold, Cadence then assesses the largest amount of tax benefit that is greater than 50 percent likely of being realized upon effective settlement with the taxing authority. Cadence reports the difference between the tax benefit recorded for financial statement purposes and the amount reflected in the tax return within income tax receivable, income tax payable, deferred tax assets or deferred tax liabilities.

The cumulative effect of adopting FIN No. 48 was reported as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets) in the Condensed Consolidated Balance Sheet for fiscal 2007. Cadence recognized a $59.4 million decrease in the net liabilities for unrecognized tax benefits, which was accounted for as an increase to the December 31, 2006 balance of retained earnings. Cadence also recognized a $42.6 million decrease in the net liabilities for unrecognized tax benefits, which was accounted for as a $35.3 million increase in the December 31, 2006 balance of Common stock and capital in excess of par value and a $7.3 million decrease in the December 31, 2006 balance of Goodwill.

Upon adoption of FIN No. 48, Cadence also recognized additional long-term income tax assets of $115.0 million and additional long-term income tax liabilities of $115.0 million to present the unrecognized tax benefits as gross amounts on the Condensed Consolidated Balance Sheet. Cadence also decreased current income tax liabilities by $26.2 million and increased long-term income tax liabilities by the same amount based on its anticipation of the amount of cash payments to be made within one year.

As of December 31, 2006, Cadence had $337.2 million of total gross unrecognized tax benefits. Of that total, $232.1 million of unrecognized tax benefits would, if recognized, affect the effective tax rate.

Upon adoption of FIN No. 48, Cadence adopted an accounting policy to classify interest and penalties on unrecognized tax benefits as income tax expense. For years prior to the adoption of FIN No. 48, Cadence also reported interest and penalties on unrecognized tax benefits as income tax expense. As of December 31, 2006, the total amounts of accrued interest and penalties were $65.8 million and $10.1 million, respectively.

The Internal Revenue Service, or IRS, and other tax authorities regularly examine Cadence s income tax returns. Cadence s United States federal income tax returns beginning with the 1997 tax year remain subject to examination by the IRS. Cadence s California income tax returns beginning with the 2001 tax year (plus any amended tax returns which need to be filed upon the potential settlement of the IRS examination of the tax years beginning with 1997) remain subject to examination by the California Franchise Tax Board.

In November 2003, the IRS completed its field examination of Cadence s federal income tax returns for the tax years 1997 through 1999 and issued a Revenue Agent s Report, or RAR, in which the IRS proposed to assess an aggregate tax deficiency for the three-year period of approximately $143.0 million. The most significant of the disputed adjustments for the tax years 1997 through 1999 relates to transfer pricing arrangements that Cadence had with a foreign subsidiary. Cadence has filed a protest to certain of the proposed adjustments with the Appeals Office of the IRS where the matter is currently being considered. Cadence believes that it is reasonably possible that the total amount of the unrecognized tax benefits for these transfer pricing arrangements could significantly increase or decrease within the next 12 months if a closing agreement can be reached with the Appeals Office of the IRS to resolve the proposed IRS adjustments to the transfer pricing arrangements. Cadence also believes that it is reasonably possible that the IRS could develop new policies and rules within the next 12 months that could impact the total amounts of unrecognized tax benefits for these transfer pricing arrangements. Because of the uncertain impact of any potential IRS policies and rules and because there is limited historical precedents of relevant tax settlements available, Cadence is currently unable to provide an estimate of the range of the reasonably possible change.

In July 2006, the IRS completed its field examination of Cadence s federal income tax returns for the tax years 2000 through 2002 and issued an RAR in which the IRS proposed to assess an aggregate tax deficiency for the three-year period of approximately $324.0 million. In November 2006, the IRS revised the proposed aggregate tax deficiency for the three-year period to be approximately $318.0 million. The IRS is contesting Cadence s qualification for deferred recognition of certain proceeds received from restitution and settlement in connection with litigation during the period. The proposed tax deficiency for this item is approximately $152.0 million. The remaining proposed tax deficiency of approximately $166.0 million is primarily related to proposed adjustments to Cadence s transfer pricing arrangements that it had with foreign subsidiaries and to Cadence s deductions for foreign trade income. The IRS took similar positions with respect to Cadence s transfer pricing arrangements in the prior examination period and may make similar claims against Cadence s transfer pricing arrangements in future examinations. Cadence has filed a timely protest with the IRS and will seek resolution of the issues through the Appeals Office of the IRS.

Cadence believes that the proposed IRS adjustments are inconsistent with applicable tax laws and Cadence is vigorously challenging these proposed adjustments. The RARs are not final Statutory Notices of Deficiency but the IRS imposes interest on the proposed deficiencies until the matters are resolved. Interest is compounded daily at rates published by the IRS, which rates are adjusted quarterly and have been between four and ten percent since 1997. The IRS is currently examining Cadence s federal income tax returns for the tax years 2003 through 2005.

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NOTE 4. ACQUISITIONS

During the nine months ended September 29, 2007, Cadence acquired Invarium, Inc., a San Jose-based developer of advanced lithography-modeling and pattern-synthesis technology, and Clear Shape Technologies, Inc., a San Jose-based design for manufacturing technology company specializing in design-side solutions to minimize yield loss for advanced semiconductor integrated circuits. Cadence acquired these two companies for an aggregate purchase price of $75.5 million, which included the payment of cash, the fair value of assumed options and acquisition costs. The $45.7 million of goodwill recorded in connection with these acquisitions is not expected to be deductible for income tax purposes. Prior to acquiring Clear Shape Technologies, Inc., Cadence had an investment of $2.0 million in the company, representing a 12% ownership interest, which had been accounted for under the cost method of accounting. In accordance with SFAS No. 141, Business Combinations, Cadence accounted for this acquisition as a step acquisition.

In connection with these acquisitions, Cadence recorded an expense of $2.7 million in the three and nine months ended September 29, 2007 for the write-off of acquired in-process technology. The purchase price allocated to acquired in-process technology was determined through established valuation techniques. The acquired in-process technology was immediately expensed because technological feasibility had not been established, and no future alternative use existed. The write-off of acquired in-process technology is a component of operating expenses in the Consolidated Income Statements.

The acquired companies results of operations and the estimated fair values of the assets acquired and liabilities assumed have been included in Cadence s Condensed Consolidated Financial Statements from the date of acquisition. Comparative pro forma financial information for these acquisitions has not been presented because the effect on results of operations was not material to Cadence s Condensed Consolidated Financial Statements.

NOTE 5. GOODWILL AND ACQUIRED INTANGIBLES

Goodwill

In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, Cadence conducts an annual impairment analysis of goodwill, which it completed during the third quarter of 2007. Based on the results of the impairment review, Cadence has determined that no indicators of impairment existed during 2007. For purposes of SFAS No. 142, Cadence operates under one reporting unit. Cadence s annual impairment review process compares the fair value of its reporting unit to its carrying value, including the goodwill related to the reporting unit. To determine the reporting unit s fair value, Cadence utilized the market valuation approach in the most recent evaluation.

The market approach provides an estimate of the fair value of Cadence based on the total number of shares of Cadence common stock outstanding, multiplied by the price per share. The estimated fair value is then compared to the carrying value of Cadence s net assets. If the carrying value of Cadence s net assets is greater than the aggregate market value of its outstanding shares of common stock, additional fair value analyses are performed on the individual intangible assets, including goodwill, to determine if any intangible assets are impaired, and, if so, an impairment charge is recorded.

The changes in the carrying amount of goodwill for the nine months ended September 29, 2007 were as follows:

		(In thousands)
Balance as of December 30, 2006	$	1,267,579

Goodwill resulting from acquisitions during the period		45,700
Additions due to earnouts		4,137
Tax benefits allocable to goodwill		(475)
Adoption of FIN No. 48		(7,318)
Other		1,464
Balance as of September 29, 2007	$	1,311,087

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Acquired Intangibles, net

Acquired intangibles with finite lives as of September 29, 2007 were as follows:

	Gross Carrying Amount	Accumulated Amortization	Acquired Intangibles, net
		(In thousands)	
Existing technology and backlog	$ 651,427	$ (595,132)	$ 56,295
Agreements and relationships	96,585	(48,398)	48,187
Distribution rights	30,100	(12,792)	17,308
Tradenames, trademarks and patents	29,367	(11,700)	17,667
Total acquired intangibles	$ 807,479	$ (668,022)	$ 139,457

Cadence acquired intangible assets of $60.7 million during the nine months ended September 29, 2007, of which $27.9 million was acquired in connection with the acquisitions described in Note 4. Of the remainder, $30.7 million is included in Agreements and relationships and $2.1 million is included in Tradenames, trademarks, and patents in the above table. The $60.7 million of acquired intangible assets had a weighted average life of 5 years at the time of acquisition.

Acquired intangibles with finite lives as of December 30, 2006 were as follows:

	Gross Carrying Amount	Accumulated Amortization	Acquired Intangibles, net
		(In thousands)	
Existing technology and backlog	$ 625,832	$ (572,315)	$ 53,517
Agreements and relationships	63,153	(41,773)	21,380
Distribution rights	30,100	(10,535)	19,565
Tradenames, trademarks and patents	26,634	(8,358)	18,276
Total acquired intangibles	$ 745,719	$ (632,981)	$ 112,738

Amortization of acquired intangibles for the three and nine months ended September 29, 2007 and September 30, 2006 was as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
		(In thousands)		

Amortization of acquired intangibles	$	12,003	$	12,248	$	34,151	$	50,450

Amortization of costs from existing technology is included in Cost of product and Cost of services. Amortization of costs from acquired maintenance contracts is included in Cost of maintenance.

Estimated amortization expense for the following fiscal years and thereafter is as follows:

		(In thousands)
2007 remaining period	$	12,488
2008		43,035
2009		33,687
2010		21,369
2011		16,066
Thereafter		12,812
Total estimated amortization expense	$	139,457

NOTE 6. CONTINGENCIES

Legal Proceedings

From time to time, Cadence is involved in various disputes and litigation matters that arise in the ordinary course of business. These include disputes and lawsuits related to intellectual property, mergers and acquisitions, licensing, contracts, distribution arrangements and employee relations matters. At least quarterly, Cadence reviews the status of each significant matter and assesses its potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount or the range of loss can be estimated, Cadence accrues a liability for the estimated loss in accordance with SFAS No. 5, Accounting for Contingencies. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, accruals are based only on the best information available at the time. As additional information becomes available, Cadence reassesses the potential liability related to pending claims and litigation matters and may revise estimates.

On February 8, 2007, Cadence, Magma Design Automation, Inc., or Magma, Altera Corp., or Altera, and Mentor Graphics Corp., or Mentor filed a complaint in the United States District Court for the Northern District of California against an individual, Narpat Bhandari, or Bhandari, and Vanguard Systems, Inc., or Vanguard. The complaint seeks a declaratory judgment that U.S. Patent No. 5,663,900, or the 900 Patent, which discloses an electronic simulation and emulation system and is allegedly owned by Bhandari and Vanguard, is not infringed and is invalid and unenforceable. The Complaint further seeks a declaratory judgment that LSI Logic Corporation, or LSI, has an ownership interest in the 900 Patent that precludes Vanguard and Bhandari from asserting the patent without first joining LSI. In March 2007, Cadence, Magma, Altera and Mentor amended the complaint to further plead non-infringement on the basis of obtaining a license to the 900 Patent from its co-owner, LSI. In April 2007, Vanguard and Bhandari answered the amended complaint, asserting counterclaims alleging that certain products of Cadence and the other plaintiffs infringe the 900 patent. In a case management conference held on May 21, 2007, the court granted the request of Cadence, Magma, Altera and Mentor to bifurcate the case and stay all issues except for the question of LSI s ownership interest in the 900 Patent. Cadence, Magma, Altera and Mentor filed a Motion for Summary Judgment that LSI was a joint-owner and that the license from LSI warranted dismissal of Vanguard and Bhandari s claim. After briefing, the motion was submitted to the Court on the papers on September 27, 2007. The motion is presently under submission, and no further proceedings are scheduled at this time.

On May 30, 2007, Ahmed Higazi, a former Cadence employee, filed suit against Cadence in the United States District Court for the Northern District of California alleging that Cadence improperly classified him as exempt from overtime pay. The suit alleges claims for unpaid overtime under the federal Fair Labor Standards Act and California law, waiting time penalties under the California Labor Code, failure to provide proper earnings statements under California law, failure to provide meal and rest breaks as required by California law, unfair business practices under California Business & Professions Code section 17200, and unpaid 401(k) contributions in violation of the Employee Retirement Income Security Act, or ERISA. Plaintiff seeks to represent a class of current and former Cadence Information Technology employees, although the scope of the purported class is not yet clear. Cadence filed an Answer denying the material allegations of the complaint and raising a number of affirmative defenses. Neither side has commenced discovery, and the court has not addressed the appropriateness of class certification. Cadence intends to defend the case vigorously.

While the outcome of these litigation matters cannot be predicted with any certainty, management does not believe that the outcome of any current matters will have a material adverse effect on Cadence s consolidated financial position, liquidity or results of operations.

Other Contingencies

Cadence provides its customers with a warranty on sales of hardware products for a 90-day period. These warranties are accounted for in accordance with SFAS No. 5. To date, Cadence has not incurred any significant costs related to warranty obligations.

Cadence s product license and services agreements include a limited indemnification provision for claims from third parties relating to Cadence s intellectual property. Such indemnification provisions are accounted for in accordance with SFAS No. 5. The indemnification is generally limited to the amount paid by the customer. To date, claims under such indemnification provisions have not been significant.

NOTE 7. NET INCOME PER SHARE

Basic net income per share is computed by dividing net income by the weighted average number of shares of common stock outstanding, less unvested restricted stock during the period. Diluted net income per share gives effect to convertible debt and equity instruments considered to be potential common shares, if dilutive, computed using the treasury stock method of accounting.

Cadence accounts for the effect of its Zero Coupon Zero Yield Senior Convertible Notes Due 2023, or the 2023 Notes, in the diluted earnings per share, or EPS, calculation using the if-converted method of accounting. Under that method, the 2023 Notes are assumed to be converted to shares (weighted for the number of days outstanding in the period) at a conversion price of $15.65, and amortization of transaction fees, net of taxes, related to the 2023 Notes is added back to net income.

EITF No. 04-08, Accounting Issues Related to Certain Features of Contingently Convertible Debt and the Effect on Diluted Earnings per Share, requires Cadence to include in diluted earnings per share the shares of Cadence s common stock into which the 1.375% Convertible Senior Notes Due 2011 and the 1.500% Convertible Senior Notes Due 2013, together, the Convertible Senior Notes, may be converted. However, since the Convertible Senior Notes meet the qualification of an Instrument C under EITF No. 90-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock, and because cash will be paid for the principal amount of the obligation upon conversion, the only shares that will be considered for inclusion in diluted EPS are those relating to the excess of the conversion premium over the principal amount, using the if-converted method of accounting. In the event Cadence s common stock exceeds $21.15 per share, for the first $1.00 the price exceeds $21.15, there would be dilution of approximately 1.1 million shares. As the share price continues to increase, dilution would continue to occur but at a declining rate. The number of shares included in diluted EPS for the Convertible Senior Notes for the three and nine months ended September 29, 2007 were 0.4 million and 0.1 million, respectively.

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The calculations for basic and diluted net income per share for the three and nine months ended September 29, 2007 and September 30, 2006 were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands, except per share amounts)			
Net income before cumulative effect of change in accounting principle	$ 72,732	$ 42,060	$ 176,749	$ 93,809
Effect of dilutive securities:				
Amortization of 2023 Notes transaction fees, net of tax	219	392	657	1,174
Net income before cumulative effect of change in accounting principle, as adjusted	$ 72,951	$ 42,452	$ 177,406	$ 94,983
Net income after cumulative effect of change in accounting principle	$ 72,732	$ 42,060	$ 176,749	$ 94,227
Effect of dilutive securities:				
Amortization of 2023 Notes transaction fees, net of tax	219	392	657	1,174
Net income after cumulative effect of change in accounting principle, as adjusted	$ 72,951	$ 42,452	$ 177,406	$ 95,401
Weighted average common shares:				
Weighted average common shares used to calculate basic net income per share	272,977	279,329	272,354	281,077
Convertible Senior Notes	449	----	122	----
2023 Notes	14,721	26,837	14,721	26,837
Options	8,845	4,313	8,217	4,811
Restricted stock and ESPP shares	2,514	1,787	2,369	1,465
Weighted average common and potential common shares used to calculate diluted net income per share	299,506	312,266	297,783	314,190
Basic net income per share:				
Net income per share before cumulative effect of change in accounting principle	$ 0.27	$ 0.15	$ 0.65	$ 0.33
Net income per share after cumulative effect of change in accounting principle	$ 0.27	$ 0.15	$ 0.65	$ 0.34
Diluted net income per share:				
Net income per share before cumulative effect of change in accounting principle	$ 0.24	$ 0.14	$ 0.60	$ 0.30

Net income per share after cumulative effect of change in accounting principle	$	0.24	$	0.14	$	0.60	$	0.30

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The following table presents the potential shares of Cadence common stock outstanding for the three and nine months ended September 29, 2007 and September 30, 2006 that were not included in the computation of diluted net income per share because the effect of including these shares would have been antidilutive:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
Options to purchase shares of common stock (various expiration dates through 2017)	10,995	26,431	11,840	24,112
Warrants to purchase shares of common stock related to the Convertible Senior Notes (various expiration dates through 2014)	23,640	----	23,640	----
Warrants to purchase shares of common stock related to the 2023 Notes (various expiration dates through 2008)	14,717	26,829	14,717	26,829
Total potential common shares excluded	49,352	53,260	50,197	50,941

NOTE 8. STOCK REPURCHASE PROGRAMS

In February 2006, the Cadence Board of Directors authorized a program to repurchase shares of Cadence s common stock in the open market with a value of up to $500.0 million in the aggregate, which program was completed during the nine months ended September 29, 2007. In November 2006, Cadence s Board of Directors authorized a new program to repurchase shares of Cadence s common stock in the open market with a value of up to an additional $500.0 million in the aggregate.

The shares repurchased under Cadence s stock repurchase programs during the three and nine months ended September 29, 2007 and September 30, 2006 were as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
Shares repurchased	12,000	6,000	17,900	15,000
Total cost of repurchased shares	$ 250,961	$ 97,554	$ 372,416	$ 258,384

As of September 29, 2007, the repurchase authorization remaining under Cadence s repurchase program totaled $155.4 million.

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NOTE 9. RETAINED EARNINGS

The changes in retained earnings for the three and nine months ended September 29, 2007 were as follows:

	Three Months Ended September 29, 2007 (In thousands)
Balance as of June 30, 2007	$ 971,762
Net income	72,732
Step acquisition adjustment	(1,556)
Balance as of September 29, 2007	$ 1,042,938

	Nine Months Ended September 29, 2007 (In thousands)
Balance as of December 30, 2006	$ 832,763
Net income	176,749
Re-issuance of treasury stock	(24,384)
Adoption effect of FIN No. 48	59,366
Step acquisition adjustment	(1,556)
Balance as of September 29, 2007	$ 1,042,938

NOTE 10. RESTRUCTURING AND OTHER CHARGES (CREDITS)

Cadence initiated a separate plan of restructuring in each year from 2001 through 2005 in an effort to operate more efficiently. The restructuring plans initiated each year from 2001 through 2005, or the 2001 Restructuring, 2002 Restructuring, 2003 Restructuring, 2004 Restructuring and 2005 Restructuring, respectively, were intended to decrease costs through workforce reductions and facility and resource consolidation in order to improve Cadence s cost structure. The 2001 and 2002 Restructurings primarily related to Cadence s design services business and certain other business or infrastructure groups throughout the world. The 2003 Restructuring, 2004 Restructuring and 2005 Restructuring were targeted at reducing costs throughout the company. The 2004 Restructuring has been completed and there was no remaining balance accrued for this restructuring as of September 29, 2007.

Since 2001, Cadence has recorded facilities consolidation charges, net of credits, of $87.5 million related to space reductions or facility closures of 49 sites. As of September 29, 2007, 28 of these sites had been vacated and space reductions had occurred at the remaining 21 sites. Cadence expects to pay remaining facilities-related restructuring liabilities for all of its restructuring plans prior to 2016.

The initial facility closure and space reduction costs included in these restructurings were comprised of payments required under leases, less any applicable estimated sublease income after the properties were abandoned, lease buyout costs and other contractual charges. To estimate the initial lease loss, which is the loss after Cadence s cost recovery efforts from subleasing all or part of a building, Cadence management made certain assumptions related to the time period over which the relevant building would remain vacant and sublease terms, including sublease rates and contractual common area charges.

Each reporting period, Cadence evaluates the adequacy of the lease loss accrual for each plan of restructuring. Cadence adjusts the lease loss accrual for changes in real estate markets or other factors that may affect estimated

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costs or sublease income. Cadence also considers executed sublease agreements and adjusts the lease loss accrual if sublease income under the agreement differs from initial estimates.

As of September 29, 2007, total accrued restructuring costs were $19.3 million, consisting solely of estimated lease losses related to certain of the restructuring activities initiated since 2001. This amount may be adjusted in the future based upon changes in the assumptions used to estimate the lease loss. Of the $19.3 million, $11.0 million was included in Accounts payable and accrued liabilities and $8.3 million was included in Other long-term liabilities.

The activity recorded in each of the restructuring plans for the three months ended September 29, 2007, which is related to payments of remaining lease obligations, net of sublease payments received, and changes in estimates related to lease loss accruals, is presented in the following table:

	2005 Restructuring	2003 Restructuring	2002 Restructuring	2001 Restructuring	Total
			(In thousands)		
Balance, June 30, 2007	$ 1,014	$ 5,350	$ 2,940	$ 17,528	$ 26,832
Adjustments to Restructuring and other charges (credits), net	(174)	269	(33)	(7,128)	(7,066)
Non-cash charges	21	37	----	----	58
Cash payments	(89)	(346)	(272)	(71)	(778)
Effect of foreign currency translation	6	105	----	192	303
Balance, September 29, 2007	$ 778	$ 5,415	$ 2,635	$ 10,521	$ 19,349

The activity recorded in each of the restructuring plans for the nine months ended September 29, 2007, which is related to payments of remaining lease obligations, net of sublease payments received, and changes in estimates related to lease loss accruals, is presented in the following table:

	2005 Restructuring	2003 Restructuring	2002 Restructuring	2001 Restructuring	Total
			(In thousands)		
Balance, December 30, 2006	$ 1,186	$ 6,252	$ 5,147	$ 18,715	$ 31,300
Adjustments to Restructuring and other charges (credits), net	(174)	130	(1,764)	(7,776)	(9,584)
Non-cash charges	57	126	----	----	183
Cash payments	(307)	(1,324)	(748)	(1,002)	(3,381)
Effect of foreign currency translation	16	231	----	584	831
Balance, September 29, 2007	$ 778	$ 5,415	$ 2,635	$ 10,521	$ 19,349

On October 5, 2007, Cadence completed a lease termination agreement for a facility included in the 2001 Restructuring whereby Cadence paid $8.2 million and was released from all future obligations related to the facility. Cadence recorded a credit to Restructuring and other charges of $7.1 million during the three months ended September 29, 2007, representing the lease loss accrual related to this facility in excess of the amount paid. As of September 29, 2007, the remaining lease loss accrual related to this facility, consisting of the $8.2 million payment made on October 5, 2007, was included in the 2001 Restructuring in the table above.

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NOTE 11. OTHER COMPREHENSIVE INCOME

Other comprehensive income includes foreign currency translation gains and losses and unrealized gains and losses on available-for-sale marketable securities, net of related tax effects. These items have been excluded from net income and are reflected instead in Stockholders Equity.

Cadence s comprehensive income for the three and nine months ended September 29, 2007 and September 30, 2006 was as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
Net income	$ 72,732	$ 42,060	$ 176,749	$ 94,227
Foreign currency translation gain (loss)	5,354	963	7,676	(3,213)
Changes in unrealized holding gains (losses) on available-for-sale securities, net of reclassification adjustment for realized gains and related tax effects	(2,330)	(4,343)	(4,024)	(6,144)
Other	16	----	(916)	----
Comprehensive income	$ 75,772	$ 38,680	$ 179,485	$ 84,870

NOTE 12. OTHER INCOME, NET

Cadence s Other income, net, for the three and nine months ended September 29, 2007 and September 30, 2006 was as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
Interest income	$ 12,609	$ 9,863	$ 37,472	$ 29,593
Gains (losses) on sale of non-marketable securities	83	(480)	5,642	16,366
Gains on available-for-sale securities	2,093	1,805	4,404	4,620
Gains (losses) on securities in Cadence s non-qualified deferred compensation trust	2,339	(863)	6,562	4,614
Gains (losses) on foreign exchange	(317)	165	(951)	338
Equity in loss from investments, net	(784)	(300)	(2,504)	(900)
Write-down of investment securities	(2,000)	(428)	(2,550)	(1,429)
Other income (expense)	178	231	(137)	(11)
Total other income, net	$ 14,201	$ 9,993	$ 47,938	$ 53,191

NOTE 13. SALE-LEASEBACK

In January 2007, Cadence completed the sale of certain land and buildings in San Jose, California for a sales price of $46.5 million cash. Concurrently with the sale, Cadence leased back from the purchaser approximately 262,500 square feet of office space, which represents all available space in the buildings. The lease agreement includes an initial term of two years, with two options to extend the lease for six months each. Cadence is obligated to make lease payments related to this lease of $0.6 million for the remaining portion of 2007, $2.4 million in 2008 and $0.2 million in 2009.

A substantial portion of the gain upon sale was recognized throughout Cadence s costs and expenses during the three months ended March 31, 2007, and the remaining gain will be recognized over the initial lease term of two years. During the lease term, Cadence is constructing an additional building located on its San Jose, California campus to replace the buildings it sold in this transaction.

NOTE 14. SEGMENT AND GEOGRAPHY REPORTING

SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information, requires disclosures of certain information regarding operating segments, products and services, geographic areas of operation and major customers. SFAS No. 131 reporting is based upon the management approach : how management organizes the company s operating segments for which separate financial information is (i) available and (ii) evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Cadence s chief operating decision maker is its President and Chief Executive Officer, or CEO.

Cadence s CEO reviews Cadence s consolidated results within one segment. In making operating decisions, the CEO primarily considers consolidated financial information, accompanied by disaggregated information about revenues by geographic region.

Outside the United States, Cadence markets and supports its products and services primarily through its subsidiaries. Revenue is attributed to geography based on the country in which the customer is domiciled. Long-lived assets are attributed to geography based on the country where the assets are located.

The following table presents a summary of revenue by geography:

	Three Months Ended		Nine Months Ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
	(In thousands)			
North America:				
United States	$ 160,895	$ 188,280	$ 523,147	$ 511,399
Other North America	5,310	7,928	21,889	24,673
Total North America	166,205	196,208	545,036	536,072
Europe, Middle East and Africa:				
Germany	14,784	26,854	46,804	71,004
Netherlands	44,373	1,702	45,105	6,959
Other Europe, Middle East and Africa	40,492	51,273	128,229	126,659
Total Europe, Middle East and Africa	99,649	79,829	220,138	204,622
Japan and Asia:				
Japan	88,863	49,246	242,442	206,418
Asia	46,207	40,865		