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

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**FORM 10-Q**

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

For the quarterly period ended October 31, 2011

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 No. 1-34795

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**MENTOR GRAPHICS CORPORATION**

(Exact name of registrant as specified in its charter)

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**Oregon**  
(State or other jurisdiction of  
incorporation or organization)

**93-0786033**  
(IRS Employer  
Identification No.)

**8005 SW Boeckman Road, Wilsonville, Oregon**  
(Address of principal executive offices)

**97070-7777**  
(Zip Code)

**Registrant's telephone number, including area code: (503) 685-7000**

**None**  
(Former name, former address and former  
fiscal year, if changed since last report)

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

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

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

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

Number of shares of common stock, no par value, outstanding as of December 1, 2011: 109,422,257

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# MENTOR GRAPHICS CORPORATION

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

Mentor Graphics Corporation  
Condensed Consolidated Statements of Operations  
(Unaudited)

	<u>Three Months Ended October 31,</u>		<u>Nine Months Ended October 31,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
<i>In thousands, except per share data</i>				
<b>Revenues:</b>				
System and software	\$ 154,363	\$ 148,101	\$ 411,503	\$ 346,042
Service and support	96,145	90,836	282,780	261,406
Total revenues	<u>250,508</u>	<u>238,937</u>	<u>694,283</u>	<u>607,448</u>
<b>Cost of revenues:</b>				
System and software	10,864	14,261	41,235	28,881
Service and support	27,621	25,430	79,676	72,230
Amortization of purchased technology	1,761	3,299	7,872	10,428
Total cost of revenues	<u>40,246</u>	<u>42,990</u>	<u>128,783</u>	<u>111,539</u>
Gross margin	<u>210,262</u>	<u>195,947</u>	<u>565,500</u>	<u>495,909</u>
<b>Operating expenses:</b>				
Research and development	81,305	73,622	220,578	208,058
Marketing and selling	83,036	80,591	236,718	225,135
General and administration	17,922	18,485	52,055	55,527
Equity in losses (earnings) of Frontline	134	(415)	(2,022)	(1,761)
Amortization of intangible assets	1,296	1,445	4,361	5,742
Special charges	1,164	1,578	7,388	8,052
Total operating expenses	<u>184,857</u>	<u>175,306</u>	<u>519,078</u>	<u>500,753</u>
<b>Operating income (loss)</b>	<u>25,405</u>	<u>20,641</u>	<u>46,422</u>	<u>(4,844)</u>
Other income (expense), net	1,836	(206)	1,890	(1,361)
Interest expense	(4,615)	(4,324)	(26,689)	(13,378)
Income (loss) before income tax	22,626	16,111	21,623	(19,583)
Income tax expense (benefit)	(1,445)	854	(4,429)	2,432
Net income (loss)	<u>\$ 24,071</u>	<u>\$ 15,257</u>	<u>\$ 26,052</u>	<u>\$ (22,015)</u>
Net income (loss) per share:				
Basic	<u>\$ 0.22</u>	<u>\$ 0.14</u>	<u>\$ 0.24</u>	<u>\$ (0.21)</u>
Diluted	<u>\$ 0.22</u>	<u>\$ 0.14</u>	<u>\$ 0.23</u>	<u>\$ (0.21)</u>
Weighted average number of shares outstanding:				
Basic	<u>109,501</u>	<u>109,364</u>	<u>110,423</u>	<u>106,942</u>
Diluted	<u>111,563</u>	<u>112,139</u>	<u>113,181</u>	<u>106,942</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

Mentor Graphics Corporation  
Condensed Consolidated Balance Sheets  
(Unaudited)

<u>As of</u> <u>In thousands</u>	<u>October 31,</u> <u>2011</u>	<u>January 31,</u> <u>2011</u>
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 111,989	\$ 133,113
Trade accounts receivable, net of allowance for doubtful accounts of \$3,773 as of October 31, 2011 and \$3,941 as of January 31, 2011	291,084	347,075
Other receivables	13,262	8,797
Inventory	9,284	8,255
Prepaid expenses and other	17,855	20,072
Deferred income taxes	16,831	15,992
Total current assets	460,305	533,304
<b>Property, plant, and equipment</b> , net of accumulated depreciation of \$276,355 as of October 31, 2011 and \$257,576 as of January 31, 2011	145,161	139,340
<b>Term receivables</b>	204,295	167,425
<b>Goodwill</b>	516,958	510,508
<b>Intangible assets</b> , net of accumulated amortization of \$168,714 as of October 31, 2011 and \$156,481 as of January 31, 2011	25,219	31,189
<b>Deferred income taxes</b>	—	869
<b>Other assets</b>	51,389	45,343
Total assets	<u>\$1,403,327</u>	<u>\$1,427,978</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Short-term borrowings	\$ 7,600	\$ 15,544
Current portion of notes payable	—	2,000
Accounts payable	10,524	16,724
Income taxes payable	3,026	5,517
Accrued payroll and related liabilities	75,732	109,173
Accrued liabilities	32,009	39,513
Deferred revenue	164,457	171,416
Total current liabilities	293,348	359,887
<b>Notes payable</b>	213,288	207,348
<b>Deferred revenue</b>	13,746	13,953
<b>Income tax liability</b>	34,432	44,095
<b>Deferred income taxes</b>	147	—
<b>Other long-term liabilities</b>	22,449	25,981
Total liabilities	<u>577,410</u>	<u>651,264</u>
<b>Commitments and contingencies (Note 9)</b>		
<b>Noncontrolling interest with redemption feature</b>	8,196	—
<b>Stockholders' equity:</b>		
Common stock, no par value, 300,000 shares authorized as of October 31, 2011 and January 31, 2011; 109,332 shares issued and outstanding as of October 31, 2011 and 111,249 shares issued and outstanding as of January 31, 2011	776,516	765,179
Incentive stock, no par value, 1,200 shares authorized and none issued as of October 31, 2011 and January 31, 2011	—	—
Retained earnings (accumulated deficit)	5,894	(20,158)
Accumulated other comprehensive income	35,311	31,693
Total stockholders' equity	<u>817,721</u>	<u>776,714</u>
Total liabilities and stockholders' equity	<u>\$1,403,327</u>	<u>\$1,427,978</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

Mentor Graphics Corporation  
Condensed Consolidated Statements of Cash Flows  
(Unaudited)

<u>Nine months ended October 31,</u>	<u>2011</u>	<u>2010</u>
<i>In thousands</i>		
<b>Operating Cash Flows:</b>		
Net income (loss)	\$ 26,052	\$(22,015)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization of property, plant, and equipment	24,137	23,169
Amortization of intangible assets and debt costs	17,200	19,872
Dividends received from unconsolidated entities, net of equity in income (loss)	3,480	1,110
Loss on debt extinguishment	3,518	—
Write-off of debt discount and debt issuance costs	8,010	—
Stock-based compensation	16,623	16,591
Deferred income taxes	177	(3,462)
Changes in other long-term liabilities	(3,575)	(3,120)
Gain on conversion of equity method investment to controlling interest	(1,519)	—
Other	(18)	252
Changes in operating assets and liabilities, net of effect of acquired businesses:		
Trade accounts receivable, net	60,828	541
Prepaid expenses and other	(6,612)	(2,439)
Term receivables, long-term	(35,712)	18,596
Accounts payable and accrued liabilities	(54,535)	(19,811)
Income taxes payable	(12,380)	(1,332)
Deferred revenue	(10,482)	(20,857)
Net cash provided by operating activities	<u>35,192</u>	<u>7,095</u>
<b>Investing Cash Flows:</b>		
Increase in restricted cash	—	(999)
Purchases of property, plant, and equipment	(25,062)	(36,769)
Acquisitions of businesses and equity interests, net of cash acquired	(1,169)	(13,204)
Net cash used in investing activities	<u>(26,231)</u>	<u>(50,972)</u>
<b>Financing Cash Flows:</b>		
Proceeds from issuance of common stock	23,391	15,632
Repurchase of common stock	(69,996)	—
Net decrease in short-term borrowings	(8,336)	(6,247)
Debt and equity issuance costs	(8,929)	(971)
Proceeds from notes payable and revolving credit facility	253,000	80,225
Repayments of notes payable and revolving credit facility	(219,919)	(81,763)
Net cash provided by (used in) financing activities	<u>(30,789)</u>	<u>6,876</u>
Effect of exchange rate changes on cash and cash equivalents	704	1,948
Net change in cash and cash equivalents	(21,124)	(35,053)
Cash and cash equivalents at the beginning of the period	<u>133,113</u>	<u>99,340</u>
Cash and cash equivalents at the end of the period	<u>\$ 111,989</u>	<u>\$ 64,287</u>

*See accompanying notes to unaudited condensed consolidated financial statements.*

Mentor Graphics Corporation  
Notes to Unaudited Condensed Consolidated Financial Statements  
*All numerical dollar and share references are in thousands, except for per share data.*

- (1) **General**—The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with United States (U.S.) generally accepted accounting principles (GAAP) and reflect all material normal recurring adjustments. However, certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). In the opinion of management, the condensed consolidated financial statements include adjustments necessary for a fair presentation of the results of the interim periods presented. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and the notes included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2011.

The preparation of condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and contingencies as of the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from these estimates. Any changes in estimates will be reflected in the financial statements in future periods.

(2) **Summary of Significant Accounting Policies**

**Principles of Consolidation**

The condensed consolidated financial statements include our financial statements and those of our wholly-owned and majority-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

We do not have off-balance sheet arrangements, financings, or other similar relationships with unconsolidated entities or other persons, also known as special purpose entities. In the ordinary course of business, we lease certain equipment and certain real properties, primarily field sales offices, and research and development facilities, as described in Note 9. “Commitments and Contingencies.”

**Revenue Recognition**

We report revenue in two categories based on how the revenue is generated: (i) system and software and (ii) service and support.

System and software revenues – We derive system and software revenues from the sale of licenses of software products, emulation hardware systems, and finance fee revenues from our long-term installment receivables from product sales. We primarily license our products using two different license types:

1. Term licenses – We use this license type primarily for software sales. This license type provides the customer with the right to use a fixed list of software products for a specified time period, typically three years, with payments spread over the license term, and does not provide the customer with the right to use the products after the end of the term. Term license arrangements may allow the customer to share products between multiple locations and remix product usage from the fixed list of products at regular intervals during the license term. We generally recognize product revenue from term license arrangements upon product delivery and start of the license term. In a term license agreement where we provide the customer with rights to unspecified or unreleased future products, we recognize revenue ratably over the license term.

2. Perpetual licenses – We use this license type for software and emulation hardware system sales. This license type provides the customer with the right to use the product in perpetuity and typically does not provide for extended payment terms. We generally recognize product revenue from perpetual license arrangements upon product delivery assuming all other criteria for revenue recognition have been met.

We include finance fee revenues from the accretion on the discount of long-term installment receivables in system and software revenues.

Service and support revenues – We derive service and support revenues from software and hardware post-contract maintenance or support services and professional services, which include consulting, training, and other services. We recognize maintenance and support revenue ratably over the support services term. We record professional service revenue as the services are provided to the customer.

We determine whether product revenue recognition is appropriate based upon the evaluation of whether the following four criteria have been met:

1. Persuasive evidence of an arrangement exists – Generally, we use either a customer signed contract or qualified customer purchase order as evidence of an arrangement for both term and perpetual licenses. For professional service engagements, we generally use a signed professional services agreement and a statement of work to evidence an arrangement. Sales through our distributors are evidenced by an agreement governing the relationship, together with binding purchase orders from the distributor on a transaction-by-transaction basis.

2. Delivery has occurred – We generally deliver software and the corresponding access keys to customers electronically. Electronic delivery occurs when we provide the customer access to the software. We may also deliver the software on a compact disc. With respect to emulation hardware systems, we transfer title to the customer upon shipment. Our software license and emulation hardware system agreements generally do not contain conditions for acceptance.

3. Fee is fixed or determinable – We assess whether a fee is fixed or determinable at the outset of the arrangement, primarily based on the payment terms associated with the transaction. We have established a history of collecting under the original contract with installment terms without providing concessions on payments, products, or services. Additionally, for installment contracts, we determine that the fee is fixed or determinable if the arrangement has a payment schedule that is within the term of the licenses and the payments are collected in equal or nearly equal installments, when evaluated on a cumulative basis. If the fee is not deemed to be fixed or determinable, we recognize revenue as payments become due and payable.

Significant judgment is involved in assessing whether a fee is fixed or determinable. We must also make these judgments when assessing whether a contract amendment to a term arrangement (primarily in the context of a license extension or renewal) constitutes a concession. Our experience has been that we are able to determine whether a fee is fixed or determinable for term licenses. If we no longer were to have a history of collecting under the original contract without providing concessions on term licenses, revenue from term licenses would be required to be recognized when payments under the installment contract become due and payable. Such a change could have a material impact on our results of operations.

4. Collectibility is probable – To recognize revenue, we must judge collectibility of the arrangement fees on a customer-by-customer basis pursuant to our credit review process. We typically sell to customers with whom there is a history of successful collection. We evaluate the financial position and a customer's ability to pay whenever an existing customer purchases new products, renews an existing arrangement, or requests an increase in credit terms. For certain industries for which our products are not considered core to the industry or the industry is generally considered troubled, we impose higher credit standards. If we determine that collectibility is not probable based upon our credit review process or the customer's payment history, we recognize revenue as payments are received.

Multiple element arrangements involving software licenses – For multiple element arrangements involving software and other software-related deliverables, vendor-specific objective evidence of fair value (VSOE) must exist to allocate the total fee among all delivered and non-essential undelivered elements of the arrangement. If undelivered elements of the arrangement are essential to the functionality of the product, we defer revenue until the essential elements are delivered. If VSOE does not exist for one or more non-essential undelivered elements, we defer revenue until such evidence exists for the undelivered elements, or until all elements are delivered, whichever is earlier. If VSOE of all non-essential undelivered elements exist but VSOE does not exist for one or more delivered elements, we recognize revenue using the residual method. Under the residual method, we defer revenue related to the undelivered elements based upon VSOE and we recognize the remaining portion of the arrangement fee as revenue for the delivered elements, assuming all other criteria for revenue recognition are met. If we can no longer establish VSOE for non-essential undelivered elements of multiple element arrangements, we defer revenue until all elements are delivered or VSOE is established for the undelivered elements, whichever is earlier.

We base our VSOE for certain product elements of an arrangement upon the pricing in comparable transactions when the element is sold separately. We primarily base our VSOE for term and perpetual support services upon customer renewal history where the services are sold separately. We also base VSOE for professional services and installation services for emulation hardware systems upon the price charged when the services are sold separately.

Multiple element arrangements involving hardware – For multiple element arrangements involving our emulation hardware systems, we allocate revenue to each element based on the relative selling price of each deliverable. In order to meet the separation criteria to allocate revenue to each element we must determine the standalone selling price of each element using a hierarchy of evidence. The authoritative guidance requires that, in the absence of VSOE or third-party evidence (TPE), a company must develop an estimated selling price (ESP). ESP is defined as the price at which the vendor would transact if the deliverable was sold by the vendor regularly on a standalone basis. A company should consider market conditions as well as entity-specific factors when estimating a selling price.

When VSOE or TPE does not exist, we base our ESP for certain elements in arrangements on either costs incurred to manufacture a product plus a reasonable profit margin or standalone sales to similar customers. In determining profit

margins, we consider current market conditions, pricing strategies related to the class of customer, and the level of penetration we have with the customer. We may have limited sales on a standalone basis to the same or similar customers and/or guaranteed pricing on future purchases of the same item. If we are unable to demonstrate value on a standalone basis of an element, we could be required to combine elements which may impact the timing of revenue recognition if not delivered together.

### **Noncontrolling Interest with Redemption Feature**

As of October 31, 2011, we have presented a noncontrolling interest in a privately-held company as a result of a business combination. In conjunction with this business combination, we also entered into an agreement which allows the other owners of the company to require us to purchase their noncontrolling interest at a future date for a price based on a formula defined in the agreement. The noncontrolling interest adjusted for this redemption feature is presented on the condensed consolidated balance sheet under the caption "Noncontrolling interest with redemption feature." Because the redemption of the noncontrolling interest is outside of our control, we have presented this interest outside of stockholders' equity.

The results of the majority-owned subsidiary will be presented in our consolidated results with an adjustment reflected on the face of our statement of operations for the noncontrolling investors' interest in the results of the subsidiary. Additionally, adjustments to the redemption feature will be recorded with an adjustment to retained earnings.

### **Recent Accounting Pronouncements**

In May 2011, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards." ASU 2011-04 is intended to improve the comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with U.S. GAAP. ASU 2011-04 will become effective prospectively for interim and annual reporting periods beginning on or after December 15, 2011. Early adoption is not permitted for public entities. We are currently evaluating the impact of ASU 2011-04 on our consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income." ASU 2011-05 increases the prominence of other comprehensive income in the financial statements and gives entities the option to present the components of net income and comprehensive income as either a single continuous statement of comprehensive income or in two separate but consecutive statements. ASU 2011-05 eliminates the option to present other comprehensive income in the statement of changes in stockholders' equity. ASU 2011-05 will become effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. We are currently evaluating the impact of ASU 2011-05 on the presentation of our consolidated financial statements.

In September 2011, the Financial Accounting Standards Board issued Accounting Standards Update ASU 2011-08, "Testing Goodwill for Impairment," which amends Accounting Standards Codification 350, "Intangibles — Goodwill and Other." The amended guidance reduces complexity and cost by allowing an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. This initial assessment serves as a basis for determining if performing the two-step goodwill impairment test is necessary. The amendments are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The implementation of this amended accounting guidance is not expected to have a material impact on our consolidated financial statements.

### **Reclassifications**

Certain items have been reclassified between cost of revenues and operating expenses, and within operating expenses for the three and nine months ended October 31, 2010. We have reclassified a portion of our information technology administrative costs out of general and administration into cost of revenues, research and development, and marketing and selling. Additionally, we have reclassified technical publication expenses associated with our products from research and development to cost of revenues. Finally, we have reclassified the salaries and other related costs of our Technical Marketing Engineers from marketing and selling to research and development. While these reclassifications reduced gross margin, they had no impact on operating income (loss) or net income (loss) for the three and nine months ended October 31, 2010.

The reclassification of our previously issued condensed consolidated statement of operations was made to conform to current period presentation. These reclassifications were the result of a refinement of our allocation of costs to more

closely align these activities with utilization. In addition these reclassifications more closely align our cost allocations with other companies in our industry.

The amounts have been reclassified in our condensed consolidated statement of operations for the time periods noted below as follows:

	Three months ended October 31, 2010		Nine months ended October 31, 2010	
	As Originally Reported	As Reclassified	As Originally Reported	As Reclassified
Revenues	\$ 238,937	\$ 238,937	\$ 607,448	\$ 607,448
Cost of revenues				
System and software	11,218	14,261	20,409	28,881
Service and support	24,445	25,430	69,511	72,230
Amortization of purchased technology	3,299	3,299	10,428	10,428
Total cost of revenues	38,962	42,990	100,348	111,539
Gross margin	199,975	195,947	507,100	495,909
Operating expenses:				
Research and development	70,727	73,622	199,904	208,058
Marketing and selling	82,603	80,591	230,889	225,135
General and administration	23,396	18,485	69,118	55,527
Equity in earnings of Frontline	(415)	(415)	(1,761)	(1,761)
Amortization of intangible assets	1,445	1,445	5,742	5,742
Special charges	1,578	1,578	8,052	8,052
Total operating expenses	179,334	175,306	511,944	500,753
Operating income (loss)	\$ 20,641	\$ 20,641	\$ (4,844)	\$ (4,844)

(3) **Fair Value Measurement**—We measure financial instruments at fair value on a quarterly basis. The Financial Accounting Standards Board established a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources. Unobservable inputs reflect our market assumptions. The fair value hierarchy consists of the following three levels:

- Level 1—Quoted prices for identical instruments in active markets;
- Level 2—Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-derived valuations whose significant inputs are observable; and
- Level 3—One or more significant inputs to the valuation model are unobservable.

The following table presents information about financial assets and liabilities measured at fair value on a recurring basis as of October 31, 2011:

	Fair Value	Level 1	Level 2	Level 3
Foreign currency exchange contracts	\$ 1,511	\$ —	\$ 1,511	\$ —
Contingent consideration	(5,671)	—	—	(5,671)
Total	\$ (4,160)	\$ —	\$ 1,511	\$ (5,671)

The following table presents information about financial assets and liabilities measured at fair value on a recurring basis as of January 31, 2011:

	Fair Value	Level 1	Level 2	Level 3
Foreign currency exchange contracts	\$ 826	\$ —	\$ 826	\$ —
Contingent consideration	(5,342)	—	—	(5,342)
Total	\$ (4,516)	\$ —	\$ 826	\$ (5,342)

In connection with certain acquisitions, payment of a portion of the purchase price is contingent upon the acquired business' achievement of certain revenue goals. We have estimated the fair value of this contingent consideration as the present value of the expected contingent payments over the term of the arrangements. Of the total recorded balance, \$795 was included in accrued liabilities and \$4,876 was included in other long term liabilities on our condensed consolidated balance sheet at October 31, 2011. The total recorded balance at January 31, 2011 was included in other long term liabilities on our condensed consolidated balance sheet.

The following table summarizes Level 3 activity:

Balance as of January 31, 2011	\$5,342
Additions	1,090
Payments/adjustments	(940)
Interest accretion	179
Balance as of October 31, 2011	<u>\$5,671</u>

The following table summarizes the fair value and carrying value of notes payable:

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
Fair value of notes payable	\$ 239,364	\$ 222,591
Carrying value of notes payable	\$ 213,288	\$ 209,348

We based the fair value of notes payable on the quoted market price or rates available to us for instruments with similar terms and maturities. Of the total carrying value of notes payable, \$2,000 as of January 31, 2011 was classified as current on our condensed consolidated balance sheets. The carrying amount of short-term borrowings of \$7,600 as of October 31, 2011 and \$15,544 as of January 31, 2011 approximates fair value because of the short-term nature of the instruments.

The carrying amounts of cash, accounts receivable, accounts payable, and accrued liabilities approximates fair value due to the short-term nature of these assets and liabilities.

- (4) **Business Combinations**—For each business we acquire, the excess of the fair value of the consideration transferred over the fair value of the net tangible assets acquired and net tangible liabilities assumed has been allocated to various identifiable intangible assets and goodwill. Identifiable intangible assets typically consist of purchased technology and customer-related intangibles, which are amortized to expense over their useful lives. Goodwill, representing the excess of the purchase consideration over the fair value of net tangible and identifiable intangible assets, is not amortized.

During the nine months ended October 31, 2011, we exchanged one of our product lines for a controlling interest in a privately-held company. The exchange was accounted for as a business combination. Prior to acquiring this controlling interest, we had a noncontrolling investment, which was accounted for under the equity method of accounting. As a result of this transaction, we recognized a gain of \$1,519 to adjust the carrying value of our equity method investment in the company to its fair value based on an income approach valuation method. The gain was included in other income (expense), net, in our condensed consolidated statement of operations. We recorded \$8,900 for the fair value of the net assets of the acquired business. See Note 2. "Summary of Significant Accounting Policies," for a description of our accounting for the noncontrolling interest.

Additionally, during the nine months ended October 31, 2011, we acquired another privately-held company, which was not material, for a total consideration of \$1,890.

The separate results of operations for the acquisition during the nine months ended October 31, 2011 were not material compared to our overall results of operations and accordingly, pro-forma financial statements of the combined entities have been omitted.

- (5) **Derivative Instruments and Hedging Activities**—We are exposed to fluctuations in foreign currency exchange rates. To manage the volatility, we aggregate exposures on a consolidated basis to take advantage of natural offsets. The primary exposures are the Japanese yen, where we are in a long position, and the euro and the British pound, where we are in a short position. Most large European revenue contracts are denominated and paid to us in U.S. dollars while our European expenses, including substantial research and development operations, are paid in local currencies causing a short position in the euro and the British pound. In addition, we experience greater inflows than outflows of Japanese yen as almost all Japanese-based customers contract and pay us in Japanese yen. While these exposures are aggregated on a consolidated basis to take advantage of natural offsets, substantial exposures remain.

To partially offset the net exposures in the euro, British pound, and the Japanese yen, we enter into foreign currency exchange contracts of less than one year which are designated as cash flow hedges. Any gain or loss on Japanese yen contracts is classified as product revenue when the hedged transaction occurs. Any gain or loss on euro and British pound contracts is classified as operating expense when the hedged transaction occurs.

We formally document all relationships between foreign currency exchange contracts and hedged items as well as our risk management objectives and strategies for undertaking various hedge transactions. All hedges designated as cash flow hedges are linked to forecasted transactions and we assess, both at inception of the hedge and on an ongoing basis, the effectiveness of the foreign currency exchange contracts in offsetting changes in the cash flows of the hedged items. We report the effective portions of the net gains or losses on foreign currency exchange contracts as a component of accumulated other comprehensive income (OCI) in stockholders' equity. Accumulated OCI associated with hedges of forecasted transactions is reclassified to the condensed consolidated statement of operations in the same period the forecasted transaction occurs. We discontinue hedge accounting prospectively when we determine that a foreign currency exchange contract is not highly effective as a hedge. To the extent a forecasted transaction is no longer deemed probable of occurring, we prospectively discontinue hedge accounting treatment and we reclassify deferred amounts to other income (expense), net in the condensed consolidated statement of operations. We noted no such instance during the three or nine months ended October 31, 2011 or 2010.

The fair values and balance sheet presentation of our derivative instruments as of October 31, 2011 are summarized as follows:

	<u>Location</u>	<u>Asset Derivatives</u>	<u>Liability Derivatives</u>
<b>Derivatives not designated as hedging instruments:</b>			
Non-designated forwards	Other receivables	<u>\$ 2,038</u>	<u>\$ (527)</u>

The fair values and balance sheet presentation of our derivative instruments as of January 31, 2011 are summarized as follows:

	<u>Location</u>	<u>Asset Derivatives</u>	<u>Liability Derivatives</u>
<b>Derivatives designated as hedging instruments:</b>			
Cash flow forwards	Other receivables	\$ 575	\$ (414)
<b>Derivatives not designated as hedging instruments:</b>			
Non-designated forwards	Other receivables	1,125	(460)
<b>Total derivatives</b>		<u>\$ 1,700</u>	<u>\$ (874)</u>

During the nine months ended October 31, 2011, we entered into 1,034 new foreign currency forward contracts. We had a total of 33 contracts outstanding with a total gross notional value of \$112,952 outstanding as of October 31, 2011. For the nine months ended October 31, 2010, we entered into 1,031 new foreign currency contracts. We had a total of 37 contracts with a total gross notional value of \$176,982 outstanding as of October 31, 2010. Notional amounts do not quantify risk or represent our assets or liabilities but are used in the calculation of cash settlements under the contracts.

By using derivative instruments, we subject ourselves to credit risk. If a counterparty fails to fulfill its performance obligations under a derivative contract, our credit risk will equal the fair value of the derivative instrument. Generally, when the fair value of our derivative contracts is a net asset, the counterparty owes us, thus creating a receivable risk. We minimize counterparty credit risk by entering into derivative transactions with major financial institutions and, therefore, we do not expect material losses as a result of default by our counterparties.

The pre-tax effect of derivative instruments in cash flow hedging relationships on income and OCI for the nine months ended October 31, 2011 is as follows:

Derivatives Designated as Hedging Instruments	Gain Recognized in OCI on Derivatives (Effective Portion)	Gain (loss) Reclassified from Accumulated OCI into Income (Effective Portion)		Gain Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing)	
	Amount	Location	Amount	Location	Amount
Cash flow forwards	\$ 147	Revenues	\$ (859)	Other income (expense), net	\$ 65
		Operating expenses	1,074		
<b>Total</b>	<b>\$ 147</b>		<b>\$ 215</b>		<b>\$ 65</b>

The gain on cash flow forwards of \$65 recognized in other income (expense), net for the nine months ended October 31, 2011 is related to the time value exclusion of foreign currency forward contracts from our assessment of hedge effectiveness.

The pre-tax effect of derivative instruments in cash flow hedging relationships on income and OCI for the nine months ended October 31, 2010 is as follows:

Derivatives Designated as Hedging Instruments	Loss Recognized in OCI on Derivatives (Effective Portion)	Loss Reclassified from Accumulated OCI into Income (Effective Portion)		Gain Recognized in Income on Derivatives (Ineffective Portion and Amount Excluded from Effectiveness Testing)	
	Amount	Location	Amount	Location	Amount
Cash flow forwards	\$ (3,117)	Revenues	\$ (657)	Other income (expense), net	\$ 46
		Operating expenses	(4,079)		
<b>Total</b>	<b>\$ (3,117)</b>		<b>\$(4,736)</b>		<b>\$ 46</b>

The gain on cash flow forwards of \$46 recognized in other income (expense), net for the nine months ended October 31, 2010 was related to the time value exclusion of foreign currency forward contracts from our assessment of hedge effectiveness.

The hedge balance in accumulated other comprehensive income was as follows:

As of	October 31, 2011	January 31, 2011
Accumulated OCI before tax effect	\$ —	\$ 69
Accumulated OCI after tax effect	\$ —	\$ (2)

The balance represents a net unrealized gain on foreign currency exchange contracts related to hedges of forecasted revenues and expenses expected to occur within the next twelve months. We will transfer this amount to the condensed consolidated statement of operations upon recognition of the related revenues and recording of the respective expenses. We expect substantially all of the hedge balance in accumulated other comprehensive income to be reclassified to the condensed consolidated statement of operations within the next twelve months.

We enter into foreign currency exchange contracts to offset the earnings impact relating to the variability in exchange rates on certain short-term monetary assets and liabilities denominated in non-functional currencies. We do not designate these foreign currency contracts as hedges. The effect of derivative instruments not designated as hedging instruments on income is as follows:

Derivatives Not Designated as Hedging Instruments	Gain (Loss) Recognized in Income on Derivatives	
	Location	Amount as of October 31, 2011
Non-designated forwards	Other income (expense), net	\$ (574)
		\$ 1,125

- (6) **Term Receivables and Trade Accounts Receivable**—We have long-term installment receivables that are attributable to multi-year, multi-element term license sales agreements. We include balances under term agreements that are due within one year in trade accounts receivable, net and balances that are due more than one year from the balance sheet date in term receivables, long-term. We discount the total product portion of the agreements to reflect the interest component of the transaction. We amortize the interest component of the transaction, using the effective interest method, to system and software revenues over the period in which payments are made and balances are outstanding. We determine the discount rate at the outset of the arrangement based upon the current credit rating of the customer. We reset the discount rate periodically considering changes in prevailing interest rates but do not adjust previously discounted balances.

Term receivable and trade accounts receivable balances were as follows:

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
Trade accounts receivable	\$113,886	\$153,733
Term receivables, short-term	\$177,198	\$193,342
Term receivables, long-term	\$204,295	\$167,425

Trade accounts receivable include billed amounts whereas term receivables, short-term are comprised of unbilled amounts. Term receivables, short term represent the portion of long-term installment agreements that are due within one year. Billings for term agreements typically occur 30 days prior to the contractual due date, in accordance with individual contract installment terms. Term receivables, long-term represent unbilled amounts which are scheduled to be collected beyond one year.

We perform a credit risk assessment of all customers using the Standard & Poor's (S&P) credit rating as our primary credit-quality indicator. The S&P credit ratings are based on the most recent S&P score available. For customers that do not have an S&P credit rating, we base our credit risk assessment on an internal credit assessment which is based on selected short-term financial ratios. Our internal credit assessment is based upon results provided in the customers' most recent financial statements.

The credit risk assessment for our long-term receivables was as follows:

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
<b>S&amp;P credit rating:</b>		
AAA+ through BBB-	\$ 99,563	\$ 84,685
BB+ and lower	20,861	19,473
	120,424	104,158
<b>Internal credit assessment</b>	<b>83,871</b>	<b>63,267</b>
<b>Total long-term term receivables</b>	<b><u>\$204,295</u></b>	<b><u>\$167,425</u></b>

We maintain allowances for doubtful accounts on trade accounts receivable and term receivables for estimated losses resulting from the inability of our customers to make required payments. We regularly evaluate the collectibility of our trade accounts receivable based on a combination of factors. When we become aware of a specific customer's inability to meet its financial obligations, such as in the case of bankruptcy or deterioration in the customer's operating results, financial position, or credit rating, we record a specific reserve for bad debt to reduce the related receivable to the amount believed to be collectible. We also record unspecified reserves for bad debt for all other customers based on a variety of factors including length of time the receivables are past due, the financial health of the customers, the current business environment, and historical experience. Current economic conditions we have considered include forecasted spending in the semiconductor industry, consumer spending for electronics, integrated circuit research and development spending, and volatility in gross domestic product. If these factors change or circumstances related to specific customers change, we adjust the estimates of the recoverability of receivables resulting in either additional selling expense or a reduction in selling expense in the period such determination is made.

The following shows the change in allowance for doubtful accounts for the nine months ended October 31, 2011:

	<u>Beginning balance as of January 31, 2011</u>	<u>Charged (credited) to expense</u>	<u>Deductions<sup>(1)</sup></u>	<u>Ending balance as of October 31, 2011</u>
Allowance for doubtful accounts	\$ 3,941	\$ 26	\$ (194)	\$ 3,773

<sup>(1)</sup> Specific account write-offs and foreign exchange.

We enter into agreements to sell qualifying accounts receivable from time to time to certain financing institutions on a non-recourse basis. We received net proceeds from the sale of receivables of \$28,295 for the nine months ended October 31, 2011 compared to \$39,244 for the nine months ended October 31, 2010.

(7) **Short-Term Borrowings**—Short-term borrowings consisted of the following:

<u>As of</u>	<u>October 31,</u> <u>2011</u>	<u>January 31,</u> <u>2011</u>
Collections of previously sold accounts receivable	\$ 2,311	\$ 10,680
Other borrowings	5,289	4,864
Short-term borrowings	<u>\$ 7,600</u>	<u>\$ 15,544</u>

In April 2011, we entered into a syndicated, senior, unsecured, four-year revolving credit facility that terminates April 27, 2015. The revolving credit facility has a maximum borrowing capacity of \$125,000. Under this revolving credit facility, we have the option to pay interest based on:

- (i) London Interbank Offered Rate (LIBOR) with varying maturities commensurate with the borrowing period we select, plus a spread of between 2.25% and 3.25% based on a pricing grid tied to a financial covenant, or
- (ii) A base rate plus a spread of between 1.25% and 2.25%, based on a pricing grid tied to a financial covenant.

The base rate is defined as the highest of:

- (i) The federal funds rate, as defined, plus 0.5%,
- (ii) The prime rate of the lead bank, or
- (iii) One-month LIBOR plus 1.0%.

As a result of these interest rate options, our interest expense associated with borrowings under this revolving credit facility will vary with market interest rates. In addition, commitment fees are payable on the unused portion of the revolving credit facility at rates between 0.40% and 0.50% based on a pricing grid tied to a financial covenant. We paid commitment fees as follows:

	<u>Three months ended October 31,</u>		<u>Nine months ended October 31,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Commitment fees	\$ 128	\$ 61	\$ 257	\$ 185

This revolving credit facility contains certain financial and other covenants, including the following:

- Our adjusted quick ratio (ratio of the sum of cash and cash equivalents, short-term investments, and net current receivables to total current liabilities) shall not be less than 1.00;
- Our tangible net worth (stockholders' equity less goodwill and other intangible assets) must exceed the calculated required tangible net worth as defined in the credit agreement, which establishes a fixed level of required tangible net worth. Each quarter the required level increases by 70% of any positive net income in the quarter (but in the aggregate no more than 70% of positive net income for any full fiscal year), 100% of the amortization of intangible assets in the quarter, and 100% of certain stock issuance proceeds. The required level also decreases each quarter by 50% of amounts paid for dividends or repurchases of our stock and certain amounts of acquired intangible assets;
- Our leverage ratio (ratio of total liabilities less subordinated debt to the sum of subordinated debt and tangible net worth) shall be less than 2.00;
- Our senior leverage ratio (ratio of total debt less subordinated debt to the sum of subordinated debt and tangible net worth) shall not be greater than 0.90; and
- Our minimum cash and accounts receivable ratio (ratio of the sum of cash and cash equivalents, short-term investments, and 42.0% of net current accounts receivable, to outstanding credit agreement borrowings) shall not be less than 1.25.

The revolving credit facility limits the aggregate amount we can pay for dividends and repurchases of our stock over the four year term of the facility to \$50,000 plus 70% of our cumulative net income.

We were in compliance with all financial covenants as of October 31, 2011. If we were to fail to comply with the financial covenants and do not obtain a waiver from our lenders, we would be in default under the revolving credit facility and our lenders could terminate the facility and demand immediate repayment of all outstanding loans under the revolving credit facility.

Short-term borrowings include amounts collected from customers on accounts receivable previously sold on a non-recourse basis to financial institutions. These amounts are remitted to the financial institutions in the following quarter.

We generally have other short-term borrowings, including multi-currency lines of credit, capital leases, and other borrowings. Interest rates are generally based on the applicable country's prime lending rate, depending on the currency borrowed.

(8) **Notes Payable**—Notes payable consist of the following:

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
4.00% Debentures due 2031	\$211,952	\$ —
6.25% Debentures due 2026, issued 2006	—	157,843
6.25% Debentures due 2026, issued fiscal 2011	—	31,705
Term Loan due 2013	—	18,500
Other	1,336	1,300
Notes payable	213,288	209,348
Term Loan due 2013, current portion	—	(2,000)
Notes payable, long-term	<u>\$213,288</u>	<u>\$207,348</u>

*4.00% Debentures due 2031*: In April 2011, we issued \$253,000 of 4.00% Convertible Subordinated Debentures (4.00% Debentures) due 2031 in a private placement pursuant to SEC Rule 144A under the Securities Act of 1933. Interest on the 4.00% Debentures is payable semi-annually in April and October.

The 4.00% Debentures are convertible, under certain circumstances, into our common stock at a conversion price of \$20.538 per share for a total of 12,319 shares as of October 31, 2011. These circumstances include:

- The market price of our common stock exceeding 120% of the conversion price;
- A call for redemption of the 4.00% Debentures;
- Specified distributions to holders of our common stock;
- If a fundamental change, such as a change of control, occurs;
- During the two months prior to, but not on, the maturity date; or
- The market price of the 4.00% Debentures declining to less than 98% of the value of the common stock into which the 4.00% Debentures are convertible.

Upon conversion of any 4.00% Debentures, a holder will receive:

- (i) Cash up to the principal amount of the 4.00% Debentures that are converted; and
- (ii) Cash or shares of common stock, at our election, for the excess, if any, of the value of the converted shares over the principal amount.

If a holder elects to convert their 4.00% Debentures in connection with a fundamental change in the company that occurs prior to April 5, 2016, the holder will also be entitled to receive a make whole premium upon conversion in some circumstances.

We may redeem some or all of the 4.00% Debentures for cash on or after April 5, 2016 at the following redemption prices expressed as a percentage of principal, plus any accrued and unpaid interest:

<u>Period</u>	<u>Price</u>
Beginning on April 5, 2016 and ending on March 31, 2017	101.143%
Beginning on April 1, 2017 and ending on March 31, 2018	100.571%
On April 1, 2018 and thereafter	100.000%

The holders, at their option, may redeem the 4.00% Debentures in whole or in part for cash on April 1, 2018, April 1, 2021, and April 1, 2026, and in the event of a fundamental change in the company. In each case, our repurchase price will be 100% of the principal amount of the 4.00% Debentures plus any accrued and unpaid interest.

As the 4.00% Debentures contain conversion features that the debt may be settled in cash upon conversion, we separately account for the implied liability and equity components of the 4.00% Debentures. The principal amount, unamortized debt discount, net carrying amount of the liability component, and carrying amount of the equity component of the 4.00% Debentures are as follows:

<u>As of</u>	<u>October 31, 2011</u>
Principal amount	\$253,000
Unamortized debt discount	(41,048)
Net carrying amount of the liability component	<u>\$211,952</u>
Equity component	<u>\$ 43,930</u>

The unamortized debt discount will be amortized to interest expense using the effective interest method through March 2018. We recognized the following amounts in interest expense in the condensed consolidated statement of operations related to the 4.00% debentures:

	<u>Three months ended October 31, 2011</u>	<u>Nine months ended October 31, 2011</u>
Interest expense at the contractual interest rate	\$ 2,530	\$ 5,819
Amortization of debt discount	\$ 1,250	\$ 2,882

The effective interest rate on the 4.00% Debentures was 7.25% for the nine months ended October 31, 2011.

*6.25% Debentures due 2026:* In March 2006, we issued \$200,000 of 6.25% Convertible Subordinated Debentures (6.25% Debentures) due 2026 in a private offering pursuant to SEC Rule 144A under the Securities Act of 1933. Interest on the 6.25% Debentures was payable semi-annually in March and September.

The principal amount, unamortized debt discount, net carrying amount of the liability component, and carrying amount of the equity component of the 6.25% Debentures, issued 2006, were as follows:

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
Principal amount	\$ —	\$165,000
Unamortized debt discount	—	(7,157)
Net carrying amount of the liability component	<u>\$ —</u>	<u>\$157,843</u>
Equity component	<u>\$ —</u>	<u>\$ 21,766</u>

We recognized the following amounts in interest expense in the condensed consolidated statements of operations related to the 6.25% Debentures, issued 2006:

	<u>Three months ended October 31,</u>		<u>Nine months ended October 31,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Interest expense at the contractual interest rate	\$ —	\$ 2,578	\$2,900	\$7,744
Amortization of debt discount	\$ —	\$ 760	\$ 793	\$2,233

The effective interest rate on the 6.25% Debentures was 8.60% for the nine months ended October 31, 2011 and 2010.

During fiscal 2011, we issued \$31,509 of 6.25% Debentures. The principal amount, unamortized premium, and net carrying amount of the 6.25% Debentures, issued fiscal 2011, were as follows:

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
Principal amount	\$ —	\$ 31,509
Unamortized debt premium	—	196
Net carrying amount of the liability component	<u>\$ —</u>	<u>\$ 31,705</u>

No equity component was recorded for the 6.25% Debentures, issued fiscal 2011, as the conversion feature was deemed to be non-beneficial when the debt was issued.

During the nine months ended October 31, 2011, we redeemed the remaining \$196,509 principal amount of 6.25% Debentures utilizing proceeds received from the issuance of the 4.00% Debentures and cash on hand. In connection with this redemption, we incurred a before tax net loss on the early extinguishment of debt of \$11,192, which included a \$6,190 write-off of net unamortized debt discount, a \$3,518 premium on redemption of the 6.25% Debentures, and a write-off of \$1,484 for the unamortized debt issuance costs. This loss is included in interest expense on the condensed consolidated statement of operations. No balance remains outstanding following this redemption.

*Term Loan due 2013:* In April 2010, we entered into a three-year term loan (Term Loan) for \$20,000 to repay borrowings under our revolving credit facility used to purchase office buildings in Fremont, California. Fixed principal of \$500 and accrued interest payments were payable quarterly in February, May, August, and November.

During the nine months ended October 31, 2011, we repaid the remaining obligation of \$18,500 under the Term Loan utilizing proceeds received from the issuance of the 4.00% Debentures. In connection with this repayment, we incurred a before tax net loss on early retirement of debt of \$312, representing the write-off of the unamortized debt issuance costs. This loss is included in interest expense on the condensed consolidated statement of operations. The effective interest rate was 4.81% for the nine months ended October 31, 2011. No balance remains outstanding following this repayment.

*Other Notes Payable:* In November 2009, we issued a subordinated note payable as part of a business combination. The note bears interest at a rate of 3.875% and is due in full along with all accrued interest on November 17, 2012.

#### (9) *Commitments and Contingencies*

##### **Leases**

We lease a majority of our field sales offices and research and development facilities under non-cancelable operating leases. In addition, we lease certain equipment used in our research and development activities. This equipment is generally leased on a month-to-month basis after meeting a six-month lease minimum. There have been no significant changes to the future minimum lease payments due under non-cancelable operating leases disclosed in our Annual Report on Form 10-K for the fiscal year ended January 31, 2011.

##### **Indemnifications**

Our license and services agreements generally include a limited indemnification provision for claims from third parties relating to our intellectual property. The indemnification is generally limited to the amount paid by the customer, a multiple of the amount paid by the customer, or a set cap. As of October 31, 2011, we were not aware of any material liabilities arising from these indemnification obligations.

##### **Legal Proceedings**

From time to time we are involved in various disputes and litigation matters that arise in the ordinary course of business. These include disputes and lawsuits relating to intellectual property rights, contracts, distributorships, and employee relations matters. Periodically, we review the status of various disputes and litigation matters and assess our potential exposure. When we consider the potential loss from any dispute or legal matter probable and the amount or the range of loss can be estimated, we will accrue a liability for the estimated loss. Legal proceedings are subject to uncertainties, and the outcomes are difficult to predict. Because of such uncertainties, we base accruals on the best information available at the time. As additional information becomes available, we reassess the potential liability related to pending claims and litigation matters and may revise estimates. We believe that the outcome of current litigation, individually and in the aggregate, will not have a material effect on our results of operations.

#### (10) *Employee Stock and Savings Plans*

##### **Stock Options Plans and Stock Plans**

Our 2010 Omnibus Incentive Plan (Incentive Plan) is administered by the Compensation Committee of our Board of Directors and permits accelerated vesting of outstanding options, restricted stock units, restricted stock awards, and other equity incentives upon the occurrence of certain changes in control of our company. Stock options under the Incentive Plan are generally expected to vest over four years, have an expiration date of ten years from the date of grant, and an exercise price no less than the fair market value of the shares on the date of grant.

##### **Employee Stock Purchase Plans**

We have an employee stock purchase plan (ESPP) for U.S. employees and an ESPP for certain foreign subsidiary employees. The ESPPs provide for six month offerings commencing on January 1 and July 1 of each year with purchases on June 30 and December 31 of each year. Each eligible employee may purchase up to six thousand shares

of stock on each purchase date (but no more than an annual offering date total fair market value of \$25) at prices no less than 85% of the lesser of the fair market value of the shares on the offering date or on the purchase date.

### Stock-Based Compensation Expense

For each of the years presented, we estimated the fair value of stock options and purchase rights under our ESPPs using a Black-Scholes option-pricing model. The Black-Scholes option-pricing model incorporates several subjective assumptions including expected volatility, expected term, and interest rates.

In determining expected volatility for options, we include the elements listed below at the weighted percentages presented:

- Historical volatility of our shares of common stock at 35%;
- Historical volatility of shares of comparable companies at 20%;
- Implied volatility of our traded options at 30%; and
- Implied volatility of traded options of comparable companies at 15%.

The greatest weighting was provided to our historic volatility based on the amount of consistent historic information available. A lesser weighting has been applied to the implied volatility of our traded options due to a low volume of trades and shorter terms. We have also included the historic and implied volatility of comparable companies in our industry in an effort to capture a broader view of the marketplace.

The relative weighting percentages are periodically reviewed for reasonableness and are subject to change depending on market conditions and our particular facts and circumstances.

The following table summarizes stock compensation expense recognized:

	Three months October 31,		Nine months ended October 31,	
	2011	2010	2011	2010
Cost of goods sold	\$ 249	\$ 221	\$ 753	\$ 671
Research and development	2,005	1,798	6,119	6,007
Marketing	1,365	1,299	4,393	4,802
Administration	1,495	1,589	5,358	5,111
Total	<u>\$5,114</u>	<u>\$4,907</u>	<u>\$16,623</u>	<u>\$16,591</u>

- (11) **Incentive Stock Rights**—Our Board of Directors has the authority to issue incentive stock in one or more series and to determine the relative rights and preferences of the incentive stock. On June 24, 2010, we adopted an Incentive Stock Purchase Rights Plan and declared a dividend distribution of one Right for each outstanding share of common stock, payable to holders of record on July 6, 2010. As long as the Rights are attached to our common stock, we will issue one Right with each new share of common stock so that all such shares will have attached Rights. Under certain conditions, each Right may be exercised to purchase 1/10,000 of a share of Series B Junior Participating Incentive Stock at a purchase price of fifty dollars, subject to adjustment. The Rights are not presently exercisable and will only become exercisable if a person or group acquires or commences a tender offer to acquire 15% or more of our common stock. If a person or group acquires 15% or more of the common stock, each Right will be adjusted to entitle its holder to receive, upon exercise, common stock (or, in certain circumstances, other assets of ours) having a value equal to two times the exercise price of the Right or each Right will be adjusted to entitle its holder to receive, upon exercise, common stock of the acquiring company having a value equal to two times the exercise price of the Right, depending on the circumstances. The Rights expire on December 31, 2011 and may be redeemed by us for \$0.001 per Right. The Rights do not have voting or dividend rights and have no dilutive effect on our earnings.
- (12) **Net Income (Loss) Per Share**—We compute basic net income (loss) per share using the weighted average number of common shares outstanding during the period. We compute diluted net income (loss) per share using the weighted average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares consist of common shares issuable upon exercise of stock options, restricted stock units,

purchase rights from ESPPs, and warrants using the treasury stock method and common shares issuable upon conversion of the convertible subordinated debentures, if dilutive.

The following provides the computation of basic and diluted net loss per share:

	<u>Three months ended October 31,</u>		<u>Nine months ended October 31,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Net income (loss)	\$ 24,071	\$ 15,257	\$ 26,052	\$ (22,015)
Weighted average common shares used to calculate basic net income (loss) per share	109,501	109,364	110,423	106,942
Employee stock options, restricted stock units and employee stock purchase plan	2,062	2,775	2,758	—
Weighted average common and potential common shares used to calculate diluted net income (loss) per share	<u>111,563</u>	<u>112,139</u>	<u>113,181</u>	<u>106,942</u>
Basic net income (loss) per share	<u>\$ 0.22</u>	<u>\$ 0.14</u>	<u>\$ 0.24</u>	<u>\$ (0.21)</u>
Diluted net income (loss) per share	<u>\$ 0.22</u>	<u>\$ 0.14</u>	<u>\$ 0.23</u>	<u>\$ (0.21)</u>

We excluded from the computation of diluted net income (loss) per share stock options, restricted stock units, and ESPP purchase rights to purchase 7,704 shares of common stock for the three months ended October 31, 2011 and 4,613 shares of common stock for the nine months ended October 31, 2011 compared to 7,178 for the three months ended October 31, 2010 and 15,376 for the nine months ended October 31, 2010. The stock options, restricted stock units, and ESPP purchase rights were anti-dilutive either because we incurred a net loss for the period or the stock options or ESPP purchase rights were determined to be anti-dilutive as a result of applying the treasury stock method.

The effect of the conversion of the Floating Rate Convertible Subordinated Debentures due 2023 (retired during fiscal 2011), the 6.25% Debentures (retired during the nine months ended October 31, 2011), and the 4.00% Debentures was anti-dilutive and therefore excluded from the computation of diluted net income (loss) per share. We assume that the 6.25% Debentures and the 4.00% Debentures will be settled in common stock for purposes of calculating the dilutive effect of the 6.25% Debentures and the 4.00% Debentures.

The conversion features of the 4.00% Debentures, which allow for settlement in cash or a combination of cash and common stock, are further described in Note 8. "Notes Payable."

(13) **Comprehensive Income (Loss)**—The following provides a summary of comprehensive income (loss):

<u>Nine months ended October 31,</u>	<u>2011</u>	<u>2010</u>
Net income (loss)	\$26,052	\$(22,015)
Change in unrealized gain on derivative instruments	2	1,191
Change in accumulated translation adjustment	3,616	3,471
Change in pension liability	—	(4)
Comprehensive income (loss)	<u>\$29,670</u>	<u>\$(17,357)</u>

(14) *Special Charges*—The following is a summary of the components of the special charges:

	Three months ended October 31,		Nine months ended October 31,	
	2011	2010	2011	2010
Employee severance and related costs	\$1,227	\$1,191	\$3,581	\$4,640
Excess leased facility costs	(173)	302	281	804
Other costs	110	85	3,526	2,608
Total special charges	<u>\$1,164</u>	<u>\$1,578</u>	<u>\$7,388</u>	<u>\$8,052</u>

Special charges primarily consist of costs incurred for employee terminations due to a reduction of personnel resources driven by modifications of business strategy or business emphasis. Special charges may also include expenses incurred related to acquisitions, excess facility costs, and asset related charges.

Employee severance and related costs of \$3,581 for the nine months ended October 31, 2011 included severance benefits, notice pay, and outplacement services. The total rebalance charge represents the aggregate of numerous unrelated rebalance plans which impacted several employee groups, none of which was individually material to our financial position or results of operations. We determined termination benefit amounts based on employee status, years of service, and local statutory requirements. We communicated termination benefits to the affected employees prior to the end of the quarter in which we recorded the charge. Approximately 67% of these costs were paid during the nine months ended October 31, 2011. We expect to pay the remainder during the fiscal year ending January 31, 2012. There have been no significant modifications to the amount of these charges.

Excess leased facility costs of \$281 for the nine months ended October 31, 2011 were primarily due to the abandonment of leased facilities.

Other special charges for the nine months ended October 31, 2011 included costs of \$3,967 related to consulting fees associated with our fiscal 2012 proxy contest, \$(545) representing adjustments to earn-outs and other costs related to acquisitions, and other costs of \$104.

Employee severance and related costs of \$4,640 for the nine months ended October 31, 2010 included severance benefits, notice pay, and outplacement services. The total rebalance charge represents the aggregate of numerous unrelated rebalance plans which impacted several employee groups, none of which was individually material to our financial position or results of operations. We determined termination benefit amounts based on employee status, years of service, and local statutory requirements. We communicated termination benefits to the affected employees prior to the end of the quarter in which we recorded the charge. Substantially all of these costs were paid during the fiscal year ending January 31, 2011. There have been no significant modifications to the amount of these charges.

Excess leased facility costs of \$804 for the nine months ended October 31, 2010 were primarily due to the abandonment of leased facilities and changes in the estimate of sublease income for previously abandoned leased facilities.

Other special charges for the nine months ended October 31, 2010 included costs of \$2,083 related to advisory fees, a recovery related to a casualty loss of \$(566), and other costs of \$1,091.

Accrued special charges are included in accrued liabilities and other long-term liabilities in the condensed consolidated balance sheets. The following table shows changes in accrued special charges during the nine months ended October 31, 2011:

	Accrued special charges as of January 31, 2011	Charges during the nine months ended October 31, 2011	Payments during the nine months ended October 31, 2011	Accrued special charges as of October 31, 2011 <sup>(1)</sup>
Employee severance and related costs	\$ 2,664	\$ 3,581	\$ (4,603)	\$ 1,642
Excess leased facility costs	1,930	281	(597)	1,614
Other costs	2,336	3,526	(4,514)	1,348
Total accrued special charges	<u>\$ 6,930</u>	<u>\$ 7,388</u>	<u>\$ (9,714)</u>	<u>\$ 4,604</u>

(1) Of the \$4,604 total accrued special charges as of October 31, 2011, \$1,095 represented the long-term portion of accrued lease termination fees and other facility costs, net of sublease income. The remaining balance of \$3,509 represented the short-term portion of accrued special charges.

(15) **Other Income (Expense), Net**—Other income (expense), net was comprised of the following:

	Three months ended October 31,		Nine months ended October 31,	
	2011	2010	2011	2010
Interest income	\$ 519	\$ 342	\$ 1,588	\$ 885
Foreign currency exchange gain (loss)	211	(435)	(183)	(1,012)
Gain on conversion of equity method investment to controlling interest	1,519	—	1,519	—
Other, net	(413)	(113)	(1,034)	(1,234)
Other income (expense), net	<u>\$1,836</u>	<u>\$(206)</u>	<u>\$ 1,890</u>	<u>\$(1,361)</u>

(16) **Income Taxes**—The provision for income taxes was comprised of the following:

	Three months ended October 31,		Nine months ended October 31,	
	2011	2010	2011	2010
Income tax expense (benefit)	\$ (1,445)	\$ 854	\$(4,429)	\$ 2,432

Generally, the provision for income taxes is the result of the mix of profits and losses earned by us and our subsidiaries in tax jurisdictions with a broad range of income tax rates, withholding taxes (primarily in certain foreign jurisdictions), changes in tax reserves, and the application of valuation allowances on deferred tax assets. Accounting guidance requires that on a quarterly basis we evaluate our provision for income tax expense (benefit) of U.S. and non-U.S. jurisdictions based on our projected results of operations for the full year and record an adjustment in the current quarter.

	Three months ended October 31,		Nine months ended October 31,	
	2011	2010	2011	2010
Effective Tax Rate	(6%)	5%	(20%)	(12%)
Period specific items benefit	\$ (3,719)	\$ (359)	\$ (8,770)	\$ (2,281)

Without period specific items, our effective tax rate is 20% for the nine months ended October 31, 2011. Inclusive of net favorable period specific items of \$(8,770), our effective tax rate is (20%). For the three and nine month periods ending October 31, 2011 our favorable period specific items resulted primarily from decreases in liabilities for uncertain tax positions. Under our forecast of income for the year, we project a 2% effective tax rate inclusive of period specific items.

Our effective tax rate differs from tax computed at the U.S. federal statutory rate of 35% primarily due to:

- The benefit of lower tax rates on earnings of foreign subsidiaries;
- Reduction in reserves for uncertain tax positions; and
- The application of tax incentives for research and development.

These differences are partially offset by:

- U.S. losses and tax credits for which no tax benefit has been recognized;
- Non-deductible employee stock purchase plan compensation expense; and
- Withholding taxes in certain foreign jurisdictions.

Actual results may differ significantly from our current projections. Further, on a quarterly basis, our effective tax rate could fluctuate considerably and could be adversely affected to the extent earnings are higher or lower than anticipated in countries where we have corresponding higher or lower statutory rates.

As of October 31, 2011, we had a liability of \$34,432 for income taxes associated with uncertain income tax positions. All of these tax positions are classified as long-term liabilities in our condensed consolidated balance sheet. We are not able to reasonably estimate the timing of any cash payments required to settle these liabilities; however, we generally do not anticipate the settlement of the liabilities will require payment of cash within the next twelve months. Further, certain liabilities may result in the reduction of deferred tax assets rather than settlement in cash. We do not believe that the ultimate settlement of these liabilities will materially affect our liquidity.

- (17) **Related Party Transactions**—Certain members of our Board of Directors also serve on the board of directors for some of our customers. Management believes the transactions between these customers and us were carried out on an arm's-length basis. As of October 31, 2011, we had accounts receivable due from these customers of \$6,317. As of January 31, 2011, accounts receivable from these customers were not significant. The following table shows revenue recognized from these customers:

	<u>Three months ended October 31,</u>		<u>Nine months ended October 31,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
Revenue from customers	\$ 5,821	\$ 7,543	\$ 30,132	\$ 27,438
Percentage of total revenue	2.3%	3.2%	4.3%	4.5%

- (18) **Supplemental Cash Flow Information**—The following provides information concerning supplemental disclosures of cash flow activities:

<u>Nine months ended October 31,</u>	<u>2011</u>	<u>2010</u>
Cash paid, net for:		
Interest	\$ 14,196	\$ 13,214
Income taxes	\$ 5,863	\$ 9,776

As part of the Valor Computerized Systems, Ltd. acquisition in fiscal 2011, we acquired an investment in Frontline PCB Solutions Limited Partnership (Frontline). During the nine months ended October 31, 2011, we received returns on investment of \$5,415 from Frontline which is included in net cash provided by operating activities in our condensed consolidated statement of cash flows.

- (19) **Segment Reporting**—Our Chief Operating Decision Makers (CODMs), which consist of the Chief Executive Officer and the President, review our consolidated results within one operating segment. In making operating decisions, our CODMs primarily consider consolidated financial information accompanied by disaggregated revenue information by geographic region.

We eliminate all intercompany revenues in computing revenues by geographic regions. Revenues related to operations in the geographic regions were:

	<u>Three months ended October 31,</u>		<u>Nine months ended October 31,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
<b>Revenues:</b>				
North America	\$ 116,256	\$ 116,644	\$ 306,650	\$ 254,930
Europe	62,555	60,347	161,394	151,812
Japan	28,793	21,227	96,193	73,056
Pacific Rim	42,904	40,719	130,046	127,650
Total revenues	<u>\$ 250,508</u>	<u>\$ 238,937</u>	<u>\$ 694,283</u>	<u>\$ 607,448</u>

For the three months ended October 31, 2011, no single customer accounted for 10% or more of total revenues. For the nine months ended October 31, 2011, one customer accounted for 13% of total revenues. For the three months ended October 31, 2010, one customer accounted for 10% of our total revenues. For the nine months ended October 31, 2010, no single customer accounted for 10% or more of our total revenues.

We segregate revenue into five categories of similar products and services. Each category includes both product and related support revenues. Revenue information is as follows:

	<u>Three months ended October 31,</u>		<u>Nine months ended October 31,</u>	
	<u>2011</u>	<u>2010</u>	<u>2011</u>	<u>2010</u>
<b>Revenues:</b>				
IC Design to Silicon	\$ 96,478	\$ 83,433	\$ 236,400	\$ 226,157
Integrated System Design	60,087	57,839	168,933	152,352
Scalable Verification	65,146	67,088	185,948	143,453
New & Emerging Products	11,895	14,877	53,479	40,001
Services & Other	16,902	15,700	49,523	45,485
Total revenues	<u>\$ 250,508</u>	<u>\$ 238,937</u>	<u>\$ 694,283</u>	<u>\$ 607,448</u>

Certain reclassifications have been made between categories in the fiscal 2011 presentation to be consistent with the fiscal 2012 presentation.

## **Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations**

*Unless otherwise indicated, numerical references are in millions, except for percentages and per share data.*

### ***Overview***

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes included elsewhere in this Form 10-Q. Certain of the statements below contain forward-looking statements. These statements are predictions based upon our current expectations about future trends and events. Actual results could vary materially as a result of certain factors, including but not limited to, those expressed in these statements. In particular, we refer you to the risks discussed in Part II, Item 1A. “Risk Factors” and in our other Securities and Exchange Commission filings, which identify important risks and uncertainties that could cause our actual results to differ materially from those contained in the forward-looking statements.

We urge you to consider these factors carefully in evaluating the forward-looking statements contained in this Form 10-Q. All subsequent written or spoken forward-looking statements attributable to our company or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The forward-looking statements included in this Form 10-Q are made only as of the date of this Form 10-Q. We do not intend, and undertake no obligation, to update these forward-looking statements.

### ***The Company***

We are a supplier of electronic design automation (EDA) tools — advanced computer software and emulation hardware systems used to automate the design, analysis, and testing of electronic hardware and embedded systems software in electronic systems and components. We market our products and services worldwide, primarily to large companies in the military/aerospace, communications, computer, consumer electronics, semiconductor, networking, multimedia, and transportation industries. Through the diversification of our customer base among these various customer markets, we attempt to reduce our exposure to fluctuations within each market. We sell and license our products through our direct sales force and a channel of distributors and sales representatives. In addition to our corporate offices in Wilsonville, Oregon, we have sales, support, software development, and professional service offices worldwide.

We focus on products and design platforms where we have leading market share, enabling us to spend more effort to cause adoption of our technology in new applications, especially for new markets in which EDA companies have not generally participated. We believe this strategy leads to a more diversified product and customer mix and can help reduce the volatility of our business and our credit risk while increasing our potential for growth. System customers make up a much larger percentage of our business than that of most of our EDA competitors.

We derive system and software revenues primarily from the sale of term software license contracts, which are typically three to four years in length. We generally recognize revenue for these arrangements upon product delivery at the beginning of the license term. Larger enterprise-wide customer contracts, which can represent 50% or more of our system and software revenue, drive the majority of our period-to-period revenue variances. We identify term licenses where collectibility is not probable and recognize revenue on those licenses when cash is received. Ratable license revenues also include short-term term licenses as well as other term licenses where we provide the customer with rights to unspecified or unreleased future products. For these reasons, the timing of large contract renewals, customer circumstances, and license terms are the primary drivers of revenue changes from period to period, with revenue changes also being driven by new contracts and increases in the capacity of existing contracts, to a lesser extent.

The EDA industry is competitive and is characterized by very strong leadership positions in specific segments of the EDA market. These strong leadership positions can be maintained for significant periods of time as the software can be difficult to master and customers are disinclined to make changes once their employees, as well as others in the industry, have developed familiarity with a particular software product. For these reasons, much of our profitability arises from areas in which we are the leader. We will continue our strategy of developing high quality tools with number one market share potential, rather than being a broad-line supplier with undifferentiated product offerings. This strategy allows us to focus investment in areas where customer needs are greatest and where we have the opportunity to build significant market share.

Our products and services are dependent to a large degree on new design projects initiated by customers in the integrated circuit and electronics system industries. These industries can be cyclical and are subject to constant and rapid technological change, rapid product obsolescence, price erosion, evolving standards, short product life cycles, and wide fluctuations in product supply and demand. Furthermore, extended economic downturns can result in reduced funding for development due to downsizing and other business restructurings. These pressures are offset by the need for the development and introduction of next generation products once an economic recovery occurs.

### ***Known Trends and Uncertainties Impacting Future Results of Operations***

Our revenue has historically fluctuated quarterly and has generally been the highest in the fourth quarter of our fiscal year due to our customers' corporate calendar year-end spending trends and the timing of contract renewals.

Our top ten accounts make up approximately 40% of our receivables, including both short and long-term balances. We have not experienced and do not presently expect to experience collection issues with these customers. Net of reserves, we have no receivables greater than 60 days past due, and continue to experience no difficulty in factoring our high quality receivables.

Bad debt expense recorded for the first nine months of fiscal 2012 was not material. However, we do have exposures within our receivables portfolio to customers with weak credit ratings. These receivables balances do not represent a material portion of our portfolio but could have a material adverse effect on earnings in any given quarter, should additional allowances for doubtful accounts be necessary.

A multi-quarter increase or decrease in service and support revenue can be an early indicator that our business is either strengthening or weakening. Our experience is that customers will scale back on the purchase of outside services in times of economic decline or weakness. Conversely, in times of economic growth and strengthening, we generally observe an increase in the purchase of outside services. In the first nine months of fiscal 2012 compared to the first nine months of fiscal 2011, service and support revenues increased approximately 10%.

Bookings during the first nine months of fiscal 2012 increased by approximately 20% compared to the first nine months of fiscal 2011. Bookings are the value of executed orders during a period for which revenue has been or will be recognized within six months for products and within twelve months for professional services and training. The ten largest transactions for the first nine months of fiscal 2012 and fiscal 2011 accounted for approximately 45% of total system and software bookings. The number of new customers during the first nine months of fiscal 2012, excluding PADS (our ready to use printed circuit board design tools) increased approximately 25% from the levels experienced during the first nine months of fiscal 2011.

We are focused on continued expense control in the operation of our business. We anticipate reductions to sales, general, and administrative expenses as a percentage of revenue over the next three fiscal years.

### ***Product Developments***

During the nine months ended October 31, 2011, we continued to execute our strategy of focusing on challenges encountered by customers, as well as building upon our well-established product families. We believe that customers, faced with leading-edge design challenges in creating new products, generally choose the best EDA products in each category to build their design environment. Through both internal development and strategic acquisitions, we have focused on areas where we believe we can build a leading market position or extend an existing leading market position.

We believe that the development and commercialization of EDA software tools is generally a three to five year process with limited customer adoption and sales in the first years of tool availability. Once tools are adopted, however, their life spans tend to be long. During the first nine months of fiscal 2012, we introduced new products and upgrades to existing products and did not have any significant products reaching the end of their useful economic life.

### ***Critical Accounting Policies***

We base our discussion and analysis of our financial condition and results of operations upon our condensed consolidated financial statements which have been prepared in accordance with United States (U.S.) generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, and contingencies as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. We evaluate our estimates on an on-going basis. We base our estimates on historical experience, current facts, and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities and the recording of revenue, costs, and expenses that are not readily apparent from other sources. As future events and their effects cannot be determined with precision, actual results could differ from those estimates.

We believe that the accounting for revenue recognition, valuation of trade accounts receivable, valuation of deferred tax assets, income tax reserves, goodwill, intangible assets, long-lived assets, special charges, and accounting for stock-based compensation are the critical accounting estimates and judgments used in the preparation of our condensed consolidated financial statements. For further discussion of our critical accounting policies, see Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies" in Part II of our Annual Report on Form 10-K for the year ended January 31, 2011.

## **RESULTS OF OPERATIONS**

### ***Revenues and Gross Margins***

	<b>Three months ended October 31,</b>			<b>Nine months ended October 31,</b>		
	<b>2011</b>	<b>Change</b>	<b>2010</b>	<b>2011</b>	<b>Change</b>	<b>2010</b>
System and software revenues	\$ 154.4	4%	\$ 148.1	\$ 411.5	19%	\$ 346.0
System and software gross margin	\$ 141.7	9%	\$ 130.5	\$ 362.4	18%	\$ 306.7
Gross margin percent	92%		88%	88%		89%
Service and support revenues	\$ 96.1	6%	\$ 90.8	\$ 282.8	8%	\$ 261.4
Service and support gross margin	\$ 68.6	5%	\$ 65.4	\$ 203.1	7%	\$ 189.2
Gross margin percent	71%		72%	72%		72%
Total revenues	\$ 250.5	5%	\$ 238.9	\$ 694.3	14%	\$ 607.4
Total gross margin	\$ 210.3	7%	\$ 195.9	\$ 565.5	14%	\$ 495.9
Gross margin percent	84%		82%	81%		82%

### ***System and Software***

	<b>Three months ended October 31,</b>			<b>Nine months ended October 31,</b>		
	<b>2011</b>	<b>Change</b>	<b>2010</b>	<b>2011</b>	<b>Change</b>	<b>2010</b>
Upfront license revenues	\$ 134.7	5%	\$ 127.8	\$ 350.9	26%	\$ 279.5
Ratable license revenues	19.7	(3%)	20.3	60.6	(9%)	66.5
Total system and software revenues	\$ 154.4	4%	\$ 148.1	\$ 411.5	19%	\$ 346.0

We derive system and software revenues from the sale of licenses of software products and emulation hardware systems, including finance fee revenues from our long-term installment receivables resulting from product sales. Upfront license revenues consist of perpetual licenses and term licenses for which we recognize revenue upon product delivery at the start of a license term. We identify term licenses where collectability is not probable and recognize revenue on those licenses when cash is received. Additionally, ratable license revenues also include short-term term licenses, term licenses where we provide the customer with rights to unspecified or unreleased future products, and finance fees from the accretion of the discount on long-term installment receivables.

Our top ten customers accounted for approximately 60% of system and software revenues for the three months ended October 31, 2011 and approximately 45% for the nine months ended October 31, 2011 compared to approximately 65% for the three months ended October 31, 2010 and 40% for the nine months ended October 31, 2010.

System and software revenues increased for the three months ended October 31, 2011 compared to the three months ended October 31, 2010 primarily as a result of an increase in term license revenues, driven by contract renewals and an increase in base business during the three months ended October 31, 2011 compared to the three months ended October 31, 2010.

System and software revenues increased for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010 as a result of an increase in term license revenues of \$53.1, driven by contract renewals and an increase in base business during the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010 and an increase in perpetual license revenues of \$10.7, primarily due to an increase in emulation revenues.

For the three months ended October 31, 2011, no single customer accounted for 10% or more of total revenues. For the nine months ended October 31, 2011, one customer accounted for 13% of our total revenues. For the three months ended October 31, 2010, one customer accounted for 10% of our total revenues. For the nine months ended October 31, 2010, no single customer accounted for 10% or more of total revenues.

System and software gross margin percentage was higher for the three months ended October 31, 2011 compared to the three months ended October 31, 2010 primarily due to a change in product mix as a result of lower emulation hardware product revenues. Emulation hardware product revenues typically have lower margins compared to our software product revenues.

System and software gross margin percentage decreased slightly for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010 primarily due to a change in product mix as a result of higher emulation hardware product revenues.

### ***Service and Support***

We derive service and support revenues from software and hardware post-contract maintenance or support services and professional services, which includes consulting, training, and other services. Professional services are lower margin offerings which are staffed according to fluctuations in demand. Support services operate under a less variable cost structure.

The increase in service and support revenues for the three months ended October 31, 2011 compared to the three months ended October 31, 2010 was driven by an increase in our installed base of products and increased customer demand for services.

The increase in service and support revenues for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010 was driven by increased support revenues of \$12.7 resulting from an increase in our installed base, which included the effect of acquisitions completed in fiscal 2011 of \$2.1. Consulting and training services increased by \$8.1 for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010, primarily due to increased customer demand for services. The effect of acquisitions completed in fiscal 2011 on consulting and training services for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010 was \$2.9.

### ***Geographic Revenues Information***

#### *Revenue by Geography*

	<u>Three months ended October 31,</u>			<u>Nine months ended October 31,</u>		
	<u>2011</u>	<u>Change</u>	<u>2010</u>	<u>2011</u>	<u>Change</u>	<u>2010</u>
North America	\$ 116.3	—	\$ 116.6	\$ 306.7	20%	\$ 254.9
Europe	62.5	4%	60.3	161.4	6%	151.8
Japan	28.8	35%	21.3	96.2	32%	73.1
Pacific Rim	42.9	5%	40.7	130.0	2%	127.6
Total revenues	<u>\$ 250.5</u>	<u>5%</u>	<u>\$ 238.9</u>	<u>\$ 694.3</u>	<u>14%</u>	<u>\$ 607.4</u>

For the three and nine months ended October 31, 2011, approximately one-third of European and substantially all Japanese revenues were subject to exchange rate fluctuations as they were booked in local currencies. We recognize additional revenues in periods when the U.S. dollar weakens in value against foreign currencies. Likewise, we recognize lower revenues in periods when the U.S. dollar strengthens in value against foreign currencies.

Foreign currency had a favorable impact of \$3.7 for the three months ended October 31, 2011 compared to the three months ended October 31, 2010 and \$10.7 for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010. The favorable impact was primarily due to the strengthening of the Japanese yen against the U.S. dollar for both comparative periods.

For additional description of how changes in foreign exchange rates affect our condensed consolidated financial statements, see discussion in Part I, “Item 3. Quantitative and Qualitative Disclosures About Market Risk –Foreign Currency Risk.”

## Operating Expenses

	Three months ended October 31,			Nine months ended October 31,		
	2011	Change	2010	2011	Change	2010
Research and development	\$ 81.3	10%	\$ 73.6	\$ 220.6	6%	\$ 208.1
Marketing and selling	83.0	3%	80.6	236.7	5%	225.1
General and administration	17.9	(3%)	18.5	52.0	(6%)	55.6
Equity in (earnings) losses of Frontline	0.1	125%	(0.4)	(2.0)	(11%)	(1.8)
Amortization of intangible assets	1.3	(7%)	1.4	4.4	(23%)	5.7
Special charges	1.2	(25%)	1.6	7.4	(9%)	8.1
Total operating expenses	<u>\$ 184.8</u>	5%	<u>\$ 175.3</u>	<u>\$ 519.1</u>	4%	<u>\$ 500.8</u>

## Selected Operating Expenses as a Percentage of Total Revenues

	Three months ended October 31,		Nine months ended October 31,	
	2011	2010	2011	2010
Research and development	32%	31%	32%	34%
Marketing and selling	33%	34%	34%	37%
General and administration	7%	8%	7%	9%
Total selected operating expenses	<u>72%</u>	<u>73%</u>	<u>73%</u>	<u>80%</u>

Certain items have been reclassified within operating expenses for the three and nine months ended October 31, 2010. We have reclassified a portion of our information technology administrative costs out of general and administration into cost of revenues, research and development, and marketing and selling. Additionally, we have reclassified technical publication expenses associated with our products from research and development to cost of revenues. Finally, we have reclassified the salaries and other related costs of our Technical Marketing Engineers from marketing and selling to research and development. For further detail regarding these reclassifications, see Note 2. "Summary of Significant Accounting Policies" in Notes to Unaudited Condensed Consolidated Financial Statements.

## Research and Development

Research and development expenses increased by \$7.7 for the three months ended October 31, 2011 compared to the three months ended October 31, 2010 and \$12.5 for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010. The components of this increase are summarized as follows:

	Change	
	Three months ended October 31,	Nine months ended October 31,
Salaries, variable compensation, and benefits expenses	\$ 7.1	\$ 10.5
Expenses associated with acquired businesses	1.0	4.3
Tax credits	(0.3)	(2.6)
Other expenses	(0.1)	0.3
Total change in research and development expenses	<u>\$ 7.7</u>	<u>\$ 12.5</u>

## Marketing and Selling

Marketing and selling expenses increased by \$2.4 for the three months ended October 31, 2011 compared to the three months ended October 31, 2010, and \$11.6 for the nine months ended October 31, 2011 compared to the nine months ended October 30, 2010. The components of this increase are summarized as follows:

	<b>Change</b>	
	<u>Three months ended October 31,</u>	<u>Nine months ended October 31,</u>
Salaries, variable compensation, and benefits expense	\$ 2.4	\$ 8.1
Expenses associated with acquired businesses	0.1	2.5
Travel expenses	0.4	2.6
Facilities expenses	(0.4)	(1.5)
Other expenses	(0.1)	(0.1)
Total change in marketing and selling expenses	<u>\$ 2.4</u>	<u>\$ 11.6</u>

### ***General and Administration***

General and administration expenses decreased by \$0.6 for the three months ended October 31, 2011 compared to the three months ended October 31, 2010, and \$3.6 for the nine months ended October 31, 2011 compared to the nine months ended October 31, 2010. There were no individually significant changes within general and administration expenses for the three months ended October 31, 2011 compared to the three months ended October 31, 2010. General and administration expenses for the nine months ended October 31, 2011 decreased from the nine months ended October 31, 2010 primarily due to a reduction in rent expense as a result of the purchase of our Fremont facility.

We incur a substantial portion of our operating expenses outside the U.S. in various foreign currencies. When currencies weaken against the U.S. dollar, our operating expense performance is positively affected and when currencies strengthen, our operating expense performance is adversely affected. We experienced unfavorable currency movements of approximately \$3.3 for the three months ended October 31, 2011 and approximately \$11.7 for the nine months ended October 31, 2011 in total operating expenses primarily due to the euro as well as other foreign currencies. The impact of these currency movements is reflected in the movements in operating expenses detailed above.

### ***Equity in Earnings of Frontline***

In connection with our acquisition of Valor Computerized Systems, Ltd. (Valor) on March 18, 2010, we acquired Valor's 50% interest in a joint venture, Frontline PCB Solutions Limited Partnership (Frontline). Frontline is owned equally by Valor and Orbotech, Ltd., an Israeli company.

Frontline reports on a calendar year basis. As such, we record our interest in the earnings or losses of Frontline in the subsequent month following incurrence. The following presents the summarized financial information of Mentor's 50% interest in Frontline for the three months ended September 30, 2011 and 2010 and for the nine months ended September 30, 2011 and the period from March 18, 2010 through September 30, 2010:

	For the three months ended September 30,		For the nine months ended September 30,	
	2011	2010	2011	2010 <sup>(1)</sup>
Net income-as reported	\$ 1.1	\$ 1.7	\$ 5.7	\$ 4.9
Amortization of purchased technology and other identified intangible assets	1.3	1.3	3.7	3.1
Equity in earnings (losses) of Frontline	<u>\$(0.2)</u>	<u>\$0.4</u>	<u>\$ 2.0</u>	<u>\$ 1.8</u>

<sup>(1)</sup> Includes financial information from the date of acquisition of March 18, 2010 through September 30, 2010.

### *Special Charges*

	Three months ended October 31,			Nine months ended October 31,		
	2011	Change	2010	2011	Change	2010
Employee severance and related costs	\$ 1.2	—	\$ 1.2	\$ 3.6	(23%)	\$ 4.7
Excess leased facility costs	(0.1)	(133%)	0.3	0.3	(63%)	0.8
Other costs, net	0.1	—	0.1	3.5	35%	2.6
Total special charges	<u>\$ 1.2</u>	<u>(25%)</u>	<u>\$ 1.6</u>	<u>\$ 7.4</u>	<u>(9%)</u>	<u>\$ 8.1</u>

Special charges primarily consist of costs incurred for employee terminations and were due to a reduction of personnel resources driven by modifications of business strategy or business emphasis. Special charges may also include expenses incurred related to potential acquisitions, excess facility costs, and asset-related charges.

Employee severance and related costs of \$1.2 for the three months ended October 31, 2011 and \$3.6 for the nine months ended October 31, 2011 included severance benefits, notice pay, and outplacement services. The total rebalance charge represents the aggregate of numerous unrelated rebalance plans which impacted several employee groups, none of which was individually material to our financial position or results of operations. We determined termination benefit amounts based on employee status, years of service, and local statutory requirements. We communicated termination benefits to the affected employees prior to the end of the quarter in which we recorded the charge. There have been no significant modifications to the amount of these charges.

Other special charges for the nine months ended October 31, 2011 included costs of \$3.9 related to consulting fees associated with our proxy contest and \$(0.4) in other costs.

Employee severance and related costs of \$1.2 for the three months ended October 31, 2010 and \$4.7 for the nine months ended October 31, 2010 included severance benefits, notice pay, and outplacement services. The total rebalance charge represents the aggregate of numerous unrelated rebalance plans which impacted several employee groups, none of which were individually material to our financial position or results of operations. We determined termination benefit amounts based on employee status, years of service, and local legal requirements. We communicated termination benefits to the affected employees prior to the end of the quarter in which we recorded the charge. There have been no significant modifications to the amount of these charges.

Excess leased facility costs and other special charges for the nine months ended October 31, 2010 included costs of \$2.1 related to advisory fees and \$1.3 in other charges.

### *Interest Expense*

Interest expense increased by \$13.3 to \$26.7 for the nine months ended October 31, 2011 compared to \$13.4 for the nine months ended October 31, 2010. The increase was primarily due to the repayment of debt in April 2011 and the resulting losses of \$11.5 on the early extinguishment of debt, which included a \$6.2 write-off of the net unamortized debt discount, a

\$3.5 premium for the redemption of the 6.25% Convertible Subordinated Debentures (6.25% Debentures), and a write-off of \$1.8 for the remaining portion of unamortized debt issuance costs.

**Other Income (Expense), Net**

	Three months ended October 31,			Nine months ended October 31,		
	2011	Change	2010	2011	Change	2010
Interest income	\$ 0.5	67%	\$ 0.3	\$ 1.6	78%	\$ 0.9
Foreign currency exchange gain (loss)	0.2	150%	(0.4)	(0.2)	80%	(1.0)
Gain on conversion of equity method investment to controlling interest	1.5	—	—	1.5	—	—
Other, net	(0.4)	(300%)	(0.1)	(1.0)	23%	(1.3)
Other income (expense), net	<u>\$ 1.8</u>	1,000%	<u>\$ (0.2)</u>	<u>\$ 1.9</u>	236%	<u>\$ (1.4)</u>

**Provision for Income Taxes**

	Three months ended October 31,			Nine months ended October 31,		
	2011	Change	2010	2011	Change	2010
Income tax expense (benefit)	\$ (1.4)	(256%)	\$ 0.9	\$(4.4)	(283%)	\$2.4

Generally, the provision for income taxes is the result of the mix of profits and losses earned by us and our subsidiaries in tax jurisdictions with a broad range of income tax rates, withholding taxes (primarily in certain foreign jurisdictions), changes in tax reserves, and the application of valuation allowances on deferred tax assets. Accounting guidance requires that on a quarterly basis we evaluate our provision for income tax expense (benefit) of U.S. and non-U.S. jurisdictions based on our projected results of operations for the full year and record an adjustment in the current quarter.

	Three months ended October 31,		Nine months ended October 31,	
	2011	2010	2011	2010
Effective Tax Rate	(6%)	5%	(20%)	(12%)
Period specific items benefit	\$ (3.7)	\$ (0.4)	\$ (8.8)	\$ (2.3)

The income tax expense and effective tax rate for the nine months ended October 31, 2011 without period specific items are \$4.3 and 20%, respectively. After the inclusion of favorable period specific items of \$(8.8), our income tax posture for the nine months ended October 31, 2011 shifts to an income tax benefit of \$(4.4) and a tax rate of (20%). For the full year, we have projected a 2% effective tax rate inclusive of period specific items.

Our effective tax rate differs from tax computed at the U.S. federal statutory rate of 35% primarily due to:

- The benefit of lower tax rates on earnings of foreign subsidiaries;
- Reduction in reserves for uncertain tax positions; and
- The application of tax incentives for research and development.

These differences are partially offset by:

- U.S. losses and tax credits for which no tax benefit has been recognized;
- Non-deductible employee stock purchase plan compensation expense; and
- Withholding taxes in certain foreign jurisdictions.

We have not provided for income taxes on the undistributed earnings of our foreign subsidiaries to the extent they are considered permanently reinvested outside of the U.S. Upon repatriation, some of these earnings may be sheltered from U.S. tax to the extent they had previously been taxed under the U.S. deferral rules, and by U.S. loss carryforwards, research and development credits and foreign tax credits, which may reduce the federal tax liability associated with any future foreign dividend. Determination of the amount of unrecognized deferred U.S. income tax liability on permanently reinvested foreign earnings is not practicable. To the extent that the earnings of our foreign subsidiaries are not treated as permanently reinvested, which include earnings of certain countries, we have considered the impact in our provision.

We determined deferred tax assets and liabilities based on differences between the financial reporting and tax basis of assets and liabilities. In addition, we record deferred tax assets for net operating loss carryforwards and tax credit carryforwards. We calculated the deferred tax assets and liabilities using the enacted tax rates and laws that will be in effect when we expect the differences to reverse. A valuation allowance is recorded when it is more likely than not that all or some portion of the

deferred tax asset will not be realized. Since 2004, we have determined it is uncertain whether our U.S. entity will generate sufficient taxable income and foreign source income to fully utilize net operating loss carryforwards, research and experimentation credit carryforwards, and foreign tax credit carryforwards before expiration. Accordingly, we recorded a valuation allowance against those deferred tax assets for which realization does not meet the more likely than not standard. We have established valuation allowances related to certain foreign deferred tax assets based on historical losses as well as future expectations in certain jurisdictions. We will continue to evaluate the realizability of the deferred tax assets on a periodic basis.

We are subject to income taxes in the U.S. and in numerous foreign jurisdictions. In the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain. The statute of limitations for adjustments to our historic tax obligations varies from jurisdiction to jurisdiction. In some cases it may be extended or be unlimited. Furthermore, net operating loss and tax credit carryforwards may be subject to adjustment after the expiration of the statute of limitations of the year such net operating losses and tax credits originated. Our larger jurisdictions generally provide for a statute of limitations from three to five years. We are currently under examination in various jurisdictions. The examinations are in different stages and timing of their resolution is difficult to predict. For U.S. federal income tax purposes, the statute of limitations is open for fiscal year 2008 and forward and net operating losses and credits carried into fiscal year 2008 are also within the statute of limitations.

We have reserves for taxes to address potential exposures involving tax positions that are being challenged or that could be challenged by taxing authorities even though we believe that the positions we have taken are appropriate. We believe our tax reserves are adequate to cover potential liabilities. We review the tax reserves quarterly and as circumstances warrant and adjust the reserves as events occur that affect our potential liability for additional taxes. Many of these events cannot be predicted, such as clarifications of tax law by administrative or judicial means, and it is often difficult to predict the final outcome or timing of resolution of any particular tax matter. We expect to record additional reserves in future periods with respect to our tax filing positions. To the extent that uncertain tax positions resolve in our favor, it could have a positive impact on our effective tax rate.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our primary ongoing cash requirements are for product development, operating activities, capital expenditures, debt service, and acquisition opportunities that may arise. Our primary sources of liquidity are cash generated from operations and borrowings on our revolving credit facility.

We currently have sufficient funds for domestic operations and do not anticipate the need to repatriate funds associated with our permanently reinvested foreign earnings for use in U.S. operations. As of October 31, 2011, we have cash totaling \$91.0 held by our foreign subsidiaries. While the majority of our foreign earnings are indefinitely reinvested in foreign operations, a significant portion of offshore cash is accessible as some of our foreign earnings were previously taxed in the U.S. and net operating loss and tax credit carryforwards are available to offset U.S. taxes upon repatriation of other foreign earnings. We have provided tax on amounts which are not permanently reinvested. In the event funds from foreign operations are needed to fund operations in the U.S. and if U.S. tax has not already been provided for, we may be required to accrue and pay additional U.S. taxes to repatriate these funds.

To date, we have experienced no loss or lack of access to our invested cash; however, we can provide no assurances that access to our cash will not be impacted by adverse conditions in the financial markets.

At any point in time, we have significant balances in operating accounts that are with individual third-party financial institutions, which may exceed the Federal Deposit Insurance Corporation insurance limits or other regulatory insurance program limits. While we monitor daily the cash balances in our operating accounts and adjust the cash balances as appropriate, these cash balances could be impacted if the underlying financial institutions fail or are subject to other adverse conditions in the financial markets.

We anticipate that the following will be sufficient to meet our working capital needs on a short-term (twelve months or less) and a long-term (more than twelve months) basis:

- Current cash balances;
- Anticipated cash flows from operating activities, including the effects of selling and financing customer term receivables;
- Amounts available under existing revolving credit facilities; and
- Other available financing sources, such as the issuance of debt or equity securities.

We have experienced no difficulties to date in raising debt. However, capital markets have been volatile, and we cannot assure you that we will be able to raise debt or equity capital on acceptable terms, if at all.

<u>Nine months ended October 31,</u>	<u>2011</u>	<u>2010</u>
Cash provided by operating activities	\$ 35.2	\$ 7.1
Cash used in investing activities	\$(26.2)	\$(51.0)
Cash provided by (used in) financing activities	\$(30.8)	\$ 6.9

### *Operating Activities*

Cash flows from operating activities consist of our net income (loss), adjusted for certain non-cash items and changes in operating assets and liabilities. Our cash flows from operating activities are significantly influenced by the payment terms on our license agreements and by our sales of qualifying accounts receivable. Our customers' inability to fulfill payment obligations could adversely affect our cash flow. Though we have not, to date, experienced a material level of defaults, material payment defaults by our customers as a result of negative economic conditions or otherwise could have a material adverse effect on our financial condition. We monitor our accounts receivable portfolio for customers with low or declining credit ratings and increase our collection efforts when necessary.

### *Trade Accounts and Term Receivables*

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
Trade accounts receivable, net	\$ 291.1	\$ 347.1
Term receivables, long-term	\$ 204.3	\$ 167.4
Average days sales outstanding in short-term receivables	105 days	102 days
Average days sales outstanding in short-term receivable, net, excluding the current portion of term receivables	41 days	45 days

The increase in the average days sales outstanding in short-term receivables for the three months ended October 31, 2011 compared to the three months ended January 31, 2011 was primarily due to a seasonal decrease in revenue in the third quarter of fiscal 2012 compared to the fourth quarter of fiscal 2011.

The current portion of term receivables was \$177.2 as of October 31, 2011 and \$193.4 as of January 31, 2011. Term receivables are attributable to multi-year term license sales agreements. We include amounts for term agreements that are due within one year in trade accounts receivable, net, and balances that are due in more than one year in term receivables, long-term. We use term agreements as a standard business practice and have a history of successfully collecting under the original payment terms without making concessions on payments, products, or services. Total term receivables were \$381.5 as of October 31, 2011 compared to \$360.8 as of January 31, 2011.

We enter into agreements to sell qualifying accounts receivable from time to time to certain financing institutions on a non-recourse basis. We received net proceeds from the sale of receivables of \$28.3 for the nine months ended October 31, 2011 compared to \$39.2 for the nine months ended October 31, 2010. We continue to have no difficulty in factoring receivables and continue to evaluate the economics of the sale of accounts receivable. We have not set a target for the sale of accounts receivables for the remainder of fiscal 2012.

### *Accrued Payroll and Related Liabilities*

<u>As of</u>	<u>October 31, 2011</u>	<u>January 31, 2011</u>
Accrued payroll and related liabilities	\$ 75.7	\$ 109.2

The decrease in accrued payroll and related liabilities as of October 31, 2011 compared to January 31, 2011 was primarily due to incentive payments made during fiscal 2012 for fiscal 2011 year-end accruals. We generally experience higher accrued payroll and related liability balances at year end primarily due to increased commission accruals associated with an increase in revenues in the fourth quarter. Additionally, we generally experience an increase in variable compensation at year end which result is due to full year achievement of results.

### ***Investing Activities***

Cash used in investing activities for the nine months ended October 31, 2011 primarily consisted of cash paid for capital expenditures.

Expenditures for property, plant, and equipment decreased to \$25.1 for the nine months ended October 31, 2011 compared to \$36.8 for the nine months ended October 31, 2010. The expenditures for property, plant, and equipment for the nine months ended October 31, 2011 were primarily a result of spending on information technology and infrastructure improvements within facilities. We expect total capital expenditures for property, plant, and equipment for fiscal 2012 to be approximately \$45.0. We plan to finance our investments in property, plant, and equipment using cash on hand or borrowings on the revolving credit facility.

During the nine months ended October 31, 2011, we acquired one privately-held company for cash. We plan to finance future business acquisitions through cash and possible common stock issuances. The cash expected to be utilized includes cash on hand, cash generated from operating activities, and borrowings on the revolving credit facility.

### ***Financing Activities***

For the nine months ended October 31, 2011, cash used in financing activities consisted primarily of the redemption of the 6.25% Debentures due 2026 and repurchases of common stock offset in part by proceeds from the issuance of the 4.00% Convertible Subordinated Debentures (4.00% Debentures) due 2031. Additional discussion regarding these notes payable is presented in the section below.

In April 2011, we announced a share repurchase program under which we may purchase up to \$150.0 of our common stock over a three year period through April 2014. During the nine months ended October 31, 2011, we repurchased 3.6 shares of common stock for a cost of \$45.0 under this program. Under the terms of our revolving credit facility, the amount we can repurchase under the share repurchase program is limited to \$50.0 plus 70% of our cumulative net income for periods after January 31, 2011. An additional \$23.2 of our stock can be repurchased under this limit as of October 31, 2011. Also in April 2011, before the approval and announcement of our share repurchase program, we repurchased 1.7 shares of common stock for a cost of \$25.0 utilizing proceeds received from the issuance of the 4.00% Debentures.

### ***Other factors affecting liquidity and capital resources***

#### ***4.00% Debentures due 2031***

In April 2011, we issued \$253.0 of the 4.00% Debentures. Interest on the 4.00% Debentures is payable semi-annually in April and October. The 4.00% Debentures are convertible, under certain circumstances, into our common stock at a conversion price of \$20.538 per share for a total of 12.3 shares as of October 31, 2011. Upon conversion of any 4.00% Debentures, a holder will receive:

- (i) Cash up to the principal amount of the 4.00% Debentures that are converted; and
- (ii) Cash or shares of common stock, at our election, for the excess, if any, of the value of the converted shares over the principal amount.

If a holder elects to convert their 4.00% Debentures in connection with a fundamental change in the company that occurs prior to April 5, 2016, the holder will also be entitled to receive a make whole premium upon conversion in some circumstances. Any make whole premium would have the effect of increasing the amount of any cash, securities, or other property or assets otherwise due to holders of debentures upon conversion.

We may redeem some or all of the 4.00% Debentures for cash on or after April 5, 2016 at the following redemption prices expressed as a percentage of principal, plus any accrued and unpaid interest:

<u>Period</u>	<u>Redemption Price</u>
Beginning on April 5, 2016 and ending on March 31, 2017	101.143%
Beginning on April 1, 2017 and ending on March 31, 2018	100.571%
On April 1, 2018 and thereafter	100.000%

The holders, at their option, may redeem the 4.00% Debentures in whole or in part for cash on April 1, 2018, April 1, 2021, and April 1, 2026, and in the event of a fundamental change in the company. In each case, the repurchase price will be 100% of the principal amount of the 4.00% Debentures plus any accrued and unpaid interest.

#### *6.25% Debentures due 2026*

Interest on the 6.25% Debentures was payable semi-annually in March and September. During April 2011, we redeemed the remaining \$196.5 principal amount of the 6.25% Debentures utilizing proceeds received from the issuance of the 4.00% Debentures and cash on hand. In connection with this redemption, during the nine months ended October 31, 2011, we incurred a before tax net loss on the early extinguishment of debt of \$11.2, which included a \$6.2 write-off of the net unamortized debt discount, a \$3.5 premium on the redemption of the 6.25% Debentures, and a write-off of \$1.5 for the remaining portion of unamortized debt issuance costs. No balance remains outstanding following this redemption.

#### *Term Loan due 2013*

In April 2010, we entered into a three-year term loan (Term Loan) to repay borrowings under our revolving credit facility used to purchase office buildings in Fremont, California. A fixed principal amount of \$0.5 and interest payments were payable quarterly in February, May, August, and November.

In April 2011, we repaid the remaining \$18.5 utilizing proceeds received from the issuance of the 4.00% Debentures. No balance remains outstanding following this repayment.

For further information on the 4.00% Debentures, 6.25% Debentures, and the Term Loan, see Note 8. "Notes Payable" in Part I, Item 1. "Financial Statements."

#### *Revolving Credit Facility*

In April 2011, we entered into a syndicated, senior, unsecured, four-year revolving credit facility with a maximum borrowing capacity of \$125.0. We have the option to pay interest on this revolving credit facility based on:

- (i) London Interbank Offered Rate (LIBOR) with varying maturities which are commensurate with the borrowing period we select, plus a spread of between 2.25% and 3.25% based on a pricing grid tied to a financial covenant; or
- (ii) A base rate plus a spread of between 1.25% and 2.25%, based on a pricing grid tied to a financial covenant.

The base rate is defined as the highest of:

- (i) The federal funds rate, as defined, plus 0.5%;
- (ii) The prime rate of the lead bank; or
- (iii) One-month LIBOR plus 1.0%.

As a result of these interest rate options, our interest expense associated with borrowings under this revolving credit facility will vary with market interest rates. In addition, commitment fees are payable on the unused portion of the revolving credit facility at rates between 0.40% and 0.50% based on a pricing grid tied to a financial covenant.

We had no borrowings against the revolving credit facility during the nine months ended October 31, 2011. The base interest rate was 4.5% as of October 31, 2011.

For further information on our revolving credit facility, see Note 7. "Short-Term Borrowings" in Part I, Item 1. "Financial Statements."

### **OFF-BALANCE SHEET ARRANGEMENTS**

We do not have off-balance sheet arrangements, financings, or other similar relationships with unconsolidated entities or other persons, also known as special purpose entities. In the ordinary course of business, we lease certain real properties, primarily field sales offices, research and development facilities, and equipment.

### **OUTLOOK FOR FISCAL 2012**

We expect revenues for the fourth quarter of fiscal 2012 to be approximately \$316 with earnings per share for the same period of approximately \$0.46 per diluted share. For the full fiscal year 2012, we expect revenues of approximately \$1.01 billion with earnings per share of \$0.69 per diluted share.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

*Unless otherwise indicated, all numerical references in tables are in millions, except interest rates and contract rates.*

#### **Interest Rate Risk**

We are exposed to interest rate risk primarily through our investment portfolio, short-term borrowings, and notes payable. We do not use derivative financial instruments for speculative or trading purposes.

We place our investments in instruments that meet high quality credit standards, as specified in our investment policy. The policy also limits the amount of credit exposure to any one issuer and type of instrument. We do not expect any material loss with respect to our investment portfolio. As of October 31, 2011, we had no short-term investments or cash equivalents outstanding in our investment portfolio.

We had convertible subordinated debentures with a principal balance of \$253.0 outstanding with a fixed interest rate of 4.00% as of October 31, 2011 compared to a principal balance of \$196.5 with a fixed interest rate of 6.25% as of October 31, 2010. Interest rate changes for fixed rate debt affect the fair value of the debentures but do not affect future earnings or cash flow.

As of October 31, 2011, we had a syndicated, senior, unsecured, revolving credit facility, which expires on April 27, 2015. Borrowings under the revolving credit facility are permitted to a maximum of \$125.0. Under this revolving credit facility, we have the option to pay interest based on:

- (i) London Interbank Offered Rate (LIBOR) with varying maturities which are commensurate with the borrowing period we select, plus a spread of between 2.25% and 3.25%; or
- (ii) A base rate plus a spread of between 1.25% and 2.25%, based on a pricing grid tied to a financial covenant.

The base rate is defined as the highest of:

- (i) The federal funds rate, as defined, plus 0.5%;
- (ii) The prime rate of the lead bank; or
- (iii) One-month LIBOR plus 1.0%.

As a result of these interest rate options, our interest expense associated with borrowings under this revolving credit facility will vary with market interest rates. This revolving credit facility contains certain financial and other covenants, including financial covenants requiring the maintenance of specified liquidity ratios, leverage ratios, and minimum tangible net worth as well as restrictions on the payment of dividends. As of October 31, 2011 and 2010, we had no balance outstanding against this revolving credit facility. Interest rate changes for variable interest rate debt generally do not affect the fair market value, but do affect future earnings and cash flow. For further information on our revolving credit facility, see Note 7. "Short-Term Borrowings" in Part I, Item 1. "Financial Statements."

We had other short-term borrowings of \$5.3 outstanding as of October 31, 2011 and \$4.9 as of October 31, 2010 with variable rates based on market indexes. Interest rate changes for variable interest rate debt generally do not affect the fair market value, but do affect future earnings and cash flow.

If the interest rates as of October 31, 2011 on the above variable rate borrowings were to increase or decrease by 1% and the level of borrowings outstanding remained constant, annual interest expense would increase or decrease by approximately \$0.1.

#### **Foreign Currency Risk**

We transact business in various foreign currencies and have established a foreign currency hedging program to hedge certain foreign currency forecasted transactions and exposures from existing assets and liabilities. Our derivative instruments consist of short-term foreign currency exchange contracts, with a duration period of a year or less. We enter into contracts with counterparties who are major financial institutions and, as such we do not expect material losses as a result of defaults by our counterparties. We do not hold or issue derivative financial instruments for speculative or trading purposes.

We enter into foreign currency forward contracts to protect against currency exchange risk associated with expected future cash flows. Our practice is to hedge a majority of our existing material foreign currency transaction exposures, which generally represent the excess of expected euro and British pound denominated expenses over expected euro and British pound denominated revenues, and the excess of Japanese yen denominated revenue over expected Japanese yen denominated

expenses. We also enter into foreign currency forward contracts to protect against currency exchange risk associated with existing assets and liabilities.

The following table provides volume information about our foreign currency forward program. The information provided is in United States dollar equivalent amounts. The table presents the gross notional amounts, at contract exchange rates, and the weighted average contractual foreign currency exchange rates. These forward contracts mature within the next twelve months.

<u>As of</u>	<u>October 31, 2011</u>		<u>January 31, 2011</u>	
	<u>Gross Notional Amount</u>	<u>Weighted Average Contract Rate</u>	<u>Gross Notional Amount</u>	<u>Weighted Average Contract Rate</u>
Forward Contracts:				
Japanese yen	\$ 29.7	76.86	\$ 99.6	82.99
Euro	20.4	0.73	40.7	0.75
Indian rupee	10.3	49.34	12.1	45.78
Swedish krona	10.1	6.65	12.9	6.65
Canadian dollar	9.8	1.02	8.4	0.99
Taiwanese dollar	8.3	30.07	7.2	28.86
British pound	4.8	0.64	13.3	0.63
Other (1)	19.6	—	15.4	—
Total forward contracts	<u>\$113.0</u>		<u>\$209.6</u>	

(1) Other includes 10 currencies which are the Korean won, Israeli shekel, Danish kroner, Hungarian forints, Russian ruble, Polish zloty, Chinese yuan, Swiss franc, Norwegian kroner, and Singapore dollars.

#### **Item 4. Controls and Procedures**

##### *(1) Evaluation of Disclosure Controls and Procedures*

We maintain disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended (Exchange Act), that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and our Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

We carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level as of the end of the period covered by this report.

##### *(2) Changes in Internal Controls Over Financial Reporting*

There has been no change in our internal control over financial reporting that occurred during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1A. Risk Factors

The forward-looking statements contained under “Outlook for Fiscal 2012” in Part I, Item 2, “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and all other statements contained in this report that are not statements of historical fact, including without limitation, statements containing the words “believes,” “expects,” “projections,” and words of similar meaning, constitute forward-looking statements that involve a number of risks and uncertainties that are difficult to predict. Moreover, from time to time, we may issue other forward-looking statements. Forward-looking statements regarding financial performance in future periods, including the statements under “Outlook for Fiscal 2012,” do not reflect potential impacts of mergers or acquisitions or other significant transactions or events that have not been announced as of the time the statements are made. Actual outcomes and results may differ materially from what is expressed or forecast in forward-looking statements. We disclaim any obligation to update forward-looking statements to reflect future events or revised expectations. Our business faces many risks, and set forth below are some of the factors that could cause actual results to differ materially from the results expressed or implied by our forward-looking statements. Forward-looking statements should be considered in light of these factors.

#### ***Weakness in the United States (U.S.) and international economies may harm our business.***

Our revenue levels are generally dependent on the level of technology capital spending, which includes worldwide expenditures for electronic design automation (EDA) software, hardware, and consulting services. Periods of economic uncertainty, such as the recession experienced in 2008 and much of 2009, a “double-dip” recession or broadening of the euro sovereign debt problems, can adversely affect our customers and postpone decisions to license or purchase our products, decrease our customers’ spending, and jeopardize or delay our customers’ ability or willingness to make payment obligations, any of which could adversely affect our business.

#### ***Our forecasts of our revenues and earnings outlook may be inaccurate.***

Our revenues, particularly new software license revenues, are difficult to forecast. We use a “pipeline” system, a common industry practice, to forecast revenues and trends in our business. Sales personnel monitor the status of potential business and estimate when a customer will make a purchase decision, the dollar amount of the sale, and the products or services to be sold. These estimates are aggregated periodically to generate a sales pipeline. Our pipeline estimates may prove to be unreliable either in a particular quarter or over a longer period of time, in part because the “conversion rate” of the pipeline into contracts can be very difficult to estimate and requires management judgment. A variation in the conversion rate could cause us to plan or budget incorrectly and materially adversely impact our business or our planned results of operations. In particular, a slowdown in customer spending or weak economic conditions generally can reduce the conversion rate in a particular quarter as purchasing decisions are delayed, reduced in amount, or cancelled. The conversion rate can also be affected by the tendency of some of our customers to wait until the end of a fiscal quarter attempting to obtain more favorable terms. This may result in failure to agree to terms within the fiscal quarter and cause expected revenue to slip into a subsequent quarter.

#### ***Our business could be impacted by fluctuations in quarterly results of operations due to customer seasonal purchasing patterns, the timing of significant orders, and the mix of licenses and products purchased by our customers.***

We have experienced, and may continue to experience, varied quarterly operating results. Various factors affect our quarterly operating results and some of these are not within our control, including customer demand and the timing of significant orders. We typically experience seasonality in demand for our products, due to the purchasing cycles of our customers, with revenues in the fourth quarter generally being the highest. If planned contract renewals are delayed or the average size of renewed contracts do not increase as we anticipate, we could fail to meet our and investors’ expectations, which could have a material adverse impact on our stock price.

Our revenues are also affected by the mix of licenses entered into where we recognize software revenues as payments become due and payable, on a cash basis, or ratably over the license term as compared to revenues recognized at the beginning of the license term. We recognize revenues ratably over the license term, for instance, when the customer is provided with rights to unspecified or unreleased future products. A shift in the license mix toward increased ratable, due and payable, and/or cash-based revenue recognition could result in increased deferral of software revenues to future periods and would decrease current revenues, which could result in us not meeting near-term revenue expectations.

The gross margin on our software is greater than that for our emulation hardware systems, software support, and professional services. Therefore, our gross margin may vary as a result of the mix of products and services sold. We also have a significant amount of fixed or relatively fixed costs, such as employee costs and purchased technology amortization, and costs which are committed in advance and can only be adjusted periodically. As a result, a small failure to reach planned

revenues would likely have a relatively large negative effect on resulting earnings. If anticipated revenues do not materialize as expected, our gross margins and operating results could be materially adversely impacted.

***We face intense price competition in the EDA industry.***

Price competition in the EDA industry is intense, which can lead to, among other things, price reductions, longer selling cycles, lower product margins, loss of market share, and additional working capital requirements. If our competitors offer significant discounts on certain products, we may need to lower our prices or offer other favorable terms to compete successfully. Any such changes would likely reduce margins and could materially adversely impact our operating results. Any broad-based changes to our prices and pricing policies could cause new software license and service revenues to decline or be delayed as the sales force implements and our customers adjust to the new pricing policies. Some of our competitors may bundle certain software products at low prices for promotional purposes or as a long-term pricing strategy. These practices could significantly reduce demand for our products or limit prices we can charge.

We currently compete primarily with two large companies: Synopsys, Inc. and Cadence Design Systems, Inc. We also compete with smaller companies and compete with manufacturers of electronic devices that have developed their own EDA products internally.

***Foreign currency fluctuations may have an adverse impact on our operating results.***

We typically generate about half of our revenues from customers outside the U.S. and we generate approximately one-third of our expenses outside the U.S. While most of our international sales are denominated in U.S. dollars, our international operating expenses are typically denominated in foreign currencies. Significant changes in currency exchange rates, particularly in the Japanese yen, euro, and the British pound, could have an adverse impact on our operating results.

***Our international operations involve risks that could increase our expenses, adversely affect our operating results, and require increased time and attention of our management.***

Our international operations subject us to risks in addition to those we face in our domestic operations, including longer receivables collection periods, changes in a specific country's or region's economic or political conditions, trade protection measures, local labor laws, import or export licensing requirements, anti-corruption and other similar laws, loss or modification of exemptions for taxes and tariffs, limitations on repatriation of earnings, and difficulties with licensing and protecting our intellectual property rights. If we violate applicable laws related to our business, we could be subject to penalties, fines, or other sanctions and could be prohibited or limited from doing business in one or more countries.

***We derive a substantial portion of our revenues from relatively few product groups.***

We derive a substantial portion of our revenues from sales of relatively few product groups and related support services. As a result, any factor adversely affecting sales of these products, including the product release cycles, market acceptance, product competition, performance and reliability, reputation, price competition, and economic and market conditions, could harm our operating results.

***We are subject to the cyclical nature of the integrated circuit (IC) and electronics systems industries.***

Purchases of our products and services are highly dependent upon new design projects initiated by customers in the IC and electronics systems industries. These industries are highly cyclical and are subject to constant and rapid technological change, rapid product obsolescence, price erosion, evolving standards, short product life cycles, and wide fluctuations in product supply and demand. The increasing complexity of ICs and resulting increase in costs to design and manufacture ICs have in recent years led to fewer design starts, which could cause a reduced demand for our products. In addition, the IC and electronics systems industries regularly experience significant downturns, often connected with, or in anticipation of, maturing product cycles within such companies or decline in general economic conditions. These downturns could cause diminished demand for our products and services.

***Customer payment defaults could adversely affect our timing of revenue recognition.***

We use fixed-term license agreements as standard business practices with customers we believe are creditworthy. These multi-year, multi-element term license agreements have payments spread over the license term and are typically about three years in length for semiconductor companies and about four years in length for military and aerospace companies. The complexity of these agreements tends to increase the risk associated with collectibility from customers that can arise for a variety of reasons including ability to pay, product dissatisfaction, and disputes. If we are unable to collect under these agreements, our results of operations could be materially adversely impacted. We use these fixed-term license agreements as a standard business practice and have a history of successfully collecting under the original payment terms without making

concessions on payments, products, or services. If we no longer had a history of collecting without providing concessions on the terms of the agreements, then revenue would be required to be recognized under U.S. generally accepted accounting principles as the payments become due and payable over the license term. This change could have a material adverse impact on our near-term results.

***IC and printed circuit board (PCB) technology evolves rapidly.***

The complexity of ICs and PCBs continues to rapidly increase. In response to this increasing complexity, new design tools and methodologies must be invented or acquired quickly to remain competitive. If we fail to quickly respond to new technological developments, our products could become obsolete or uncompetitive, which could materially adversely impact our business.

***Errors or defects in our products and services could expose us to liability and harm our reputation.***

Our customers use our products and services in designing and developing products that involve a high degree of technological complexity and have unique specifications. Due to the complexity of the systems and products with which we work, some of our products and designs can be adequately tested only when put to full use in the marketplace. As a result, our customers or their end users may discover errors or defects in our software, or the products or systems designed with or manufactured using tools that may not operate as expected. Errors or defects could result in:

- Loss of current customers and loss of, or delay in, revenue and loss of market share;
- Failure to attract new customers or achieve market acceptance;
- Diversion of development resources to resolve the problems resulting from errors or defects; and
- Increased support or service costs.

In addition, we include limited amounts of third-party technology in our products and we rely on those third parties to provide support services to us. Failure of those third parties to provide necessary support services could materially adversely impact our business.

***Long sales cycles and delay in customer completion of projects make the timing of our revenues difficult to predict.***

We have a lengthy sales cycle. A lengthy customer evaluation and approval process is generally required due to the complexity and expense associated with our products and services. Consequently, we may incur substantial expenses and devote significant management effort and expense to develop potential relationships that do not result in agreements or revenues and may prevent us from pursuing other opportunities. Sales of our products and services are sometimes discretionary and may be delayed if customers delay approval or commencement of projects due to budgetary constraints, internal acceptance review procedures, timing of budget cycles, or timing of competitive evaluation processes. Long sales cycles for our hardware products may subject us to risks over which we have limited control, including insufficient, excess, or obsolete inventory, variations in inventory valuation, and fluctuations in quarterly operating results.

***Any loss of our leadership position in certain segments of the EDA market could harm our business.***

The industry in which we compete is characterized by very strong leadership positions in specific segments of the EDA market. For example, one company may have a large percentage of sales in the physical verification segment of the market while another may have a similarly strong position in mixed-signal simulation. These strong leadership positions can be maintained for significant periods of time as the software is difficult to master and customers are disinclined to make changes once their employees, as well as others in the industry, have developed familiarity with a particular software product. For these reasons, much of our profitability arises from niche areas in which we are the leader. Conversely, it is difficult for us to achieve significant profits in niche areas where other companies are the leaders. If for any reason we lose our leadership position in a niche, we could be materially adversely impacted.

***Accounting rules governing revenue recognition are complex and may change.***

The accounting rules governing software revenue recognition are complex and have been subject to authoritative interpretations that have generally made it more difficult to recognize software revenues at the beginning of the license period.

***We may have additional tax liabilities.***

Significant judgments and estimates are required in determining the provision for income taxes and other tax liabilities. Our tax expense may be impacted if our intercompany transactions, which are required to be computed on an arm's-length basis,

are challenged and successfully disputed by the tax authorities. Also, our tax expense could be impacted depending on the applicability of withholding taxes on software licenses and related intercompany transactions in certain jurisdictions. In determining the adequacy of income taxes, we assess the likelihood of adverse outcomes that could result if our tax positions were challenged by the Internal Revenue Service (IRS) and other tax authorities. The tax authorities in the U.S. and other countries where we do business regularly examine our income and other tax returns. The ultimate outcome of these examinations cannot be predicted with certainty. Should the IRS or other tax authorities assess additional taxes as a result of examinations, we may be required to record charges to operations that could have a material impact on the results of operations, financial position, or cash flows.

***Forecasting our income tax rate is complex and subject to uncertainty.***

The computation of income tax expense (benefit) is complex as it is based on the laws of numerous taxing jurisdictions and requires significant judgment on the application of complicated rules governing accounting for tax provisions under U.S. generally accepted accounting principles. Income tax expense (benefit) for interim quarters is based on a forecast of our U.S. and non-U.S. effective tax rates for the year, which includes forward looking financial projections, including the expectations of profit and loss by jurisdiction, and contains numerous assumptions. Various items cannot be accurately forecasted and future events may be treated as discrete to the period in which they occur. Our income tax rate can be materially impacted, for example, by the geographical mix of our profits and losses, changes in our business, such as internal restructuring and acquisitions, changes in tax laws and accounting guidance, and other regulatory, legislative or judicial developments, tax audit determinations, changes in our uncertain tax positions, changes in our intent and capacity to permanently reinvest foreign earnings, changes to our transfer pricing practices, tax deductions attributed to equity compensation, and changes in our valuation allowance for deferred tax assets. For these reasons, our overall global tax rate may be materially different than our forecast.

***There are limitations on the effectiveness of controls.***

We do not expect that disclosure controls or internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. Failure of our control systems to prevent error or fraud could materially adversely impact us.

***We may not realize revenues as a result of our investments in research and development.***

We incur substantial expense to develop new software products. Research and development activities are often performed over long periods of time. This effort may not result in a successful product offering because of either a change in market conditions or a failure to successfully develop products based on that research and development activity. As a result, we could realize little or no revenues related to our investment in research and development.

***We may acquire other companies and may not successfully integrate them.***

The industry in which we compete has experienced significant consolidation in recent years. During this period, we have acquired numerous businesses and have frequently been in discussions with potential acquisition candidates, and we may acquire other businesses in the future. While we expect to carefully analyze all potential transactions before committing to them, we cannot assure that any completed transaction will result in long-term benefits to us or our shareholders or that we will be able to manage the acquired businesses effectively. In addition, growth through acquisition involves a number of risks. If any of the following events occurs after we acquire another business, it could materially adversely impact us:

- Difficulties in combining previously separate businesses into a single unit;
- The substantial diversion of management's attention from ongoing business when integrating the acquired business;
- The failure to realize anticipated benefits, such as cost savings and increases in revenues;
- The failure to retain key personnel of the acquired business;
- Difficulties related to assimilating the products of an acquired business in, for example, distribution, engineering, and customer support areas;
- Unanticipated costs;
- Unanticipated liabilities or litigation in connection with or as a result of an acquisition, including claims from terminated employees, customers, or third parties;

- Adverse impacts on existing relationships with suppliers and customers; and
- Failure to understand and compete effectively in markets in which we have limited experience.

Acquired businesses may not perform as projected, which could result in impairment of acquisition-related intangible assets. Additional challenges include integration of sales channels, training and education of the sales force for new product offerings, integration of product development efforts, integration of systems of internal controls, and integration of information systems. Accordingly, in any acquisition there will be uncertainty as to the achievement and timing of projected synergies, cost savings, and sales levels for acquired products. All of these factors could impair our ability to forecast, meet revenues and earnings targets, and manage effectively our business for long-term growth. We cannot assure that we can effectively meet these challenges.

***We may not adequately protect our proprietary rights or we may fail to obtain software or other intellectual property licenses.***

Our success depends, in large part, upon our proprietary technology. We generally rely on patents, copyrights, trademarks, trade secret laws, licenses, and restrictive agreements to establish and protect our proprietary rights in technology and products. Despite precautions we may take to protect our intellectual property, we cannot assure that third parties will not try to challenge, invalidate, or circumvent these protections. The companies in the EDA industry, as well as entities and persons outside the industry, are obtaining patents at a rapid rate. We cannot predict if any of these patents will cover any of our products. In addition, many of these entities have substantially larger patent portfolios than we have. As a result, we may on occasion be forced to engage in costly patent litigation to protect our rights or defend our customers' rights. We may also need to settle these claims on terms that are unfavorable; such settlements could result in the payment of significant damages or royalties, or force us to stop selling or redesign one or more products. We cannot assure that the rights granted under our patents will provide us with any competitive advantage, that patents will be issued on any of our pending applications, or that future patents will be sufficiently broad to protect our technology. Furthermore, the laws of foreign countries may not protect our proprietary rights in those countries to the same extent as U.S. law protects these rights in the U.S.

Some of our products include software or other intellectual property licensed from third parties, and we may have to seek new licenses or renew existing licenses for software and other intellectual property in the future. Failure to obtain software or other intellectual property licenses or rights from third parties on favorable terms could materially adversely impact us.

***Our use of open source software could negatively impact our ability to sell our products and may subject us to unanticipated obligations.***

The products, services or technologies we acquire, license, provide or develop may incorporate or use open source software. We monitor our use of open source software in an effort to avoid unintended consequences, such as reciprocal license grants, patent retaliation clauses, and the requirement to license our products at no cost. Nevertheless, we may be subject to unanticipated obligations regarding our products which incorporate open source software.

***Our failure to attract and retain key employees may harm us.***

We depend on the efforts and abilities of our senior management, our research and development staff, and a number of other key management, sales, support, technical, and services personnel. Competition for experienced, high-quality personnel is intense, and we cannot assure that we can continue to recruit and retain such personnel. Our failure to hire and retain such personnel could impair our ability to develop new products and manage our business effectively.

***We have global sales and research and development offices in parts of the world that are not as politically stable as the United States.***

We have global sales and research and development offices, some of which are in parts of the world that are not as politically stable as the United States. In particular our offices in Egypt and Pakistan may be subject to disruption or closure from time to time. As a result, we may face a greater risk of business interruption as a result of potential unrest, terrorist acts, or military conflicts than businesses located domestically.

***Oregon law and our shareholder rights plan may have anti-takeover effects.***

The Oregon Business Combination Act limits the ability of parties who acquire a significant amount of voting stock to exercise control over us. This provision may have the effect of lengthening the time required to acquire control of us through a proxy contest or the election of a majority of the Board of Directors. In June 2010, we adopted a shareholder rights plan, which has the effect of making it more difficult for a person to acquire control of us in a transaction not approved by our board of directors. The provisions of the Oregon Business Combination Act and our shareholder rights plan could have the effect of delaying, deferring, or preventing a change of control of us, could discourage bids for our common stock at a

premium over the market price of our common stock and could materially adversely impact the market price of, and the voting and other rights of the holders of, our common stock.

***Our revolving credit facility has financial and non-financial covenants, and default of any covenant could materially adversely impact us.***

Our bank revolving credit facility imposes operating restrictions on us in the form of financial and non-financial covenants. Financial covenants include adjusted quick ratio, tangible net worth, leverage ratio, senior leverage ratio, and minimum cash and accounts receivable ratio. If we were to fail to comply with the financial covenants and did not obtain a waiver from our lenders, we would be in default under the revolving credit facility and our lenders could terminate the facility and demand immediate repayment of all outstanding loans under the revolving credit facility. The declaration of an event of default could have a material adverse effect on our financial condition. We could also find it difficult to obtain other bank lines or credit facilities on comparable terms.

***We have a substantial level of indebtedness.***

As of October 31, 2011, we had \$261.9 million of outstanding indebtedness, which includes \$253.0 million of 4.00% Convertible Subordinated Debentures due 2031, \$1.3 million in other notes payable, and \$7.6 million in short-term borrowings. This level of indebtedness among other things could:

- Make it difficult for us to satisfy our payment obligations on our debt;
- Make it difficult for us to incur additional indebtedness or obtain any necessary financing in the future for working capital, capital expenditures, debt service, acquisitions, or general corporate purposes;
- Limit our flexibility in planning for or reacting to changes in our business;
- Reduce funds available for use in our operations;
- Make us more vulnerable in the event of a downturn in our business; and
- Place us at a possible competitive disadvantage relative to less leveraged competitors and competitors that have greater access to capital resources.

We may also be unable to borrow funds as a result of an inability of financial institutions to lend due to restrictive lending policies and/or institutional liquidity concerns.

If we experience a decline in revenues, we could have difficulty paying amounts due on our indebtedness. Any default under our indebtedness could have a material adverse impact on our business, operating results, and financial condition.

***Our stock price could become more volatile, and your investment could lose value.***

All of the factors discussed in this “Risk Factors” section could affect our stock price. The timing of announcements in the public market regarding new products, product enhancements, or technological advances by our competitors or us, and any announcements by us of acquisitions, major transactions, or management changes could also affect our stock price. Our stock price is subject to speculation in the press and the analyst community, changes in recommendations or earnings estimates by financial analysts, changes in investors’ or analysts’ valuation measures for our stock, our credit ratings, and market trends unrelated to our performance. A significant drop in our stock price could also expose us to the risk of securities class actions lawsuits, which could result in substantial costs and divert management’s attention and resources, which could adversely affect our business.

***Our business could be negatively affected as a result of actions of activist shareholders.***

Responding to actions by activist shareholders can be costly and time-consuming, disrupting our operations and diverting the attention of management and our employees. The perceived uncertainties as to our future direction may result in the loss of potential business opportunities, and may make it more difficult to attract and retain qualified personnel and business partners.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The table below sets forth information regarding repurchases of our common stock by us during the three months ended October 31, 2011:

<u>Period</u>	<u>Total number of shares purchased</u>	<u>Average price paid per share</u>	<u>Total number of shares purchased as part of publicly announced programs</u>	<u>Maximum dollar value of shares that may yet be purchased under the programs</u>
August 1 - August 31, 2011	142,200	\$ 10.66	142,200	\$ 113,484,840
September 1 - September 30, 2011	783,200	10.83	783,200	105,001,484
October 1 - October 31, 2011	—	—	—	105,001,484
Total	<u>925,400</u>	<u>\$ 10.81</u>	<u>925,400</u>	

On April 18, 2011, we announced a share repurchase program approved by our Board of Directors which authorized the repurchase of up to \$150.0 million of our common stock over a three year period.

**Item 6. Exhibits**

- 31.1 Certification of Chief Executive Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Chief Financial Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certifications of Chief Executive Officer and Chief Financial Officer of Registrant Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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.

Dated: December 7, 2011

MENTOR GRAPHICS CORPORATION  
(Registrant)

/S/ GREGORY K. HINCKLEY

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Gregory K. Hinckley  
President, Chief Financial Officer

**CERTIFICATIONS**

I, Walden C. Rhines, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mentor Graphics Corporation, the registrant;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: December 7, 2011

/S/ WALDEN C. RHINES

Walden C. Rhines  
Chief Executive Officer

**CERTIFICATIONS**

I, Gregory K. Hinckley, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Mentor Graphics Corporation, the registrant;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: December 7, 2011

/S/ GREGORY K. HINCKLEY

Gregory K. Hinckley  
President, Chief Financial Officer

**Certification of Periodic Financial Report Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Mentor Graphics Corporation (the "Company") hereby certifies to such officer's knowledge that:

(i) the Quarterly Report on Form 10-Q of the Company for the quarter ended October 31, 2011 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: December 7, 2011

/s/ WALDEN C. RHINES

Walden C. Rhines

Chief Executive Officer

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. § 1350, and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing. A signed original of this written statement required by Section 906 has been provided to Mentor Graphics Corporation and will be retained by Mentor Graphics Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

**Certification of Periodic Financial Report Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

Pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Mentor Graphics Corporation (the "Company") hereby certifies to such officer's knowledge that:

(i) the Quarterly Report on Form 10-Q of the Company for the quarter ended October 31, 2011 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: December 7, 2011

/s/ GREGORY K. HINCKLEY

Gregory K. Hinckley

President, Chief Financial Officer

The foregoing certification is being furnished solely to accompany the Report pursuant to 18 U.S.C. § 1350, and is not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and is not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing. A signed original of this written statement required by Section 906 has been provided to Mentor Graphics Corporation and will be retained by Mentor Graphics Corporation and furnished to the Securities and Exchange Commission or its staff upon request.