CADENCE DESIGN SYSTEMS INC
Form 10-Q
October 28, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended October 1, 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 number 0-15867

CADENCE DESIGN SYSTEMS, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

(408) 943-1234

Registrant s Telephone Number, including Area Code

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant 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 x No ¨

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

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

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

On October 1, 2011, 272,333,660 shares of the registrant s common stock, $0.01 par value, were outstanding.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

CADENCE DESIGN SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

(Unaudited)

ASSETS

	October 1, 2011	January 1, 2011
Current Assets:		
Cash and cash equivalents	$ 696,101	$ 557,409
Short-term investments	2,959	12,715
Receivables, net of allowances of $65 and $7,604, respectively	152,433	191,893
Inventories	47,056	39,034
Prepaid expenses and other	59,910	78,355
Total current assets	958,459	879,406
Property, plant and equipment, net of accumulated depreciation of $650,786 and $648,676, respectively	259,940	285,115
Goodwill	192,153	158,893
Acquired intangibles, net of accumulated amortization of $84,725 and $105,158, respectively	180,045	179,198
Installment contract receivables	9,178	23,380
2015 Notes Hedges	179,658	130,211
Other assets	81,244	75,913
Total Assets	$ 1,860,677	$ 1,732,116

LIABILITIES AND STOCKHOLDERS EQUITY

	October 1, 2011	January 1, 2011
Current Liabilities:		
Convertible notes	$ 148,530	$ 143,258
Accounts payable and accrued liabilities	140,422	216,864
Current portion of deferred revenue	360,580	337,426
Total current liabilities	649,532	697,548
Long-Term Liabilities:		
Long-term portion of deferred revenue	88,039	85,400
Convertible notes	420,982	406,404
2015 Notes Embedded Conversion Derivative	179,658	130,211
Other long-term liabilities	145,870	135,899
Total long-term liabilities	834,549	757,914
Commitments and Contingencies (Note 9 and Note 14)		
Stockholders Equity:		
Common stock and capital in excess of par value	1,713,151	1,715,541
Treasury stock, at cost	(294,285)	(353,090)

Accumulated deficit	(1,092,468)	(1,138,853)
Accumulated other comprehensive income	50,198	53,056
Total stockholders equity	376,596	276,654
Total Liabilities and Stockholders Equity	$ 1,860,677	$ 1,732,116

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

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CADENCE DESIGN SYSTEMS, INC.

CONDENSED CONSOLIDATED INCOME STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	October 1, 2011	October 2, 2010	October 1, 2011	October 2, 2010
Revenue:				
Product	$ 163,966	$ 118,221	$ 463,723	$ 338,053
Services	29,102	23,945	86,384	75,123
Maintenance	99,389	95,768	291,722	273,760
Total revenue	292,457	237,934	841,829	686,936
Costs and Expenses:				
Cost of product	18,185	10,757	52,453	23,172
Cost of services	20,410	19,102	61,101	62,583
Cost of maintenance	11,223	9,960	32,837	31,839
Marketing and sales	79,914	76,065	235,292	222,340
Research and development	103,154	97,275	303,721	278,585
General and administrative	24,041	25,081	68,720	64,973
Amortization of acquired intangibles	3,786	4,459	12,750	9,701
Restructuring and other charges (credits)	(433)	(1,682)	277	(3,073)
Total costs and expenses	260,280	241,017	767,151	690,120
Income (loss) from operations	32,177	(3,083)	74,678	(3,184)
Interest expense	(10,830)	(10,476)	(32,584)	(25,879)
Other income (expense), net	7,244	(2,907)	20,107	(33)
Income (loss) before provision (benefit) for income taxes	28,591	(16,466)	62,201	(29,096)
Provision (benefit) for income taxes	485	(143,219)	864	(192,671)
Net income	$ 28,106	$ 126,753	$ 61,337	$ 163,575
Basic net income per share	$ 0.11	$ 0.49	$ 0.23	$ 0.63
Diluted net income per share	$ 0.10	$ 0.48	$ 0.23	$ 0.62
Weighted average common shares outstanding basic	264,723	258,606	263,149	261,122
Weighted average common shares outstanding diluted	270,741	263,302	270,068	265,383

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

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CADENCE DESIGN SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	October 1, 2011	October 2, 2010
Cash and Cash Equivalents at Beginning of Period	$ 557,409	$ 569,115
Cash Flows from Operating Activities:		
Net income	61,337	163,575
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	68,934	64,795
Amortization of debt discount and fees	22,068	18,331
Loss on extinguishment of debt		5,321
Stock-based compensation	31,589	32,817
Loss from equity method investments	104	105
Gain on investments, net	(19,324)	(5,133)
Gain on sale of property, plant and equipment		(799)
Write-down of investment securities		1,500
Non-cash restructuring and other charges	202	272
Impairment of property, plant and equipment		491
Deferred income taxes	(4,741)	(70,617)
Provisions (recoveries) for losses (gains) on trade and installment contract receivables	(6,596)	(13,339)
Other non-cash items	3,689	1,987
Changes in operating assets and liabilities, net of effect of acquired businesses:		
Receivables	(8,906)	(44,422)
Installment contract receivables	72,635	97,818
Inventories	(9,767)	(16,005)
Prepaid expenses and other	19,718	(23,828)
Other assets	3,718	5,396
Accounts payable and accrued liabilities	(71,832)	3,308
Deferred revenue	20,245	45,229
Other long-term liabilities	(4,868)	(124,673)
Net cash provided by operating activities	178,205	142,129
Cash Flows from Investing Activities:		
Proceeds from the sale of available-for-sale securities	9,588	
Proceeds from the sale of long-term investments	4,824	10,276
Proceeds from the sale of property, plant and equipment		900
Purchases of property, plant and equipment	(17,703)	(28,940)
Purchases of software licenses		(2,706)
Investment in venture capital partnerships and equity investments	(608)	(3,000)
Cash paid in business combinations and asset acquisitions, net of cash acquired	(44,052)	(256,117)
Net cash used for investing activities	(47,951)	(279,587)
Cash Flows from Financing Activities:		
Principal payments on receivable sale financing	(2,829)	(3,540)

Proceeds from issuance of 2015 Notes		350,000
Payment of 2011 Notes and 2013 Notes		(187,150)
Payment of 2015 Notes issuance costs		(10,419)
Purchase of 2015 Notes Hedges		(76,635)
Proceeds from termination of 2011 and 2013 Notes Hedges		280
Proceeds from sale of 2015 Warrants		37,450
Tax effect related to employee stock transactions allocated to equity	2,897	(9,624)
Proceeds from issuance of common stock	16,994	13,269
Stock received for payment of employee taxes on vesting of restricted stock	(9,926)	(5,875)
Purchases of treasury stock		(39,997)
Net cash provided by financing activities	7,136	67,759
Effect of exchange rate changes on cash and cash equivalents	1,302	9,619
Increase (decrease) in cash and cash equivalents	138,692	(60,080)
Cash and Cash Equivalents at End of Period	$ 696,101	$ 509,035

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

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CADENCE DESIGN SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1. BASIS OF PRESENTATION

The Condensed Consolidated Financial Statements included in this Quarterly Report on Form 10-Q have been prepared by Cadence Design Systems, Inc., or Cadence, without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission, or the SEC. Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. However, Cadence believes that the disclosures contained in this Quarterly Report on Form 10-Q comply with the requirements of Section 13(a) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, for a Quarterly Report on Form 10-Q and are adequate to make the information presented not misleading. These Condensed Consolidated Financial Statements are meant to be, and should be, read in conjunction with the Consolidated Financial Statements and the Notes thereto included in Cadence s Annual Report on Form 10-K for the fiscal year ended January 1, 2011. Certain prior period balances have been reclassified to conform to current period presentation.

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

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

Cadence adopted new revenue recognition standards on the first day of fiscal 2011. See Note 3 for an additional description of Cadence s adoption of these standards.

Cadence evaluated subsequent events through the date on which this Quarterly Report on Form 10-Q was filed with the SEC.

NOTE 2. CONVERTIBLE NOTES

2.625% Cash Convertible Senior Notes Due 2015

In June 2010, Cadence issued $350.0 million principal amount of its 2.625% Cash Convertible Senior Notes Due 2015, or the 2015 Notes. The 2015 Notes have a stated interest rate of 2.625%, mature on June 1, 2015 and contain a conversion feature based on Cadence s stock price, but the 2015 Notes may only be converted to cash and not equity. The indenture for the 2015 Notes does not contain any financial covenants. Interest on the 2015 Notes is payable semi-annually each December 1st and June 1st.

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Prior to March 1, 2015, holders may convert their 2015 Notes into cash only upon the occurrence of any one of the following conversion conditions, or the 2015 Notes Conversion Conditions:

During any fiscal quarter, and only during such fiscal quarter, if the closing price of Cadence s common stock exceeds $9.81 for 20 or more of the final 30 trading days in the preceding fiscal quarter;

Specified corporate transactions; or

The trading price of the 2015 Notes falls below 98% of the product of (i) the closing sale price of Cadence s common stock and (ii) the conversion rate on that date.

As of October 1, 2011, none of the 2015 Notes Conversion Conditions were met. As of July 2, 2011, the stock price 2015 Notes Conversion Condition was met and the 2015 Notes were convertible into cash during the three months ended October 1, 2011. As of July 2, 2011, Cadence had classified the net liability associated with the 2015 Notes as a current liability on its Condensed Consolidated Balance Sheet because the 2015 Notes were convertible as of that date, but because the 2015 Notes were not convertible as of October 1, 2011, the net liability of the 2015 Notes are classified as long-term. As of October 1, 2011, the net liability of the 2015 Notes was $290.6 million.

From March 1, 2015 through May 28, 2015, holders may convert their 2015 Notes into cash at any time, regardless of the occurrence of any of the 2015 Conversion Conditions. Cadence may not redeem the 2015 Notes prior to maturity.

The initial cash conversion rate for the 2015 Notes payable to the holders of the 2015 Notes upon conversion, is 132.5205 shares of Cadence common stock for each $1,000 principal amount of the 2015 Notes, equivalent to a cash conversion price of approximately $7.55 per share of Cadence common stock, payable in cash upon conversion. The conversion value of the 2015 Notes increases to the extent Cadence s stock price exceeds $7.55 per share. Upon conversion, holders will receive cash equal to the settlement amount, as determined pursuant to the indenture, which is calculated based on the volume weighted average price of Cadence s common stock over a specified period relating to the conversion date. If a fundamental change, as defined in the indenture for the 2015 Notes (which includes certain fundamental corporate changes relating to Cadence, such as certain mergers, recapitalizations, or sales of substantially all of its assets, or the delisting of its common stock), were to occur prior to maturity of the 2015 Notes and Cadence s stock price were greater than $6.16 per share at that time, then the holders of the 2015 Notes would be entitled to a make-whole premium in the form of an increase to the conversion rate.

The cash conversion feature of the 2015 Notes, or the 2015 Notes Embedded Conversion Derivative, requires bifurcation from the 2015 Notes and is accounted for as a derivative liability. The fair value of the 2015 Notes Embedded Conversion Derivative at the time of issuance of the 2015 Notes was $76.6 million and was recorded as original debt discount for purposes of accounting for the debt component of the 2015 Notes. This discount is amortized as interest expense using the effective interest method over the term of the 2015 Notes. The 2015 Notes Embedded Conversion Derivative is recorded on Cadence s Condensed Consolidated Balance Sheet as of October 1, 2011 at its estimated fair value of $179.7 million.

At the time the 2015 Notes were issued, Cadence also entered into hedge transactions, or the 2015 Notes Hedges, to limit additional cash payments that may be due to the 2015 Note holders if the underlying Cadence stock price increases during the term of the 2015 Notes. Under the terms of the 2015 Notes Hedges, Cadence has the option to receive the cash that may be due to note holders upon maturity of the 2015 Notes or upon conversion of the 2015 Notes by the holders in excess of the $350.0 million principal amount of the notes, subject to certain conversion rate adjustments. This option expires on June 1, 2015 and must be settled in cash. The aggregate cost of the 2015 Notes Hedges was $76.6 million. The 2015 Notes

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Hedges are accounted for as derivative assets. The 2015 Notes Hedges are recorded on Cadence s Condensed Consolidated Balance Sheet as of October 1, 2011 at their estimated fair value of $179.7 million. The 2015 Notes Embedded Conversion Derivative liability and the 2015 Notes Hedges asset are adjusted to fair value each reporting period and unrealized gains and losses are reflected in Cadence s Condensed Consolidated Income Statements. The 2015 Notes Embedded Conversion Derivative and the 2015 Notes

Hedges are designed to have similar fair values. Accordingly, the changes in the fair values of these instruments during the three and nine months ended October 1, 2011, did not have a net impact on Cadence s Condensed Consolidated Income Statements for the respective periods.

The classification of the 2015 Notes, the 2015 Notes Embedded Conversion Derivative liability and the 2015 Notes Hedges asset as current or long-term on the Condensed Consolidated Balance Sheet is evaluated at each balance sheet date and may change from time to time depending on whether the closing stock price threshold 2015 Notes Conversion Condition is met.

To reduce the hedging cost, Cadence also sold warrants in separate transactions, or the 2015 Warrants, for the purchase of up to approximately 46.4 million shares of Cadence s common stock at a price of $10.78 per share, for total proceeds of $37.5 million, which was recorded as an increase in Stockholders equity. The 2015 Warrants expire on various dates from September 2015 through December 2015 and must be settled in net shares. Changes in the fair value of the 2015 Warrants will not be recognized in Cadence s Condensed Consolidated Financial Statements as long as the instruments remain classified as equity.

The components of the 2015 Notes as of October 1, 2011 and January 1, 2011 were as follows:

	As of	
	October 1, 2011	January 1, 2011
	(In thousands)	
Principal amount	$ 350,000	$ 350,000
Unamortized debt discount	(59,438)	(69,604)
Net liability of 2015 Notes	$ 290,562	$ 280,396

The effective interest rate and components of interest expense of the 2015 Notes for the three and nine months ended October 1, 2011 and October 2, 2010 were as follows:

	Three Months Ended		Nine Months Ended	
	October 1, 2011	October 2, 2010	October 1, 2011	October 2, 2010
	(In thousands, except percentages)			
Effective interest rate	8.1%	8.1%	8.1%	8.1%
Contractual interest expense	$ 2,289	$ 2,289	$ 6,867	$ 2,716
Amortization of debt discount	$ 3,453	$ 3,196	$ 10,166	$ 3,788

As of October 1, 2011, the if-converted value of the 2015 Notes to the note holders exceeded the principal amount of the 2015 Notes. The total fair value of the 2015 Notes was $481.5 million.

1.375% Convertible Senior Notes Due December 15, 2011 and 1.500% Convertible Senior Notes Due December 15, 2013

In December 2006, Cadence issued $250.0 million principal amount of its 1.375% Convertible Senior Notes Due December 15, 2011, or the 2011 Notes, and $250.0 million principal amount of its 1.500% Convertible Senior Notes Due December 15, 2013, or the 2013 Notes. The 2011 Notes have a stated

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interest rate of 1.375% and mature on December 15, 2011. The 2013 Notes have a stated interest rate of 1.500% and mature on December 15, 2013. Both the 2011 Notes and the 2013 Notes may be settled in cash up to the principal amount of the notes and in shares to the extent the conversion price exceeds the principal amount of the notes. The indentures for the 2011 Notes and the 2013 Notes do not contain any financial covenants. Interest on the 2011 Notes and the 2013 Notes is payable semi-annually each December 15th and June 15th. The remaining principal balance as of October 1, 2011 is $150.0 million for the 2011 Notes and $144.5 million for the 2013 Notes.

Prior to the maturity of the 2011 Notes and the 2013 Notes, holders may convert their notes upon the occurrence of any one of the following conversion conditions, or the 2011 Notes and 2013 Notes Conversion Conditions:

- During any calendar quarter, and only during such calendar quarter, if the closing price of Cadence s common stock exceeds $27.50 for 20 or more of the final 30 trading days in the preceding calendar quarter;
- Specified corporate transactions occur; or
- The trading price of the 2011 Notes and the 2013 Notes falls below 98% of the product of (i) the closing sale price of Cadence s common stock and (ii) the conversion rate on that date.

As of October 1, 2011, none of the 2011 Notes and 2013 Notes Conversion Conditions had been met.

From November 2, 2011 in the case of the 2011 Notes, and November 1, 2013 in the case of the 2013 Notes, and until the close of business on the trading day immediately preceding the maturity date, holders may convert their 2011 Notes or 2013 Notes into cash and Cadence shares at any time, regardless of the occurrence of any of the 2011 Notes and 2013 Notes Conversion Conditions. Cadence may not redeem the 2011 Notes or the 2013 Notes prior to maturity.

The initial conversion rate for the 2011 Notes and the 2013 Notes is 47.2813 shares of Cadence common stock for each $1,000 principal amount of the 2011 Notes and the 2013 Notes, equivalent to a conversion price of approximately $21.15 per share of Cadence common stock. Upon conversion, as defined in the indentures for the 2011 Notes and the 2013 Notes, holders will receive cash for the principal amount of the notes. If the conversion value exceeds the principal amount of the notes, holders will receive shares of Cadence s common stock for the amount that the conversion value exceeds the principal amount of the notes.

If a fundamental change, as defined in the indentures for the 2011 Notes and the 2013 Notes (which includes certain fundamental corporate changes relating to Cadence, such as certain mergers, recapitalizations, or sales of substantially all of its assets, or the delisting of its common stock), were to occur prior to maturity and Cadence s stock price were greater than $18.00 per share at that time, the holders may be entitled to a make-whole premium in the form of an increase to the conversion rate.

The classification of the 2011 Notes and 2013 Notes as a current or long-term liability on the Condensed Consolidated Balance Sheet is evaluated at each balance sheet date and may change from time to time, depending on whether the closing stock price threshold 2011 Notes and 2013 Notes Conversion Condition is met for that particular quarter. The 2011 Notes mature on December 15, 2011 and the liability component of the 2011 Notes is classified as a current liability as of October 1, 2011.

During the nine months ended October 2, 2010, Cadence purchased in the open market $100.0 million principal amount of the 2011 Notes and $100.0 million principal amount of the 2013 Notes. During the three months ended January 1, 2011, Cadence purchased in the open market $5.5 million principal amount of the 2013 Notes. At settlement, the fair value of the liability component of the notes immediately prior to its extinguishment was measured first, and the difference between the fair value of the aggregate consideration remitted to its holders and the fair value of the liability component of the notes immediately prior to its extinguishment was attributed to the reacquisition of the equity component of the notes. The remaining consideration remitted was allocated to the debt component of the notes.

The loss on early extinguishment of debt for the fiscal 2010 repurchases was as follows:

	2011 Notes	2013 Notes	Total
		(In thousands)	
Loss on early extinguishment of debt	$ (3,499)	$ (2,206)	$ (5,705)

At the time the 2011 Notes and the 2013 Notes were issued, Cadence also entered into hedge transactions, or the 2011 and 2013 Notes Hedges, to reduce the impact of potential dilution resulting from conversion of the 2011 Notes or the 2013 Notes. Under the terms of the 2011 and 2013 Notes Hedges, Cadence has the option to receive the amount of shares that may be owed to the 2011 Notes or the 2013 Notes holders at maturity or upon conversion of the notes, subject to certain conversion rate adjustments. These options expire on December 15, 2011 in the case of the 2011 Notes, and on December 15, 2013 in the case of the 2013 Notes, and must be settled in net shares. The aggregate cost of the 2011 and 2013 Notes Hedges was $119.8 million and was recorded as a reduction to Stockholders equity. In connection with the purchase of a portion of the 2011 Notes and 2013 Notes in June and November 2010, Cadence also sold a portion of the 2011 and 2013 Notes Hedges representing options to purchase approximately 9.7 million shares of Cadence s common stock for proceeds of $0.4 million. The estimated fair value of the remaining 2011 and 2013 Notes Hedges was $1.9 million as of October 1, 2011. Subsequent changes in the fair value of the 2011 and 2013 Notes Hedges will not be recognized in Cadence s Condensed Consolidated Financial Statements as long as the instruments remain classified as equity.

To reduce the hedging cost, Cadence also sold warrants in separate transactions, or the 2011 and 2013 Notes Warrants, for the purchase of up to 23.6 million shares of Cadence s common stock at a price of $31.50 per share for proceeds of $39.4 million, which was recorded as an increase in Stockholders equity. In connection with the purchase of a portion of the 2011 Notes and the 2013 Notes in June and November 2010, Cadence also purchased a portion of the 2011 and 2013 Notes Warrants, reducing the number of shares of Cadence common stock available for purchase by 9.7 million shares at a cost of $0.1 million. The 2011 and 2013 Notes Warrants expire on various dates from February 2012 through April 2012 in the case of the 2011 Notes, and February 2014 through April 2014 in the case of the 2013 Notes, and must be settled in net shares. Changes in the fair value of the 2011 and 2013 Notes Warrants will not be recognized in Cadence s Condensed Consolidated Financial Statements as long as the instruments remain classified as equity.

The components of the 2011 Notes and 2013 Notes as of October 1, 2011 and January 1, 2011 were as follows:

	As of	
	October 1, 2011	January 1, 2011
	(In thousands)	
Equity component of 2011 Notes and 2013 Notes	$ 111,375	$ 111,375
Principal amount	$ 294,461	$ 294,461
Unamortized debt discount	(15,689)	(25,373)
Liability component of 2011 Notes and 2013 Notes	$ 278,772	$ 269,088

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The effective interest rate and components of interest expense of the 2011 Notes and 2013 Notes for the three and nine months ended October 1, 2011 and October 2, 2010, were as follows:

	Three Months Ended		Nine Months Ended	
	October 1, 2011	October 2, 2010	October 1, 2011	October 2, 2010
	(In thousands, except percentages)			
Effective interest rate	6.3%	6.3%	6.3%	6.3%
Contractual interest expense	$ 1,053	$ 1,075	$ 3,161	$ 4,515
Amortization of debt discount	$ 3,275	$ 3,130	$ 9,684	$ 12,931

As of October 1, 2011, the if-converted value of the 2011 Notes and 2013 Notes to the note holders did not exceed the principal amount of the 2011 Notes and 2013 Notes. The total fair value of the 2011 Notes and 2013 Notes, including the equity component, was $288.7 million.

Zero Coupon Zero Yield Senior Convertible Notes Due 2023

In August 2003, Cadence issued $420.0 million principal amount of its Zero Coupon Zero Yield Senior Convertible Notes Due 2023, or the 2023 Notes. As of October 1, 2011, the remaining balance and the total fair value of the 2023 Notes was $0.2 million.

NOTE 3. REVENUE RECOGNITION

Cadence adopted new revenue recognition accounting standards on the first day of fiscal 2011 for revenue arrangements that include both hardware and software elements. These new standards require companies to account for product or service deliverables separately rather than as one combined unit in a multiple element arrangement, or MEA. Under these new standards, hardware products containing software components and nonsoftware components that function together to deliver the hardware product s essential functionality are excluded from the pre-existing software revenue standards. In addition, hardware components of a tangible product containing software components are always excluded from the pre-existing software revenue standards. The residual method is no longer allowed when allocating consideration for arrangements under these new accounting standards.

An MEA is any arrangement that includes or contemplates rights to a combination of software or hardware products, software license types, services, training or maintenance in a single arrangement. From time to time, Cadence may include individual deliverables in separately priced and separately executed contracts with the same customer. Cadence evaluates all relevant facts and circumstances in determining whether the separate contracts should be accounted for individually as distinct arrangements or whether the separate contracts are, in substance, an MEA. Significant judgment can be involved in determining whether a group of contracts might be so closely related that they are, in effect, part of a single arrangement.

For a single transaction or MEA that includes software and nonsoftware elements, Cadence allocates consideration to all deliverables based on their relative standalone selling prices. In these circumstances, the new accounting standards establish a hierarchy to determine the standalone selling price to be used for allocating consideration to deliverables as follows:

Vendor-specific objective evidence of fair value, or VSOE;

Third-party evidence of selling price, or TPE; and

Best estimate of the selling price, or ESP.

The new accounting standards do not generally change the separate elements identified in Cadence s revenue transactions. For MEAs that contain software and nonsoftware elements, Cadence allocates the consideration to software or software-related elements as a group, and to any nonsoftware element separately based on the standalone selling price hierarchy. The consideration allocated to each element is then recognized as revenue when the basic revenue recognition criteria are met for each element. Once the consideration is allocated to the group of software and software-related elements, it then follows the recognition principles of pre-existing software accounting guidance.

The most significant impact of the adoption of the new revenue recognition accounting standards is the timing of revenue recognition for Cadence s hardware products when sold with other hardware products or with software licenses for which revenue is recognized ratably. Using the residual method under the pre-existing accounting standards, revenue was recognized when all undelivered elements had vendor-specific objective evidence of fair value, or VSOE. In an arrangement that included multiple hardware products, revenue for the delivered hardware products was required to be deferred until the final hardware product was delivered. In these arrangements, the time period between shipment of the first hardware product and the last hardware product can vary, generally ranging from one to four quarters. Under the newly adopted accounting standards, the consideration allocated to each hardware product will be recognized as revenue upon the respective delivery of each hardware product. In addition, if a hardware product is sold with nonessential software licenses, hardware revenue will no longer be required to be recognized ratably over the software license term.

Cadence adopted these new accounting standards on a prospective basis. Therefore, revenue will continue to be recognized in future periods under the pre-existing accounting standards for arrangements that were entered into on or prior to January 1, 2011. Cadence began applying the new accounting standards for arrangements entered into or materially modified on or after January 2, 2011. If Cadence had accounted for arrangements entered into on or after January 2, 2011 under the pre-existing accounting standards, revenue for the three months ended October 1, 2011 would have been $9.0 million less than reported and revenue for the nine months ended October 1, 2011 would have been $11.1 million less than reported. Changes in assumptions or judgments or changes to the elements in an arrangement could cause a material increase or decrease in the amount of revenue that Cadence reports in a particular period.

Cadence has established VSOE for certain service offerings based upon the pricing of these elements when sold separately. VSOE for maintenance is based upon the customer s stated annual renewal rate. Cadence has not established VSOE for any of its products, for annual maintenance that is not cancellable by the customer, or for maintenance of less than 12 months.

TPE is determined based on competitor prices for similar deliverables when sold separately. Generally, Cadence s offerings contain significant differentiation such that comparable pricing of products with similar functionality cannot be obtained. Furthermore, Cadence is unable to reliably determine what similar competitor products selling prices are when those products are sold on a stand-alone basis. Therefore, Cadence typically is not able to obtain TPE and TPE is not used to determine any standalone selling prices.

Cadence calculates the ESP of its hardware products based on its pricing practices, including the historical average prices charged for comparable hardware products. Cadence s process for determining ESP for its software deliverables without VSOE or TPE takes into account multiple factors that vary depending upon the unique facts and circumstances related to each deliverable. Key external and internal factors considered in developing the ESPs include prices charged by Cadence for similar arrangements, historical pricing practices and the nature of the product. In addition, when developing ESPs, Cadence may consider other factors as appropriate including the pricing of competitive alternatives if they exist, and product-specific business objectives.

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Cadence generally has a minimum of two deliverables contained in arrangements involving the sale of its hardware. The first deliverable is the hardware product and software essential to the functionality of the hardware product delivered at the time of sale, and the second deliverable is the right to receive maintenance on the hardware product and the hardware product s essential software. Cadence allocates consideration between these deliverables based on the relative standalone selling price for each deliverable. Consideration allocated to the hardware product and the related essential software is recognized as revenue at the time of delivery provided all other conditions for revenue recognition have been met. Consideration allocated to the maintenance is deferred and recognized as revenue on a straight-line basis over the respective maintenance terms.

Cadence accounts for MEAs that consist only of software or software-related products in accordance with industry-specific accounting guidance for software and software-related transactions. If VSOE exists for all undelivered elements, the consideration is allocated using the residual method. Under the residual method, the VSOE of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized up-front as the software products are delivered. If VSOE does not exist for all elements to support the allocation of the total fee among all elements of the arrangement, or if VSOE does not exist for all undelivered elements to apply the residual method, revenue is recognized ratably over the term of the undelivered elements.

NOTE 4. ACQUISITIONS

For each of Cadence s acquisitions, the results of operations and the estimated fair value of the assets acquired and liabilities assumed have been included in Cadence s Condensed Consolidated Financial Statements from the date of the acquisition.

2011 Acquisitions

During the nine months ended October 1, 2011, Cadence acquired companies for a combined purchase price of $49.3 million and recorded a total of $32.3 million of goodwill and $21.6 million of other intangible assets with a weighted average life of approximately 7 years. The $32.3 million of goodwill recorded in connection with these acquisitions is not expected to be deductible for income tax purposes. The fair value of the intangible assets acquired with these companies was determined using the income approach with significant inputs that are not observable in the market. Key assumptions include the economy in general, conditions and demands specific to electronic design automation software development, expected future cash flows, the timing of the expected future cash flows and discount rates consistent with the level of risk.

One of the 2011 acquisitions includes contingent consideration payments based on certain future financial measures associated with the acquired technology. Cadence makes estimates regarding the fair value of contingent consideration liabilities on the acquisition date and at the end of each reporting period until the contingency is resolved. Cadence estimates the fair value of these liabilities based on Cadence s expectations as to the projected financial measures and Cadence s assessment of the probability of achievement. Cadence believes that its estimates and assumptions are reasonable, but there is significant judgment involved. Changes in the fair value of contingent consideration liabilities subsequent to the acquisition are recorded in General and administrative expense in Cadence s Condensed Consolidated Income Statements.

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The contingent consideration arrangement for the 2011 acquisition requires payments of up to $5.0 million if certain financial measures are met during the three-year period subsequent to October 1, 2011. The initial fair value of the contingent consideration arrangement of $3.5 million was determined using significant inputs that are not observable in the market. Key assumptions include discount rates consistent with the level of risk of achievement and probability-adjusted revenue projections. The expected outcomes were recorded at net present value. The fair value of the contingent consideration was $3.6 million as of October 1, 2011 which included $0.1 million of accretion of the contingent consideration recorded after the date of acquisition.

Denali Software, Inc.

In June 2010, Cadence acquired Denali Software, Inc., or Denali. Denali was a privately-held provider of electronic design automation software and intellectual property used in system-on-chip design and verification. Cadence acquired Denali to expand its portfolio to provide system component modeling and intellectual property integration. The aggregate initial purchase price was $296.8 million, which was paid in cash. Of the $12.6 million of purchase price payments that were deferred on the acquisition date, $1.0 million remains unpaid as of October 1, 2011 and is conditioned upon certain Denali shareholders remaining employees of Cadence over the stated retention periods. Of the $12.6 million deferred purchase price, Cadence expensed $10.2 million during fiscal 2010, $1.2 million during the nine months ended October 1, 2011 and Cadence will expense the remaining $1.2 million over the stated retention periods.

The financial information in the table below summarizes the combined results of operations of Cadence and Denali, on a pro forma basis, as though the companies had been combined as of the beginning of the three and nine months ended October 2, 2010. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisition had taken place on January 3, 2010 or of results that may occur in the future.

	Three Months Ended October 2, 2010	Nine Months Ended October 2, 2010
	(In thousands)	
Total revenue	$ 237,934	$ 698,831
Net income	$ 131,549	$ 143,057

Acquisition-Related Contingent Consideration

Cadence accounts for business combinations with acquisition dates on or before January 3, 2009 under the purchase method in accordance with Statement of Financial Accounting Standard, or SFAS, No. 141, Business Combinations, and contingent consideration is added to Goodwill as it is paid. See Note 5 for the amount of Goodwill recorded during the nine months ended October 1, 2011 in connection with acquisitions accounted for under SFAS No. 141. Cadence accounts for business combinations with acquisition dates after January 3, 2009 under the acquisition method in accordance with the Accounting Standards Codification and contingent consideration is recorded at fair value on the acquisition date.

In connection with Cadence s business combinations and asset acquisitions completed before October 1, 2011, Cadence may be obligated to make payments based on, or subject to the satisfaction of,

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certain performance metrics. If performance is such that these payments are fully achieved, Cadence may be obligated to pay up to an aggregate of $30.7 million in cash during the next 55 months. Of the $30.7 million, up to $20.8 million would be expensed in Cadence s Condensed Consolidated Income Statements and up to $5.6 million would be recorded as additional goodwill.

NOTE 5. GOODWILL AND ACQUIRED INTANGIBLES

Goodwill

Cadence completed its annual goodwill impairment test during the three months ended October 1, 2011 and determined that the fair value of Cadence s single reporting unit substantially exceeded the carrying amount of its net assets and that no impairment existed.

The changes in the carrying amount of goodwill during the nine months ended October 1, 2011 were as follows:

	Gross Carrying Amount (In thousands)
Balance as of January 1, 2011	$ 158,893
Goodwill resulting from the acquisitions during the period (Note 4)	32,250
Additions due to contingent consideration (Note 4)	1,347
Effect of foreign currency translation	(337)
Balance as of October 1, 2011	$ 192,153

Acquired Intangibles, Net

Acquired intangibles with finite lives as of October 1, 2011 were as follows, excluding intangibles that were fully amortized as of January 1, 2011:

	Gross Carrying Amount	Accumulated Amortization	Acquired Intangibles, Net
		(In thousands)	
Existing technology	$ 90,453	$ (14,225)	$ 76,228
Agreements and relationships	118,034	(24,343)	93,691
Distribution rights	30,100		