What do you want?

Electronics Consumer No. 1

Cadence 1997 Annual Report

This year, we asked a few people to share their visions for the future of technology. They set some lofty goals.

I COULD REALLY USE A VIRTUAL CASHIER — A WIRELESS COUNTERTOP SELF-SERVICE CHECKOUT DEVICE WITH TOUCHSCREEN MENUS, A MULTI-LINGUAL RECIPE BUILDER, AN AUTOMATIC INVENTORY AND REORDER SYSTEM, AND A PROFIT AND LOSS CALCULATOR WITH A FRIENDLY FACE AND VOICE — SO I CAN RETIRE.

Electronics Consumer No. 451; Hong Kong, China
Make it fast. Make it talk. Make it feel.

Seems like just about everybody on the planet has a request—and sooner or later, people expect their dreams to come true. ⇨

I want a collar-sized digital cellular behavior modification system with voice recognition that will train Charmane what not to eat before a performance. And it better be less expensive than a day with the dietician.

Electronics Consumer No. 2,356; Belo Horizonte, Brazil
Make it portable. Make it programmable. Make it affordable.

It drives the technology business crazy. The demands are outrageous. ⇨

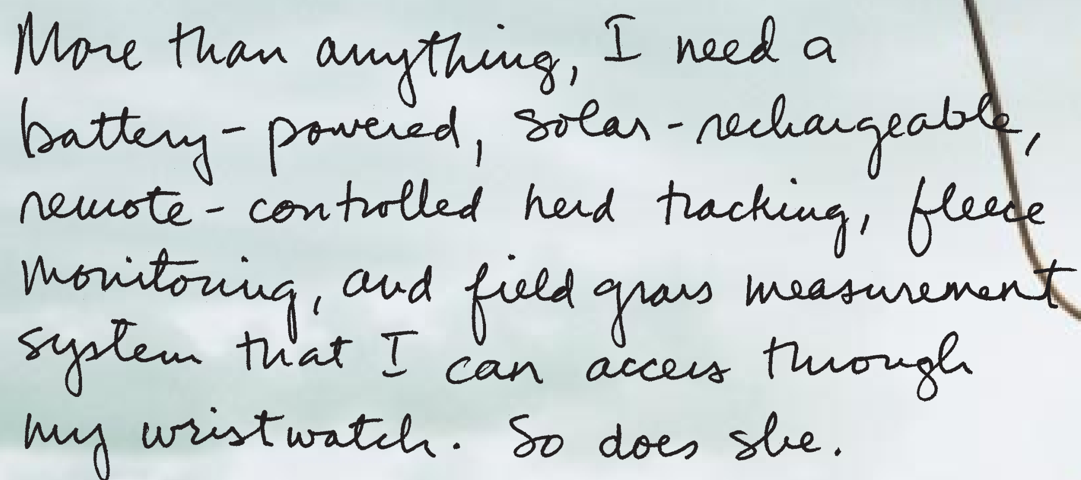
But then again, so are the opportunities. ⇨

YOU KNOW WHAT I NEED? A PUTTER THAT MEASURES HEAT, HUMIDITY, WIND, AND AIR PRESSURE — AND TELLS ME EXACTLY HOW FAR TO PULL BACK, EXACTLY HOW HARD TO HIT THE BALL, AND EXACTLY WHAT ANGLE'S GOING TO WORK. WHILE IT'S ON THE JOB, IT SHOULD ALSO REDIRECT CALLS FROM MENKIS INTO A SPECIAL "SORRY, I'M AT A CUSTOMER MEETING" VOICEMAIL BOX.

Electronics Consumer No. 456,597; San Francisco, California
Make it do more. Make it fit in this. Make it by December.

The situation creates some powerful decisions for designers of electronic products. ⇨

What specific capabilities to pursue? ⇨



Electronics Consumer No. 15,958,362; Kenmare, Ireland
Make it use less power. Make it wireless. Make it small.

What software tools to buy? ⇨

How much to design in-house? How to design, period? ⇨

Right now, I need a wireless spy-cam small enough to hide in the dashboard of my parents' car... with real-time geopositioning, audio, and video feeds directly into my PC, so I can get this place cleaned up before they get home.

Electronics Consumer No. 3,893,374,199; Suffern, New York
Make it see. Make it hear. Make it know where it is.

How to get more and more products to market faster, cheaper, smaller, better?

Make it battery-pow...

MAKE IT FEEL.

Make it listen

Make it portable.

make it move.

...ke it now.

MAKE IT SMALL.

Make it ...

Make it cool.

MAKE IT LAST LONGER.

MAKE IT AFFORDABLE.

Make it cost less.

Make it work better.

MAKE IT DO MORE.

...it think

Make it fast...

MAKE it TALK.

MAKE IT FAST.

MAKE IT FIT IN THIS.

Make it Hear.

Make it know where it is.

MAKE IT CONNE...

Make it see.

...e it cheaper.

Make it smaller.

Make it use less power.

Make it ...

Make it wire...

What's Cadence doing about it?

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Whatever need

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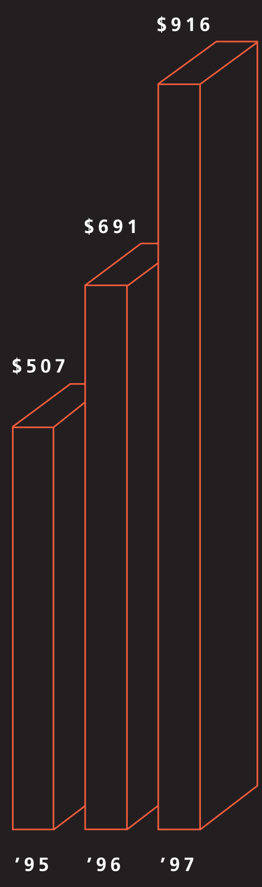
Made it wireless. Made it work better. Made it faster. Made it connect. Made it happen. Made it talk. Made it different. Made it see.
Made it think. Made it know where it is. Made it cheaper. Made it do what we used to need three

ds to be done.



For comparative purposes, these results exclude the effects of IMS and unusual items.

Electronics Consumer No. 5,903 *Make it sound good. Make it last a long time. Make it affordable.*

Motorola Radio Products

Two-way radios keep people in touch with each other—parents with their kids, skiers on a mountain, hunters and fishermen in the wilderness. But they don't help much in a crowded mall or amusement park if interference keeps you from hearing clearly. And dead batteries don't help a lost hiker. The big challenge—how do you optimize for sound quality and battery life, and still fit in a family's budget?

16(a)

Made it sound great, nearly everywhere. Made it work for hours. Made it less than $150.

Motorola Radio Products and Cadence

Smart frequency conversion design is crucial in saving chip space and avoiding power drain. But if you go too far, signal noise starts interfering with quality. For years, Motorola trusted only its manual measurements of test chips to get the tradeoff right. And that takes a long time. Cadence showed how computerized simulation could provide the same accuracy in minutes—instead of days or weeks or months. With extra time to innovate, Motorola made its two-way radios reach clearly for two miles, last for eight hours on batteries, and sell for under $150.

16(b)

Letter to Shareholders

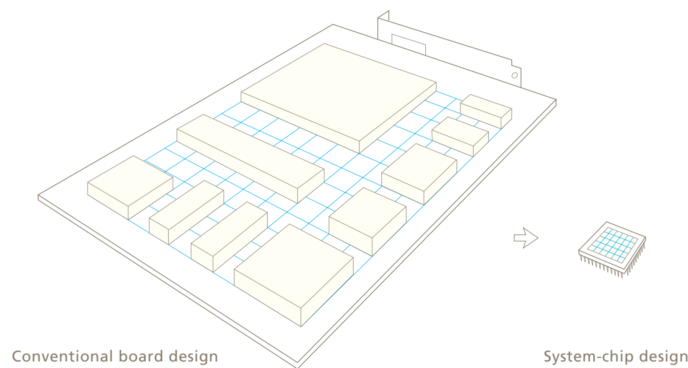
Our business—a powerful reflection of what the world wants. You see it all around you. Everything is becoming "electronic." From homes to cars to businesses… it's hard to count how many microelectronic components you come in contact with every day. And the phenomenon is global. Emerging nations are installing cellular systems—skipping over the wired communications generation entirely. Today, it's difficult to find a school without a computer. And in many countries, telephone area codes are being split again and again, thanks to homes and businesses adding more and more lines to access the worldwide information system.

Everyone, everywhere, is being influenced by an explosion in the worldwide electronics consumer marketplace. Yesterday's dreams (for things like cell phones, home computing, automobile navigation, medical equipment, electronic games, and entertainment) have become not just today's realities, but today's expectations. And tomorrow's wish list is growing exponentially.

All this means that the demands—as well as opportunities—are enormous. Make it smaller. Make it faster. Make it cheaper. Make it better. The song is the same. But the volume—of electronic design work and product output—has become deafening. There's a tremendous need for resources to manage the situation.

That's where we come in. Simply put, Cadence® helps companies design electronic products. We do whatever it takes. We provide the complex software that electrical engineers use to create chips, boards, and entire systems. We offer comprehensive services to help them do their jobs faster, easier, and more efficiently. And we can even design electronics on a company's behalf.

Our business is all about helping customers successfully get electronic products to market. And considering the demands the world is putting on the electronics industry… helping companies do it is an extraordinarily fertile business. Great for Cadence Design Systems, Inc. Great for our customers. Great for our shareholders. And apparently, great for about 5 billion worldwide electronics consumers.



System-on-a-chip What used to be lots of separate chips is now being squeezed into a new generation of sophisticated system-

Want to see some great numbers? The Company continued to set new financial records[†] in 1997. Revenue totaled $916 million, up from $691 million in 1996—a 33% increase. Here's what's so remarkable. Cadence is the electronic design automation (EDA) leader—yet, the Company has outpaced the growth rate of the EDA industry by 150%… for the third year in a row.

Product revenue, representing our electronic design software, was $531 million, up 42% from 1996. Services revenue, including electronic design services, consulting, and education grew 42% in 1997, reaching $161 million. Maintenance revenue increased 10% to $224 million. We also closed the year with momentum on our side—the Company's bookings exceeded revenue for the nineteenth consecutive quarter.

Full year diluted earnings per share increased 39% over 1996 to $0.93. And in the fourth quarter, Cadence declared a 2-for-1 stock split, effected in the form of a stock dividend payable to shareholders.

The financial position of Cadence Design Systems has never looked better. We made it consistent. Made it reliable. Made it go up and to the right.

What's behind all this business? For the electronics industry to reach its $1.2 trillion expected size by the year 2000,[††] the traditional barriers surrounding product development will have to fall. The rate of increasing complexity, the shortening of development cycles, and the decreasing of price points will cripple electronics developers who don't embrace new ways of doing design and doing business.

These macroeconomic factors and the microelectronic possibilities are working hand in hand. Because products need to be developed smaller, faster, cheaper, and better… an electronic design revolution known as "system-on-a-chip" has been ignited. What used to be a large, clunky board containing multiple chips from multiple manufacturers is quickly becoming a single chip, integrating multiple "virtual components" from as many sources.

It's not just because people want smaller products. It's because it's remarkably more affordable to craft a single chip and mass produce it than it is to create many and affix them to boards. Semiconductor fabrication plants have tooled up for the change. The writing is on the wall. The only way for product developers to thrive is to join the system-on-a-chip revolution.

The challenges electronics designers face are many-fold. The tiny size of today's electronics is creating new problems. When wires are hundredths the width of a human hair, the electrons running through them can become a bit unmanageable.

Then comes the "virtual component" challenge. The traditional electronic product industry has been created around shipping chips from one company to another. A cell phone manufacturer could find someone to create a chip to generate the dialing tones, someone else to build a separate voice-to-digital conversion chip, and yet someone else to provide a separate chip for interfacing with the antenna. These days, the smartest thing to do is to integrate those kinds of separate functions onto one chip. But the infrastructure for sharing building blocks of chip layout is in its infancy. The system-on-a-chip revolution needs to find ways to replace solder with new chip layout techniques and sharing protocols.

Cadence plays an important role in system-on-a-chip. Cadence is helping lead the system-on-a-chip revolution to success. With the industry's leading deep submicron (DSM) design tools—for creating chips with wires thinner than 0.25 micron[‡]—we're enabling electronic designers to dive into new territory. Specifically, our new Silicon Ensemble™ DSM place-and-route solution was adopted at a record pace in 1997. And in fact, our entire suite of electronic design software is helping companies take advantage of new DSM technology and create cutting-edge products that work correctly the first time out.

[†] For comparitive purposes, these results exclude the effects of IMS and unusual items. [††] Dataquest [‡] For reference, the diameter of the period at the end of this sentence is roughly 00 microns.

Electronics Consumer No. 918,763 *Make it inexpensive. Make it look and sound better. Make it now.*

Hughes Network Systems

A TV's set-top box does a lot more than change channels these days. Smart ones perform so the pictures look better and the music sounds better. And making it smarter doesn't mean you get to charge more. The big question—how to deal with all that added complexity and price pressure, and still get done on time?

Made it for less. Made it handle Digital VHS recording. Made it on schedule.

Hughes Network Systems and Cadence

Simulation is the only hope when you're trying to pack all the logic required for Direct TV onto a single chip. Hughes needed one for its set-top box. But simulation was taking 24 hours per run until Cadence helped Hughes test the latest advances. With electronic tests running as much as 50 times faster, Hughes could try many more ways to fit all the features viewers want in an affordable package—and still got the product out on time, on shelves, and on TVs.

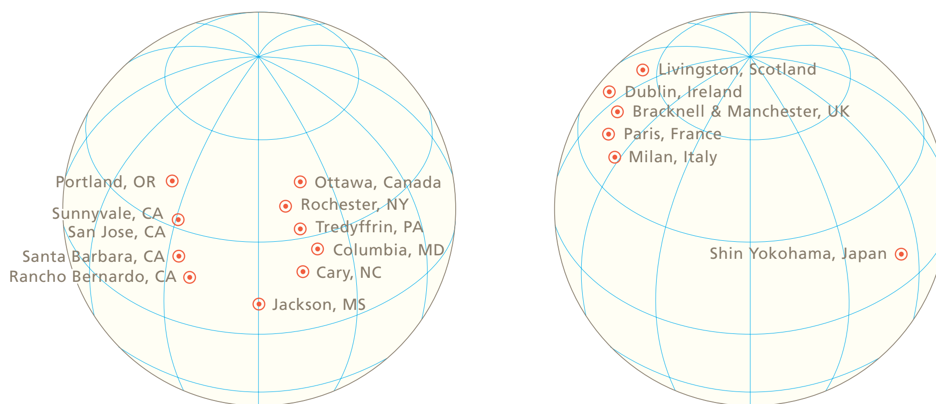
Beyond software, Cadence is also working to create the best environment for electronics companies worldwide to pursue the system-on-a-chip initiative. In one of the most unique arrangements ever conceived in electronics, Cadence and the government of Scotland have joined forces to create the System-on-a-Chip Institute. Announced at the end of 1997, Project Alba will ensure that the electronics industry, academia, and a national government will be working toward a common goal—simplifying and making possible system-on-a-chip technologies, enabling the development of engineers with relevant expertise, and establishing a regulatory environment designed to foster success.

The System-on-a-Chip Institute is also a great transaction for Cadence. Akin to establishing an airport and then being its anchor tenant and managing partner, Project Alba will result in substantial revenues over six years. Along the way, we expect to be involved with many of the world's top electronics companies, helping develop next-generation chip designs while gaining valuable access to design expertise for the future. Our facility in Scotland will create our largest worldwide electronics design center, housing more than 1,800 engineers by the year 2004. The system-on-a-chip global market is anticipated to grow at a rate of 40% a year, and represent over $20 billion by the year 2000.[#] Cadence is positioned to be at the heart of that opportunity.

Look at the advanced technology behind today's electronics. While the system-on-a-chip revolution gets underway, Cadence is also seeing extraordinary success in traditional electronic design markets. EDA tools are arguably some of the most complicated software to create. However, in 1997, Cadence released more new versions of its software than ever, making electronic product design easier, and increasing revenue dramatically.

Our Silicon Ensemble DSM place and route tools, IC Craftsman® layout automation product, NC Verilog® simulator, and Alta™ family of high-level design software saw particular successes this year. And the introduction of the Cadence Cobra simulator, and SPECCTRAQuest™ planner, along with enhancements in our Vampire® verification, among many others, helped drive product sales to new heights for the Company.

[#] Dataquest



The Cadence Design Factory Network With electrical engineering professionals located around the globe, Cadence puts local design expertise at customers' fingertips worldwide.

Anticipating technological change among electrical engineering teams, Cadence also released versions of our complete printed circuit board (PCB) design software suite for the Windows NT platform. Further ensuring that customers will have flexible and high-performance solutions from Cadence in years to come, the Company also announced close alignments with key hardware manufacturers—together, we will optimize our software for next-generation platforms. And our advanced research and development group, Cadence Labs, anchored by sites in Berkeley, California and Rome, Italy, continued to create innovations that elevate our tools to new levels of engineering sophistication.

Cadence provides EDA software to just about every electronics company on the planet. And in 1997, notable contracts with AMD, Ericsson, Motorola, NEC, Philips Semiconductor, Seimens, Toshiba, and TriTech Microelectronics helped Cadence continue to lead the electronic design tools market.

Services are making the biggest difference. The key differentiator between Cadence and other traditional EDA companies is our comprehensive services offering. And 1997 was an extraordinary year for all aspects of our services organization.

Multimillion-dollar transactions with companies like Applied Magic, Domosys, Ericsson, ICL, Lucent, Motorola, Racal, Sony, and Toshiba—encompassing nearly all the components of our services offerings, from software education and engineering process consulting to design services and design sourcing—helped our services division achieve more than ever.

The methodologies developed by Cadence services are being deployed at companies large and small, worldwide. The financial successes for Cadence are obvious. And the value our services deliver is now becoming crystal-clear—Motorola estimates that through a recent engagement with Cadence services, they've eliminated $12 million in annual production costs for one design process and trimmed development time from five months to three weeks. This is powerful stuff.

Our worldwide Design Factory℠ network—a collection of the industry's best engineering talent—has also seen significant expansion to meet the needs of global electronics development. In 1997, Cadence added international sites in Ottawa, Canada; Dublin, Ireland; and Paris, France; and Jackson, Mississippi; Portland, Oregon; Cary, North Carolina; and Santa Barbara, California, in the USA. These sites join the other dozen Cadence Design Factory sites and nearly 1,000 engineers across the globe in providing design expertise to the world's electronic product developers.

Cadence—The Design Realization Company.℠ The year 1997 was an extraordinarily important one for Cadence. We experienced more success than ever. Our most recent and most significant mergers and acquisitions were finalized. We experienced a change in leadership. And our seasoned executive team has been assembled.

In the same year, Cadence was honored as management firm Mitchell & Company's first-ever "400-Year Project" prototype company. The distinction represents the firm's belief that Cadence's management practices, position for rapid growth, and significant contribution to the industrialized world create a model that could achieve 20 times the normal rate of progress over a 20-year period.

Meeting that challenge is all about doing whatever it takes. Cadence has emerged from the EDA market as the preeminent leader in electronic design. In fact, it's hard to call us an EDA company anymore. We do so much more than that. Cadence is uniquely poised to deliver complete electronic design solutions to customers of all kinds—ones that employ vast numbers of sophisticated electrical engineering talent, and ones that aren't necessarily in the electronics design business at all, but occasionally need electronic design expertise to win in the increasingly electronic age.

Harris Semiconductor

DVD technology has elevated the image and sound quality standards of home movie viewers. PC users are next in line to demand the same. Awesome complexity must be compressed into multimedia chips to equip PCs with DVD capability, but consumers show no mercy. They want it now and they don't want to pay much more. How to do it all?

Made it DVD quality. Made it a $3 chip. Made it by Christmas.

Harris Semiconductor and Cadence

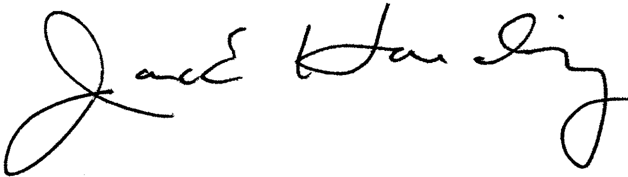
The more you cram into chip design, the longer it takes to make sure it works. Harris Semiconductor used to do computerized verification overnight. But today's multimedia chips created a different story. At 20 hours per run, verification was eating into designers' workdays so deeply that a crucial project wouldn't get done by Christmas break. Cadence spread the verification load across multiple computers—and saved Harris two precious weeks. The result... a new era in A/V quality for PCs that can even be used as DVD players for your TV.

That's what makes Cadence the Design Realization Company. We help customers of all kinds "realize" their electronic designs… and, in turn, help deliver them to the worldwide electronics consumer marketplace. Offering the world's most comprehensive electronic design software and services is good for business. Cadence is expanding the definition of what an electronic design company can do.

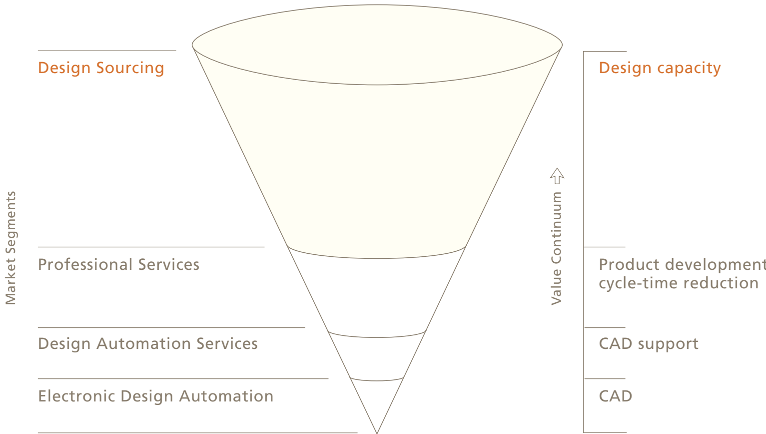
My executive staff and I are profoundly excited to be at the helm of the Company. There has never been a better time to be here. We've got the right people, the right technology, the right customers, the right reputation, and the right successes that make it easy to reach for the opportunities ahead.

In short, our performance in 1997 has been a great reflection on Cadence, on our customers, on our shareholders, and on worldwide electronics consumers.

Here's to 1998.



Jack Harding, President and Chief Executive Officer
February 27, 1998



Opportunities in Electronic Product Design Cadence is expanding its role—and the industry—into markets that are larger and deliver greatly enhanced value.

Selected Financial Data

Five fiscal years ended January 3, 1998

(in thousands, except per share amounts)

	1997	1996	1995	1994	1993
Revenue	$ 915,893	$ 741,459	$ 548,418	$ 429,072	$ 368,623
Unusual items[1]	$ 44,053	$ 100,543	$ —	$ 14,707	$ 19,650
Income (loss) from operations	$ 234,007	$ 91,259	$ 117,860	$ 44,047	$ (8,415)
Income before cumulative effect of change in accounting method[2]	$ 181,742	$ 29,038	$ 97,270	$ 36,648	$ (12,779)
Net income (loss)[3]	$ 169,466	$ 29,038	$ 97,270	$ 36,648	$ (12,779)
Net income (loss) per share–diluted	$ 0.77	$ 0.16	$ 0.51	$ 0.19	$ (0.07)
Total assets	$ 1,023,850	$ 717,001	$ 374,035	$ 361,048	$ 339,301
Long-term obligations	$ 1,599	$ 20,292	$ 1,619	$ 2,098	$ 4,001

1 Unusual items are as follows for each of the years ended 1997, 1996, 1994, and 1993. There were no unusual items in 1995:

1997 included restructuring charges of $34.4 million, $6.6 million for write-offs of in-process research and development, and $3.1 million for write-offs of capitalized software development costs.
1996 included write-offs of in-process research and development of $95.7 million, $2.7 million for write-off of capitalized software development, and $2.1 million for restructuring charges.
1994 included a provision for litigation settlement of $10.1 million and a $4.6 million write-off of in-process research and development.
1993 included restructuring charges of $13.5 million and a $6.2 million loss from operations of a disposed division.

2 Income before cumulative effect of change in accounting method in 1997 included a $12.3 million charge, net of taxes of $5.2 million, for re-engineering project costs that had been previously capitalized by the Company associated with its implementation of enterprise-wide information systems.

3 Net income included a $9.2 million and a $13.6 million after tax gain on the sale of stock of a subsidiary in 1997 and 1995, respectively. A $3.1 million after tax gain on the sale of an equity investment was included in net income for 1994.

Summary Quarterly Data—Unaudited

(in thousands, except per share amounts)

	1997				1996			
	4th	3rd	2nd	1st	4th	3rd	2nd	1st
Revenue	$ 283,013	$ 234,866	$ 210,466	$ 187,548	$ 212,262	$ 188,741	$ 177,026	$ 163,430
Cost of revenue	$ 53,795	$ 46,812	$ 43,592	$ 38,897	$ 42,807	$ 39,262	$ 37,765	$ 33,639
Income (loss) from operations[1]	$ 83,733	$ 74,615	$ 37,382	$ 38,277	$ (40,729)	$ 49,982	$ 43,433	$ 38,573
Income before cumulative effect of change in accounting method[2]	$ 60,874	$ 55,301	$ 28,466	$ 37,122	$ (57,816)	$ 32,687	$ 28,588	$ 25,579
Net income (loss)[3]	$ 48,597	$ 55,301	$ 28,446	$ 37,122	$ (57,816)	$ 32,687	$ 28,588	$ 25,579
Net income (loss) per share–diluted	$ 0.21	$ 0.24	$ 0.13	$ 0.19	$ (0.36)	$ 0.18	$ 0.16	$ 0.14

1 Income (loss) from operations for 1997 and 1996 included certain unusual item charges for $44.1 million and $100.5 million, respectively, which follow:

For the fourth quarter ended January 3, 1998, unusual items totaled $9.9 million, of which $6.3 million was for restructuring charges, $1.9 million represented a write-off of capitalized software development costs, and $1.7 million was for the write-off of in-process research and development.

For the second quarter ended June 28, 1997, unusual items totaled $22.4 million, of which $21.2 million was for restructuring charges and $1.2 million was a write-off of capitalized software development costs.

For the first quarter ended March 29, 1997, unusual items totaled $11.7 million, of which $6.8 million was for restructuring charges and $4.9 million represented a write-off of in-process research and development.

For the fourth quarter ended December 28, 1996, unusual items totaled $100.5 million, of which $95.7 million was for the write-off of in-process research and development, $2.7 million represented a write-off of capitalized software development costs, and $2.1 million was for restructuring charges.

2 For the fourth quarter ended January 3, 1998, income before cumulative effect of change in accounting method included a $12.3 million charge, net of taxes of $5.2 million, for re-engineering project costs that had been previously capitalized by the Company associated with its implementation of enterprise-wide information systems.

3 Net income included a $13.1 million after tax gain on the sale of stock of a subsidiary in first quarter ended March 28, 1997.

Management's Discussion and Analysis
of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the five-year summary of selected financial data and the Company's consolidated financial statements and notes thereto. All references to years represent fiscal years unless otherwise noted. Except for the historical information contained herein, the following discussion contains forward looking statements based on current expectations that involve certain risks and uncertainties. The Company's actual results could differ materially from those discussed herein. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below in "Factors That May Affect Future Results," "Disclosures about Market Risk," and "Liquidity and Capital Resources."

In November 1997, the Company effected a two-for-one stock split in the form of a stock dividend. Prior periods have been restated to reflect the stock split.

Overview

Cadence Design Systems, Inc. (the Company) provides comprehensive services and technology for the product development requirements of the world's leading electronics companies. The Company licenses its leading-edge electronic design automation (EDA) software technology and provides a range of professional services to companies throughout the world to help optimize its customers' product development processes. Recently, the Company has expanded the role it plays with companies that produce electronic products and with an emerging class of companies that require electronic content in their products, but who may not have any internal expertise in electronic design. The Company's business objectives are based on providing complete solutions, which range from individual software tools to complete outsourcing of design work. The Company is now a supplier of "design realization" solutions, which are used by companies to design and develop integrated circuits (ICs) and systems—including semiconductors, computer systems and peripherals, telecommunications and networking equipment, mobile and wireless devices, automotive electronics, consumer products, and other advanced electronics.

In May 1997, the Company merged with Cooper and Chyan Technology, Inc. (CCT), whose software products were used to design sophisticated integrated circuits and high-speed printed circuit boards. In connection therewith, the Company issued approximately 22.8 million shares of common stock. The acquisition was accounted for as a pooling of interests. The operations of CCT were not material to the Company's consolidated operations and financial position; therefore, prior period financial statements were not restated. The results of CCT from the date of acquisition forward have been recorded in the Company's consolidated financial statements.

In December 1996, the Company completed the acquisition of High Level Design Systems, Inc. (HLDS), a company which developed, marketed, and supported EDA software for the design of high-density, high performance ICs. The acquisition was accounted for as a purchase and, accordingly, the results of HLDS from the date of the acquisition forward have been recorded in the Company's consolidated financial statements.

In November 1996, the Company consummated a secondary public offering whereby 11.5 million shares of common stock were sold, generating $202.1 million of net proceeds.

In July 1995, the Company and its wholly-owned subsidiary, Integrated Measurement Systems, Inc. (IMS), sold to the public approximately 3 million shares of common stock, of which approximately 2.6 million shares were sold by the Company as the sole selling stockholder of IMS, and 0.4 million shares were sold by IMS. As a result of the offering and sale of shares by the Company, the Company's ownership interest in IMS decreased to approximately 55%. As the Company remained the majority stockholder at December 28, 1996, the consolidated financial statements of the Company for fiscal years 1996 and 1995 included the accounts of IMS after elimination of inter-company accounts and transactions and minority interest adjustments. In February 1997, the Company and IMS sold 1.7 million shares of IMS common stock to the public of which 0.95 million were owned by the Company. As a result, the Company received approximately $18.6 million, reduced its ownership in IMS to approximately 37%, and began accounting for its investment in IMS using the equity method of accounting.

Results of Operations

Revenue

(in millions)	1997	1996	1995	% Change 97/96	% Change 96/95
Product	$ 530.5	$ 414.1	$ 292.2	28%	42%
Services	160.9	114.6	65.9	40%	74%
Maintenance	224.5	212.8	190.3	5%	12%
Total revenue	$ 915.9	$ 741.5	$ 548.4	24%	35%

Sources of Revenue as a Percent of Total Revenue

	1997	1996	1995
Product	58%	56%	53%
Services	18%	15%	12%
Maintenance	24%	29%	35%

In 1997, strong demand for the Company's products and services generated a 24% increase in revenue as compared to the prior year.

Product revenue recorded in 1997 did not include product revenue from IMS, since IMS' results were not consolidated with the Company in 1997. The product revenue in 1996 included product revenue of $40.3 million from IMS. The Company's product revenue includes product revenue for CCT, from the date of acquisition on May 7, 1997 forward. CCT's product revenues in early 1997, prior to the acquisition, and in fiscal year 1996, totaled $7.8 million and $27.3 million, respectively. If IMS' sales had been excluded from the 1996 results and if CCT's product revenue had been included in 1997 and 1996, product revenue would have shown an increase of $137.2 million or 34% in 1997, as compared to 1996. The increase was primarily driven by increased demand for products used by customers to develop custom ICs and deep submicron designs—including design entry tools, place-and-route tools, physical verification tools, and system-level tools.

The 1996 increase, as compared to 1995, was attributed to increased sales volume of the Company's automatic place-and-route, physical layout, verification, and timing-driven design process tools. Also, demand increased for electronic systems design automation products, produced by the Company's Alta business unit, which are designed to allow customers to include product concepts in the EDA environment—thereby accelerating and enhancing the early phases of system development.

The increases in services revenue in 1997 and 1996 were the result of significant demand for the Company's services offerings, which provide a range of solutions to address the product development needs of its customers in North America, Europe, Japan, and Asia. The increase in 1996 over 1995 was also driven by the first full year of an outsourcing agreement with Unisys Corporation (Unisys) pursuant to which the Company assumed a substantial portion of Unisys' internal silicon design operation. This five-year agreement was signed in March 1995 for a total contract value of at least $75 million.

The increase in maintenance revenue in 1997 and 1996 was attributable to an increase in the Company's installed base of products. The decreased maintenance revenue growth rates in 1997 and 1996 were due to customers renewing maintenance contracts at a slower rate than in the prior years.

Revenue from international sources was approximately $470.2 million, $350.2 million, and $271.8 million, or 51%, 47%, and 50% of total revenue for 1997, 1996, and 1995, respectively. In 1997, domestic and international revenue increased 14% and 34%, respectively, following increases of 41% and 29%, respectively, in 1996. The increase in total revenue from international sources in 1997, as compared to 1996, was primarily attributable to product revenue growth and new services contracts in all regions. The higher percentage increase in international revenue in 1997, as compared to domestic revenue, was primarily attributable to an increase in international product revenue in 1997, as compared to 1996. The increase in international revenue in 1997, as compared to 1996, and in 1996 as compared to 1995, more than offset the negative impact of $32.4 million and $31.4 million, respectively, on revenue as a result of the weakening of certain foreign currencies, primarily the Japanese yen, in relation to the U.S. dollar.

Cost of Revenue

(in millions)	1997	1996	1995	% Change 97/96	% Change 96/95
Product	$ 41.5	$ 48.4	$ 44.8	(14)%	8%
Services	$ 114.8	$ 81.0	$ 55.0	42%	47%
Maintenance	$ 26.8	$ 24.1	$ 16.7	11%	44%
Cost of Revenue as a Percent of Related Revenue					
Product	8%	12%	15%		
Services	71%	71%	83%		
Maintenance	12%	11%	9%		

Cost of product revenue includes costs of production personnel, packaging and documentation, amortization of capitalized software development costs, and in 1996 and 1995, costs related to IMS' automated test equipment hardware business. If IMS's costs had been excluded from the costs incurred in 1996, and CCT's costs, prior to the acquisition date, had been included in 1996 and early 1997, cost of product would have increased $6.1 million or 17% from 1996 to 1997. The increase was primarily driven by additional costs incurred for the Company's new European manufacturing facility, increases in software amortization, and royalty expenses. On the same basis, cost of revenue as a percent of product sales would have been 9% in 1996. The decreases in cost of product as a percentage of product revenue in 1997, as compared to 1996, and in 1996, as compared to 1995, were primarily due to revenues growing at a faster rate than costs. The increase in cost of product in absolute dollars in 1996, as compared to 1995, was primarily due to increased purchased software amortization and the write-off of $1.6 million of capitalized software development costs related to products at the end of their life cycle.

Cost of services revenue includes personnel and related costs associated with providing services to customers and the infrastructure to manage a services organization, as well as costs to recruit, develop, and retain services professionals. Cost of services increased in total dollars in both 1997 and 1996 due to investments in services capacity, primarily headcount related, and the continued development of this line of business. The services gross margin in 1997 remained consistent with 1996 at 29%. Continued investment in the services business offset operating efficiencies from a larger revenue base. Continued investment in developing new services offerings and the cost of integrating new services professionals performing a growing number of services offerings will continue to put pressure on services gross margins until operating efficiencies are obtained. The improvement in services gross margins to 29% in 1996, as compared to 17% in 1995, was due to increased operating efficiencies attained within existing services offerings.

Cost of maintenance revenue includes the cost of customer services such as hot-line and on-site support and the production cost of the maintenance renewal process. The increase in cost of maintenance in total dollars, and as a percentage of maintenance revenue in 1997 and 1996, was principally due to additional on-site support costs necessary to support a larger installed base. The 1997 costs also increased due to additional costs associated with the Company's new European manufacturing facility.

Operating Expenses

(in millions)	1997	1996	1995	% Change 97/96	% Change 96/95
Marketing and sales	$ 257.8	$ 226.5	$ 185.0	14%	22%
Research and development	$ 140.4	$ 115.3	$ 88.6	22%	30%
General and administrative	$ 56.5	$ 54.4	$ 40.4	4%	34%
Operating Expenses as a Percent of Total Revenue					
Marketing and sales	28%	31%	34%		
Research and development	15%	16%	16%		
General and administrative	6%	7%	7%		

General Operating expenses incurred in 1997 excluded expenses from IMS and included expenses from CCT for the period from May 7, 1997 through January 3, 1998.

Marketing and Sales The increase in marketing and sales expenses for 1997, as compared to 1996, was primarily the result of an increase of $24.1 million in employee related expenses—attributable to increased headcount and commissions, as well as increases in consulting and other services costs of $6.1 million, management information systems costs of $5.9 million, and costs associated with business trips of $5.8 million. These increases were partially offset by a decrease of $11.9 million related to the deconsolidation of IMS and additionally by the weakening of certain foreign currencies, primarily the Japanese yen, in relation to the U.S. dollar which favorably impacted marketing and sales expenses by approximately $5.6 million in 1997, as compared to the prior year. Marketing and sales expenses grew from 1995 to 1996 due to an additional $26.6 million of employee related costs resulting from increased headcount, including commissions, recruiting, relocations, and a higher volume of pre-sales activities and advertising. These increases were partially offset by the weakening of certain foreign currencies, particularly the Japanese yen, which resulted in a favorable impact of $5.6 million.

Research and Development The Company's investment in research and development, prior to the reduction for capitalization of software development costs, was $155.4 million, $128.9 million, and $100.4 million for 1997, 1996, and 1995, respectively, representing 17%, 17%, and 18% of total revenue, respectively. The expense increases for 1997, as compared to 1996, were primarily attributable to higher salary-related costs due to an increased headcount of $22.5 million, and management information systems costs of $9.7 million. These increases were partially offset by a decrease of $7.5 million related to the deconsolidation of IMS. The increase of $26.7 million in 1996, as compared to 1995, was primarily attributable to higher salary-related costs due to increased headcount of $15.6 million and $6 million of higher consulting and recruiting, computer maintenance, and facilities costs. The Company capitalized approximately $15 million, $13.6 million, and $11.8 million of software development costs in the years 1997, 1996, and 1995, respectively, which represented approximately 10%, 11%, and 12% of total research and development expenditures incurred in those years. The amount of capitalized software development costs in any given period may vary depending on the exact nature of the development performed.

General and Administrative General and administrative expenses increased in 1997, as compared to 1996, primarily as a result of increased management information systems costs of $9.6 million, partially offset by decreases in legal expenses of $4.6 million, and a decrease of $3.5 million resulting from the deconsolidation of IMS. The increase in 1996, as compared to 1995, was due to higher legal costs of $5.9 million, higher management information and telecommunication costs of $2.2 million, and higher outside service costs of $1 million. The percentage change in general and administrative expenses between 1997 and 1996, as compared to the percentage change between 1996 and 1995, decreased primarily due to high legal expenses incurred by the Company in 1996.

Unusual Items and Restructuring Described below are unusual items and restructuring charges in 1997 and 1996. None were recorded in 1995.

(in millions)	1997	1996
Restructuring charges	$ 34.4	$ 2.1
Write-off of in-process research and development	6.6	95.7
Write-off of capitalized software development costs	3.1	2.7
Total unusual items	$ 44.1	$ 100.5

Unusual items included restructuring charges of $34.4 million recorded by the Company in 1997 for the reduction of personnel whose duties were made redundant, closure of duplicated and excess facilities, fees of financial advisors, attorneys, and accountants, and other expenses associated with the merger with CCT, and the acquisition of HLDS. Additionally, the Company restructured its international business operations to reduce the Company's cost structure, and to further integrate and reduce selling and marketing activities. In connection with the 1997 restructuring activities, the Company reduced its workforce by approximately 230 employees representing various sales, marketing, and research and development departments. The majority of the restructuring charges were utilized during the year, with the exception of facility costs which will be paid out through the year 2000, and some severance costs to be paid during 1998.

In 1997, the Company wrote off $6.6 million of acquired in-process research and development associated with its acquisitions of Synthesia AB and Advanced Microelectronics. These costs reflected research and development which had not reached technological feasibility and, in management's opinion, had no probable alternative future use. Additionally, the Company wrote off capitalized software development costs of $3.1 million for products developed by the Company which were replaced by CCT products or by license of replacement technology.

Included in 1996 unusual items was a $95.7 million write-off of in-process research and development, $2.7 million of capitalized software development costs for products developed by the Company which were replaced by HLDS products, as well as $2.1 million of restructuring charges consisting of employee termination costs associated with the outsourcing of the Company's management information technology services, and costs associated with excess facilities. The in-process research and development had not reached technological feasibility and, in management's opinion, had no probable alternative future use.

Liabilities for excess facilities and other restructuring charges are included in other current and non-current liabilities, while severance and benefits liabilities are included in payroll and payroll-related accruals.

Change in Accounting Method In November, the Emerging Issues Task Force of the Financial Accounting Standards Board issued Ruling 97-13 "Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Re-engineering and Information Technology," which requires companies to expense costs incurred for business process re-engineering projects. As a result, the Company recorded a $12.3 million charge in 1997, net of taxes of $5.3 million, as a cumulative effect of change in accounting method for re-engineering project costs that had been previously capitalized by the Company, associated with its implementation of enterprise wide information systems.

Other Income and Expense Other income (expense) for 1997, 1996, and 1995 is as follows:

(in millions)	1997	1996	1995
Interest income	$ 17.9	$ 4.3	$ 4.8
Gain on sale of IMS stock	13.1	—	18.9
Equity earnings in IMS	1.9	—	—
Minority interest expense	(0.4)	(3.0)	(1.4)
Gain (loss) on foreign exchange	(1.4)	0.2	(0.1)
Interest expense	(2.5)	(1.9)	(2.2)
Other expense, net	(3.0)	(0.4)	(2.8)
Total other income (expense)	$ 25.6	$ (0.8)	$ 17.2

Interest income increased in 1997, as compared to 1996, by $13.6 million, primarily due to higher average cash and investment balances throughout 1997. The decrease in 1996, as compared to 1995, was primarily attributable to prevailing interest rates being lower in 1996, as compared to 1995.

In 1995, an $18.9 million gain was recorded on the sale of approximately 45% of the stock of IMS, then a previously wholly-owned subsidiary of the Company. In 1997, the Company sold additional shares of IMS for a $13.1 million gain, thereby reducing its ownership to approximately 37%. As a result, the Company began reporting its share of IMS earnings using the equity method of accounting, which generated $1.9 million in equity income in 1997, and reduced minority interest expense by $2.6 million in 1997, as compared to 1996. The increase in minority interest expense in 1996, as compared to 1995, was due to higher minority interest expense associated with IMS and a Japanese subsidiary.

The loss on foreign exchange increased in 1997, as compared to 1996, due to unfavorable volatile Asian currencies, primarily the Japanese yen and Korean won. The increase in other expense in 1997, as compared to 1996, was due primarily to investment losses. The decrease in 1996, as compared to 1995, was due primarily to losses recorded for abandoned equipment in 1995.

Income Taxes The provision for income taxes and the effective tax rates for 1997, 1996, and 1995 are as follows:

(in millions)	1997	1996	1995
Provision for income taxes*	$ 72.6	$ 61.4	$ 37.8
Effective tax rate	30%	68%	28%

*Includes tax benefit in 1997 of $5.3 million on cumulative effect of change in accounting method.

At January 3, 1998, the Company had total net deferred tax assets of approximately $88.1 million. Realization of the deferred tax assets will be dependent on generating sufficient taxable income prior to the expiration of the loss and tax credit carryforwards. The net valuation allowance decreased by $10.8 million in 1997. The decrease in valuation allowance for equity and intangibles of $9.1 million was due to the expected realization of the tax benefits of stock option deductions generated in prior years. The valuation allowance provision for income taxes decreased by $1.7 million due to the realization of net operating losses and tax credits generated in prior years. Although realization is not assured, management believes that it is more likely than not that the net deferred tax assets will be realized. The amount of the net deferred tax assets, however, could be reduced or increased in the near term if actual facts, including the estimate of future taxable income, differ from those estimated.

The effective tax rate of 30% for 1997 was lower than the effective tax rate in 1996 due primarily to foreign earnings, which were taxed at lower rates. The 1996 effective tax rate of 33% excluded the write-off of $95.7 million for in-process research and development costs associated with the HLDS acquisition, which was not deductible for tax purposes. The increase in the 1996 effective tax rate, as compared to the 1995 effective tax rate, was primarily due to an increase in state income taxes and a smaller reduction in the valuation allowance.

Disclosures about Market Risk

Interest Rate Risk The Company's exposure to market risk for changes in interest rates relates primarily to the Company's investment portfolio. The Company places its investments with high credit quality issuers and, by policy, limits the amount of credit exposure to any one issuer. As stated in its policy, the Company is averse to principal loss and seeks to preserve its invested funds by limiting default risk, market risk, and reinvestment risk.

The Company mitigates default risk by investing in only safe and high credit quality securities, and by positioning its portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer or guarantor. The portfolio includes only marketable securities with active secondary or resale markets to ensure portfolio liquidity.

The table below presents the carrying value and related weighted average interest rates for the Company's investment portfolio. The carrying value approximates fair value at January 3, 1998. All investments mature, by policy, in one year or less.

(in millions, except for average interest rates)	Carrying Value	Average Interest Rate
Investment Securities:		
Cash equivalents—fixed rate	$ 81.8	5.76%
Short-term investments—fixed rate	46.2	5.56%
Short-term investments—variable rate	51.0	6.14%
Total investment securities	$ 179.0	5.82%
Money market funds—variable	36.4	5.68%
Total interest bearing instruments	$ 215.4	5.80%

Foreign Currency Risk The Company transacts business in various foreign currencies, primarily in Japan, emerging market countries in Asia, and certain European countries. The Company has established a foreign currency hedging program, utilizing foreign currency forward exchange contracts (forward contracts) to hedge certain foreign currency transaction exposures in Japan, Canada, Asia, and certain European countries. Under this program, increases or decreases in the Company's foreign currency transactions are partially offset by gains and losses on the forward contracts, so as to mitigate the possibility of short-term earnings volatility. The Company does not use forward contracts

for trading purposes. All outstanding forward contracts at the end of a period are marked-to-market with unrealized gains and losses included in other income (expense), and thus are recognized in income in advance of the actual foreign currency cash flows. As these forward contracts mature, the realized gains and losses are recorded and are included in net income as a component of other income (expense). The Company's ultimate realized gain or loss with respect to currency fluctuations will depend on the currency exchange rates and other factors in effect as the contracts mature.

The table below provides information as of January 3, 1998 about the Company's forward contracts. The information is provided in U.S. dollar equivalent amounts. The table presents the notional amounts (at contract exchange rates) and the weighted average contractual foreign currency exchange rates. These forward contracts mature in less than thirty days.

(in millions, except for average contract rates)	Notional Amount	Average Contract Rate
Forward Contracts:		
Japanese yen	$ 20.0	129.35
British pound sterling	$ 5.4	0.61
German deutschemarks	$ 8.1	1.79
French franc	$ 3.7	5.98
Swedish krona	$ (3.3)	7.82
Canadian dollars	$ 3.1	1.42
Italian lira	$ 1.6	1,753.48

The unrealized gain (loss) on the outstanding forward contracts at January 3, 1998 was immaterial to the Company's consolidated financial statements. Due to the short-term nature of the forward contracts, the fair value at January 3, 1998 was negligible. The realized gain (loss) on these contracts as they matured was not material to the consolidated operations of the Company.

Equity Price Risk The Company, as part of its authorized repurchase program, has purchased call options that entitle the Company to buy on a specified day one share of common stock at a specified price to satisfy anticipated stock repurchase requirements under the Company's systematic repurchase programs. Additionally, the Company has sold put warrants through private placements.

The table below provides information at January 3, 1998 about the Company's put warrants and call options. The table presents the contract amounts and the weighted average strike prices. The put warrants and call options expire at various dates through February 26, 1999.

(shares and contract amounts in millions)	1998 Maturity	1999 Maturity	Estimated Fair Value
Put Warrants:			
Shares	4.5	1.3	
Weighted average strike price	$ 23.81	$ 24.20	
Contract amount	$ 108	$ 30.3	$ 17.5
Call Options:			
Shares	3.4	0.9	
Weighted average strike price	$ 23.90	$ 24.45	
Contract amount	$ 81.2	$ 20.8	$ 20.5

The Company has the right to settle the put warrants with stock. Settlement of the put warrants with stock could cause the Company to issue a substantial number of shares, depending on the exercise price of the put warrants and the per share fair value of the Company's common stock at the time of exercise. In addition, settlement of the put warrants in stock could lead to the disposition by put warrant holders of shares of the Company's common stock that such holders may have accumulated in anticipation of the exercise of the put warrants or call options, which may impact the price of the Company's common stock.

Liquidity and Capital Resources

At January 3, 1998, the Company's principal sources of liquidity consisted of $304.2 million of cash and short-term investments, as compared with $285.5 million and $96.6 million at December 28, 1996 and December 30, 1995, respectively, and a three-year, $120 million secured revolving line of credit agreement. As of January 3, 1998, the Company had no borrowings under the revolving line of credit.

Cash generated from operating activities increased $23 million in the year ended January 3, 1998, as compared to the year ended December 28, 1996, primarily due to higher net income and increases in accrued liabilities and payables and income taxes payable. This increase was partially offset by increases in accounts receivable, installment contract receivables, and deferred income taxes. Cash generated from operating activities decreased $21.8 million to $175.3 million for the year ended December 28, 1996, as compared to the year ended December 30, 1995. The decrease was primarily due to increases in accounts receivable, prepaid expenses and other assets, and lower deferred income taxes, partially offset by an increase in net income prior to the write-off of in-process research and development, an increase in accrued liabilities and payables, and higher deferred revenue.

At January 3, 1998, the Company had net working capital of $340.3 million, as compared with $259.6 million at December 28, 1996. The primary reasons for the increase were increases in accounts receivable of $56.6 million and in prepaid expenses and other assets of $50.8 million, partly offset by an increase in accounts payable and accrued liabilities of $40.3 million. The increase in accounts receivable was attributable to increased billing activity, primarily due to higher revenue. The increase in accounts payable and accrued liabilities was primarily attributable to payments expected to be made in early 1998, including bonus and commissions payments, restructuring charges, sales taxes, and withholdings for issuance of stock under the Company's Employee Stock Purchase Plan (ESPP).

In addition to its short-term investments, the Company's primary investing activities were purchases of property and equipment, purchases of software and intangibles, the capitalization of software development costs, and an investment in a limited partnership, which combined represented $123 million and $96.4 million of cash used for investing activities in the years ended January 3, 1998 and December 28, 1996, respectively. In 1998, the Company anticipates the completion of a new building and improvements on the San Jose, California campus with an estimated cost of approximately $14.5 million. Additionally, new facilities in Scotland will be constructed in conjunction with the Company's pending business transaction with the government of Scotland. If the Company becomes the owner of such facilities, absent of any financing from any third party, the Company may incur estimated land and building costs of approximately $115 million over the next seven years.

In May 1997, Cadence announced that its board of directors had rescinded the Company's previously-announced stock repurchase program, with the exception of continued systematic stock repurchases under its seasoned stock repurchase program for the Company's ESPP. The Company rescinded the stock repurchase program in connection with its merger with CCT in order to comply with requirements for the pooling of interests accounting treatment. Cadence announced a new seasoned systematic stock repurchase program in September of 1997 in connection with the establishment of the new 1997 Stock Option Plan (the 1997 Plan). The shares acquired by the Company under this new program will be used to meet the recurring share issuance requirements of the 1997 Plan. The repurchase authorization for the 1997 Plan is 4 million shares over a two year period; 2.4 million additional shares are authorized for repurchase for the ESPP over a two year period. In November 1997, the Company announced a new 10 million-share stock repurchase program. The shares acquired by the Company under this program will be used for general corporate purposes.

Since 1994, as part of its previously discussed authorized stock repurchase program, the Company has sold put warrants and purchased call options through private placements. The Company had a maximum potential obligation related to the put warrants at January 3, 1998 to buy back 5.8 million shares of its common stock at an aggregate price of approximately $138.3 million. The put warrants will expire at various dates from February 1998 through February 1999. The Company has the ability to settle these put warrants with stock and, therefore, no amount was classified out of stockholders' equity in the consolidated balance sheet. The effect of the exercise of these put warrants and call options is reported in stockholders' equity.

Anticipated cash requirements for 1998 include the repurchase of stock for the Company's stock repurchase programs and the contemplated additions of property, plant, and equipment of approximately $85 million, including the new building and improvements on the San Jose, California campus as discussed previously.

As part of its overall investment strategy, the Company has committed to participating in a venture capital partnership as a limited partner. The Company's total committed investment of at least $35 million will be made over the next two to three years. At January 3, 1998, the Company had contributed approximately $20 million, which is reflected in other assets in the consolidated balance sheet, net of operating losses.

The Company anticipates that current cash and short-term investment balances, cash flows from operations, and its $120 million revolving line of credit should be sufficient to meet its working capital and capital expenditure requirements on a short- and long-term basis.

New Accounting Standards

In 1997, the Company adopted Statement of financial Accounting Standards (SFAS) No. 129, "Disclosure of Information About Capital Structure." SFAS No. 129 requires companies to disclose certain information about their capital structure. SFAS No. 129 did not have a material impact on the Company's consolidated financial statement disclosures.

In 1997, the financial Accounting Standards Board (FASB) issued SFAS No. 130, "Comprehensive Income," which will be adopted by the Company in the first quarter of 1998. SFAS No. 130 requires companies to report a new, additional measure of income on the income statement or to create a new financial statement that has the new measure of income on it. "Comprehensive Income" is to include foreign currency translation gains and losses and other unrealized gains and losses that have been previously excluded from net income and reflected instead in equity. The Company anticipates that SFAS No. 130 will not have a material impact on its consolidated financial statements.

In 1997, the FASB issued SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," which will be adopted by the Company in its 1998 annual consolidated financial statements. SFAS No. 131 requires companies to report financial and descriptive information about its reportable operating segments, including segment profit or loss, certain specific revenue and expense items, and segment assets, as well as information about the revenues derived from the Company's products and services, the countries in which the Company earns revenues and holds assets, and major customers.

In 1997, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statement of Position (SOP) 97-2, "Software Revenue Recognition," which will be adopted by the Company in the first quarter of 1998. SOP 97-2 provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. The Company anticipates that SOP 97-2 will not have a material impact on its consolidated financial statements.

Factors That May Affect Future Results

Because of rapid technological changes in the EDA industry, the Company's future revenues will depend on its ability to develop or acquire new products and enhance its existing products on a timely basis to keep pace with innovations in technology and to support a range of changing computer software, hardware platforms, and customer preferences. Changes in manufacturing technology may render the Company's software tools obsolete. Lack of market acceptance or significant delays in product development could result in a loss of competitiveness of the Company's products, with a resulting loss of revenues.

The Company has been involved in a number of significant merger and acquisition transactions. These transactions have been motivated by many factors, including the desire to obtain new technologies, the desire to expand and enhance the Company's product and service lines, and the desire to attract personnel. Growth through acquisition has several identifiable risks, including risks related to integration of the previously distinct businesses into a single unit, the substantial management time devoted to such activities, undisclosed liabilities, the failure to realize anticipated benefits (such as cost savings and synergies), and issues related to product transition (such as distribution, engineering, and customer support).

The Company's operating expenses are partially based on its expectations regarding future revenue. The Company's consolidated results of operations may be adversely affected if revenue does not materialize in a quarter as anticipated. Since expenses are usually committed in advance of revenues, and because only a small portion of expenses vary with revenue, the Company's consolidated operating results may be impacted significantly by lower revenue which would be attributable to various factors and could affect quarter to quarter comparisons. The Company's focus on providing services is relatively recent. The percentage revenue growth from this source from 1996 to 1997 may not be indicative of future growth.

In addition, a substantial portion of the Company's revenues from services are earned pursuant to fixed price contracts. Variances in costs associated with those contracts could have a material adverse effect on the Company's business, financial condition, and results of operations. Although the Company's revenues are not generally seasonal in nature, the Company has experienced, and may continue to experience, decreases in first quarter revenue compared with the preceding fourth quarter, which is believed to result primarily from the capital purchase cycle of the Company's customers.

The Company is dependent upon the efforts and abilities of its senior management, its research and development staff, and a number of other key management, sales, support, technical, and services personnel. As noted above, the Company has recently increased its focus on offering professional services to its customers. To the extent that the Company is not able to attract, retain, train, and motivate highly skilled employees, directly or through acquisition, who are able to provide services that satisfy customer's expectations, the Company's business and consolidated operating results would be adversely affected.

The Company expects that international revenues will continue to account for a significant portion of its total revenues. The Company's international operations involve a number of risks normally associated with such operations including, among others, adoption and expansion of government trade restrictions, volatile foreign exchange rates, currency conversion risks, limitations on repatriation of earnings, reduced protection of intellectual property rights, the impact of possible recessionary environments in economies outside the U.S., longer receivables collection periods and greater difficulty in accounts receivable collection, difficulties in managing foreign operations, political and economic instability, unexpected changes in regulatory requirements and tariffs, and other trade barriers. Currency exchange fluctuations in countries in which the Company conducts business could also materially adversely affect the Company's business, financial condition, and results of operations. The Company enters into forward contracts to hedge the short-term impact of foreign currency fluctuations. Although the Company attempts to reduce the impact of foreign currency fluctuations, significant exchange rate movements may have a material adverse impact on the Company's consolidated results of operations.

Effective July 1, 1997, the Company reorganized the operation of its business in Japan, acquiring an equity position in and entering into a long-term exclusive arrangement for distribution of EDA software products with Innotech Corporation. The Company will continue to market and provide design services in Japan through a wholly-owned subsidiary. Future results may be adversely affected if the Company fails to realize the benefits contemplated by the reorganization of its Japanese business operations.

The Company's operations are dependent on its ability to protect its computer equipment and the information stored in its databases against damage by fire, natural disaster, power loss, telecommunications failures, unauthorized intrusion, and other catastrophic events. The Company believes it has taken prudent measures to reduce the risk of interruption in its operations. However, there can be no assurance that these measures are sufficient. Any damage or failure that causes interruptions in the Company's operations could have a material adverse effect on its business, results of operations, and financial condition.

The Company is currently in the process of transitioning to new computer software for its financial, accounting, project system accounting, and order management information systems. The successful implementation of these new systems is crucial to the efficient operation of the Company's business. There can be no assurance that the Company will implement its new systems in an efficient and timely manner or that the new systems will be adequate to support the Company's operations. Problems with installation or initial operation of the new systems could cause substantial management difficulties in operations planning, financial reporting, and management, and thus could have a material adverse effect on the Company's business, financial condition, and results of operations.

The Company believes that all of its most current releases of its products will not cease to perform nor generate incorrect or ambiguous data or results solely due to a change in date to or after January 1, 2000, and will calculate any information dependent on such dates in the same manner, and with the same functionality, data integrity, and performance, as such products do on or before December 31, 1999 (collectively, "Year 2000 Compliance"). Year 2000 Compliance issues may arise with respect to any modifications made to the Company's products by a party other than the Company or from the combination or use of the Company's products with any other software programs or hardware devices not provided by the Company, and therefore may result in unforeseen Year 2000 Compliance problems for some of the Company's customers, which may have an adverse effect on the Company.

Additionally, as with any company with a computing infrastructure and utilizing business-application software programs written over many years, the Company's internal operations may be subject to Year 2000 Compliance issues. The Company has been implementing enterprise-wide information systems which support a majority of the Company's operations. These systems are considered to be Year 2000 Compliant and are expected to be used worldwide by April 1998. Based solely due to a change in date to or after January 1, 2000 thereon, the Company believes that its internal operations will not be materially adversely impacted.

Due to the foregoing, as well as other factors, past financial performance should not be considered an indicator of future performance. In addition, the Company's participation in a highly dynamic industry often results in significant volatility of the Company's common stock price. Any change in revenues or operating results below levels expected by securities analysts for the Company or its competitors, and the timing of the announcement of such shortfalls, could have an immediate and significant adverse effect on the trading price of the Company's common stock in any given period.

Consolidated Balance Sheets

January 3, 1998 and December 28, 1996

(in thousands, except per share amounts)	1997	1996
Assets		
Current Assets:		
Cash and cash equivalents	$ 207,024	$ 284,512
Short-term investments	97,180	1,015
Accounts receivable, less allowances of $21,200 in 1997 and $8,772 in 1996	205,006	148,449
Inventories	—	8,133
Prepaid expenses and other	99,849	49,026
Total current assets	609,059	491,135
Property, plant, and equipment, net	197,421	160,927
Software development costs, net	15,068	21,295
Purchased software and intangibles, net	10,117	10,267
Other assets	192,185	33,377
	$ 1,023,850	$ 717,001
Liabilities and Stockholders' Equity		
Current Liabilities:		
Notes payable and current portion of long-term debt	$ 794	$ 3,349
Accounts payable and accrued liabilities	156,426	116,174
Income taxes payable	5,161	4,901
Deferred revenue	106,414	107,154
Total current liabilities	268,795	231,578
Long-Term Liabilities:		
Long-term debt	1,599	20,292
Minority interest liability	121	15,205
Other long-term liabilities	26,238	22,378
Total long-term liabilities	27,958	57,875
Commitments and Contingencies		
Stockholders' Equity:		
Preferred stock—$0.01 par value; authorized 400 shares in 1997 and 2,000 shares in 1996, none issued or outstanding	—	—
Common stock and capital in excess of $0.01 par value Authorized: 300,000 shares Issued: 214,405 shares in 1997 and 236,168 shares in 1996 Outstanding: 207,666 shares in 1997 and 173,223 shares in 1996	502,602	603,430
Treasury stock at cost: 6,739 shares in 1997 and 62,945 shares in 1996	(97,285)	(325,637)
Retained earnings	328,934	151,596
Accumulated translation adjustment	(7,154)	(1,841)
Total stockholders' equity	727,097	427,548
	$ 1,023,850	$ 717,001

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Income

For the three fiscal years ended January 3, 1998

(in thousands, except per share amounts)	1997	1996	1995
Revenue			
Product	$ 530,513	$ 414,029	$ 292,198
Services	160,890	114,620	65,860
Maintenance	224,490	212,810	190,360
Total revenue	915,893	741,459	548,418
Costs and Expenses			
Cost of product	41,509	48,383	44,793
Cost of services	114,747	80,963	54,988
Cost of maintenance	26,840	24,127	16,749
Marketing and sales	257,867	226,496	185,025
Research and development	140,375	115,301	88,566
General and administrative	56,495	54,387	40,437
Unusual items	44,053	100,543	—
Total costs and expenses	681,886	650,200	430,558
Income from operations	234,007	91,259	117,860
Other income (expense), net	25,624	(782)	17,237
Income before provision for income taxes and cumulative effect of change in accounting method	259,631	90,477	135,097
Provision for income taxes	77,889	61,439	37,827
Income before cumulative effect of change in accounting method	181,742	29,038	97,270
Cumulative effect of change in accounting method, net of taxes of $5,261	12,276	—	—
Net income	$ 169,466	$ 29,038	$ 97,270
Net Income Per Share			
Net income before cumulative effect of change in accounting method	$ 0.93	$ 0.19	$ 0.59
Net income	$ 0.87	$ 0.19	$ 0.59
Net Income Per Share—Assuming Dilution			
Net income before cumulative effect of change in accounting method	$ 0.83	$ 0.16	$ 0.51
Net income	$ 0.77	$ 0.16	$ 0.51
Weighted average common and potential common shares outstanding	194,900	156,773	165,510
Weighted average common and potential common shares outstanding—assuming dilution	219,552	183,789	191,114

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Stockholders' Equity

For the three fiscal years ended January 3, 1998 (in thousands)	Common Stock Shares	Common Stock Par Value and Capital In Excess of Par	Treasury Stock Shares	Treasury Stock Amount	Retained Earnings	Accumulated Translation Adjustment
Balance, December 31, 1994	214,173	$ 265,173	(43,590)	$ (133,728)	$ 43,377	$ 1,241
Purchase of treasury stock	—	—	(28,860)	(163,928)	—	—
Issuance of common stock	13,416	26,984	1,990	6,772	(734)	—
Tax benefits from employee stock transactions	—	8,463	—	—	—	—
Purchase of warrant	—	(1,746)	—	—	(15,442)	—
Unrealized gain on investment in subsidiary	—	670	—	—	—	—
Translation adjustment	—	—	—	—	—	(291)
Net income	—	—	—	—	97,270	—
Balance, December 30, 1995	227,589	299,544	(70,460)	(290,884)	124,471	950
Purchase of treasury stock	—	—	(10,314)	(124,204)	—	—
Issuance of common stock	8,579	30,498	1,205	5,401	(3)	—
Tax benefits from employee stock transactions	—	58,418	—	—	—	—
Purchase of warrant	—	(2,437)	—	—	(1,910)	—
Treasury stock issued in connection with an acquisition	—	73,492	5,124	25,906	—	—
Shares issued in secondary offering, net of expenses	—	143,915	11,500	58,144	—	—
Translation adjustment	—	—	—	—	—	(2,791)
Net income	—	—	—	—	29,038	—
Balance, December 28, 1996	236,168	603,430	(62,945)	(325,637)	151,596	(1,841)
Purchase of treasury stock	—	(720)	(4,592)	(104,526)	—	—
Issuance of common stock	14,962	64,549	1,167	7,308	—	—
Tax benefits from employee stock transactions	—	123,180	—	—	—	—
Treasury stock issued in connection with acquisitions	—	1,041	22,906	34,184	7,872	121
Unrealized gain on investment in subsidiary	—	2,758	—	—	—	—
Use of treasury shares for common stock dividend	(36,725)	(291,636)	36,725	291,386	—	—
Translation adjustment	—	—	—	—	—	(5,434)
Net income	—	—	—	—	169,466	—
Balance, January 3, 1998	214,405	$ 502,602	(6,739)	$ (97,285)	$ 328,934	$ (7,154)

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

For the three fiscal years ended January 3, 1998

(in thousands)	1997	1996	1995
Cash and Cash Investments at Beginning of Year	$ 284,512	$ 84,867	$ 75,011
Cash Flows From Operating Activities			
Net income	169,466	29,038	97,270
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	56,637	51,742	46,019
Gain on sale of stock of subsidiary	(13,061)	—	(18,873)
Deferred income taxes	(68,465)	(15,943)	5,693
Write-off of in-process research and development	6,571	95,700	—
Write-off of capitalized software development costs	3,067	4,843	—
Write-off of business process re-engineering costs	17,537	—	—
Equity in income from investee	(1,934)	—	—
Increase in other long-term liabilities and minority interest expense	2,668	5,992	3,135
Write-offs of equipment and other long-term assets	3,073	1,719	2,281
Provisions for doubtful accounts and inventory write-offs	12,428	2,672	5,821
Changes in current assets and liabilities, net of effect of acquired and disposed businesses:			
Accounts receivable	(84,039)	(59,736)	(13,760)
Inventories	—	(981)	(4,059)
Prepaid expenses and other	(29,449)	(33,091)	(2,132)
Installment contract receivables	(61,830)	—	—
Accounts payable and accrued liabilities	64,072	30,041	29,427
Income taxes payable	126,486	48,795	15,012
Deferred revenue	(4,868)	14,521	31,262
Net cash provided by operating activities	198,359	175,312	197,096
Cash Flows From Investing Activities			
Maturities of short-term investments—held-to-maturity	37,039	18,618	43,296
Purchases of short-term investments—held-to-maturity	(82,204)	(7,859)	(33,205)
Maturities of short-term investments—available-for-sale	128,170	—	—
Purchases of short-term investments—available-for-sale	(179,170)	—	—
Purchases of property, plant, and equipment	(92,428)	(62,089)	(28,338)
Capitalization of software development costs	(15,011)	(13,560)	(11,845)
Increase in purchased software, intangibles, and other assets	(4,586)	(13,326)	(3,954)
Net proceeds from sale of subsidiary stock	18,582	—	29,920
Effect of deconsolidation and reorganization on cash	(25,118)	—	—
Investment in limited partnership	(10,974)	(7,471)	(1,500)
Effect of acquisitions on cash	30,596	—	—
Sale of put warrants	19,016	13,870	1,304
Purchase of call options	(19,016)	(13,870)	(1,304)
Net cash used for investing activities	(195,104)	(85,687)	(5,626)
Cash Flows From Financing Activities			
Principal payments on notes payable and long-term debt	(22,921)	(2,676)	(26,542)
Net proceeds from issuance of long-term debt	—	19,763	—
Sale of common stock	54,365	226,749	26,500
Purchases of treasury stock	(105,118)	(124,204)	(163,928)
Purchase of warrant	—	(4,347)	(17,188)
Net cash (used for) provided by financing activities	(73,674)	115,285	(181,158)
Effect of exchange rate changes on cash	(7,069)	(5,265)	(456)
Increase (decrease) in cash and cash equivalents	(77,488)	199,645	9,856
Cash and Cash Equivalents at End of Year	$ 207,024	$ 284,512	$ 84,867

The accompanying notes are an integral part of these consolidated financial statements.

Notes to Consolidated Financial Statements

January 3, 1998

The Company

Cadence Design Systems, Inc. (Cadence or the Company) provides comprehensive services and technology for the product development requirements of the world's leading electronics companies. The Company licenses its leading-edge electronic design automation software technology and provides a range of professional services to companies throughout the world to help optimize product development processes. Recently, the Company has expanded the role it plays with companies that produce electronic products and with an emerging class of companies that require electronic content in their products, but who may not have any internal expertise in electronic design. The Company's business objectives are based on providing complete solutions, which range from individual software tools to complete outsourcing of design work. The Company is now a supplier of "design realization" solutions, which are used by companies to design and develop integrated circuits and systems—including semiconductors, computer systems and peripherals, telecommunications and networking equipment, mobile and wireless devices, automotive electronics, consumer products, and other advanced electronics.

Summary of Significant Accounting Policies

Principles of Consolidation and Basis of Presentation The consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries after elimination of intercompany accounts and transactions. Investments in companies in which ownership interests range from 20 to 50 percent or to which the Company exercises significant influence over operating and financial policies are accounted for using the equity method of accounting.

The Company's fiscal year end is the Saturday closest to December 31. Certain prior year consolidated financial statement balances have been reclassified to conform to the 1997 presentation.

Stock Split In October 1997, the Company's Board of Directors effected a two-for-one stock split, payable in the form of a dividend of one additional share of the Company's common stock for every share owned by stockholders. Par value remained at $0.01 per share. The stock split resulted in the issuance of approximately 104.4 million additional shares of common stock from authorized but unissued shares and treasury shares. In May 1996 and October 1995, the Company's Board of Directors effected three-for-two stock splits payable in the form of a dividend of one additional share of the Company's common stock for every two shares owned by stockholders. The stock splits resulted in the issuance of approximately 51.6 million and 75.6 million additional shares of common stock from authorized but unissued shares in 1996 and 1995, respectively. Accordingly, all share and per share data have been adjusted to retroactively reflect the stock splits.

Use of Estimates The preparation of consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Foreign Currency Translation Assets and liabilities of foreign subsidiaries, where the functional currency is the local currency, are translated using exchange rates in effect at the end of the period and revenues and costs are translated using average exchange rates for the period. Gains and losses on the translation into U.S. dollars of amounts denominated in foreign currencies are included in net income for those operations whose functional currency is the U.S. dollar, and as a separate component of stockholders' equity for those operations whose functional currency is the local currency.

Derivative Financial Instruments The Company enters into foreign currency forward exchange contracts (forward contracts) to manage exposure related to certain foreign currency transactions. The Company does not enter into derivative financial instruments for trading purposes. All outstanding forward contracts at the end of the period are marked-to-market, with unrealized gains and losses included in net income as a component of other income (expense). The Company may, from time to time, adjust its foreign currency hedging position by taking out additional contracts or by terminating or offsetting existing forward contracts. These adjustments may result from changes in the underlying foreign currency exposures or from fundamental shifts in the economics of particular exchange rates. Gains and losses on terminated forward contracts, or on contracts that are offset, are recognized in income in the period of contract termination or offset.

Revenue Recognition Product revenue consists principally of revenue earned under software license agreements and is generally recognized when the software has been shipped, there are no significant obligations remaining, and collection is probable. Installment contract receivables result from customer contracts with the Company's top-rated credit customers. The Company uses installment contracts as a standard business practice and has a history of successfully collecting under the original payment terms without making concessions on payments, products, or services. Any maintenance included in these arrangements is recognized ratably over the term of the arrangement. Revenue from subscription license agreements which include software, rights to future software products, and maintenance is deferred and recognized ratably over the term of the subscription period. Test equipment revenue was recognized upon shipment.

Services revenue consists primarily of revenues received for performing product design development and process improvement and education and assimilation of software products into the customers' product development process. Services revenue is generally recognized as the services are performed or on the percentage of completion method of accounting, depending upon the nature of the project. Under the percentage of completion method, revenue recognized is that portion of the total contract price that costs expended to date bears to the anticipated final total costs, based on current estimates of the costs to complete the project. If the total estimated costs to complete a project exceed the total contract amount, indicating a loss, the entire anticipated loss would be recognized currently.

Maintenance revenue consists of fees for providing system updates, user documentation, and technical support for software products. Maintenance revenue is recognized ratably over the term of the agreement.

In 1997, no one customer accounted for more than 10% of total revenues. In 1996 and 1995, one customer (a distributor), which in 1996 and 1995 held a minority interest in a subsidiary of the Company, accounted for 14% and 15% of total revenue, respectively. Outstanding trade accounts receivable from this related party were approximately $3.4 million and $5.4 million at December 28, 1996 and December 30, 1995, respectively.

Net Income Per Share In 1997, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 128 "Earning per Share." SFAS No. 128 requires companies to compute net income per share under two different methods, basic and diluted. Net income per share for each period is calculated by dividing net income by the weighted average shares of common stock outstanding during the period, and assuming dilution, net income is divided by the weighted average shares of common stock outstanding and potential common shares during the period. As a result, 1996 and 1995 net income per share have been restated to conform to the new standard. Potential common shares included in the diluted calculation consist of dilutive shares issuable upon the exercise of outstanding common stock options, warrants, and put warrants computed using the treasury stock method.

Cash, Cash Equivalents, and Short-Term Investments The Company considers all highly liquid debt instruments, including commercial paper, Euro time deposits, repurchase agreements, and certificates of deposit with an original maturity of ninety days or less to be cash equivalents. Investments with original maturities greater than ninety days and less than one year are classified as short-term investments. At January 3, 1998, there were no investments with maturities greater than one year.

Management determines the appropriate classification of its investments in debt and marketable equity securities at the time of purchase and reevaluates such designation as of each balance sheet date. The Company has classified all marketable debt securities as held-to-maturity and has accounted for these investments at amortized

cost. The Company has classified its auction rate securities as available-for-sale. These securities are carried at fair value, with the unrealized gains and losses reported as a component of stockholders' equity when these unrealized gains and losses are material to consolidated financial operations of the Company.

Inventories During 1997, the Company changed its accounting method for Integrated Measurement Systems Inc. to the equity method as described at "Integrated Measurement Systems, Inc." further below and, as a result, no inventories were recorded at January 3, 1998. Inventories totaling $8.1 million at December 28, 1996, consisting primarily of test equipment were stated at the lower of cost (first-in, first-out method) or market. Cost includes labor, material, and manufacturing overhead.

Property, Plant, and Equipment Land, property, plant, and equipment is stated at cost. Depreciation and amortization are provided over the estimated useful lives, by the straight-line method, as follows:

Buildings	10–32 years
Leasehold and building improvements	Shorter of the lease term or the estimated useful life
Software	3–8 years
Equipment	3–5 years
Furniture and fixtures	3–5 years

Software Development Costs, Purchased Software, and Intangibles The Company capitalizes software development costs in compliance with SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased, or Otherwise Marketed." Capitalization of software development costs begins upon the establishment of technological feasibility of the product. The establishment of technological feasibility and the ongoing assessment of the recoverability of these costs requires considerable judgment by management with respect to certain external factors including, but not limited to, anticipated future gross product revenue, estimated economic life, and changes in software and hardware technology. Amortization of capitalized software development costs begins when the products are available for general release to customers and is generally computed on a straight-line basis over three years or, if less, the remaining estimated economic life of the product. Purchased software and intangibles are amortized on a straight-line basis over the remaining estimated economic life of the underlying product (one to seven years). It is reasonably possible that the estimates of anticipated future gross revenues, the remaining estimated economic life of the products, or both could differ from those used to assess the recoverability of these costs and result in a write-down of the carrying amount or a shortened life of the costs in the near term.

In the accompanying consolidated statements of income, amortization is included in cost of product for capitalized software development costs and in either cost of product or cost of services for purchased software costs, as determined by the nature of the underlying transaction. In total, amortization of capitalized and purchased software and intangibles amounted to approximately $21 million, $22.5 million, and $19.7 million for 1997, 1996, and 1995, respectively. The Company wrote off approximately $3.1 million of capitalized software development costs in 1997 that related to products that were replaced (or discontinued) as a result of a merger or license of replacement technology. The Company wrote off approximately $4.3 million of capitalized software development costs related to products at the end of their life cycle in 1996, of which $2.7 million related to products that were replaced (or discontinued) as a result of the High Level Design Systems, Inc. acquisition.

Accounting for Stock-Based Compensation In October 1995, the Financial Accounting Standards Board (FASB) issued SFAS No. 123, "Accounting for Stock-Based Compensation," which encourages entities to recognize compensation costs for stock-based employee compensation plans using the fair value based method of accounting defined in SFAS No. 123, but allows for the continued use of the intrinsic value based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees," as further described at "Stockholders' Equity." The Company has elected to continue with the accounting prescribed by APB Opinion No. 25 and, as such, is required to disclose pro forma net income and earnings per share as if the fair value based method of accounting had been applied.

Concentrations of Credit Risk Financial instruments, including derivative financial instruments, which may potentially subject the Company to concentrations of credit risk, consist principally of cash investments, short-term investments, accounts receivable, forward contracts, and call options purchased in conjunction with the Company's stock repurchase program. The Company's investment policy limits investments to short-term, low-risk instruments. Concentration of credit risk related to accounts receivable is limited, due to the varied customers comprising the Company's customer base and their dispersion across geographies. Credit exposure related to the forward contracts and the call options is limited to the unrealized gains on these contracts. All financial instruments are executed with financial institutions with strong credit ratings, which minimizes risk of loss due to nonpayment. The Company has not experienced any losses due to credit impairment related to its financial instruments.

New Accounting Standards In 1997, the Company adopted SFAS No. 129, "Disclosure of Information About Capital Structure." SFAS No. 129 requires companies to disclose certain information about their capital structure. SFAS No. 129 did not have a material impact on the Company's consolidated financial statement disclosures.

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In 1997, the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants issued Statement of Position (SOP) 97-2, "Software Revenue Recognition," which will be adopted by the Company in the first quarter of 1998. SOP 97-2 provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. The Company anticipates that SOP 97-2 will not have a material impact on its consolidated financial statements.

Financial Instruments

Short-Term Investments A summary of the Company's held-to-maturity and available-for-sale investment portfolios follows:

(in thousands)	1997	1996
Held-to-maturity:		
Commercial paper	$ 23,732	$ 112,965
Certificates of deposit	1,000	4,221
Corporate debt securities	18,020	1,015
Corporate equity securities	3,000	—
Foreign debt securities	8,602	—
Euro time deposits	—	20,000
Repurchase agreements	60,094	19,803
U.S. Government notes	7,488	—
State and local municipalities notes	6,075	—
Total held-to-maturity	128,011	158,004
Available-for-sale:		
Auction rate securities	51,000	—
Total available-for-sale	51,000	—
Total investment securities	179,011	158,004
Less: Cash equivalents	81,831	156,989
Total short-term investments	$ 97,180	$ 1,015

Investments in debt securities classified as held-to-maturity and available-for-sale at January 3, 1998, have various maturity dates which do not exceed one year. The cost of the securities held is based on the specific identification method. The carrying value of cash and cash equivalents and short-term investments approximate the fair value (based on quoted market prices) of such investments. Accordingly, unrealized gains and losses were immaterial at January 3, 1998.

Derivative Financial Instruments The Company enters into forward contracts to hedge the impact of foreign currency fluctuations. The Company does not enter into derivative financial instruments for trading purposes. At January 3, 1998, the Company had outstanding forward contracts with notional amounts totaling approximately $38.6 million. These contracts, which mature in less than thirty days, are hedges of certain foreign currency transaction exposures in the British pound sterling, German deutschemark, French franc, Italian lira, Swedish krona, Canadian dollar, and Japanese yen. The estimated fair value at January 3, 1998 and December 28, 1996 was negligible.

Balance Sheet Components

A summary of balance sheet components follows:

(in thousands)	1997	1996
Inventories		
Raw materials and supplies	$ —	$ 3,981
Work-in-process	—	3,031
Finished goods	—	1,121
Inventories	$ —	$ 8,133
Property, Plant, and Equipment		
Equipment	$ 185,054	$ 161,155
Land	47,754	38,848
Buildings	45,324	38,613
Furniture and fixtures	28,282	23,524
Leasehold and building improvements	28,232	26,091
Total cost	334,646	288,231
Less: Accumulated depreciation and amortization	137,225	127,304
Property, plant, and equipment, net	$ 197,421	$ 160,927
Software Development Costs		
Cost	$ 40,545	$ 58,781
Less: Accumulated amortization	25,477	37,486
Software development costs, net	$ 15,068	$ 21,295
Purchased Software and Intangibles		
Cost	$ 31,888	$ 32,226
Less: Accumulated amortization	21,771	21,959
Purchased software and intangibles, net	$ 10,117	$ 10,267
Other Assets		
Deferred income taxes	$ 74,860	$ 10,725
Installment contract receivables	61,326	—
Other assets	55,999	22,652
Other assets	$ 192,185	$ 33,377
Accounts Payable and Accrued Liabilities		
Payroll and payroll related accruals	$ 87,076	$ 65,424
Other accrued liabilities	47,402	34,990
Accounts payable	21,948	15,760
Accounts payable and accrued liabilities	$ 156,426	$ 116,174

Financing

In April 1996, the Company entered into a senior secured revolving credit facility (the Facility) which allows the Company to borrow up to $120 million through April 1999. The Facility is secured by the majority of the Company's property, plant, equipment, cash, investments, intangibles, and certain other assets. The Company has the option to pay interest based upon the London Interbank Offered Rate (LIBOR) plus 1.5%, or the higher of the federal funds effective rate plus 0.5% or prime. The Company must comply with certain financial covenants and conditions as defined in the Facility, with which the Company was in compliance at January 3, 1998. At January 3, 1998, the Company had no outstanding borrowings under the Facility.

In May 1996, the Company's wholly-owned real estate partnership, River Oaks Place Associates L.P., entered into a $20 million long-term financing arrangement (the ROPA Loan) with a bank. The ROPA loan was repaid in 1997.

Long-term debt consisted of the following:

(in thousands)	1997	1996
Capital lease obligations	$ 1,693	$ 4,016
Other long-term debt	700	—
Note payable (ROPA Loan)	—	19,625
Total	2,393	23,641
Less: Current portion	794	3,349
Long-term debt	$ 1,599	$ 20,292

Commitments

Equipment and facilities are leased under various capital and operating leases expiring at various dates through the year 2008. Certain of these leases contain renewal options. Rental expense was approximately $15.9 million, $12.3 million, and $10.7 million for 1997, 1996, and 1995, respectively. In 1998, the Company anticipates the completion of a new building and improvements on the San Jose, California campus with an estimated cost of approximately $14.5 million. Additionally, new facilities in Scotland will be constructed in conjunction with the Company's pending business transaction with the government of Scotland. If the Company becomes the owner of such facilities, absent of any financing from any third party, the Company may incur estimated land and building costs of approximately $115 million over the next seven years.

At January 3, 1998, future minimum lease payments under capital and operating leases and the present value of the capital lease payments were as follows:

(in thousands)	Capital Leases	Operating Leases
For the years:		
1998	$ 865	$ 17,414
1999	547	14,566
2000	317	8,031
2001	74	5,683
2002	8	2,560
Thereafter	—	89
Total lease payments	1,811	$ 48,343
Less: Amount representing interest (Average interest rate of 6.8%)	118	
Present value of lease payments	1,693	
Less: Current portion	794	
Long-term portion	$ 899	

The cost of equipment under capital leases included in the consolidated balance sheets as property, plant, and equipment at January 3, 1998 and December 28, 1996 was approximately $3.6 million and $11 million, respectively. Accumulated amortization of the leased equipment at January 3, 1998 and December 28, 1996 was approximately $2 million and $8.4 million, respectively.

Contingencies

From time to time, the Company is involved in various disputes and litigation matters which have arisen in the ordinary course of business. These include disputes and lawsuits related to intellectual property, licensing, contract law, distribution arrangements, and employee relations matters.

The Company filed a complaint in the United States District Court for the Northern District of California on December 6, 1995 against Avant! Corporation and certain of its employees for misappropriation of trade secrets, copyright infringement, conspiracy, and other illegalities.

On January 16, 1996, Avant! filed various counterclaims against the Company and the Company's former President and Chief Executive Officer, and with leave of the court, on January 29, 1998 filed a Second Amended Counterclaim. The second amended counterclaim alleges, *inter alia,* that the Company and its former President and Chief Executive Officer had cooperated with the Santa Clara County District Attorney and initiated and pursued its complaint against Avant! for anticompetitive reasons, engaged in wrongful activity in an attempt to manipulate Avant!'s stock price, and utilized certain pricing policies and other acts to unfairly compete against Avant! in the marketplace. The amended counterclaim also alleges that certain Company insiders engaged in illegal insider trading with respect to Avant!'s stock. The Company and its former President and Chief Executive Officer believe that each has meritorious defenses to Avant!'s claims, and each intends to defend such action vigorously. By an order dated July 13, 1996, the court bifurcated Avant!'s counterclaim from the Company's complaint. The second amended counterclaim remains severed from the Company's complaint and stayed pending resolution of the Company's complaint.

On April 19, 1996, the Company filed a motion seeking a preliminary injunction to prevent further use of Cadence copyrighted code and trade secrets by Avant!. On March 18, 1997, the District Court issued an order in which it granted in part and denied in part that motion. On September 23, 1997, the United States Court of Appeals for the Ninth Circuit reversed the District Court's decision and directed the District Court (a) to issue an order enjoining the sale of Avant!'s ArcCell products and (b) to determine whether Avant!'s Aquarius software infringes Cadence's code and, if so, to enter an order enjoining the sale of that software. On February 19, 1998, Avant! filed a petition for *writ of certiorar* to the United States Supreme Court, requesting a review of the Ninth Circuit Court's decision. In an order issued on December 19, 1997, as modified on January 26, 1998, the district court entered an injunction barring any further infringement of Cadence's copyrights in Design Framework II software, or selling, licensing, or copying such product derived from Design Framework II, including but not limited to, Avant!'s ArcCell products. The Company's motion for an injunction covering Avant!'s Aquarius product line remains pending before the District Court.

By an order dated July 22, 1997, the District Court stayed most activity in the case pending in that Court and ordered Avant! to post a $5 million bond, in light of criminal proceedings pending against Avant! and several of its executives. The District Court has not yet set a trial date for the civil proceedings. The Company intends to pursue its claim vigorously.

Management believes that the ultimate resolution of the disputes and litigation matters discussed above will not have a material adverse impact on the Company's consolidated financial position or results of operations.

Stockholders' Equity

Net Income Per Share The following is a reconciliation of the weighted average common shares used to calculate net income per share to the weighted average common shares used to calculate net income per share—assuming dilution, for the years 1997, 1996, and 1995:

(in thousands)	1997	1996	1995
Weighted average common shares used to calculate net income per share	194,900	156,773	165,510
Options	24,362	26,512	24,865
Warrants	232	341	733
Puts	58	163	6
Weighted average common shares used to calculate net income per share—assuming dilution	219,552	183,789	191,114

Options to purchase 1,051,043 shares of common stock at the weighted average price of $26.88 per share were outstanding at January 3, 1998, but were not included in the computation of diluted income per share because the options' exercise prices were greater than the average market price of the common shares. The options, which expire in 2007, remained outstanding at January 3, 1998. Put warrants to purchase 5,792,650 shares of common stock at the weighted average price of $23.88 per share were outstanding at January 3, 1998, but were not included in the computation of diluted income per share because the put warrants' exercise prices were less than the average market price of the common shares. The put warrants outstanding expire at various dates from February 1998 to February 1999.

Stock Compensation Plans *Fixed Stock Option Plans* The Company's 1997 Nonstatutory Stock Option Plan (the 1997 Plan) provides for the issuance of non-qualified options to its employees to purchase up to 20,000,000 shares of common stock at an exercise price not less than the fair market value of the stock on the date of grant. Options granted under the 1997 Plan become exercisable over a five year period, with, generally, one-fifth of the shares vesting one year from the vesting commencement date with respect to initial grants, and the remaining shares vesting in 48 equal monthly installments. Options under the 1997 Plan generally expire ten years from the date of grant.

The Company's Employee Stock Option Plan (the 1987 Plan) provides for the issuance of either incentive or non-qualified options to its employees to purchase up to 61,370,100 shares of common stock at an exercise price not less than fair market value of the stock on the date of grant. Options granted under the Plan become exercisable over periods of up to five years and expire five to ten years from the date of grant.

The Company's Non-Statutory Stock Option Plan (the 1993 Non-Statutory Plan) provides for the issuance of non-qualified options to its employees to purchase up to 24,750,000 shares of common stock at an exercise price not less than the fair market value of the stock on the date of grant. Options granted under the Non-Statutory Plan become exercisable over a four year period, with one-fourth of the shares vesting one year from the vesting commencement date, and the remaining shares vesting in 36 equal monthly installments. Options under the Non-Statutory Plan generally expire ten years from the date of grant.

Under the Directors Stock Option Plans (the Directors Plans), the Company may grant non-qualified options to its non-employee directors for up to 3,352,496 shares of common stock at an exercise price not less than the fair market value of the stock on the date of grant. Options granted under the Directors Plans have a term of up to ten years. Certain of the option grants vest one year from the date of grant, and certain other option grants vest one-third one year from the date of grant and two-thirds ratably over the subsequent two years.

The Company has assumed certain options granted to former employees of acquired companies (Acquired Options). The Acquired Options were assumed by the Company outside of the Plan, but all are administered as if issued under the Plan. All of the Acquired Options have been adjusted to effectuate the conversion under the terms of the Agreements and Plans of Reorganization between the Company and the companies acquired. The Acquired Options generally become exercisable over a four year period and generally expire either five or ten years from the date of grant. No additional options will be granted under any of the acquired companies' plans.

A summary of the status of all of the Company's fixed stock option plans as of and during the years ended January 3, 1998 and December 28, 1996 follows:

	1997		1996	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	38,974,434	$ 3.41	41,149,588	$ 4.23
Assumption of HLDS options	—	$ —	1,012,220	$ 7.45
Assumption of CCT options	3,724,294	$ 5.31	—	$ —
Granted	18,741,739	$ 16.48	7,079,596	$ 16.00
Exercised	(14,960,681)	$ 3.65	(8,580,116)	$ 2.77
Forfeited	(4,015,057)	$ 7.74	(1,683,266)	$ 6.52
Expired	—	$ —	(3,588)	$ 2.14
Outstanding at end of year	42,464,729	$ 11.77	38,974,434	$ 3.41
Options exercisable at year end	15,863,817		20,298,078	
Options available for future grant	14,853,922		9,955,568	
Weighted average fair value of options granted during the year	$ 7.52		$ 5.90	

Combined activity as of and during the year ended December 30, 1995 was as follows:

	1995 Shares
Outstanding at beginning of year	45,587,232
Granted	12,967,410
Exercised ($0.09 per share to $5.85 per share)	(13,416,982)
Canceled	(3,988,072)
Outstanding at end of year	41,149,588
Range of exercise price of outstanding options at end of year	$0.10–$12.98
Options exercisable at year end	18,240,078
Options available for future grant	15,132,394

A summary of the status of all of the Company's fixed stock option plans at January 3, 1998 follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 1/3/98	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable at 1/3/98	Weighted Average Exercise Price
$0.14–$5.00	10,272,658	5.8	$ 2.47	8,646,714	$ 2.46
$5.01–$10.00	7,705,379	7.6	$ 7.68	4,071,562	$ 7.62
$10.01–$15.00	11,164,054	8.9	$ 14.36	1,874,459	$ 13.42
$15.01–$20.00	8,937,413	9.0	$ 16.77	1,181,778	$ 18.24
$20.01–$25.00	3,161,984	9.7	$ 22.98	78,608	$ 22.38
$25.01–$30.00	1,223,241	9.7	$ 26.70	10,696	$ 26.97
Total	42,464,729			15,863,817	

Stock Repurchase Plan The Company has a seasoned authorized stock repurchase program under which it repurchases common stock to satisfy estimated requirements for shares to be issued under its Employee Stock Purchase Plan (ESPP). Such repurchases are intended to cover the Company's expected reissuances under the ESPP for the next 12 months. In 1997, the Company adopted a new seasoned systematic stock repurchase program. The shares acquired under this new program will be untainted shares used to meet the recurring share issuance requirements of the recently adopted 1997 Stock Option Plan.

As part of its authorized repurchase program, the Company has sold put warrants through private placements. At January 3, 1998, there were 5.8 million put warrants outstanding which entitle the holder to sell one share of common stock to the Company on a specified date and at a specified price ranging from $23.09 to $24.34 per share. Additionally, during this same period, the Company purchased call options that entitle the Company to buy on a specified date one share of common stock at a specified price. At January 3, 1998, the Company had 4.3 million call options outstanding at prices ranging from $23.22 to $24.47 per share to satisfy anticipated stock repurchase requirements under the Company's systematic repurchase programs. The put warrants and call options outstanding at January 3, 1998 are exercisable on various dates through February 26, 1999. At January 3, 1998, the fair value of the call options was approximately $20.5 million and the fair value of the put warrants was approximately $17.5 million. The fair value of put warrants and call options was estimated by the Company's investment bankers.

The Company has the right to settle the put warrants with stock equal to the difference between the exercise price and the fair value at the date of exercise. Settlement of the put warrants with stock could cause the Company to issue a substantial number of shares, depending on the exercise price of the put warrants and the per share fair value of the Company's common stock at the time of exercise. In addition, settlement of put warrants in stock could lead to the disposition by put warrant holders of shares of the Company's common stock that such holders may have accumulated in anticipation of the exercise of the put warrants or call options, which may impact the price of the Company's common stock. At January 3, 1998, the Company had the ability to settle these put warrants with stock and, therefore, no amount was classified out of stockholders' equity in the consolidated balance sheet. The effect of the exercise of these put warrants and call options is reported in stockholders' equity.

Employee Stock Purchase Plan Under the 1990 Employee Stock Purchase Plan (ESPP), the Company is authorized to issue up to 17,500,000 shares of common stock to its employees. Under the terms of the ESPP, employees can choose each year to have up to 12% of their annual base earnings plus bonuses withheld to purchase the Company's common stock. The purchase price of the stock is 85% of the lesser of the fair market value as of the beginning or the end of the semiannual option periods. Under the ESPP, the Company issued 1,167,474, 1,211,074, and 1,989,456 shares to employees in 1997, 1996, and 1995, respectively. The weighted average purchase price and the weighted average fair value of shares issued in 1997 was $14.59 and $20.50, respectively.

Pro Forma Information This information is required to illustrate the financial results of operations as if the Company had accounted for its employee stock options granted subsequent to December 31, 1994 under the fair value method of SFAS No. 123. The fair value of the Company's options granted and shares purchased under the ESPP for years ended January 3, 1998, December 28, 1996, and December 30, 1995 reported below was estimated at the date of grant using a Black-Scholes option pricing model with the following weighted average assumptions assuming a dividend yield of zero for all periods:

	1997	1996	1995
Risk-free interest rate	6.20%	6.16%	6.41%
Volatility factors of the expected market price of the Company's common stock	44%	35%	35%
Weighted average expected life of an option	4 years	4 years	4 years

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. The Company's options have characteristics significantly different from those of traded options, and changes in the subjective input assumptions can materially affect the fair value estimate. In management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its stock options granted to its employees.

For purposes of pro forma disclosures, the estimated fair value of the options is amortized over the options' vesting period. Had the Company's fixed stock option and employee stock purchase plans been accounted for under SFAS No. 123, net income and earnings per share would have been reduced to the following pro forma amounts:

(in thousands, except per share amounts)	1997	1996	1995
Net income:			
As reported	$ 169,466	$ 29,038	$ 97,270
Pro forma	$ 128,214	$ 6,445	$ 87,300
Net income per share:			
As reported	$ 0.87	$ 0.19	$ 0.59
Pro forma	$ 0.66	$ 0.04	$ 0.53
Net income per share—assuming dilution:			
As reported	$ 0.77	$ 0.16	$ 0.51
Pro forma	$ 0.58	$ 0.04	$ 0.45

The effects of applying SFAS No. 123 on pro forma disclosures of net income and net income per share for 1997, 1996, and 1995 are not likely to be representative of the pro forma effects on net income and earnings per share in future years.

Warrants In connection with the acquisition of High Level Design Systems, Inc., in December 1996, the Company issued a warrant to Goldman, Sachs & Co. (Goldman warrant) to purchase 170,400 shares of the Company's common stock at $28.79 per share. The warrant expires in August 1999 and can be exercised at any time, in whole or in part. The warrant was valued at the time of the acquisition at approximately $0.6 million and was included as part of the total purchase price of HLDS.

In connection with the purchase of the business and certain assets of Comdisco Systems, Inc. (Comdisco), a subsidiary of Comdisco, Inc., in June 1993, the Company issued a warrant (Comdisco Warrant) to purchase 5,850,000 shares of the Company's common stock at $3.23 per share. Pursuant to the original terms of the warrant agreement, during 1996 and 1995, the Company repurchased portions of the warrant applicable to 300,000 and 5,310,000 shares, respectively, for approximately $4.3 million and $17.2 million, respectively. The warrant for the remaining 240,000 shares expires in June 2003 and can be exercised at any time, in increments of not less than 50,000 shares. The warrant was valued at the time of issuance at approximately $1.8 million and was included as part of the total purchase price of Comdisco.

Reserved for Future Issuance At January 3, 1998, the Company had reserved the following shares of authorized but unissued common stock for future issuance:

Employee stock option plans	55,629,481
Other option agreements	65,000
Directors stock option plans	1,624,170
ESPP	5,526,824
Put warrants	5,792,650
Comdisco warrant	240,000
Goldman warrant	170,400
Total	69,048,525

Stockholder Rights Plan On February 9, 1996, the Company adopted a new Stockholder Rights Plan (the Preferred Rights Plan) to protect stockholders' rights in the event of a proposed or actual acquisition of 15% or more of the outstanding shares of the Company's common stock. As part of this plan, each share of the Company's common stock carries a right to purchase one one-thousandth (1/1000) of a share of Series A Junior Participating Preferred Stock (the Right), par value $0.01 per share, of the Company at a price of $240 per one one-thousandth of a share, subject to adjustment. The Rights are subject to redemption at the option of the Board of Directors at a price of $0.01 per Right until the occurrence of certain events. The Rights expire on February 20, 2006.

Cumulative Effect of Change in Accounting Method

In November 1997, the FASB Emerging Issues Task Force issued Ruling 97-13 "Accounting for Costs Incurred in Connection with a Consulting Contract or an Internal Project That Combines Business Process Re-engineering and Information Technology," which requires companies to expense costs incurred for business process re-engineering projects. As a result, the Company recorded a $12.3 million charge in 1997, net of income taxes of $5.3 million, as a cumulative effect of change in accounting method for re-engineering project costs that had been previously capitalized by the Company associated with its implementation of enterprise wide information systems. This change in accounting method effected net income per share and net income per share—assuming dilution by $0.06.

Income Taxes

The provision for income taxes consisted of the following components:

(in thousands)	1997	1996	1995
Current:			
Federal	$ 106,053	$ 59,412	$ 11,954
State	15,772	9,712	4,095
Foreign	19,268	8,258	16,085
Total current	141,093	77,382	32,134
Deferred (prepaid):			
Federal	(64,363)	(15,309)	4,989
State	(2,818)	(750)	201
Foreign	(1,284)	116	503
Total deferred (prepaid)	(68,465)	(15,943)	5,693
Total provision for income taxes	$ 72,628	$ 61,439	$ 37,827

Income before income taxes for 1997, 1996, and 1995 included income of approximately $144.3 million, $25.3 million, and $34.2 million, respectively, from the Company's foreign subsidiaries.

The provision for income taxes is net of the benefit of operating loss carryforwards, totaling $3.6 million, $2.6 million, and $9.7 million, for 1997, 1996, and 1995, respectively.

The provision for income taxes differs from the amount estimated by applying the statutory federal income tax rate to income before income taxes as follows:

(in thousands)	1997	1996	1995
Provision computed at federal statutory rate	$ 84,733	$ 31,667	$ 47,284
State income tax, net of federal tax effect	10,251	5,964	2,662
Non-deductible acquisition costs	6,005	—	—
Foreign withholding taxes	5,049	2,823	3,414
Amortization of goodwill	706	897	390
Write-off of in-process research and development	—	33,495	—
Change in valuation allowance	(1,714)	(11,835)	(19,999)
Research and development tax credit	(4,112)	(207)	(494)
Foreign tax credit	(5,049)	—	(769)
Foreign income tax at a (lower) higher rate	(25,608)	—	2,129
Other	2,367	(1,365)	3,210
Provision for income taxes	$ 72,628	$ 61,439	$ 37,827
Effective tax rate	30%	68%	28%

The components of deferred tax assets and liabilities consisted of the following:

(in thousands)	1997	1996
Deferred Tax Assets:		
Tax credits	$ 27,622	$ 12,029
Accrued royalty	24,714	—
Sales returns and allowance	14,412	3,636
Depreciation and amortization	7,969	6,630
Vacation accrual	3,865	3,517
Restructure reserves	3,431	2,228
Net operating losses	2,802	7,789
Deferred revenue	1,763	5,367
Other	12,996	6,797
Total deferred tax assets	99,574	47,993
Valuation allowance-provision for income taxes	—	(1,714)
Valuation allowance-equity and intangibles	—	(9,041)
Net deferred tax assets	99,574	37,238
Deferred tax liabilities:		
Capitalized software	(9,127)	(8,132)
Other	(2,337)	(9,202)
Total deferred tax liabilities	(11,464)	(17,334)
Total net deferred tax assets	$ 88,110	$ 19,904

The Company provides United States income taxes on the earnings of foreign subsidiaries unless they are considered permanently invested outside of the United States. At January 3, 1998, the cumulative amount of earnings upon which United States income taxes have not been provided are approximately $126.3 million. At January 3, 1998, the unrecognized deferred tax liability for these earnings was approximately $30.8 million.

The net valuation allowance decreased by $10.8 million in 1997. The decrease in valuation allowance-equity and intangibles of $9.1 million is due to the expected realization of the tax benefits of stock option deductions generated in prior years. The valuation allowance-provision for income taxes decreased by $1.7 million, due to the realization of net operating losses and tax credits generated in prior years.

The remaining net operating loss carryforwards will expire at various dates from 1998 through 2010 and federal tax credit carryforwards will expire at various dates from 1998 through 2012.

The Company's federal income tax returns for 1989 through 1991 have been examined by the Internal Revenue Service (IRS). Tax credits of $15.6 million have been disallowed by the IRS. The Company is contesting these adjustments and is pursuing administrative remedies. Management believes that adequate provision has been made for any deficiency that may result from this examination and that the resolution of this matter will not have a material adverse impact on the Company's consolidated financial position or results of operations.

Statement of Cash Flows

The supplemental cash flow information for 1997, 1996, and 1995 follows:

(in thousands)	1997	1996	1995
Cash Paid During the Year for:			
Interest	$ 1,229	$ 2,185	$ 2,423
Income taxes (including foreign withholding tax)	$ 11,942	$ 24,349	$ 12,968
Non-Cash Investing and Financing Activities:			
Capital lease obligations incurred for equipment	$ 2,570	$ 3,070	$ 1,149
Common and treasury stock issued under the ESPP and for acquisitions	$ 52,594	$ 110,607	$ 6,522
Tax benefits from employee stock transactions	$ 123,180	$ 58,418	$ 8,463

Integrated Measurement Systems, Inc.

In July 1995, the Company reduced its ownership in Integrated Measurement Systems, Inc. (IMS), its wholly-owned subsidiary, to 55% by selling to the public approximately 3 million shares of common stock at $11 per share in a registered initial public offering. Of these shares, approximately 0.4 million were sold by IMS and approximately 2.6 million were sold by the Company as the sole selling stockholder of IMS. The sale generated net proceeds to the Company of approximately $26.6 million and a pre-tax gain of approximately $18.9 million, which is reflected as other income in the consolidated statement of income. In 1997, the Company's ownership was reduced to approximately 37%, due to the sale of 1 million shares of IMS common stock. Net proceeds totaled $18.6 million and a $13.1 million gain was recorded. Accordingly, beginning in 1997, its investment in IMS is recorded using the equity method of accounting. The minority interest liability for IMS at December 28, 1996 totaled $13.5 million.

Acquisitions

Advanced Microelectronics In October 1997, the Company acquired certain assets and related business from the Advanced Microelectronics division of the Institute for Technology Development, a non-profit corporation organized to conduct and transfer scientific research into usable high technology for commercial application. This division provided contract engineering services on a time-and-materials basis for the design and development of integrated circuits. The total purchase price was $2.4 million and the acquisition was accounted for as a purchase; accordingly, the results of Advanced Microelectronics from the date of acquisition forward have been included in the consolidated financial statements. The excess of purchase price over net assets acquired was $2.1 million, of which $1.7 million related to the write-off of in-process research and development that had not reached technological feasibility and, in management's opinion, had no probable alternative future use. Comparative pro forma financial information has not been presented as the results of operations of Advanced Microelectronics were not material to the Company's consolidated financial statements.

Cooper and Chyan Technology, Inc. In May 1997, the Company merged with Cooper and Chyan Technology, Inc., whose software products were used to design sophisticated integrated circuits and high-speed printed circuit boards. In connection therewith, the Company issued approximately 22.8 million shares of common stock. The acquisition was accounted for as a pooling of interests. The operations of CCT were not material to the Company's consolidated operations and financial position; therefore, prior period consolidated financial statements were not restated. The results of CCT from the date of acquisition forward have been recorded in the Company's consolidated financial statements.

Synthesia AB In February 1997, the Company acquired all of the outstanding stock of Synthesia AB (Synthesia) for 115,166 shares of the Company's common stock and cash. The total purchase price was $4.7 million, and the acquisition was accounted for as a purchase; accordingly, the results of Synthesia from the date of acquisition forward have been included in the consolidated financial statements. In connection with the acquisition, net intangibles of $5.6 million were acquired, of which $4.9 million was reflected as a one-time charge to operations for the write-off of in-process research and development that had not reached technological feasibility and, in management's opinion, had no probable alternative future use. Comparative pro forma financial information has not been presented as the results of operations of Synthesia were not material to the Company's consolidated financial statements.

High Level Design Systems, Inc. In December 1996, the Company acquired all of the outstanding stock of High Level Design Systems, Inc. (HLDS) for approximately 5.2 million shares of the Company's common stock. The total purchase price was approximately $101.4 million. HLDS developed, marketed, and supported electronic design automation software for the design of high-density, high-performance integrated circuits. The acquisition was accounted for as a purchase and, accordingly, the results of HLDS from the date of acquisition forward have been recorded in the Company's consolidated financial statements. In connection with the acquisition, net intangibles of $99.6 million were acquired, of which $95.7 million was reflected as a one-time charge to operations for the write-off of in-process research and development that had not reached technological feasibility and, in management's opinion, had no probable alternative future use. The remaining intangible of $3.9 million, consisting of goodwill, is included in purchased software and intangibles in the consolidated balance sheets and is being amortized over its estimated useful life of five years.

In connection with the acquisition, net assets acquired were as follows:

(in thousands)

Trade accounts receivable and other current assets	$ 1,840
Intangibles, including in-process research and development	99,594
Property, equipment, and other long-term assets	5,945
Current liabilities assumed	(5,680)
Long-term liabilities assumed	(300)
Net assets acquired	$ 101,399

The following unaudited pro forma information shows the results of operations for the years ended December 28, 1996 and December 30, 1995, as if the HLDS acquisition had occurred at the beginning of each period presented and at the purchase price established in December 1996. The results are not necessarily indicative of what would have occurred had the acquisition actually been made at the beginning of each of the respective periods presented or of future operations of the combined companies. The pro forma results for 1996 combine the Company's results for the year ended December 28, 1996 with the results of HLDS for the period from January 1, 1996 through the date of acquisition and includes the $95.7 million write-off discussed above. The following unaudited pro forma results include the straight-line amortization of intangibles over a period of five years.

(in thousands, except per share amounts)	1996	1995
Revenue	$ 751,453	$ 558,545
Net income	$ 24,924	$ 94,819
Net income per share—assuming dilution	$ 0.13	$ 0.48
Weighted average common and potential common shares outstanding	189,227	196,552

Other Income and Expense

Other income (expense) components for 1997, 1996, and 1995 is as follows:

(in thousands)	1997	1996	1995
Interest income	$ 17,961	$ 4,362	$ 4,854
Gain on sale of IMS stock	13,061	—	18,873
Equity earnings in IMS	1,934	—	—
Minority interest expense	(353)	(3,016)	(1,341)
Gain (loss) on foreign exchange	(1,424)	164	(117)
Interest expense	(2,508)	(1,913)	(2,222)
Other expense, net	(3,047)	(379)	(2,810)
Total other income (expense)	$ 25,624	$ (782)	$ 17,237

Unusual Items and Restructuring

Described below are unusual items and restructuring charges in 1997 and 1996. None were recorded in 1995.

(in thousands)	1997	1996
Restructuring charges	$ 34,417	$ 2,119
Write-off of in-process research and development	6,571	95,700
Write-off of capitalized software development costs	3,065	2,724
Total unusual items	$ 44,053	$ 100,543

Unusual items included restructuring charges of $34.4 million recorded by the Company in 1997 for the reduction of personnel whose duties were made redundant, closure of duplicated and excess facilities, fees of financial advisors, attorneys and accountants, and other expenses associated with the merger with CCT, and the acquisition of HLDS. Additionally, the Company restructured its international business operations to reduce the Company's cost structure and to further integrate and reduce selling and marketing activities. In connection with the 1997 restructuring activities, the Company reduced its workforce by approximately 230 employees representing various sales, marketing, and research and development departments. The majority of the restructuring charges were utilized during the year with the exception of facility costs, which will be paid out through the year 2000, and some severance costs to be paid during 1998.

In 1997, the Company wrote off $6.6 million of acquired in-process research and development associated with its acquisitions of Synthesia AB and Advanced Microelectronics. These costs reflected research and development which had not reached technological feasibility and, in management's opinion, had no probable alternative future use. Additionally, the Company wrote off capitalized software development costs of $3.1 million for products developed by the Company which were replaced by CCT products or by license of replacement technology.

Included in 1996 unusual items was a $95.7 million write-off of in-process research and development, $2.7 million of capitalized software development costs for products developed by the Company which were replaced by HLDS products, as well as $2.1 million of restructuring charges consisting of employee termination costs associated with the outsourcing of the Company's management information technology services and costs associated with excess facilities. The in-process research and development had not reached technological feasibility and, in management's opinion had no probable alternative future use.

Liabilities for excess facilities and other restructuring charges are included in other current and non-current liabilities while severance and benefits liabilities are included in payroll and payroll related accruals. The following table summarizes the Company's restructuring activity during the years ended in 1997 and 1996:

(in thousands)	Severance and Benefits	Excess Facilities	Other Restructuring	Assets	Total
Balance, December 30, 1995	$ —	$ —	$ —	$ —	$ —
1996 restructuring charges	1,047	1,072	—	—	2,119
Cash charges	(392)	—	—	—	(392)
Balance, December 28, 1996	655	1,072	—	—	1,727
1997 restructuring charges	11,895	2,102	18,073	2,347	34,417
Non-cash charges	—	—	—	(2,347)	(2,347)
Cash charges	(10,263)	(536)	(14,223)	—	(25,022)
Balance, January 3, 1998	$ 2,287	$ 2,638	$ 3,850	$ —	$ 8,775

Operations by Geographic Area

The Company operates primarily in one industry segment: the development and marketing of computer-aided design software and related services. The Company's products have been marketed internationally through distributors and through the Company's subsidiaries in Europe and Asia/Pacific. Intercompany revenue results from licenses that are based on a percentage of the subsidiaries' revenue from unaffiliated customers. The following table presents a summary of operations by geographic area:

(in thousands)	1997	1996	1995
Revenue			
Domestic operations[1]	$ 705,995	$ 633,997	$ 440,618
European operations	415,791	119,455	97,596
Asia/Pacific operations	152,258	129,157	107,556
Eliminations	(358,151)	(141,150)	(97,352)
Consolidated	$ 915,893	$ 741,459	$ 548,418
Intercompany Revenue (Eliminated in Consolidation)			
Domestic operations	$ 158,055	$ 94,156	$ 58,719
European operations	171,436	16,984	15,893
Asia/Pacific operations	28,660	30,010	22,740
Consolidated	$ 358,151	$ 141,150	$ 97,352
Income From Operations			
Domestic operations	$ 8,195	$ (2,322)	$ 41,367
European operations	157,591	29,917	31,888
Asia/Pacific operations	68,221	63,664	44,605
Consolidated	$ 234,007	$ 91,259	$ 117,860
Identifiable Assets			
Domestic operations	$ 837,320	$ 750,040	$ 396,676
European operations	295,229	53,716	50,303
Asia/Pacific operations	69,811	59,008	63,680
Eliminations	(178,510)	(145,763)	(136,624)
Consolidated	$ 1,023,850	$ 717,001	$ 374,035

[1] Domestic operations revenue includes export revenue of approximately $15.5 million, $25 million, and $14.7 million to Europe for 1997, 1996, and 1995, respectively, and approximately $91.2 million, $125.9 million, and $90.6 million to Asia/Pacific for 1997, 1996, and 1995, respectively.

Report of
Independent Public Accountants

To Stockholders and Board of Directors of Cadence Design Systems, Inc.:

We have audited the accompanying consolidated balance sheets of Cadence Design Systems, Inc. (a Delaware corporation) and subsidiaries as of January 3, 1998 and December 28, 1996, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended January 3, 1998. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Cadence Design Systems, Inc. and subsidiaries as of January 3, 1998 and December 28, 1996, and the results of their operations and their cash flows for each of the three years in the period ended January 3, 1998, in conformity with generally accepted accounting principles.

Arthur Andersen LLP

San Jose, California
January 23, 1998

Market Information—Common Stock

The Company's Common Stock is traded on the New York Stock Exchange under the symbol CDN. The Company has never declared or paid any cash dividends on its common stock in the past and none are planned to be paid in the future.

The following table sets forth the high and low sales price for the Common Stock for each calendar quarter in the two-year period ended January 3, 1998:

	High	Low
1997		
First Quarter	$ 21.94	$ 15.69
Second Quarter	19.00	13.38
Third Quarter	27.50	16.75
Fourth Quarter	28.75	22.31

	High	Low
1996		
First Quarter	$ 15.17	$ 11.50
Second Quarter	21.88	14.84
Third Quarter	18.94	11.50
Fourth Quarter	20.69	16.32

Corporate Directory

Board of Directors

Donald L. Lucas
Chairman,
Cadence Design Systems, Inc.
Private Venture Capital Investor

John R. Harding
President and Chief Executive Officer,
Cadence Design Systems, Inc.

Carol Bartz
Chairman and Chief Executive Officer,
Autodesk, Inc.

H. Raymond Bingham
Executive Vice President and
Chief Financial Officer,
Cadence Design Systems, Inc.

Dr. Leonard Y. W. Liu
Chairman, President, and
Chief Executive Officer,
Walker Interactive Systems, Inc.

Dr. Alberto Sangiovanni-Vincentelli
Professor of Electrical Engineering
and Computer Science,
University of California, Berkeley

George M. Scalise
President, Semiconductor
Industry Association

Dr. John B. Shoven
Dean of Humanities and Sciences,
Stanford University

Corporate Officers

John R. Harding
President and
Chief Executive Officer

H. Raymond Bingham
Executive Vice President and
Chief Financial Officer

Michael W. Bealmear
Executive Vice President,
Worldwide Services

K.C. Murphy
Executive Vice President,
Strategic Business Group and
Corporate Strategic Planning

John F. Olsen
Executive Vice President,
Worldwide Sales and Marketing

Shane V. Robison
Executive Vice President,
Engineering

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Vice President,
Finance and Treasurer

R. L. Smith McKeithen
Vice President,
General Counsel and Secretary

Kevin Palatnik
Vice President,
Financial Planning and Analysis

William Porter
Vice President,
Corporate Controller
and Assistant Secretary

Independent Public Accountants

Arthur Andersen LLP 333 West San Carlos Street, San Jose, CA 95110

Transfer Agent

Harris Trust and Savings Bank 311 W. Monroe Street, 11th Floor, Chicago, IL 60690

Form 10-K

A copy of the Company's Form 10-K, as filed with the Securities and Exchange Commission for the year ended January 3, 1998, is available without charge upon written request from: Cadence Design Systems, Inc., Attn: Stockholder Services, 2655 Seely Avenue, San Jose, California 95134.

Annual Meeting

The Cadence Design Systems, Inc. Annual Meeting of Stockholders will be held May 6, 1998 at 3:00pm at the Company's executive offices at 2655 Seely Avenue, San Jose, California.

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