# Form 10-K

# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE FISCAL YEAR ENDED DECEMBER 31, 2004**

**COMMISSION FILE NUMBER 0 – 13442**

# MENTOR GRAPHICS CORPORATION

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Oregon**<br>(State or other jurisdiction of<br>incorporation or organization) | **93-0786033**<br>(IRS Employer<br>Identification No.) |
| **8005 SW Boeckman Road**<br>**Wilsonville, Oregon**<br>(Address of principal executive offices) | **97070-7777**<br>(Zip Code) |

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

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, without par value

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes /X/ No / /

The aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $1,077,813,711 on June 30, 2004 based upon the last price of the Common Stock on that date reported in the Nasdaq National Market. On February 28, 2005, there were 78,030,496 shares of the Registrant's Common Stock outstanding.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or in any amendment to this Form 10-K. / X/

***DOCUMENTS INCORPORATED BY REFERENCE***

| Document | Part of Form 10-K into which incorporated |
|---|---|
| Portions of the 2005 Proxy Statement | Part III |

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## Part I

### Item 1. Business

*This Form 10-K contains forward-looking statements that involve risks and uncertainties. Actual results may differ materially from the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those set forth under the caption "Factors That May Affect Future Results and Financial Condition" under Item 7. "Management's Discussion and Analysis of Financial Condition and Results of Operations."*

**GENERAL**

Mentor Graphics Corporation (the Company) is a technology leader in electronic design automation (EDA), providing software and hardware design solutions that enable companies to develop better electronic products faster and more cost-effectively. The Company develops, manufactures, markets, sells and supports EDA products and provides related services, which are used by engineers to design, analyze, simulate, model, implement and verify the components of electronic systems. The Company markets its products and services worldwide, primarily to large companies in the military/aerospace, communications, computer, consumer electronics, semiconductor, networking, multimedia and transportation industries. Customers use the Company's products in the design of wire harness systems and semiconductors, such as microprocessors, field programmable gate arrays (FPGAs), printed circuit boards and memory and application specific integrated circuits. Consequently, the Company's products are used in the design of a diverse set of electronic products, including automotive electronics, video game consoles, telephone-switching systems, cellular handsets, computer network hubs and routers, signal processors, personal computers, video conferencing equipment, 3-D graphics boards, digital audio broadcast radios, smart cards, and products enabled with the Bluetooth short-range wireless radio technology and 802.11 wireless networking technology. The Company licenses its products through its direct sales force and a channel of distributors and sales representatives. The Company was incorporated in Oregon in 1981 and its common stock is traded on the Nasdaq National Market under the symbol "MENT." The Company's executive offices are located at 8005 S.W. Boeckman Road, Wilsonville, Oregon 97070-7777. The telephone number at that address is (503) 685-7000. The Company website address is www.mentor.com. Electronic copies of reports filed by the Company with the Securities and Exchange Commission (SEC) are available through the Company's website promptly after such reports are filed with the SEC.

**PRODUCTS**

The Company's products help engineers overcome the increasingly complex challenges they face in the design of electronic systems. The Company's products are designed to make design engineers more productive, improve the accuracy of complex designs and shrink time-to-market schedules.

Electrical engineers begin the design process by describing the architectural, behavioral, functional and structural characteristics of an integrated circuit (IC), a printed circuit board (PCB) or an electronic system. In this process the engineer describes the overall product system architecture, implements it by creating a design description, verifies the design to reveal defects and modifies the description until it meets the previously determined design specifications. Engineers use the Company's products to specify the components of the IC, PCB or electronic system, determine the interconnections among the components and define the components' associated physical properties. Engineers use the Company's verification products throughout the design process to identify design errors and test design alternatives before the design is manufactured. The Company's verification products are used to identify functionality and performance issues while the cost to correct is still low. During the manufacturing process, the Company's software test products are used to help identify defective parts.

*Scalable Verification*

The Company provides its customers critical tools for verifying that complex chip designs actually function as intended. Functional errors at the system level are the leading cause of design revisions affecting product time to market and profitability. Hardware Description Languages (HDLs) supported by these products include Verilog, SystemVerilog, VHDL, System C and Assertion-Based Verification with property specification language (PSL).

ModelSim® is a leading HDL mixed-language digital simulator that enables hardware designers to verify that their chip designs function correctly before the design is sent for manufacture. ModelSim is heavily used for application-specific integrated circuits (ASIC), System on Chip (SoC) and FPGA design verification. Centered around ModelSim is the Company's Scalable Verification™ Platform which combines standards support, new tools and a design for verification methodology to minimize functional verification cycles and avoid costly re-designs. The HDL Designer Series ™ addresses high-end HDL design creation and management processes with a family of HDL capture, analysis, documentation and management tools. The Scalable Verification Platform enables verification to be performed at the earliest stages of design. The 2004 acquisition of 0-In Design Systems has added advanced capability to the Scalable Verification Platform in the areas of assertion based verification, coverage driven verification and engineered methods such as clock domain crossing verification.

Along with the ModelSim digital simulator, the Company's ADVance MS™, Mach TA™ simulator, Eldo® analog/mixed-signal simulator and Eldo RF™ steady-state and modulated steady-state simulators address the unique challenges of analog/mixed-signal and leading edge submicron designs. These products allow circuit designers to verify the functionality and performance of very large and complex designs quickly and accurately and also help avoid long verification cycles, excessive iterations and expensive silicon turns. The Eldo analog and radio frequency (RF) system simulator software products are primarily used for the design and verification of complex analog and RF effects in digital and mixed-signal circuits. The ADVance MS™ tool combines ModelSim, Eldo, Mach TA and Eldo RF simulator technology into a single, integrated tool.

SoC Verification products include the Seamless® hardware/software co-verification software product family and emulation products of the Mentor Emulation Division (MED). The Seamless product family enables simultaneous simulation of the hardware and software components of a system design. Seamless tools allow designers to verify software early in the system design process instead of waiting until the hardware design has been completed, verified and manufactured into a prototype. Early verification of the system identifies functionality and performance issues while the cost to correct them is smaller and reduces the overall design cycle. The Company's MED Division provides CelaroPRO™ and VStation™ emulation hardware systems, which are part of the Company's Scalable Verification™ strategy. The Company's emulators allow users to create functional and logical equivalent models of actual electronic circuits to verify the function and/or timing of such circuits. Consequently, designers can emulate highly complex designs of integrated circuits and systems at near real-time speeds.

*Design to Silicon*

In advanced process technologies the handoff between IC layout and manufacturing has changed. In older technologies, the handoff was a simple check when the design went to manufacturing. Now it is a multi-step process where the layout database is modified so the design can be manufactured. Issues arise concerning manufacturing process effects, photolithography, data volumes and achieving a cost-effective yield of finished chips from each wafer.

To meet these challenges, the Calibre® product line is specifically engineered for physical verification and manufacturability of leading-edge nanometer IC designs. The Calibre tool integrates physical verification with subwavelength design resolution enhancement and mask data preparation. The Calibre physical verification tool suite, Calibre DRC™ and Calibre LVS™, helps ensure that IC physical designs conform to foundry manufacturing rules and match the intended functionality of the chip. For subwavelength designs, the Calibre product line capitalizes on its verification engine to provide a tool suite to model, modify and verify layouts for all resolution enhancement technology techniques, including optical and process correction, phase-shift mask, scattering bars and off-axis illumination. With the addition of mask data preparation capability, the Calibre tool has extended this flow to aspects of mask manufacturing. The Calibre xRC™ product, a full-chip, transistor level parasitic extraction tool, addresses the distinct requirements for parasitic extraction, a process to extract resistances and capacitances of the circuit. The Calibre tool family solution is the standard for the majority of the world's largest integrated device manufacturers, foundries and leading-edge submicron library providers.

*Integrated PCB-FPGA Systems Design*

As ICs, ASICs and FPGAs become more complex and PCB fabrication technology advances to include embedded components and high-density interconnect layers, the design of PCBs is reaching new levels of complexity. These are frequently a source of design bottlenecks.

The Company's PCB-FPGA Systems Design software products support the printed circuit design process from schematic entry, where the electronic circuit is defined by engineers, through physical layout of the PCB, to providing digital output data for manufacturing, assembly and test. Most types of designs, including analog, radio frequency (RF), high-speed digital and mixed signal, are supported by the Company's PCB design tools. The Company has specific integrated products for process management, component library creation, simulation and verification of the PCB design. The Board Station® and Expedition ™ series are the two main PCB design families of products used typically by large enterprise customers. The Company also offers the "ready to use" PADS® Personal Automated Design Systems product line which provides a lower cost Windows-based PCB design and layout solution. I/O Designer ™ integrates FPGA I/O planning with the Company's PCB design tools resulting in improved routing in large complex designs. The XtremePCB™ tool is a new product that offers a method for simultaneous design where multiple designers can edit the same design at the same time and view each others' edits in real-time. It is a true multi-user environment in which customers can achieve significant cycle time reductions for complex PCB designs.

The AutoActive® products, with next generation place and route technology on UNIX and Windows Platforms, are used to replace older generation routers in PCB design flows from the Company, Cadence Design Systems, Inc. and others. The AutoActive technology, which is incorporated into both the Board Station and Expedition product lines, enables improved design quality, design cycles and manufacturability through increased productivity, reduced interactive and automatic routing times and shorter learning curves. The Company's Hyperlynx® and ICX® high-speed design technology tools address signal integrity and timing challenges of complex, high-speed PCB designs to help make simulation more efficient and accurate.

For FPGA synthesis, the Company's Precision® Synthesis product family is a next-generation synthesis platform created to maximize the performance of both existing FPGA and multi-million gate field programmable system-on-chip devices. The Company's FPGA Advantage® offering combines features of the HDL Designer Series, ModelSim and Precision Synthesis products to provide a complete design flow and a unified solution for FPGA design within a single tool suite.

*New and Emerging Products*

With the advent of 90 nanometer geometries and multi-million-gate SoC designs, complex electronics have outgrown traditional design methods. To cope with the complexity, designers are moving beyond slow, labor-intensive register-transfer level (RTL) methodologies to methodologies based on the C programming language, which offer a more efficient path to implementation. Mentor Graphics C-based design tools, including Catapult C, allow engineers to work at a higher level of abstraction, freeing them to easily explore alternative device architectures, tune designs for optimal performance, size or power consumption, and automatically generate error-free RTL descriptions, potentially saving weeks or months of development time.

In the cabling area, the Company's Capital Harness™ Systems business unit provides specialized software for design, analysis, manufacture and data management of complex wire harness systems used by automotive, aerospace and other industries.

The Company's Data Management Systems (DMS) applications address the systems design and manufacturing cycle by providing electronics systems designers with relevant design information from enterprise PLM (product lifecycle management) and ERP (enterprise resource planning) information sources. In addition, DMS applications can manage work-in-process electronics designs and multi-site, multi-technology library data.

The Company's Embedded Systems Division provides tools and technology to developers of embedded systems that take developers from start to finish with a full suite of Nucleus® software including modeling software, development tools such as debuggers and compilers, prototyping tools, real-time operating systems (RTOS) and middleware. Embedded software controls the function of hardware components dedicated to specialized tasks for any microprocessor-based system. These systems include common consumer products such as cellular telephones and set-top boxes, and reach into applications such as engine management systems of vehicles and in-flight aircraft controls systems. The Company's Nucleus product line offers a complete and integrated solution for developing embedded systems.

The Company's suite of integrated Design-for-Test (DFT) solutions for testing an ASIC or IC design's logic and memories includes scan insertion, automatic test pattern generation (ATPG), logic and memory built-in self-test (BIST), boundary scan and Embedded Deterministic Test (EDT™). As part of the ATPG solution, the DFTAdvisor™, FastScan™ and FlexTest™ tools provide scan insertion and automatic test pattern generation. The Company's BIST solutions include MBISTArchitect™, a flexible tool for testing a design's embedded memories and LBISTArchitect™, a complete design environment for analysis, insertion and simulation of logic BIST, which is primarily used for in-system testing of an IC. BSDArchitect™ automates boundary scan insertion and provides chip-level test control. In addition, the Company's patented EDT technology compresses test data volume and time while providing high test quality, allowing semiconductor manufacturers to cost-effectively increase the quantity and quality of semiconductor testing. The Company's EDT product, TestKompress®, allows semiconductor manufacturers to reduce the scan test time and scan test data volume for manufacturing tests for ASIC, IC and SoC designs by up to 100 times.

The Company's Intellectual Property (IP) division provides pre-verified, standards-based reusable "building blocks" or "cores" of frequently used circuit functions, referred to in the industry as IP, for the design of hardware components. Customers have a growing need for licensing standardized IP instead of inventing it in house so that engineers can then focus on the more application intensive and differentiating aspects of the design. Using third party, validated, and tested IP reduces risk during development, lowers the overall system costs, and achieves a higher level of design productivity. The Company's IP Division offers industry-leading IP for standards-based products such as Ethernet, USB, Storage, and PCI Express.

**PLATFORMS**

The Company's software products are available on UNIX, Windows and LINUX platforms in a broad range of price and performance levels. Customers purchase platforms primarily from Hewlett-Packard Company, International Business Machines Corporation, Sun Microsystems Inc. and leading personal computer suppliers. These computer manufacturers have a substantial installed base and make frequent introductions of new products.

**MARKETING AND CUSTOMERS**

The Company's marketing emphasizes a direct sales force and large corporate account penetration in the communications, computer, consumer electronics, semiconductor, military/aerospace, networking, multimedia and transportation industries. The Company licenses its products worldwide through its direct sales force, sales representatives and distributors. During the years ending December 31, 2004, 2003 and 2002, sales outside of the Americas accounted for 57%, 51%, and 49% of total sales, respectively. The Company enters into foreign currency forward and option contracts in an effort to help mitigate the impact of foreign currency fluctuations. These contracts do not eliminate all potential impact of foreign currency fluctuations. Significant exchange rate movements may have a material adverse impact on the Company's results. See page 22, "*Effects of Foreign Currency Fluctuations*," for a discussion of the effect foreign currency fluctuation may have on the Company's business and operating results.

No material portion of the Company's business is dependent on a single customer. The Company has traditionally experienced some seasonal fluctuations of orders, with orders being typically stronger in the second and fourth quarters of the year. Due to the complexity of the Company's products, the selling cycle can be three to six months or longer. During the selling cycle the

Company's account managers, application engineers and technical specialists make technical presentations and product demonstrations to the customer. At some point during the selling cycle, the Company's products may also be "loaned" to customers for on-site evaluation. The Company generally ships its products to customers within 180 days after receipt of an order and a substantial portion of quarterly shipments tend to be made in the last month of each quarter. The Company licenses its products and some third party products pursuant to end-user license agreements.

**BACKLOG**

The Company's backlog of firm orders was approximately $82 million on December 31, 2004 as compared to $61 million on December 31, 2003. This backlog includes products requested for delivery within six months and unfulfilled professional services and training requested for delivery within one year. The Company does not track backlog for support services. Support services are typically delivered under annual contracts that are accounted for on a pro rata basis over the twelve-month term of each contract. Substantially all the December 31, 2004 backlog of orders is expected to ship during 2005.

**MANUFACTURING OPERATIONS**

The Company's manufacturing operations primarily consist of reproduction of the Company's software and documentation. In the Americas, manufacturing is substantially outsourced, with distribution to Western Hemisphere customers occurring from Wilsonville, Oregon; San Jose, California and Mobile, Alabama. The Company's line of emulation products, which has a large hardware component, is manufactured in the United States and France. Mentor Graphics (Ireland) Limited manufactures and distributes the Company's products to markets outside the Americas through the Company's established sales channels.

**PRODUCT DEVELOPMENT**

The Company's research and development is focused on continued improvement of its existing products and the development of new products. During the years ended December 31, 2004, 2003 and 2002, the Company expensed $202 million, $185 million, and $164 million, respectively, related to product research and development. The Company also seeks to expand existing product offerings and pursue new lines of business through acquisitions. In 2004, the Company recorded purchased technology from acquisitions of $6 million. The Company's future success depends on its ability to develop and/or acquire competitive new products that satisfy customer requirements.

**CUSTOMER SUPPORT AND CONSULTING**

The Company has a worldwide organization to meet its customers' needs for software and hardware support. The Company offers support contracts providing software updates and software support, as well as hardware support for emulation products. Most of the Company's customers have entered into support contracts. The Company has won five Software Technical Assistance Recognition (STAR) Awards from the Software Support Professionals Association for superior service in the Complex Support category. This category acknowledges companies that consistently provide a superior level of support for software used in high-end, mission-critical applications in fields such as engineering science, telecommunications and other technical environments. Mentor Consulting, the Company's professional services division, is comprised of a worldwide team of consulting professionals. The services provided to customers are concentrated around the Company’s products. Mentor Consulting's model for delivering services, Knowledge-Sourcing$^{SM}$, focuses on solving a customer's immediate design challenge while giving the organization the knowledge it needs to solve similar challenges in the future.

**COMPETITION**

The markets for the Company's products are competitive and are characterized by price reductions, rapid technological advances in application software, operating systems and hardware and by new market entrants. The EDA industry tends to be labor intensive rather than capital intensive. This means that the number of actual and potential competitors is significant. While two competitors are large companies with extensive capital and marketing resources, the Company also competes with small companies with little capital but innovative ideas.

The Company believes the main competitive factors affecting its business are breadth and quality of application software, product integration, ability to respond to technological change, quality of a company's sales force, price, size of the installed base, level of customer support and professional services. The Company believes that it generally competes favorably in these areas. The Company can give no assurance, however, that it will have financial resources, marketing, distribution and service capability, depth of key personnel or technological knowledge to compete successfully in its markets.

The Company's principal competitors are Cadence Design Systems, Inc. and Synopsys, Inc.

**EMPLOYEES**

The Company and its subsidiaries employed approximately 3,856 people full time as of December 31, 2004. The Company's success will depend in part on its ability to attract and retain employees. The Company continues to have satisfactory employee relations.

**PATENTS AND LICENSES**

The Company holds 163 United States and 22 foreign patents on various technologies. In 2004, the Company obtained 23 patents. While the Company believes the patent applications it has pending relate to patentable technology, there can be no assurance that any patent will be issued or that any patent can be successfully defended. Although the Company believes that patents are less significant to the success of its business than technical competence, management ability, marketing capability and customer support, the Company believes that patents are becoming increasingly important in the EDA industry.

The Company regards its products as proprietary and protects its products by contract and technical safeguards, with copyright and trade secret laws, and with internal and external non-disclosure safeguards, as well as with patents, when appropriate, as noted above. The Company typically includes restrictions on disclosure, use and transferability in its agreements with customers and other third parties.

**Item 2. Properties**

The Company owns six buildings on 53 acres of land in Wilsonville, Oregon. The Company occupies approximately 405,000 square feet, in five of those buildings, as its corporate headquarters. The Company also owns an additional 69 acres of undeveloped land adjacent to its headquarters. Most administrative functions and a significant amount of the Company's domestic research and development operations are located at the Wilsonville site.

The Company leases additional space in San Jose, California; Longmont, Colorado; Huntsville and Mobile, Alabama; and Marlboro and Waltham, Massachusetts where some of its domestic research and development takes place; and in various locations throughout the United States and in other countries, primarily for sales and customer service operations. Additional research and development is done in locations outside the United States including locations in Egypt, France, Finland, India, Pakistan, Poland and the United Kingdom. The Company believes that it will be able to renew or replace its existing leases as they expire and that its current facilities will be adequate through at least 2005.

**Item 3. Legal Proceedings**

From time to time the Company is involved in various disputes and litigation matters that arise from the ordinary course of business. These include disputes and lawsuits relating to intellectual property rights, licensing, contracts and employee relations matters. The Company believes that the outcome of current litigation, individually and in the aggregate, will not have a material affect on the Company's results of operations.

**Item 4. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of the security holders of the Company during the fourth quarter of the fiscal year ended December 31, 2004.

***EXECUTIVE OFFICERS OF REGISTRANT***

The following are the executive officers of the Company:

| *Name* | *Position* | *Age* |
|---|---|---|
| Walden C. Rhines | Chairman of the Board and Chief Executive Officer | 58 |
| Gregory K. Hinckley | President and Director | 58 |
| L. Don Maulsby | Senior Vice President, World Trade | 53 |
| Dean Freed | Vice President, General Counsel and Secretary | 46 |
| Robert Hum | Vice President and General Manager Design Verification and Test Division | 52 |
| Henry Potts | Vice President and General Manager System Design Division | 58 |
| Jue-Hsien Chern | Vice President and General Manager Deep Submicron Division | 50 |
| Joseph Sawicki | Vice President and General Manager Design-to-Silicon Division | 44 |
| Brian Derrick | Vice President, Corporate Marketing | 41 |
| Anthony B. Adrian | Vice President, Corporate Controller | 62 |
| Dennis Weldon | Vice President, Corporate Development and Investor Relations and Treasurer | 56 |

The executive officers are elected by the Board of Directors of the Company at its annual meeting. Officers hold their positions until they resign, are terminated or their successors are elected. There are no arrangements or understandings between the officers or any other person pursuant to which officers were elected. None of the officers are related.

Dr. Rhines has served as Chairman of the Board and Chief Executive Officer since November 2000. Dr. Rhines served as Director, President and Chief Executive Officer of the Company from October 1993 to October 2000. Dr. Rhines is currently a director of Cirrus Logic, Inc. and Triquint Semiconductor, Inc., both semiconductor manufacturers.

Mr. Hinckley has served as President since November 2000. Mr. Hinckley served as Executive Vice President, Chief Operating Officer and Chief Financial Officer of the Company from January 1997 to October 2000. Mr. Hinckley is a director of Amkor Technology, Inc., an IC packaging, assembly and test services company and Unova, Inc., a provider of integrated systems solutions.

Mr. Maulsby has served as Senior Vice President, World Trade since October 1999. From June 1998 to October 1999, he was president of Tri-Tech and Associates, a manufacturer's representative firm.

Mr. Freed has served as Vice President, General Counsel and Secretary of the Company since July 1995. Mr. Freed served as Deputy General Counsel and Assistant Secretary of the Company from April 1994 to July 1995.

Mr. Hum has served as Vice President and General Manager of the Design Verification and Test Division since 2002. From 1997 to 2002, Mr. Hum served as Chief Operating Officer and Vice President of Engineering of IKOS Systems, Inc.

Mr. Potts has served as Vice President and General Manager of the Systems Design Division (SDD) since joining the Company in April 1999. From 1997 to 1998, Mr. Potts was Vice President of Engineering for Hitachi Micro Systems, a semiconductor research and development company.

Dr. Chern has served as Vice President and General Manager of the Company's Deep Submicron (DSM) Division since joining the Company in January 2000. From August 1999 to December 1999, Dr. Chern was President of Ultima Corporation. From 1994 to 1998, Dr. Chern served as Vice President and Chief Technology Officer for Technology Modeling Associates. In 1998 Technology Modeling Associates merged with Avant! Corporation and Dr. Chern became head of Avant!'s DSM Business Unit. Dr. Chern is a director of Quinton Cardiology System, Inc., which manufactures diagnostic cardiology systems.

Mr. Sawicki has served as Vice President and General Manager of the Company's Design-to-Silcon (D2S) Division since July 2003. From January 2002 to June 2003, he was General Manager of the Physical Verification (PVX) Division. From March 2000 to December 2001, Mr. Sawicki served as General Manager of the Company's Calibre business unit. Mr. Sawicki has been with the Company for 15 years in various roles including applications engineering, sales and marketing and management.

Mr. Derrick has served as Vice President, Corporate Marketing since January 2002. From November 2000 to December 2001 he was Vice President and General Manager of the Company's PVX Division. From March 1998 to November 2000, he was the Director of the Company's Calibre and Velocity Strategic Business Unit. From January 1997 to March 1998, he was marketing manager for the Company's Calibre Business Unit. Mr. Derrick has been with the Company since 1997.

Mr. Adrian has served as Vice President, Corporate Controller since joining the Company in January 1998.

Mr. Weldon has served as Vice President, Corporate Development and Investor Relations and Treasurer since 2004. He served as Treasurer and Director of Corporate Business Development from 1996 to 2004.

## PART II

**Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The Company's Common Stock trades on the Nasdaq National Market under the symbol "MENT." The following table sets forth for the periods indicated the high and low sales prices for the Company's Common Stock, as reported by the Nasdaq National Market:

| **Quarter ended** | **March 31** | **June 30** | **September 30** | **December 31** |
|---|---|---|---|---|
| **2004** | | | | |
| High | $ 17.99 | $ 18.06 | $ 14.76 | $ 15.29 |
| Low | $ 14.65 | $ 15.13 | $ 10.38 | $ 10.80 |
| **2003** | | | | |
| High | $ 10.11 | $ 15.00 | $ 20.99 | $ 18.93 |
| Low | $ 7.23 | $ 8.00 | $ 14.18 | $ 12.81 |

As of December 31, 2004, the Company had 649 stockholders of record.

No dividends were paid in 2004 or 2003. The Company's credit facility prohibits the payment of dividends.

**Item 6. Selected Consolidated Financial Data**
*In thousands, except per share data and percentages*

| **Year ended December 31**, | **2004** | **2003** | **2002** | **2001** | **2000** |
|---|---|---|---|---|---|
| **Statement of Operations Data** | | | | | |
| Total revenues | $ 710,956 | $ 675,668 | $ 596,179 | $ 600,371 | $ 589,835 |
| Operating income (loss) | $ 39,175 | $ 12,893 | $ (13,826) | $ 30,443 | $ 63,589 |
| Net income (loss) | $ (20,550) | $ 7,933 | $ (14,314) | $ 31,104 | $ 54,987 |
| Gross margin percent | 85% | 83% | 80% | 81% | 80% |
| Operating income (loss) as a percent of revenues | 6% | 2% | (2)% | 5% | 11% |
| **Per Share Data** | | | | | |
| Net income (loss) per share – basic | $ (0.28) | $ 0.12 | $ (0.22) | $ 0.48 | $ 0.86 |
| Net income (loss) per share – diluted | $ (0.28) | $ 0.11 | $ (0.22) | $ 0.46 | $ 0.81 |
| Weighted average number of shares outstanding – basic | 72,381 | 67,680 | 65,766 | 64,436 | 64,125 |
| Weighted average number of shares outstanding – diluted | 72,381 | 70,464 | 65,766 | 67,681 | 67,509 |
| **Balance Sheet Data** | | | | | |
| Cash and investments, short-term | $ 94,287 | $ 71,324 | $ 38,826 | $ 147,176 | $ 141,872 |
| Working capital (deficit) | $ 90,621 | $ 87,943 | $ (4,755) | $ 149,293 | $ 132,695 |
| Property, plant and equipment, net | $ 91,224 | $ 91,350 | $ 90,259 | $ 82,247 | $ 82,560 |
| Total assets | $ 1,021,907 | $ 940,688 | $ 804,848 | $ 521,221 | $ 530,914 |
| Short-term borrowings | $ 9,632 | $ 6,910 | $ 17,670 | $ -- | $ -- |
| Notes payable and other long-term liabilities | $ 303,081 | $ 309,929 | $ 196,960 | $ 14,466 | $ 7,247 |
| Stockholders' equity | $ 433,715 | $ 374,366 | $ 359,720 | $ 326,208 | $ 316,537 |

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**
*All numerical references in thousands, except percentages, per share data and number of employees*

**Overview**

*The Company*

The Company is a supplier of electronic design automation (EDA) systems -- advanced computer software, emulation hardware systems and intellectual property designs and databases used to automate the design, analysis and testing of electronic hardware and embedded systems software in electronic systems and components. The Company markets its products and services worldwide, primarily to large companies in the military/aerospace, communications, computer, consumer electronics, semiconductor, networking, multimedia and transportation industries. Through the diversification of the Company's customer base among these various customer markets, the Company attempts to reduce its exposure to fluctuations within each market. The Company sells and licenses its products through its direct sales force and a channel of distributors and sales representatives. In addition to its corporate offices in Wilsonville, Oregon, the Company has sales, support, software development and professional service offices worldwide.

*Business Environment*

Beginning in late 2000, the electronics industry experienced a broad economic downturn. Since a majority of the Company's business originates from electronics industry customers, the Company was negatively impacted. The semiconductor industry, a subset of the electronics industry, experienced the deepest downturn in its history. As a result of this downturn, customers reduced research and development (R&D) budgets, limited general investment in design tools and reduced engineering staff. In addition, many smaller companies and start-ups went out of business. However, even in a depressed environment, customers still require the newest tools to solve leading-edge design problems. The Company attempts to fill those demands through its relatively young and diverse product portfolio, and as a result, the Company had a solid 2004 despite the economic troubles facing many of its customers.

For the first three quarters of 2004, the Company consumed backlog, meaning that systems and software revenue was higher than bookings. The Company decided that backlog had reached unacceptably low levels. As a result, the Company reduced revenue and earnings guidance for the fourth quarter. The Company's results for the fourth quarter accomplished management's goal of rebuilding backlog as 2004 ending backlog was approximately 35% higher than ending backlog in 2003. The Company views backlog as an important tool to mitigate forecast risk as it reduces dependency on any one customer transaction.

While the EDA business environment experienced a modest improvement in 2004, the Company's management is not predicting a broad recovery of EDA spending in 2005. The Company will continue its strategy of developing best in class point tools with number one market share potential. This strategy creates a diversified product portfolio for the Company that solves customers' critical design problems. The Company's management believes that this product strategy, in conjunction with a customer diversification strategy, has helped reduce the impact of marketplace fluctuations in the past and should continue to do so in the future.

*License Model Mix*

License model trends can have a material impact on various aspects of the Company's business. See "Critical Accounting Estimates – Revenue Recognition" on pages 12-13 for a description of the types of product licenses sold by the Company. As the mix among perpetual licenses, fixed term licenses (term) with upfront revenue recognition and term licenses with ratable revenue recognition (which includes due and payable revenue recognition) shifts, revenues, earnings, cash flow and days sales outstanding (DSO) are either positively or negatively affected. The year ended December 31, 2004 marked the fourth consecutive year in which, as a percentage of product revenue, term revenue increased while perpetual revenue decreased. This trend was primarily the result of two factors. First, the Company's customers are moving toward the term license model, which provides the customer with greater flexibility for product usage, including the option to share the products between multiple locations and reconfigure consumption at regular intervals from a fixed product list. As such, some of the Company's customers have converted their existing installed base from perpetual to term licenses. Second, the weakness in the United States high-technology economy has disproportionately impacted the Company's smaller customers. Historically these customers have purchased under the perpetual license model.

Under this ongoing shift from perpetual licenses to term licenses with upfront revenue recognition, which the Company's management views as a positive trend, the Company expects no measurable impact to earnings, but a negative impact on cash flow and DSO. As customers move away from perpetual licenses and into term licenses, the renewability and repeatability of the Company's business is increased. This provides opportunity for increased distribution of young products earlier in their lifecycles. While this shift in license models may continue, the rate of movement from perpetual licenses to term licenses is expected to decrease.

*Product Developments*

During 2004, the Company continued to execute its strategy of focusing on new customer problem areas, as well as building upon its well-established product families. The Company's management believes that customers, faced with leading-edge design challenges, choose the best products in each category to build their design environment. Through both internal development and strategic acquisitions, the Company has focused on areas where it believes it can build a number one market position, or extend an existing number one market position.

The Company internally developed and, in 2004, delivered several significant products. These new products include Xtreme PCB (allows simultaneous team design of a single PCB), Constraint Editing System (for PCB), ADMS 4.0 (support for multiple languages and testbenches for analog/digital design), Catapult C (synthesis of pure un-timed C into RTL) and Calibre DFM functionality (first tools to analyze and modify designs for increased manufacturability).

Also in 2004, the Company acquired several new products or technologies. These include Assertion Technology (0-In), Parallel and Serial ATA IP (Palmchip), Unified Modeling Language for high-level design of embedded software (Project Technology), Compiler development tool for embedded software (Atair), and low end cabling tools for wire harness (Vesys).

The Company's management believes that the development and commercialization of EDA software tools is usually a multi-year process with limited customer adoption in the first years of tool availability. Once tools are adopted, however, their life spans tend to be long and healthy. The Company's management believes that the Company's relatively young and diverse product lines are positioned for growth over the long-term.

*2004 Financial Performance*

- Total revenues were $710,956, a 5% increase over 2003, resulting from strength in Scalable Verification and to a lesser extent in New and Emerging Markets. Revenue strength in Scalable Verification was paced by the Analog Mixed Signal and ModelSim product lines, while New and Emerging Markets strength came from the Company's Cabling and Embedded Systems product lines.
- System and software revenues were $422,672, a 7% increase over 2003 system and software revenues of $394,449. Product revenue split by license model was 52% term with upfront revenue recognition, 33% perpetual and 15% term with ratable revenue recognition (which includes due and payable revenue recognition), compared to 2003 product revenue splits of 48% term with upfront revenue recognition, 38% perpetual and 14% term with ratable revenue recognition. Term product revenue with upfront revenue recognition increased 16% to $219,200, as compared to $189,100 in 2003.
- Service and support revenues were $288,284, a 3% increase over 2003 service and support revenues of $281,219, primarily due to the strengthening of certain foreign currencies and the growth in our installed base.
- By geography, year-over-year revenues decreased 7% in the Americas, and increased 6% in Europe, 30% in Japan and 34% in Pacific Rim. The Americas contributed the largest share of revenues at nearly 43%, down from 49% in 2003. Japan and Pacific Rim regions increased their percentage of total revenues to 18% and 10%, respectively, in 2004 as compared to 15% and 8%, respectively, in 2003.
- Net loss for 2004 was $20,550, compared to a net income of $7,933 in 2003. Increased revenues in 2004 were partially offset by increased operating expenses. The resulting increase in income before income taxes was more than offset by a tax expense resulting from the Company's $120 million inter-company dividend declared in 2004.
- Trade accounts receivable, net increased to $242,690 at year-end, up 9% from $223,670 at the end of 2003. Average days sales outstanding increased to 102 days at the end of 2004 from 100 days at the end of 2003.
- Cash generated from operating activities was $40,519 compared to a use of cash in 2003 of $14,631. At year end, cash, cash equivalents and short-term investments were $94,287, up 32% from $71,324 at the end of 2003.

**Critical Accounting Estimates**

The Company's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities and contingencies as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. The Company evaluates its estimates on an on-going basis. The Company bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company believes the following are the critical accounting estimates and judgments used in the preparation of its consolidated financial statements.

*Revenue Recognition*
The Company reports revenue in two categories based upon how the revenue is generated: (i) system and software and (ii) service and support.

System and software revenue - System and software revenues are derived from the sale of licenses of software products and emulation hardware systems.

The Company licenses software using two different license types:

1. Term licenses are for a specified time period, typically three years with payments spread over the license term, and do not provide the customer with the right to use the product after the end of the term. The Company generally recognizes product revenue from term installment license agreements upon shipment and start of the license term. The Company uses these agreements 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. If the Company no longer had a history of collecting without providing concessions on term agreements, then revenue would be required to be recognized as the payments become due and payable over the license term. This change would have a material impact on the Company's near-term results of operations. In a situation in which a risk of concession may exist on a term license agreement, revenue is recognized on a due and payable basis, which is the lesser of the ratable portion of the entire fee or the customer installments as they become due and payable. In a term license agreement where the Company provides the customer with rights to unspecified or unreleased future products, revenue is recognized ratably over the license term.
2. Perpetual licenses provide the customer with the right to use the product in perpetuity and typically do not provide for extended payment terms. The Company recognizes product revenue from perpetual license agreements upon delivery to the customer when the likelihood of product return is remote. If the agreement provides for customer payment terms that are different than the standard payment terms in the customer's jurisdiction, product revenue is recognized as payments become due and payable.

Service and support revenue - Service and support revenues consist of revenues from support contracts and professional services, which include consulting services, training services and other services. The Company records service revenue as the services are provided to the customer. Support revenue is recognized over the support term. For multi-element arrangements that include support, support is allocated based on vendor specific objective evidence (VSOE) of the fair value of support. For term licenses, VSOE is established by the price charged when such support is offered as optional during the license term. For perpetual licenses, VSOE is established by the price charged when such support is sold separately.

The Company determines whether software product revenue recognition is appropriate based upon the evaluation of whether the following four criteria have been met:

1. Persuasive evidence of an arrangement exists – An agreement signed by the customer and the Company.
2. Delivery has occurred – The software has been shipped, the customer is in possession of the software or the software has been made available to the customer through electronic delivery.
3. Fee is fixed or determinable – The amount of the fee and the due date have been fixed at execution of the arrangement without the possibility of future adjustments or concessions.
4. Collectibility is probable – The customer is expected to pay for products or services without the Company providing future concessions to the customer.

*Valuation of Trade Accounts Receivable*

The Company maintains allowances for doubtful accounts on trade accounts receivable and term receivables, long-term for estimated losses resulting from the inability of its customers to make required payments. The Company regularly evaluates the collectibility of its trade accounts receivable based on a combination of factors. When it becomes aware of a specific customer's inability to meet its financial obligations, such as in the case of bankruptcy or deterioration in the customer's operating results or financial position, a specific reserve for bad debt is recorded to reduce the related receivable to the amount believed to be collectible. The Company also records unspecified reserves for bad debt for all other customers based on a variety of factors including length of time the receivables are past due, the financial health of the customers, the current business environment and historical experience. If circumstances related to specific customers change, estimates of the recoverability of receivables would be adjusted resulting in either additional selling expense or a reduction in selling expense in the period such determination was made.

*Valuation of Deferred Tax Assets*

Deferred tax assets are recognized for deductible temporary differences, net operating loss carryforwards and credit carryforwards if it is more likely than not that the tax benefits will be realized. The Company has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for valuation allowances. The Company has recorded a valuation allowance to reduce its deferred tax assets to the amount that is more likely than not to be realized. In the event the Company was to determine that it would be able to realize its deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase either income or contributed capital, or decrease goodwill, in the period such determination was made. Also, if the Company was to determine that it would not be able to realize all or part of its net deferred tax asset in the future, an adjustment to increase the valuation allowance on such net deferred tax assets would be charged to expense or contributed capital in the period such determination was made.

*Income Tax Reserves*
The Company has reserves for taxes to address potential exposures involving tax positions that could be challenged by taxing authorities, even though the Company believes that the positions taken on previously filed tax returns are appropriate. The tax reserves are reviewed as circumstances warrant and adjusted as events occur that affect the Company's potential liability for additional taxes. The Company is subject to income taxes in the United States and in numerous foreign jurisdictions and in the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain.

*Goodwill, Intangible Assets and Long-Lived Assets*
The Company reviews long-lived assets and the related intangible assets for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. Recoverability of an asset is determined by comparing its carrying amount, including any associated intangible assets, to the forecasted undiscounted net cash flows of the operation to which the asset relates. If the operation is determined to be unable to recover the carrying amount of its assets, then intangible assets are written down first, followed by the other long-lived assets of the operation, to fair value. Fair value is determined based on discounted cash flows or appraised values, depending upon the nature of the assets. Goodwill and intangible assets with indefinite lives are tested for impairment annually and whenever there is an impairment indicator using a fair value approach. In the event that, in the future, it is determined that the Company's goodwill, intangible or other long-lived assets have been impaired, an adjustment would be made that would result in a charge for the write-down in the period that determination was made.

*Inventory*
The Company purchases and commits to purchase inventory based upon forecasted shipments of its emulation hardware systems. The Company evaluates, on a quarterly basis, the need for inventory reserves based on projections of systems expected to ship within six months. Reserves for excess and obsolete inventory are established to account for the differences between forecasted shipments and the amount of purchased and committed inventory. The Company also has emulation hardware system demonstration and loan equipment at customer locations in anticipation of securing sales. The cost of the emulation hardware system demonstration and loan equipment is amortized to selling expense over the lesser of the loan period or six months.

*Restructuring Charges*
The Company has recorded restructuring charges in connection with its plans to better align the cost structure with projected operations in the future. Effective January 1, 2003, in accordance with Statement of Financial Accounting Standards (SFAS) No. 146, "Accounting for Costs Associated with Exit or Disposal Activities," the Company records liabilities for costs associated with exit or disposal activities when the liability is incurred. Prior to January 1, 2003, in accordance with Emerging Issues Task Force (EITF) No. 94-3, the Company accrued for restructuring costs when management made a commitment to an exit plan that specifically identified all significant actions to be taken.

The Company has recorded restructuring charges in connection with employee rebalances based on estimates of the expected costs associated with severance benefits. If the actual cost incurred exceeds the estimated cost, additional special charges will be recognized. If the actual cost is less than the estimated cost, a benefit to special charges will be recognized.

The Company has also recorded restructuring charges in connection with excess leased facilities to offset future rent, net of estimated sublease income that could be reasonably obtained, of the abandoned office space and to write-off leasehold improvements on abandoned office space. The Company worked with external real estate experts in each of the markets where properties are located to obtain assumptions used to determine the best estimate of the net loss. The Company's estimates of expected sublease income could change based on factors that affect the Company's ability to sublease those facilities such as general economic conditions and the real estate market. If the real estate markets worsen and the Company is not able to sublease the properties as expected, additional adjustments may be required, which would result in additional special charges in the period such determination was made. Likewise, if the real estate market strengthens and the Company is able to sublease the properties earlier or at more favorable rates than projected, a benefit to special charges will be recognized.

**Recent Acquisitions**

During 2004, the Company acquired 0-In Design Automation Inc. (0-In), a provider of electronic design automation tools for integrated circuit and system-on-chip designs. The acquisition was an investment aimed at expanding the Company's product offering and increasing revenue growth which supported the premium paid over the fair market value of the individual assets. The outstanding shares of common stock and preferred stock of 0-In were converted into approximately 4,507 shares of the Company's common stock, of which approximately 541 shares have been deposited in an indemnity escrow account. The shares were valued at the closing price of $11.00 per share as reported on The NASDAQ Stock Market on September 1, 2004. 0-In stockholders and certain employees will receive future contingent earn-out payments based on the Company's revenues derived from 0-In products and technologies. The total purchase price including acquisition costs was $52,319. The Company recorded severance costs related to 0-In employees of $105 due to the overlap of employee skill sets as a result of the acquisition. In addition, the Company recorded costs for termination of a distributor contract of $282. The excess of tangible assets acquired over liabilities assumed was $1,001. The cost of the acquisition was allocated on the basis of the estimated fair value of assets and liabilities assumed. The purchase accounting allocations resulted in a charge for in-process research and development (R&D) of $6,400, goodwill of $39,071, technology of $4,400, other identified intangible assets of $5,990, net of related deferred tax liability of $4,156. The technology is being amortized to cost of revenues over three years. The other identified intangible assets are being amortized to operating expenses over two to five years.

Additionally, during the 2004, the Company acquired (i) Project Technology Inc., (ii) the remaining 49% ownership interest of its Korean distributor, Mentor Korea Co. Ltd. (MGK) for a total ownership interest of 100%, (iii) the parallel and serial ATA IP business division of Palmchip Corporation (Palmchip) and (iv) VeSys Limited. The acquisitions were investments aimed at expanding the Company's product offerings and increasing revenue growth. The aggregate purchase price including acquisition costs for these four acquisitions was $8,791. The aggregate excess of liabilities assumed over tangible assets acquired was $349. The minority interest recorded in connection with the original 51% ownership in MGK was $3,383, less dividends paid in prior years to minority shareholders of $1,975, reducing the acquisition cost to be allocated by a total of $1,408. The purchase accounting allocations resulted in a charge for in-process R&D of $1,300, goodwill of $4,022, technology of $1,510 and other identified intangible assets of $980, net of related deferred tax liability of $80. The technology is being amortized to cost of revenues over two to three years. The other identified intangible assets are being amortized to operating expenses over three years. In connection with the Palmchip acquisition, the Company concurrently licensed software to Palmchip under term licenses and entered into an agreement to provide services. Payment for these arrangements was incorporated into the purchase price of the acquisition and resulted in a reduction of cash paid to Palmchip of $1,208.

The Company used an independent third party valuation firm to assist management in determining the allocation of the purchase price of these acquisitions.

**Results of Operations**

*Revenues and Gross Margins*

| **Year ended December 31,** | **2004** | **Change** | **2003** | **Change** | **2002** |
|---|---|---|---|---|---|
| System and software revenues | $ 422,672 | 7% | $ 394,449 | 23% | $ 321,994 |
| System and software gross margins | $ 395,409 | 9% | $ 362,306 | 26% | $ 287,641 |
| Gross margin percent | 94% | | 92% | | 89% |
| Service and support revenues | $ 288,284 | 3% | $ 281,219 | 3% | $ 274,185 |
| Service and support gross margins | $ 207,990 | 6% | $ 196,665 | 3% | $ 191,354 |
| Gross margin percent | 72% | | 70% | | 70% |
| Total revenues | $ 710,956 | 5% | $ 675,668 | 13% | $ 596,179 |
| Total gross margins | $ 603,399 | 8% | $ 558,971 | 17% | $ 478,995 |
| Gross margin percent | 85% | | 83% | | 80% |

*System and Software*

System and software revenues are derived from the sale of licenses of software products and emulation hardware systems. System and software revenues were higher for 2004 compared to 2003 due to an increase in Scalable Verification product revenues primarily attributable to the ModelSim and Analog/Mixed Signal product lines as a result of major customer deal renewals and customers expanding their usage of the products within their organizations. The increase was partially offset by (i) a decrease in Design to Silicon revenues primarily attributable to the Physical Verification and Analysis product lines as a result of record revenue performance in 2003 combined with strong backlog growth in the Calibre product line in the fourth quarter of 2004, and (ii) a decrease in emulation product revenues. In addition, system and software revenues were favorably impacted by approximately 2% due to the strengthening of the Japanese yen, the Euro and the British pound sterling in 2004.

System and software revenues were higher for 2003 compared to 2002 primarily due to (i) an increase in the Design to Silicon product revenues attributable to strength in the Calibre product line as a result of customers expanding their usage of the product within their organizations, and (ii) continued strength in systems design product revenues attributable to demand for new board design software, particularly from military and aerospace customers, and acquisitions in 2002. In addition, system and software revenues were favorably impacted by approximately 1% due to the strengthening of the Japanese yen, the Euro and the British pound sterling in 2003.

During 2004, system and software bookings exceeded system and software revenues only for the three months ended December 31, 2004. Accordingly, the Company's backlog of firm orders increased from $61,000 at December 31, 2003 and $45,000 at September 30, 2004 to $82,500 at December 31, 2004.

System and software gross margins were higher for 2004 compared to 2003 primarily due to a greater mix of higher margin software product revenue versus lower margin emulation hardware system revenue in addition to a reduction in the amount of royalties paid on increased software product revenues.

System and software gross margins were higher for 2003 compared to 2002 primarily due to a $5,731 write-down of emulation hardware systems inventory in 2002 compared to write-downs of $2,703 in 2003. These reserves reduce inventory to the amount that is expected to ship within six months on the assumption that any excess would be obsolete. Gross margin was also impacted by an increase in amortization of purchased technology to cost of revenues attributable to a full year of amortization related to three acquisitions in 2002 and a partial year of amortization related to four acquisitions in 2003.

Amortization of purchased technology costs to system and software cost of revenues was $10,624, $9,422 and $6,688 for 2004, 2003 and 2002, respectively. The increase in amortization in 2004 was primarily attributable to a full year of amortization related to four technology acquisitions during 2003 and a partial year of amortization related to nine technology acquisitions in 2004. During 2004, the Company acquired technology as part of four of the Company's five business acquisitions, and also acquired technology totaling $3.634 in five technology purchases that did not include other business assets. The increase in amortization in 2003 was primarily attributable to the recognition of a full year of amortization related to three technology acquisitions during 2002. Purchased technology costs are amortized over two to five years to system and software cost of revenues. Exclusive of future acquisitions, amortization of purchased technology will increase slightly in 2005 primarily as a result of a full year of amortization on purchased technology related to nine technology acquisitions during 2004 offset by the complete amortization of purchased technology related to a prior year technology acquisition.

*Service and Support*

Service and support revenues consist of revenues from support contracts and professional services, which include consulting services, training services and other services. Service and support revenues were favorably impacted by approximately 2% due to the strengthening of foreign currencies in 2004.

Service and support revenues increased for 2003 compared to 2002 primarily due to growth in physical verification and analysis support revenue and strength in systems design software support revenue. The 3% increase in service and support revenues, 2% of which was attributable to a weaker United States dollar, was not as significant as the corresponding 23% increase in the system and software revenues due to a greater allocation of available funds to the Company's products, instead of support, by the Company's customers due to the continued weakness in the economy.

Professional service revenues totaled approximately $28,000, $25,000 and $25,000 in 2004, 2003 and 2002, respectively. Professional service revenues increased in 2004 primarily due to the strengthening of foreign currencies. Professional service revenues remained flat in 2003 as a result of the continued weakness in the economy.

Service and support gross margins increased in 2004 primarily due to higher revenue resulting from the strengthening of foreign currencies and lower costs resulting from headcount reductions. Service and support gross margins remained flat as a percentage for 2003 compared to 2002, including a 1% increase attributable to a weaker United States dollar.

*Geographic Revenues Information*

| **Year ended December 31,** | **2004** | **Change** | **2003** | **Change** | **2002** |
|---|---|---|---|---|---|
| Americas | $ 306,911 | (7%) | $ 331,307 | 8% | $ 305,542 |
| Europe | $ 199,417 | 6% | $ 188,657 | 20% | $ 157,679 |
| Japan | $ 131,107 | 30% | $ 100,737 | 23% | $ 81,757 |
| Pacific Rim | $ 73,521 | 34% | $ 54,967 | 7% | $ 51,201 |
| Total | $ 710,956 | | $ 675,668 | | $ 596,179 |

Revenues decreased in the Americas in 2004 primarily as a result of lower software product and emulation hardware system sales in addition to declines in software and emulation support revenues. Revenues increased in the Americas in 2003 primarily as a result of higher software product sales, partially offset by declines in both software support and consulting revenues. Revenues outside the Americas represented 57%, 51% and 49% of total revenues in 2004, 2003 and 2002, respectively. Most large European revenue contracts are denominated and paid to the Company in the United States dollar. The effects of exchange rate differences from the European currencies to the United States dollar positively impacted European revenues by approximately 2% in 2004 and 2003. Exclusive of currency effects, higher revenues in Europe for 2004 were primarily a result of higher software product and support sales partially offset by lower emulation hardware system sales. Higher European revenues in 2003 were primarily a result of higher software product and emulation hardware system sales and an increase in service revenue. The effects of exchange rate differences from the Japanese yen to the United States dollar positively impacted Japanese revenues by approximately 6% in 2004 and 7% in 2003. Exclusive of currency effects, higher revenues in Japan for 2004 were primarily a result of higher software product and support sales partially offset by lower emulation hardware system sales. Higher Japanese revenues in 2003 were primarily a result of higher software product and emulation hardware system sales and an increase in service revenue. Revenues increased in Pacific Rim in 2004 primarily as a result of higher software product and support sales while the increase in 2003 was primarily a result of higher software product and support sales partially offset by lower emulation hardware system sales. Since the Company generates approximately half of its revenues outside of the United States and expects this to continue in the future, revenue results may be impacted by the effects of future foreign currency fluctuations.

*Operating Expenses*

| Year ended December 31, | | 2004 | Change | | 2003 | Change | | 2002 |
|---|---|---|---|---|---|---|---|---|
| Research and development | $ | 202,289 | 9% | $ | 184,797 | 13% | $ | 164,228 |
| Marketing and selling | $ | 267,181 | 9% | $ | 245,170 | 12% | $ | 218,963 |
| General and administration | $ | 74,255 | (2%) | $ | 75,984 | 5% | $ | 72,491 |
| Amortization of intangible assets | $ | 3,586 | (8%) | $ | 3,883 | 72% | $ | 2,255 |
| Emulation litigation settlement | $ | -- | (100%) | $ | 20,264 | -- | $ | -- |
| Special charges | $ | 9,213 | (35%) | $ | 14,120 | 128% | $ | 6,184 |
| Merger and acquisition related charges | $ | 7,700 | 314% | $ | 1,860 | (94)% | $ | 28,700 |

*Research and Development*

For 2004 compared to 2003, the increase in R&D costs was primarily attributable to increased headcount, primarily in the systems design and embedded system product lines and due to a weaker United States dollar during 2004, which increased R&D expenses by approximately 2% in 2004. For 2003 compared to 2002, the increase in R&D costs was primarily attributable to acquisitions in the first half of 2002, resulting in higher R&D headcount and related costs, including an increase in variable compensation primarily due to performance above plan related to the Calibre product line, and due to a weaker United States dollar during 2003 that increased R&D expenses by approximately 2% in 2003.

*Marketing and Selling*

For 2004 compared to 2003, the increase in marketing and selling costs was primarily attributable to increased headcount and a weaker United States dollar during 2004, which increased marketing and selling expenses by approximately 3% in 2004. For 2003 compared to 2002, the increase in marketing and selling costs was primarily attributable to an increase in variable compensation due to higher revenues and due to a weaker United States dollar during 2003 that increased marketing and selling expenses by approximately 3% in 2003.

*General and Administration*

For 2004 compared to 2003, the decrease in general and administration costs was primarily attributable to no emulation litigation related costs in 2004 due to the settlement of the emulation litigation with Cadence Design Systems, Inc. in 2003 and due to a decrease in variable compensation. These decreases were partially offset by a weaker United States dollar during 2004 which increased general and administration expenses by 4%. For 2003 compared to 2002, the increase in general and administration costs was primarily attributable to an increase in variable compensation due to growth in operating income and due to a weaker United States dollar during 2003 that increased general and administration expenses by approximately 2% in 2003. These increases were partially offset by a decrease in emulation litigation expenses as a result of the settlement of this litigation during 2003.

*Amortization of Intangible Assets*

Amortization of intangible assets decreased from 2003 to 2004 and increased from 2002 to 2003. For 2004 compared to 2003, the decrease was primarily attributable to the complete amortization of certain intangible assets acquired through acquisitions in 2002. For 2003 compared to 2002, the increase was primarily attributable to the recognition of a full year of amortization related to three acquisitions during 2002. Exclusive of future acquisitions, amortization of intangible assets is expected to decrease slightly in 2005 primarily as a result of the complete amortization of certain intangible assets acquired through acquisitions in 2002 partially offset by a full year of amortization for intangible assets acquired in 2004.

*Emulation Litigation Settlement*

Cadence Design Systems, Inc. (Cadence) and the Company announced in September 2003 that they had agreed to settle all outstanding litigation between the companies relating to emulation and acceleration systems. The companies also reached agreement that, for a period of seven years, neither will sue the other over patented emulation and acceleration technology. In connection with the settlement, the Company recorded emulation litigation settlement costs of $20,264, which included a cash settlement of $18,000 paid to Cadence, costs to make available certain of its products to the OpenAccess computing environment as specified in the settlement agreement and attorneys' fees.

*Special Charges*

During 2004, the Company recorded special charges of $9,213. The charges primarily consist of costs incurred for employee terminations and excess leased facility costs.

The Company rebalanced the workforce by 118 employees during 2004. This reduction primarily impacted the sales and research and development organizations. Employee severance costs of $5,655 included severance benefits, notice pay and outplacement services. The total rebalance charge represents the aggregate of numerous unrelated rebalance plans, none of which was individually material to the Company's financial position or results of operations. Termination benefits were communicated to the affected employees prior to year-end. The majority of these costs will be expended in the first half of 2005. There have been no significant modifications to the amount of these charges.

Excess leased facility costs of $1,946 in 2004 include $1,229 in adjustments to previously recorded non-cancelable lease payments primarily for the lease of one facility in North America. These adjustments are primarily a result of reductions to the estimated expected sublease income due to the real estate markets remaining at depressed levels longer than originally anticipated. Non-cancelable lease payments on these excess leased facilities will be expended over six years. The Company also recorded a $758 write-off of leasehold improvements for a facility lease in North America that was permanently abandoned. In addition, the Company reversed $41 related to the decision to utilize space that was previously abandoned for the lease of one facility in North America.

The Company acquired a defined benefit pension plan liability (Plan) in connection with an acquisition in 1999. The Company made the Plan dormant immediately after the acquisition, and then began the process to sever any ongoing obligation to the Plan. During this process, in 2004, a legally-mandated actuarial evaluation was performed which indicated that the Plan needed additional funding related to services rendered prior to the acquisition for which the Company received no benefit. The Company recorded special charges of $1,237 in 2004 when this liability was determined.

Other costs of $590 include costs incurred to restructure the organization other than employee rebalances and excess leased facility costs.

In addition, the Company reversed $215 of the remaining accrual related to the emulation litigation with Cadence Design Systems, Inc.

During 2003, the Company recorded special charges of $14,120. The charges primarily consist of costs incurred for excess leased facility costs and employee terminations.

Excess leased facility costs of $10,034 in 2003 consist of $4,925 in non-cancelable lease payments primarily for three facilities in North America. These facilities were permanently abandoned and the payments are net of estimated sublease income. Non-cancelable lease payments on these excess leased facilities will be expended over seven years. In addition, the Company recorded $4,608 in adjustments to previously recorded non-cancelable lease payments primarily for the leases of two facilities in North America. These adjustments are a result of reductions to the estimated expected sublease income primarily due to the real estate markets remaining at depressed levels longer than originally anticipated. Non-cancelable lease payments on these excess leased facilities will be expended over seven years. In addition, the Company recorded a $501 write-off of leasehold improvements for facility leases in Europe and in North America that were permanently abandoned.

The Company rebalanced the workforce by 126 employees during 2003. This reduction primarily impacted the sales and research and development organizations. Employee severance costs of $4,000 included severance benefits, notice pay and outplacement services. Termination benefits were communicated to the affected employees prior to year-end. These costs were expended in 2004. There were no significant modifications to the amount of these charges.

During 2002, the Company recorded special charges of $6,184. The charges primarily consist of costs incurred for employee terminations, partially offset by a net benefit from reduction of accrued excess leased facility costs. Additionally, a $515 benefit for the reversal of excess accruals related to acquisitions that occurred in prior years was included in special charges.

In addition to acquisition related terminations of 176, the Company rebalanced the workforce by 332 employees during 2002. This reduction primarily impacted the sales organization, research and development organization and, to a lesser extent, the consulting division. Employee severance costs of $12,023 included severance benefits, notice pay and outplacement services. Termination benefits were communicated to the affected employees prior to year-end. These costs were expended in 2002 and 2003. There were no significant modifications to the amount of these charges.

The Company recorded excess leased facility costs for leases of facilities in North America and Europe in the fourth quarter of 2001 based on the presumption that such facilities would be permanently abandoned. During 2002, the Company determined that a facility in North America was to be re-occupied as a result of requirements following acquisitions in 2002. At that time, the remaining accrual for $5,855 was reversed. In addition, the Company reduced its accrual for lease termination fees by $777 as a result of changes in assumptions regarding lease payments for an abandoned facility in Europe. In 2002, the Company also recorded $1,223 related to non-cancelable lease payments, net of sublease income, and a $299 write-off of assets and leasehold improvements for leases of facilities in North America, Europe and Japan that the Company had committed to permanently abandon in 2003. The majority of the non-cancelable lease payments on these excess leased facilities were expended during 2003.

During 2002, the Company recorded a benefit to special charges of $2,066 as a result of a reversal of a hold-back liability recorded as a part of the acquisition of the ECAD division of CADIX Incorporated in 2000. Cadix Incorporated relinquished its right to the hold-back amount in exchange for the Company's withdrawal of its filing of damage claims. In an unrelated matter, this benefit was partially offset by the Company's payment of $1,500 related to the settlement of disputed royalties. These settlements resulted in a net benefit to special charges of $566.

*Merger and Acquisition Related Charges*

In 2004, the Company incurred merger and acquisition related charges of $7,700 for in-process R&D related to five acquisitions during the year. In 2003, the Company incurred merger and acquisition related charges of $1,710 for in-process R&D related to three acquisitions during the year. In addition, during 2003, the Company recorded a one-time charge to operations of $150 for the acquisition of the in-process R&D of New Design Paradigm, Limited, a developer and marketer of engineering-design software systems for the automotive and aerospace industries. In 2002, the Company incurred merger and acquisition related charges of $28,700 for in-process R&D related to three acquisitions during the year.

The Company uses an independent third party valuation firm to assist management in determining the value of the in-process R&D acquired in its business acquisitions. The value assigned to in-process R&D for the charges incurred in 2002, 2003 and 2004 related to research projects for which technological feasibility had not been established. The value was determined by estimating the net cash flows from the sale of products resulting from the completion of such projects and discounting the net cash flows back to their present value. The rate used to discount the net cash flows was based on the weighted average cost of capital. Other factors considered were the inherent uncertainties in future revenue estimates from technology investments including the uncertainty surrounding the successful development of the acquired in-process technology, the useful life of the technology, the profitability levels of the technology and the stage of completion of the technology. The stage of completion of the products at the date of the acquisition were estimated based on R&D costs that had been expended as of the date of acquisition as compared to total R&D costs expected at completion. The percentages derived from this calculation were then applied to the net present value of future cash flows to determine the in-process charge. The nature of the efforts to develop the in-process technology into commercially viable products principally related to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the product can be produced to meet its design specification, including function, features and technical performance requirements. The estimated net cash flows from these products were based on estimates of related revenues, cost of sales, R&D costs, selling, general and administrative costs and income taxes. These estimates are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur or that the Company will realize any anticipated benefits of the acquisition. The risks associated with acquired R&D are considered high and no assurance can be made that these products will generate any benefit or meet market expectations.

The in-process R&D charge related to the 0-In acquisition was $6,400. At the date of the 0-In acquisition, the R&D efforts were focused on the development of the Archer v3.0 product. For purposes of valuing the in-process R&D in accordance with the methodology discussed above, the following estimates were used: revenue growth ranging from 107% beginning in year two to a revenue decline of 100% in year six; cost of revenues of approximately 5% of revenue in each year; selling, general and administrative expenses of approximately 45% of revenue in each year and maintenance ranging from 8% of revenue beginning in year two to 5% of revenue in year five. The rate used to discount the net cash flows from the purchased in-process technology was 30%.

The aggregate in-process R&D charge related to the 2004 acquisitions of (i) Project Technology Inc., (ii) the remaining 49% ownership interest of its Korean distributor, Mentor Korea Co. Ltd. (MGK) for a total ownership interest of 100%, (iii) the parallel and serial ATA IP business division of Palmchip Corporation (Palmchip) and (iv) VeSys Limited was $1,300. The R&D efforts of the acquired companies at the time of acquisition were focused on the development of various products.

The aggregate in-process R&D charge related to the 2003 acquisitions was $1,710. The R&D efforts of the acquired companies at the time of acquisition were focused on the development of various products.

The in-process R&D charge related to the 2002 ATI acquisition was $4,000. At the date of the ATI acquisition, the R&D efforts were focused on the development of the Nucleus and code|lab products. The in-process R&D charge related to each of those projects was $1,500 and $2,500, respectively. For purposes of valuing the in-process R&D in accordance with the methodology discussed above, the following estimates were used: revenue growth ranging from 414% beginning in year two to a revenue decline of 51% in year eight; cost of revenues of approximately 15% of revenue in each year; selling, general and administrative expenses ranging from 49% of revenue in year one to 35% of revenue in year eight and maintenance of 5% of revenue in each year. The rate used to discount the net cash flows from the purchased in-process technology was 35%.

The in-process R&D charge related to the 2002 IKOS acquisition was $12,000. At the date of the IKOS acquisition, the R&D efforts were focused on the development of the next generation Vstation product, including the additional functionalities of a co-modeling tool, more capacity and an FPGA compiler. For purposes of valuing the in-process R&D in accordance with the methodology discussed above, the following estimates were used: revenue growth ranging from 194% beginning in year two to 30% in year six; cost of revenues of 20% of revenue in each year; selling, general and administrative expenses ranging from 50% of revenue in year one to 35% of revenue in year six and maintenance of 5% of revenue in each year. The rate used to discount the net cash flows from the purchased in-process technology was 30%.

The in-process R&D charge related to the 2002 Innoveda acquisition was $12,700. At the date of the Innoveda acquisition, the R&D efforts were focused on the development of the following products: Integrated PCB, QUIET™ Expert and TransDesign v1.4. The in-process R&D charge related to each of those projects was $11,600, $300 and $800, respectively. For purposes of valuing the in-process R&D in accordance with the methodology discussed above, the following estimates were used: revenue growth ranging from 528% for certain products beginning in year two to a revenue decline of 48% in year six; cost of revenues of 18% of revenue in each year; selling, general and administrative expenses of 30% of revenue in each year and maintenance ranging from 2% to 7% of revenue in each year. The rate used to discount the net cash flows from the purchased in-process technology was 35% for Integrated PCB and 50% for QUIET Expert and TransDesign v1.4.

*Other Income, Net*

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Other income, net | $ 8,388 | $ 5,460 | $ 6,905 |

Interest income was $8,159, $5,679 and $6,653 in 2004, 2003 and 2002, respectively, which includes income relating to the time value of foreign currency contracts of $1,116, $480 and $1,020 in 2004, 2003 and 2002, respectively. Foreign currency loss was $499, $1,481 and $199 in 2004, 2003 and 2002, respectively, due to fluctuations in currency rates. Minority interest expense was $7, $281 and $703 in 2004, 2003 and 2002, respectively. In addition, other income, net was favorably impacted by gain on sale of investments of $1,403, $2,390 and $2,438 in 2004, 2003 and 2002, respectively.

*Interest Expense*

Interest expense was $18,619, $17,224 and $11,696 in 2004, 2003 and 2002, respectively. Interest expense increased in 2003 primarily as a result of the issuance of the Company's convertible subordinated notes and debentures in June 2002 and August 2003, respectively. The Company recorded interest expense relating to the time value of foreign currency contracts of $512, $669 and $551 in 2004, 2003 and 2002, respectively.

*Provision for Income Taxes*

The provision for income taxes was an expense of $49,494 in 2004 and a benefit of $6,804 and $4,303 in 2003 and 2002, respectively. In 2004, the Company's book net income before income taxes of $28,944 consisted of $10,203 of pre-tax loss in the United States and $39,147 of foreign pre-tax income. The income tax expense of $49,494 in 2004 was primarily the result of the mix of profits (losses) earned by the Company and its subsidiaries in tax jurisdictions with a broad range of income tax rates and the tax effect of a large intercompany dividend. Deferred tax assets consist of net operating loss carryforwards in several tax jurisdictions, including the United States, credit carryovers and timing differences between book and tax income. A valuation allowance is recorded when it is more likely than not that some portion of the deferred tax assets will not be realized.

The provision for income taxes for the year differs from tax computed at the federal statutory income tax rate primarily due to the impact of a large dividend declared by a foreign subsidiary, an increase in the valuation allowance on United States deferred tax assets, the impact of state taxes and the amortization of a deferred tax charge recorded in 2002, offset in part by the impact of the tax rate differential on earnings of foreign subsidiaries. Tax expense of $36,650, net of associated foreign tax credits, was provided on the declaration of a $120,000 dividend from a foreign subsidiary in 2004 for which provisions of the American Jobs Creation Act of 2004 do not apply. Because the Company had sufficient net operating loss and tax credit carryforwards to offset the tax liability for tax return purposes, the Company incurred a federal cash tax liability of approximately $2,200 for alternative minimum tax and a state cash tax liability of approximately $200 as a result of the dividend.

The Company provides for United States income taxes on the earnings of foreign subsidiaries unless they are considered permanently invested outside of the United States. At December 31, 2004, the cumulative amount of earnings upon which United States income taxes have not been provided is approximately $140,854. Upon repatriation, some of these earnings would generate foreign tax credits, which may reduce the federal tax liability associated with any future foreign dividend.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (the "Act"). The Act creates a temporary incentive for United States corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. The deduction is subject to a number of limitations and uncertainty remains as to how to interpret numerous provisions in the Act. In December 2004, the FASB issued FASB Staff Position (FSP) No. 109-2, *Accounting and Disclosure Guidance for the foreign Repatriation within the American Jobs Creation Act of 2004 (FSP 109-2).* FSP 109-2 provides guidance for recording the potential impact of the repatriation provisions of the Act on an entity's income tax expense and deferred tax liability. The Company is not yet in a position to decide on whether, and to what extent, it might repatriate foreign earnings that have not yet been remitted to the United States. Based on the analysis to date, it is reasonably possible that the Company may repatriate some amount between zero to $140,854. Accordingly, the Company has not adjusted its tax expense or deferred tax liability to reflect the repatriation provisions of the Act as the tax effects cannot be reasonably estimated. The Company expects to be in a position to finalize its assessment by the end of 2005.

As of December 31, 2004, the Company, for federal income tax purposes, had net operating loss carryforwards of approximately $31,430, foreign tax credits of $2,539, research and experimentation credit carryforwards of $11,762, alternative minimum tax credits of $3,711 and child care credits of $300. As of December 31, 2004, the Company, for state income tax purposes, had net operating loss carryforwards totaling $98,218 from multiple jurisdictions and research and experimentation and other miscellaneous state credits of $3,351. As of December 31, 2004, the Company also had net operating losses in multiple foreign jurisdictions of $15,161. If not used by the Company to reduce income taxes payable in future periods, net operating loss carryforwards will expire between 2006 and 2023, the foreign tax credits will expire between 2009 and 2014, research and experimentation credit carryforwards between 2009 and 2024 and child care credits between 2023 and 2024. The alternative minimum tax credits do not expire.

In 2002, the Company transferred certain technology rights acquired in the ATI, IKOS and Innoveda acquisitions to one of its wholly owned foreign subsidiaries in a transaction that was projected to generate approximately $110,000 of taxable gain for federal and state income tax purposes over the next three years, with approximately $65,000 recognized in 2002. Due to the intercompany nature of the transfer, the associated income tax expense was to be recorded over a three-year period, and $6,783 of expense was recorded in 2002. The remaining federal and state income tax expense of $25,463 was recorded as a deferred tax charge included in other assets to be amortized to the book provision for income taxes over the remaining years. The recognition of a taxable gain in the United States allowed the Company to utilize domestic deferred tax assets for which a valuation allowance had previously been taken. Accordingly, primarily as a result of the intercompany sale, the valuation allowance for deferred tax assets decreased by $22,223 in 2002, with $20,831 of the related benefit being applied directly to contributed capital as a tax benefit of stock option exercises.

In 2003, the Company reduced the amount payable by its foreign subsidiary for the transfer of IKOS technology rights by approximately $45,000. This was due to declining emulation revenue primarily attributable to lower prices paid by customers as a result of intense competition and the weakened economy. As a result of the corresponding decrease in the projected taxable gain, the deferred tax charge recorded in 2002 for this transaction was reduced by $17,940. The decrease in projected income tax expense from this transaction resulted in the restoration of $13,900 of deferred tax assets that were not utilized under the revised transaction. The amortization of deferred tax charge for 2003 and 2004 was $3,060. The remaining balance of the deferred tax charge as of December 31, 2004 was $1,403.

Under SFAS No. 109, "Accounting for Income Taxes", deferred tax assets and liabilities are determined based on differences between financial reporting and tax basis of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. SFAS No. 109 provides for the recognition of deferred tax assets without a valuation allowance if realization of such assets is more likely than not. Based on the weight of available evidence, the Company has provided a valuation allowance against certain deferred tax assets. A portion of the valuation allowance for deferred tax assets relates to the difference between financial and tax reporting of employee stock option exercises, for which subsequently recognized tax benefits will be applied directly to increase contributed capital. A portion of the valuation allowance for deferred tax assets relates to certain of the tax attributes acquired from IKOS and 0-In, for which subsequently recognized tax benefits will be applied directly to reduce goodwill. The remainder of the valuation allowance was based on the historical earnings patterns within individual taxing jurisdictions that make it uncertain that the Company will have sufficient income in the appropriate jurisdictions to realize the full value of the assets. The Company will continue to evaluate the realizability of the deferred tax assets on a quarterly basis.

The Company had net deferred tax assets of $31,125 at December 31, 2004, a decrease of $47,683 from December 31, 2003. This decrease was a result of current year utilization of deferred tax assets in connection with the $120,000 dividend from a foreign subsidiary, the recording of deferred tax liabilities identified in the purchase accounting for the 0-In acquisition with a corresponding increase to goodwill and the utilization of deferred tax assets from the settlement of an examination with the Internal Revenue Service for the Company's United States federal income tax returns for the years 2000 and 2001. Also during 2004, the Company determined it is uncertain whether the Company's United States entities will generate sufficient taxable income and foreign source income to utilize foreign tax credit carryforwards, research and experimentation credit carryforwards and net operating loss carryforwards before expiration. Accordingly, the Company recorded valuation allowances against the portion of those deferred tax assets for which realization is uncertain, resulting in a $20,531 net increase in valuation allowances and a corresponding decrease in net deferred tax assets.

The Company has reserves for taxes to address potential exposures involving tax positions that could be challenged by taxing authorities, even though the Company believes that the positions taken on previously filed tax returns are appropriate. The tax reserves are reviewed as circumstances warrant and adjusted as events occur that affect the Company's potential liability for additional taxes. The Company is subject to income taxes in the United States and in numerous foreign jurisdictions and in the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain.

During 2004, the Company settled an examination with the Internal Revenue Service for its United States federal income tax returns for the years 2000 and 2001. The results of this exam have been reflected in the deferred tax asset balances and taxes payable balances as of December 31, 2004. There was no impact on tax expense because, as a result of audit findings, an additional assessment of tax liability for the audit period had been adequately provided for in previous periods. See "Factors That May Affect Future Results and Financial Condition" below. In addition, the Company is currently under examination by the IRS for its 2002 and 2003 federal income tax returns. While it is often difficult to predict the final outcome or the timing of resolution of any particular tax matter, the Company believes the tax reserves are adequate to cover any potential liabilities that could result from the current examinations.

*Effects of Foreign Currency Fluctuations*

More than half of the Company's revenues and approximately one-fourth of its expenses were generated outside of the United States in 2004. For 2004 and 2003, approximately one-fourth of European and all Japanese revenues were subject to exchange rate fluctuations as they were recorded in local currencies. Most large European revenue contracts are denominated and paid to the Company in the United States dollar while the Company's European expenses, including substantial research and development operations, are paid in local currencies causing a short position in the Euro and the British pound sterling. In addition, the Company experiences greater inflows than outflows of Japanese yen as substantially all Japanese-based customers contract and pay the Company in local currency. While these exposures are aggregated on a consolidated basis to take advantage of natural offsets, substantial exposure remains. For exposures that are not offset, the Company enters into short-term foreign currency forward and option contracts to partially offset these anticipated exposures. The option contracts are generally entered into at contract strike rates that are different than current market rates. As a result, any unfavorable currency movements below the strike rates will not be offset by the foreign currency option contract and could negatively affect operating results. These contracts address anticipated future cash flows for periods up to one year and do not hedge 100% of the potential exposures related to these currencies. As a result, the effects of currency fluctuations could have a substantial effect on the Company's overall results of operations.

Foreign currency translation adjustment, a component of accumulated other comprehensive income reported in the stockholders' equity section of the consolidated balance sheets, increased to \$30,762 at December 31, 2004 from \$25,922 at December 31, 2003. This reflects the increase in the value of net assets denominated in foreign currencies since year-end 2003 as a result of a weaker United States dollar at the close of 2004 versus 2003.

*New Accounting Pronouncements*

In October 2004, the EITF ratified its consensus on EITF No. 04-08, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share". EITF No. 04-08 requires that contingently convertible debt instruments that become convertible on satisfaction of a market price condition be included in diluted earnings per share using the if-converted method, regardless of whether the market price condition has been met. The EITF is effective for reporting periods ending after December 15, 2004 and requires the retroactive restatement of earnings per share. Under the provisions of EITF No. 04-08, the Company's Debentures, which represent 4,700 potential shares of common stock, will be included in the calculation of diluted earnings per share, if dilutive, regardless of whether the contingent requirements have been met for conversion to common stock. The Company adopted EITF No. 04-08 in the fourth quarter of 2004. There was no impact on the Company's diluted earnings per share or earnings per share as stated in prior periods.

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4". SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material and requires that such items be recognized as current-period charges. Additionally, SFAS No. 151 requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. Unallocated overheads must be recognized as an expense in the period incurred. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 is not expected to have a material impact on the Company's financial position or results of operations.

In December 2004, the FASB issued FASB Staff Position (FSP) No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004". FSP No. 109-2 provides guidance under SFAS No. 109, "Accounting for Income Taxes," with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the Jobs Act) on enterprises' income tax expense and deferred tax liability. The Jobs Act was enacted on October 22, 2004. FSP No. 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS No. 109. The Company has not yet completed evaluating the impact of the repatriation provisions. Accordingly, as provided for in FSP No. 109-2, the Company has not adjusted its tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Act.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R), which replaces SFAS No. 123, "Accounting for Stock-Based Compensation," and supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees". SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005, with early adoption encouraged. The pro forma disclosures previously permitted under SFAS No. 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS No. 123R in the third quarter of 2005, beginning July 1, 2005. Under SFAS No. 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The Company is evaluating the requirements of SFAS No. 123R and expects that the adoption of SFAS No. 123R will have a material impact on the Company's results of operations. The Company has not yet determined the method of adoption or the effect of adopting SFAS No. 123R, and it has not determined whether adoption will result in amounts that are similar to the current pro forma disclosures under SFAS No. 123.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions". SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on the Company's financial position or results of operations.

**Liquidity and Capital Resources**

| **Year Ended December 31,** | **2004** | **2003** |
|---|---|---|
| Current assets | $ 375,732 | $ 340,945 |
| Cash and investments, short-term | $ 94,287 | $ 71,324 |
| Cash provided by (used in) operating activities | $ 40,519 | $ (14,631) |
| Cash used in investing activities, excluding short-term investments | $ (37,455) | $ (38,441) |
| Cash provided by financing activities | $ 19,347 | $ 84,641 |

*Cash, Cash Equivalents and Short-Term Investments*

Cash, cash equivalents and short-term investments were $94,287 at December 31, 2004, an increase of $22,963, or 32%, from $71,324 at December 31, 2003. Cash provided by operating activities was $40,519 in 2004 compared to cash used in operating activities of $14,631 in 2003. The increase in cash flows from operating activities was primarily due to (i) income before income taxes of $28,944 in 2004 compared to $1,129 in 2003, (ii) an increase in deferred revenue in 2004, and (iii) non-cash asset write-downs of $8,458 and $2,587 in 2004 and 2003, respectively. The increase in cash flows from operating activities was partially offset by a smaller increase in accounts receivable in 2004 than in 2003 and a decrease in accounts payable and accrued liabilities in 2004 as compared to a significant increase in 2003.

Cash used in investing activities, excluding short-term investments, was $37,455 in 2004 compared to $38,441 in 2003. Cash used in investing activities includes (i) cash paid for acquisitions of $10,801 and $17,299 in 2004 and 2003, respectively, (ii) purchases of intangible assets of $3,634 in 2004 and (iii) capital expenditures of $24,423 and $23,532 in 2004 and 2003, respectively.

Cash provided by financing activities was $19,347 in 2004 compared to $84,641 in 2003. The decrease of $65,294 in 2004 was primarily due to proceeds of $110,000 received from the issuance of long-term notes payable in 2003. In addition, the Company repurchased shares of its common stock in 2003 for $29,785. Financing cash flows were positively impacted by proceeds from the issuance of common stock upon exercise of stock options and employee stock plan purchases of $19,907 and $22,625 in 2004 and 2003, respectively.

*Trade Accounts Receivable, Net*

Trade accounts receivable, net increased to $242,690 at December 31, 2004 from $223,670 at December 31, 2003. Excluding the current portion of term receivables of $125,832 and $119,627, average days sales outstanding were 49 days and 46 days at December 31, 2004 and 2003, respectively. Average days sales outstanding in total accounts receivable increased from 100 days at the end of 2003 to 102 days at the end of 2004. The increase in total accounts receivable days sales outstanding was primarily due to a higher percentage of product revenue from term versus perpetual contracts in 2004 as compared to 2003. In quarters where term contract revenue is recorded, only the first twelve months of the receivable is reflected in current trade accounts receivable. In the following quarters, the amount due in the next twelve months is reflected in current trade accounts receivable without the corresponding revenue. As a result, if the Company's mix of contracts were to shift to a higher percentage of term contracts, average days sales outstanding would be expected to increase.

*Term Receivables, Long-Term*

Term receivables, long-term increased to $139,146 at December 31, 2004 from $98,207 at December 31, 2003. The balances were attributable to multi-year, multi-element term license sales agreements. Balances under term agreements that are due within one year are included in trade accounts receivable and balances that are due in more than one year are included in term receivables, long-term. The Company uses term agreements 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. The increase was primarily attributable to the increase in term agreements during 2004 and 2003, which were included in term receivables, long-term at December 31, 2004.

*Deferred Revenue*

Deferred revenue consists primarily of prepaid annual software support contracts. Deferred revenue increased to $103,336 at December 31, 2004 from $74,662 at December 31, 2003. The increase was primarily due to annual contract renewals during 2004, higher renewal rates, higher business levels and support contracts moving from quarterly to annual billing cycles.

*Capital Resources*

Expenditures for property and equipment increased to $24,423 for 2004 compared to $23,532 for 2003. Expenditures for property and equipment in 2004 and 2003 did not include any individually significant projects. In 2004, the Company acquired (i) Project Technology Inc., (ii) a minority equity interest in M2000, a French company, (iii) the remaining 49% minority interest in MGK, (iv) 0-In Design Automation Inc., (v) the parallel and serial ATA IP business division of Palmchip Corporation and (vi) VeSys Limited, which together resulted in total net cash payments of $8,791. Additionally, the Company paid $2,010 relating to holdbacks on prior year acquisitions. The Company also paid $3,634 related to purchases of technology from (i) Atair, (ii) LSI Logic, (iii) Analog Bits, (iv) Rox Software Technology and (v) Red Hat in 2004. In 2003, the Company acquired (i) the Technology Licensing Group business of Alcatel, (ii) Translogic, (iii) the distributorship, Mentor Italia and (iv) the business and technology of DDE and (v) First Earth Limited, which resulted in net cash payments of $13,229. Additionally, the Company paid $4,070 primarily relating to a holdback on a prior year acquisition.

In August 2003, the Company issued $110,000 of Floating Rate Convertible Subordinated Debentures (Debentures) due 2023 in a private offering pursuant to SEC Rule 144A for general corporate purposes and to fund the purchase of 1,750 shares of the Company's stock. The Debentures have been registered with the SEC for resale under the Securities Act of 1933. Interest on the Debentures is payable quarterly at a variable interest rate equal to 3-month LIBOR plus 1.65%. The effective interest rates for 2004 and 2003 were 3.15% and 2.80%, respectively. The Company pays interest on the Debentures quarterly in February, May, August and November. The Debentures are convertible, under certain circumstances, into the Company's common stock at a conversion price of $23.40 per share, for a total of 4,700 shares. These circumstances generally include (a) the market price of the Company's common stock exceeding 120% of the conversion price, (b) the market price of the Debentures declining to less than 98% of the value of the common stock into which the Debentures are convertible, or (c) a call for redemption of the Debentures or certain other corporate transactions. Some or all of the Debentures may be redeemed by the Company for cash on or after August 6, 2007. Some or all of the Debentures may be redeemed at the option of the holder for cash on August 6, 2010, 2013 or 2018.

In June 2002, the Company issued $172,500 of 6-7/8% Convertible Subordinated Notes ("Notes") due 2007 in a private offering pursuant to SEC Rule 144A to fund the purchase of Innoveda. The Notes have been registered with the SEC under the Securities Act of 1933. The Company pays interest on the Notes semi-annually in June and December. The Notes are convertible into the Company's common stock at a conversion price of $23.27 per share, a total of 7,370 shares for the Notes remaining outstanding at December 31,2004. Some or all of the Notes may be redeemed by the Company for cash on or after June 20, 2005. The Notes rank pari passu with the Debentures. In 2004, the Company purchased on the open market Notes with a principal balance of $1,000 for a total purchase price of $1,028. In connection with this purchase, the Company incurred before tax expenses for the early extinguishment of debt of $43. Expenses include the call premium on the Notes and the write-off of unamortized deferred debt issuance costs.

In July 2003, the Company renewed its syndicated, senior, unsecured credit facility that allows the Company to borrow up to $100,000. This facility is a three-year revolving credit facility, which terminates on July 14, 2006. Under this facility, the Company has the option to pay interest based on LIBOR plus a spread of between 1.25% and 2.00% or prime plus a spread of between 0% and 0.75%, based on a pricing grid tied to a financial covenant. As a result, the Company's interest expense associated with borrowings under this credit facility will vary with market interest rates. In addition, commitment fees are payable on the unused portion of the credit facility at rates between 0.35% and 0.50% based on a pricing grid tied to a financial covenant. The facility contains certain financial and other covenants, including financial covenants requiring the maintenance of specified liquidity ratios, leverage ratios and minimum tangible net worth. The Company had no borrowings against the credit facility during 2004 and had no balance outstanding at December 31, 2004 and 2003.

The Company's primary ongoing cash requirements will be for product development, operating activities, capital expenditures, debt service and acquisition opportunities that may arise. The Company's primary sources of liquidity are cash generated from operations and borrowings under the revolving credit facility. The Company anticipates that current cash balances, anticipated cash flows from operating activities, including the effects of financing customer term receivables, and amounts available under existing credit facilities will be sufficient to meet its working capital needs on a short-term and long-term basis. The Company's sources of liquidity could be adversely affected by a decrease in demand for the Company's products or a deterioration of the Company's financial ratios.

*Off-Balance Sheet Arrangements*

The Company does not have off-balance sheet arrangements, financings or other relationships with unconsolidated entities or other persons, also known as special purpose entities. In the ordinary course of business, the Company leases certain real properties, primarily field office facilities, and equipment.

In February 2004, the Company purchased a 10% interest in M2000, a French company. The Company assessed its interest in this variable interest entity and concluded it should not consolidate that entity based on guidance included in FASB Interpretation No. 46R, "Consolidation of Variable Interest Entities". Accordingly, the Company has accounted for this variable interest entity pursuant to the cost method for investments in equity securities that do not have readily determinable fair values.

*Contractual Obligations*

The Company is contractually obligated to make the following payments as of December 31, 2004:

| | Payments due by period | | | | |
|---|---|---|---|---|---|
| | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Convertible subordinated notes | $ 281,500 | $ - | $ 171,500 | $ - | $ 110,000 |
| Other long-term notes payable | 2,483 | - | 2,483 | - | - |
| Other long-term liabilities | 19,098 | - | 7,900 | 6,708 | 4,490 |
| Short-term borrowings | 9,510 | 9,510 | - | - | - |
| Capital leases | 122 | 122 | - | - | - |
| Purchase obligations | 1,617 | 1,617 | - | - | - |
| Operating leases | 129,708 | 29,278 | 41,618 | 30,372 | 28,440 |
| Total contractual obligations | $ 444,038 | $ 40,527 | $ 223,501 | $ 37,080 | $ 142,930 |

**Outlook for 2005**

Revenues for the year 2005 are expected in the range of $760,000. Earnings per share for the year 2005 are expected to range between $0.60 and $0.65, which excludes the impact of expensing stock options in accordance with SFAS No. 123R. The Company is required to commence expensing stock options in the third quarter of 2005, but has not yet estimated the expected impact on 2005 earnings.

***FACTORS THAT MAY AFFECT FUTURE RESULTS AND FINANCIAL CONDITION***

The statements contained under "Outlook for 2005" above and other statements contained in this report that are not statements of historical fact, including without limitation, statements containing the words "believes," "expects," "projections" and words of similar import, constitute forward-looking statements that involve a number of risks and uncertainties that are difficult to predict. Moreover, from time to time, the Company may issue other forward-looking statements. Forward-looking statements regarding financial performance in future periods, including the statements above under "Outlook for 2005", do not reflect potential impacts of mergers or acquisitions or other significant transactions or events that have not been announced as of the time the statements are made. Actual outcomes and results may differ materially from what is expressed or forecast in forward-looking statements. The Company disclaims any obligation to update forward-looking statements to reflect future events or revised expectations. The following discussion highlights factors that could cause actual results to differ materially from the results expressed or implied by the Company's forward-looking statements. Forward-looking statements should be considered in light of these factors.

*Weakness in the United States and international economies may materially adversely affect the Company.*

United States and international economies can experience economic downturns, which may have an adverse affect on the Company's results of operations. Weakness in these economies may adversely affect the timing and receipt of orders for the Company's products and the Company's results of operations. Revenue levels are dependent on the level of technology capital spending, which include expenditures for EDA software, hardware and consulting services, in the United States and abroad. In addition, demand for the Company's products and services may be adversely affected by mergers and company restructurings in the electronics industry worldwide which could result in decreased or delayed capital spending patterns.

*The Company is subject to the cyclical nature of the integrated circuit and electronics systems industries and any future downturns may, materially adversely affect the Company.*

Purchases of the Company's products and services are highly dependent upon new design projects initiated by customers in the integrated circuit and electronics systems industries. These industries are highly cyclical and are subject to constant and rapid technological change, rapid product obsolescence, price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The integrated circuit and electronics systems industries regularly experience significant downturns, often connected with, or in anticipation of, maturing product cycles of companies in these industries and their customers' products and a decline in general economic conditions. These downturns cause diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. During such downturns, the number of new design projects generally decreases, which can adversely affect demand for the Company's products and services.

Over the past several years, IC manufacturers and electronics systems companies have experienced a downturn in demand and production, which has resulted in reduced research and development spending by many of the Company's customers. While many of these companies appear to have experienced a gradual recovery in the second half of 2003 and in 2004, they have continued their focus on cost containment. Any economic downturn could harm the Company's business, operating results and financial condition.

*Fluctuations in quarterly results of operations due to the timing of significant orders and the mix of licenses used to sell the Company's products could hurt the Company's business and the market price of the Company's common stock.*

The Company has experienced, and may continue to experience, varied quarterly operating results. Various factors affect the Company's quarterly operating results and some of these are not within the Company's control, including customer demand, the timing of significant orders and the mix of licenses used to sell the Company's products. The Company receives a majority of its software product revenue from current quarter order performance, of which a substantial amount is usually booked in the last few weeks of each quarter. A significant portion of the Company's revenue comes from multi-million dollar contracts, the timing of the completion of and the terms of delivery of which can have a material impact on revenue recognition for a given quarter. If the Company fails to receive expected orders in a particular quarter, particularly large orders, the Company's revenues for that quarter could be adversely affected. In such an event, the Company could fail to meet investors' expectations, which could adversely affect the Company's stock price.

The Company uses fixed-term license agreements as a standard business practice. These multi-year, multi-element term license agreements are typically three years in length, with customers the Company believes are credit-worthy, and have payments spread over the license term. The complexity of these agreements tends to increase the risk associated with collectibility from customers that can arise for a variety of reasons including ability to pay, product dissatisfaction, disagreements and disputes. If the Company is unable to collect under any of these multi-million dollar agreements, the Company's results of operations could be adversely affected. The Company uses these fixed-term license agreements 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. If the Company no longer had a history of collecting without providing concessions on term agreements, then revenue would be required to be recognized as the payments become due and payable over the license term. This change would have a material impact on the Company's results.

The Company's revenue is also affected by the mix of licenses entered into where the Company recognizes software product revenue as payments become due and payable or ratably over the license term as compared to revenue recognized at the beginning of the license term. The Company recognizes revenue ratably over the license term when the customer is provided with rights to unspecified or unreleased future products. A shift in the license mix toward increased ratable or due and payable revenue recognition would result in increased deferral of software product revenue to future periods and would decrease current revenue, possibly resulting in the Company not meeting revenue expectations.

The gross margin on the Company's software products is greater than that for the Company's hardware products, software support and professional services. Therefore, the Company's gross margin may vary as a result of the mix of products and services sold. Additionally, the margin on software products varies year to year depending on the amount of third-party royalties due to third parties from the Company for the mix of products sold. The Company also has a significant amount of fixed or relatively fixed costs, such as professional service employee costs and purchased technology amortization, and costs which are committed in advance and can only be adjusted periodically. As a result, a small failure to reach planned revenue would likely have a relativity large negative effect on resulting earnings. If anticipated revenue does not materialize as expected, the Company's gross margins and operating results would be materially adversely affected.

*Accounting Rules Governing Revenue Recognition May Change*

The accounting rules governing software revenue recognition have been subject to authoritative interpretations that have generally made it more difficult to recognize software product revenue at the beginning of the license period. If this trend continues, new and revised standards and interpretations could adversely affect the Company's ability to meet revenue expectations.

*Forecasting the Company's tax rates is complex and subject to uncertainty.*

Forecasts of the Company's income tax position and resultant effective tax rate are complex and subject to uncertainty as the Company's income tax position for each year combines: (a) the effects of a mix of profits (losses) earned by the Company and its subsidiaries in tax jurisdictions with a broad range of income tax rates, (b) benefits from available deferred tax assets, (c) taxes, interest or penalties resulting from tax audits and (d) changes in tax laws or the interpretation of such tax laws. In order to forecast the Company's global tax rate, pre-tax profits and losses by jurisdiction are estimated and tax expense by jurisdiction is calculated. If the mix of profits and losses or effective tax rates by jurisdiction are different than those estimates, the Company's actual tax rate could be materially different than forecast.

*New accounting standard related to equity compensation will cause the Company to recognize an additional expense, which will result in a reduction in the Company's net income.*

In December 2004, the FASB issued SFAS No. 123R, "Share-Based Payment", which replaces SFAS No. 123 and supercedes APB Opinion No. 25, relating to the accounting for equity-based compensation. This statement requires the Company to record a charge to compensation expense for stock option grants. The Company currently accounts for stock options under SFAS No. 123, "Accounting for Stock-Based Compensation". As permitted by SFAS No. 123, the Company has elected to use the intrinsic value method prescribed by Accounting Principles Board Opinion (APB) No. 25, "Accounting for Stock Issued to Employees," to measure compensation expense for stock-based awards granted to employees, under which the granting of stock options is not considered compensation if the option exercise price is not less than the fair market value of the common stock at the grant date. Starting in July 2005, the FASB's statement will require that stock-based awards be accounted for using a fair-value based method, which would require the Company to measure the compensation expense for all such awards, including stock options, at fair-value at the grant date. The Company is evaluating the requirements of SFAS No. 123R and expects that the adoption will have a material adverse effect on the Company's net income.

*The Company's business is subject to evolving corporate governance and public disclosure regulations that have increased both our costs and the risk of noncompliance, which could have an adverse effect on our stock price.*

Because the Company's common stock is publicly traded on the Nasdaq Stock Market, the Company is subject to rules and regulations promulgated by a number of governmental and self-regulated organizations, including the SEC, Nasdaq and the Public Company Accounting Oversight Board, which monitors the accounting practices of public companies. Many of these regulations have only recently been enacted, and continue to evolve, making compliance more difficult and uncertain. In particular, Section 404 of Sarbanes-Oxley Act of 2002 and related regulations have required the Company to include a management assessment of the Company's internal controls over financial reporting and auditor attestation of that assessment in this annual report for the Company's fiscal year ending December 31, 2004. This effort has required, and continues to require, the commitment of significant financial and managerial resources. A failure to complete a favorable assessment and obtain our auditors' attestation could have a material adverse effect on our stock price.

*Outcome of Internal Revenue Service and other tax authorities examinations could have a material adverse affect on the Company.*

The Internal Revenue Service and other tax authorities regularly examine the Company's income tax returns. Significant judgment is required in determining our provision for income taxes. In determining the adequacy of our income taxes, the Company assesses the likelihood of adverse outcomes resulting from the Internal Revenue Service and other tax authorities' examinations. The ultimate outcome of these examinations cannot be predicted with certainty. Should the Internal Revenue Service or other tax authorities assess additional taxes as a result of examinations, the Company may be required to record charges to operations in future periods that could have a material impact on the results of operations, financial position or cash flows in the applicable period or periods recorded.

*Limitations on the effectiveness of controls.*

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

*The lengthy sales cycle for the Company's products and services, and delay in customer consummation of projects, makes the timing of the Company's revenue difficult to predict.*

The Company has a lengthy sales cycle that generally extends between three and six months. The complexity and expense associated with the Company's products and services generally requires a lengthy customer evaluation and approval process. Consequently, the Company may incur substantial expenses and devote significant management effort and expense to develop potential relationships that do not result in agreements or revenue and may prevent the Company from pursuing other opportunities. In addition, sales of the Company's products and services may be delayed if customers delay approval or commencement of projects because of customers' budgetary constraints, internal acceptance review procedures, timing of budget cycles or timing of competitive evaluation processes.

*Any loss of the Company's leadership position in certain portions of the EDA market could have a material adverse affect on the Company.*

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

*Intense competition in the EDA industry could materially adversely affect the Company.*

Competition in the EDA industry is intense, which can lead to, among other things, price reductions, longer selling cycles, lower product margins, loss of market share and additional working capital requirements. The Company's success depends upon the Company's ability to acquire or develop and market products and services that are innovative and cost-competitive and that meet customer expectations.

The Company currently competes primarily with two large companies: Cadence Design Systems, Inc. and Synopsys, Inc. The Company also competes with numerous smaller companies, a number of which have combined with other EDA companies. The Company also competes with manufacturers of electronic devices that have developed, or have the capability to develop, their own EDA products internally.

*The Company may acquire other companies and may not successfully integrate them or the companies the Company has recently acquired.*

The industry in which the Company competes has seen significant consolidation in recent years. During this period, the Company has acquired numerous businesses, and it is frequently in discussions with potential acquisition candidates and may acquire other businesses in the future. While the Company expects to carefully analyze all potential transactions before committing to them, the Company cannot assure that any transaction that is completed will result in long-term benefits to the Company or its shareholders or that the Company's management will be able to manage the acquired businesses effectively. In addition, growth through acquisition involves a number of risks. If any of the following events occurs after the Company acquires another business, it could materially adversely affect the Company:

- difficulties in combining previously separate businesses into a single unit;
- the substantial diversion of management's attention from day-to-day business when evaluating and negotiating acquisition transactions and then integrating the acquired business;
- the discovery after the acquisition has been completed of liabilities assumed with the acquired business;
- the failure to realize anticipated benefits, such as cost savings and revenue increases;
- the failure to retain key personnel of the acquired business;
- difficulties related to assimilating the products of an acquired business in, for example, distribution, engineering and customer support areas;
- unanticipated costs;
- adverse effects on existing relationships with suppliers and customers; and
- failure to understand and compete effectively in markets in which we have limited previous experience.

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

*Risks of international operations and the effects of foreign currency fluctuations can adversely impact the Company's business and operating results.*

The Company realizes more than half of the Company's revenue from customers outside the United States and approximately one-fourth of the Company's expenses are generated outside of the United States. Significant changes in exchange rates can have an adverse effect on the Company. For further discussion of foreign currency effects, see "Effects of Foreign Currency Fluctuations" discussion above. In addition, international operations subject the Company to other risks including longer receivables collection periods, changes in a specific country's or region's economic or political conditions, trade protection measures, import or export licensing requirements, loss or modification of exemptions for taxes and tariffs, limitations on repatriation of earnings and difficulties with licensing and protecting the Company's intellectual property rights.

*Delay in production of components or the ordering of excess components for the Company's Mentor Emulation Division hardware products could materially adversely affect the Company.*

The success of the Company's Mentor Emulation Division depends on the Company's ability to procure hardware components on a timely basis from a limited number of suppliers, assemble and ship systems on a timely basis with appropriate quality control, develop distribution and shipment processes, manage inventory and related obsolescence issues and develop processes to deliver customer support for hardware. The Company's inability to be successful in any of the foregoing could materially adversely affect the Company.

The Company commits to purchase component parts from suppliers based on sales forecasts of the Company's Mentor Emulation Division products. If the Company cannot change or be released from these non-cancelable purchase commitments, or if orders for the Company's products do not materialize as anticipated, the Company could incur significant costs related to the purchase of excess components which could become obsolete before the Company can use them. Additionally, a delay in production of the components could materially adversely affect the Company's operating results.

*The Company's failure to adequately protect the Company's proprietary rights or to obtain software or other intellectual property licenses could materially adversely affect the Company.*

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

Some of the Company's products include software or other intellectual property licensed from third parties, and the Company may have to seek new licenses or renew existing licenses for software and other intellectual property in the future. The Company's failure to obtain software or other intellectual property licenses or rights on favorable terms could materially adversely affect the Company.

*Future litigation may materially adversely affect the Company.*

Any future litigation may result in injunctions against future product sales and substantial unanticipated legal costs and divert the efforts of management personnel, any and all of which could materially adversely affect the Company.

*Errors or defects in the Company's products and services could expose the Company to liability and harm the Company's reputation.*

The Company's customers use the Company's products and services in designing and developing products that involve a high degree of technological complexity and have unique specifications. Because of the complexity of the systems and products with which the Company works, some of the Company's products and designs can be adequately tested only when put to full use in the marketplace. As a result, the Company's customers or their end users may discover errors or defects in the Company's software or the systems we design, or the products or systems incorporating the Company's designs and intellectual property may not operate as expected. Errors or defects could result in:

- loss of current customers and loss of, or delay in, revenue and loss of market share;
- failure to attract new customers or achieve market acceptance;
- diversion of development resources to resolve the problems resulting from errors or defects; and
- increased service costs.

*The Company's failure to attract and retain key employees may harm the Company.*

The Company depends on the efforts and abilities of the Company's senior management, the Company's research and development staff and a number of other key management, sales, support, technical and services personnel. Competition for experienced, high-quality personnel is intense, and the Company cannot assure that it can continue to recruit and retain such personnel. The failure by the Company to hire and retain such personnel would impair the Company's ability to develop new products and manage the Company's business effectively.

Regulations adopted by the Nasdaq Stock Market require stockholder approval for new stock option plans and significant amendments to existing plans, including increases in options. These regulations could make it more difficult for the Company to grant equity compensation to employees in the future. To the extent that these regulations make it more difficult or expensive to grant equity compensation to employees, the Company may incur increased compensation costs or find it difficult to attract and retain employees, which could materially and adversely affect the Company.

*Terrorist attacks and other acts of violence or war may materially adversely affect the markets on which the Company's securities trade, the markets in which the Company operates, the Company's operations and the Company's profitability.*

Terrorist attacks may negatively affect the Company's operations and investment in the Company's business. These attacks or armed conflicts may directly impact the Company's physical facilities or those of the Company's suppliers or customers. Furthermore, these attacks may make travel and the transportation of the Company's products more difficult and more expensive and ultimately affect the Company's sales.

Any armed conflict entered into by the United States could have an impact on the Company's sales and the Company's ability to deliver products to the Company's customers. Political and economic instability in some regions of the world may also result from an armed conflict and could negatively impact the Company's business. The Company currently has operations in Pakistan, Egypt and Israel, countries that maybe particularly susceptible to this risk. The consequences of any armed conflict are unpredictable, and the Company may not be able to foresee events that could have an adverse effect on the Company's business.

More generally, any of these events could cause consumer confidence and spending to decrease or result in increased volatility in the United States and worldwide financial markets and economy. They also could result in or exacerbate economic recession in the United States or abroad. Any of these occurrences could have a significant impact on the Company's operating results, revenues and costs and may result in volatility of the market price for the Company's securities.

*The Company's articles of incorporation, Oregon law and the Company's shareholder rights plan may have anti-takeover effects.*

The Company's board of directors has the authority, without action by the shareholders, to designate and issue up to 1,200,000 shares of incentive stock in one or more series and to designate the rights, preferences and privileges of each series without any further vote or action by the shareholders. Additionally, the Oregon Control Share Act and the Business Combination Act limit the ability of parties who acquire a significant amount of voting stock to exercise control over the Company. These provisions may have the effect of lengthening the time required for a person to acquire control of the Company through a proxy contest or the election of a majority of the board of directors. In February 1999, the Company adopted a shareholder rights plan which has the effect of making it more difficult for a person to acquire control of the Company in a transaction not approved by the Company's board of directors. The potential issuance of incentive stock, the provisions of the Oregon Control Share Act and the Business Combination Act and the Company's shareholder rights plan may have the effect of delaying, deferring or preventing a change of control of the Company, may discourage bids for the Company's common stock at a premium over the market price of the Company's common stock and may adversely affect the market price of, and the voting and other rights of the holders of, the Company's common stock.

*The Company's debt obligations expose the Company to risks that could adversely affect the Company's business, operating results and financial condition, and could prevent the Company from fulfilling its obligations under such indebtedness.*

The Company has a substantial level of indebtedness. As of December 31, 2004, the Company had $293.5 million of outstanding indebtedness, which includes $171.5 million of 6 7/8% Convertible Subordinated Notes (Notes) due 2007 and $110.0 million of Floating Rate Convertible Subordinated Debentures (Debentures) due 2023. This level of indebtedness among other things, could:

- make it difficult for the Company to satisfy its payment obligations on its debt;
- make it difficult for the Company to incur additional indebtedeness or obtain any necessary financing in the future for working capital, capital expenditures, debt service, acquisitions or general corporate purposes;
- limit the Company's flexibility in planning for or reacting to changes in its business;
- reduce funds available for use in the Company's operations;
- make the Company more vulnerable in the event of a downturn in its business;
- make the Company more vulnerable in the event of an increase in interest rates if the Company must incur new debt to satisfy its obligations under the Notes and Debentures; or
- place the Company at a possible competitive disadvantage relative to less leveraged competitors and competitors that have greater access to capital resources.

If the Company experiences a decline in revenue due to any of the factors described in this section entitled "Factors That May Affect Future Results and Financial Condition" it could have difficulty paying amounts due on its indebtedness. Any default under the Company's indebtedness could have a material adverse effect on its business, operating results and financial condition.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**
*All numerical references in thousands, except rate data*

**Interest Rate Risk**

The Company is exposed to interest rate risk primarily through its investment portfolio, short-term borrowings and long-term notes payable. The Company does not use derivative financial instruments for speculative or trading purposes.

The Company places its investments in instruments that meet high credit quality standards, as specified in the Company's investment policy. The policy also limits the amount of credit exposure to any one issuer and type of instrument. The Company does not expect any material loss with respect to its investment portfolio.

The table below presents the carrying value and related weighted-average fixed interest rates for the Company's investment portfolio. The carrying value approximates fair value at December 31, 2004. In accordance with the Company's investment policy, all investments mature in twelve months or less.

| Principal (notional) amounts in United States dollars: | Carrying Value | Average Fixed Interest Rate |
|---|---|---|
| *In thousands, except interest rates* | | |
| Cash equivalents – fixed rate | $ 36,049 | 2.27% |
| Short-term investments – fixed rate | 26,329 | 2.23% |
| Total fixed rate interest bearing instruments | $ 62,378 | 2.26% |

The Company had convertible subordinated notes of $171,500 outstanding with a fixed interest rate of 6 7/8% at December 31, 2004. For fixed rate debt, interest rate changes affect the fair value of the notes but do not affect earnings or cash flow.

The Company had floating rate convertible subordinated debentures of $110,000 outstanding with a variable interest rate of 3-month LIBOR plus 1.65% at December 31, 2004. For variable interest rate debt, interest rate changes affect earnings and cash flow. If the interest rates on the variable rate borrowings were to increase or decrease by 1% for the year and the level of borrowings outstanding remained constant, annual interest expense would increase or decrease by approximately $1,100.

At December 31, 2004 the Company had a three-year revolving credit facility, which terminates on July 14, 2006, which allows the Company to borrow up to $100,000. Under this facility, the Company has the option to pay interest based on LIBOR plus a spread of between 1.25% and 2.00% or prime plus a spread of between 0% and 0.75%, based on a pricing grid tied to a financial covenant. As a result, the Company's interest expense associated with borrowings under this credit facility will vary with market interest rates. In addition, commitment fees are payable on the unused portion of the credit facility at rates between 0.35% and 0.50% based on a pricing grid tied to a financial covenant. The facility contains certain financial and other covenants, including financial covenants requiring the maintenance of specified liquidity ratios, leverage ratios and minimum tangible net worth. The Company had no short-term borrowings against the credit facility at December 31, 2004.

The Company had other long-term notes payable of $2,483 and short-term borrowings of $9,632 outstanding at December 31, 2004 with variable rates based on market indexes. For variable rate debt, interest rate changes generally do not affect the fair market value, but do affect future earnings or cash flow. If the interest rates on the variable rate borrowings were to increase or decrease by 1% for the year and the level of borrowings outstanding remained constant, annual interest expense would increase or decrease by approximately $121.

**Foreign Currency Risk**

The Company transacts business in various foreign currencies and has established a foreign currency hedging program to hedge certain foreign currency forecasted transactions and exposures from existing assets and liabilities. Derivative instruments held by the Company consist of foreign currency forward and option contracts. The Company enters into contracts with counterparties who are major financial institutions and believes the risk related to default is remote. The Company does not hold or issue derivative financial instruments for trading purposes.

The Company enters into foreign currency option contracts for forecasted revenues and expenses between its foreign subsidiaries. These instruments provide the Company the right to sell/purchase foreign currencies to/from third parties at future dates with fixed exchange rates. As of December 31, 2004, the Company had options outstanding to sell Japanese yen with contract values totaling $45,729 at a weighted average contract rate of 106.06 and had options outstanding to buy the Euro with contract values totaling $30,950 at a weighted average contract rate of 1.28.

The Company enters into foreign currency forward contracts to protect against currency exchange risk associated with expected future cash flows and existing assets and liabilities. The Company's practice is to hedge a majority of its existing material foreign currency transaction exposures.

The table provides information as of December 31, 2004 about the Company's foreign currency forward contracts. The information provided is in United States 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 the first half of 2005.

| | Notional Amount | Weighted Average Contract Rate | Contract Currency |
|---|---|---|---|
| Forward Contracts: | | | |
| Japanese yen | $ 60,208 | 106.74 | JPY |
| Euro | 53,518 | 1.29 | USD |
| Canadian dollar | 5,710 | 1.22 | CAD |
| British pound sterling | 2,419 | 1.91 | USD |
| Swedish krona | 1,923 | 6.79 | SEK |
| India rupee | 1,560 | 44.70 | INR |
| Danish krona | 1,548 | 5.62 | DKK |
| Other | 2,657 | -- | |
| Total | $ 129,543 | | |

## Item 8. Financial Statements and Supplementary Data

**Mentor Graphics Corporation**
**Consolidated Statements of Operations**

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| *In thousands, except per share data* | | | |
| **Revenues:** | | | |
| System and software | $ 422,672 | $ 394,449 | $ 321,994 |
| Service and support | 288,284 | 281,219 | 274,185 |
| Total revenues | 710,956 | 675,668 | 596,179 |
| **Cost of revenues:** | | | |
| System and software | 16,639 | 22,721 | 27,665 |
| Service and support | 80,294 | 84,554 | 82,831 |
| Amortization of purchased technology | 10,624 | 9,422 | 6,688 |
| Total cost of revenues | 107,557 | 116,697 | 117,184 |
| Gross margin | 603,399 | 558,971 | 478,995 |
| **Operating expenses:** | | | |
| Research and development | 202,289 | 184,797 | 164,228 |
| Marketing and selling | 267,181 | 245,170 | 218,963 |
| General and administration | 74,255 | 75,984 | 72,491 |
| Amortization of intangible assets | 3,586 | 3,883 | 2,255 |
| Emulation litigation settlement | -- | 20,264 | -- |
| Special charges | 9,213 | 14,120 | 6,184 |
| Merger and acquisition related charges | 7,700 | 1,860 | 28,700 |
| Total operating expenses | 564,224 | 546,078 | 492,821 |
| **Operating income (loss)** | 39,175 | 12,893 | (13,826) |
| Other income, net | 8,388 | 5,460 | 6,905 |
| Interest expense | (18,619) | (17,224) | (11,696) |
| Income (loss) before income taxes | 28,944 | 1,129 | (18,617) |
| Provision for (benefit from) income taxes | 49,494 | (6,804) | (4,303) |
| Net income (loss) | $ (20,550) | $ 7,933 | $ (14,314) |
| Net income (loss) per share: | | | |
| Basic | $ (0.28) | $ 0.12 | $ (0.22) |
| Diluted | $ (0.28) | $ 0.11 | $ (0.22) |
| Weighted average number of shares outstanding: | | | |
| Basic | 72,381 | 67,680 | 65,766 |
| Diluted | 72,381 | 70,464 | 65,766 |

*See accompanying notes to consolidated financial statements.*

**Mentor Graphics Corporation**
**Consolidated Balance Sheets**

| **As of December 31,** *In thousands* | **2004** | **2003** |
|---|---|---|
| **Assets** | | |
| **Current assets:** | | |
| Cash and cash equivalents | $ 67,916 | $ 68,333 |
| Short-term investments | 26,371 | 2,991 |
| Trade accounts receivable, net of allowance for doubtful accounts of $5,272 in 2004 and $4,149 in 2003 | 242,690 | 223,670 |
| Other receivables | 7,719 | 7,003 |
| Inventory | 5,168 | 5,489 |
| Prepaid expenses and other | 15,570 | 14,672 |
| Deferred income taxes | 10,298 | 18,787 |
| Total current assets | 375,732 | 340,945 |
| **Property, plant and equipment, net** | 91,224 | 91,350 |
| **Term receivables, long-term** | 139,146 | 98,207 |
| **Goodwill** | 333,806 | 290,352 |
| **Intangible assets, net** | 40,338 | 35,929 |
| **Deferred income taxes** | 20,827 | 60,021 |
| **Other assets** | 20,834 | 23,884 |
| Total assets | $ 1,021,907 | $ 940,688 |
| **Liabilities and Stockholders' Equity** | | |
| **Current liabilities:** | | |
| Short-term borrowings | $ 9,632 | $ 6,910 |
| Accounts payable | 18,037 | 18,105 |
| Income taxes payable | 35,299 | 35,122 |
| Accrued payroll and related liabilities | 81,709 | 80,484 |
| Accrued liabilities | 37,098 | 37,719 |
| Deferred revenue | 103,336 | 74,662 |
| Total current liabilities | 285,111 | 253,002 |
| **Notes payable** | 283,983 | 286,768 |
| **Other long-term liabilities** | 19,098 | 23,161 |
| Total liabilities | 588,192 | 562,931 |
| **Commitments and contingencies (Note 17)** | | |
| **Minority interest** | -- | 3,391 |
| **Stockholders' equity:** | | |
| Common stock, no par value, 200,000 and 100,000 shares authorized for 2004 and 2003 respectively; 76,430 and 68,277 issued and outstanding for 2004 and 2003, respectively | 363,455 | 294,180 |
| Incentive stock, no par value, authorized 1,200 shares; none issued | -- | -- |
| Deferred compensation | (508) | (2,601) |
| Retained earnings | 39,717 | 57,800 |
| Accumulated other comprehensive income | 31,051 | 24,987 |
| Total stockholders' equity | 433,715 | 374,366 |
| Total liabilities and stockholders' equity | $ 1,021,907 | $ 940,688 |

*See accompanying notes to consolidated financial statements.*

**Mentor Graphics Corporation**
**Consolidated Statements of Cash Flows**

| Year ended December 31, | 2004 | 2003 | 2002 |
|---|---|---|---|
| *In thousands* | | | |
| **Operating Cash Flows:** | | | |
| Net income (loss) | $ (20,550) | $ 7,933 | $ (14,314) |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: | | | |
| Depreciation and amortization of property, plant and equipment | 24,418 | 23,146 | 21,426 |
| Amortization | 19,302 | 18,704 | 16,385 |
| Deferred income taxes | 39,876 | (12,223) | (3,873) |
| Changes in other long-term liabilities and minority interest | (4,568) | 2,805 | (7,703) |
| Tax benefit of employee stock option plans | 950 | 3,458 | 20,831 |
| Write-down of assets | 8,458 | 2,587 | 28,700 |
| Gain on sale of investments | (1,403) | (2,390) | (2,438) |
| Changes in operating assets and liabilities, net of effect of acquired businesses: | | | |
| Trade accounts receivable, net | (12,303) | (52,676) | 2,272 |
| Prepaid expenses and other | (415) | (2,561) | (20,238) |
| Term receivables, long-term | (37,723) | (14,798) | (16,361) |
| Accounts payable and accrued liabilities | (4,625) | 23,164 | (14,050) |
| Income taxes payable | 3,869 | (10,642) | (4,662) |
| Deferred revenue | 25,233 | (1,138) | (10,491) |
| Net cash provided by (used in) operating activities | 40,519 | (14,631) | (4,516) |
| **Investing Cash Flows:** | | | |
| Proceeds from the sales and maturities of short-term investments | 26,749 | 3,857 | 33,659 |
| Purchases of short-term investments | (50,129) | (2,991) | (7,902) |
| Purchases of property, plant and equipment | (24,423) | (23,532) | (20,409) |
| Purchases of intangible assets | (3,634) | -- | -- |
| Proceeds from sale of investments | 1,403 | 2,390 | 2,438 |
| Acquisitions of businesses and equity interests | (10,801) | (17,299) | (288,383) |
| Net cash used in investing activities | (60,835) | (37,575) | (280,597) |
| **Financing Cash Flows:** | | | |
| Proceeds from issuance of common stock | 19,907 | 22,625 | 17,663 |
| Repurchase of common stock | -- | (29,785) | -- |
| Net increase (decrease) in short-term borrowings | 2,396 | (11,400) | 13,599 |
| Note issuance costs | -- | (5,161) | (5,518) |
| Proceeds from long-term notes payable | -- | 110,000 | 177,831 |
| Repayments of long-term notes payable | (2,956) | (1,638) | (7,860) |
| Net cash provided by financing activities | 19,347 | 84,641 | 195,715 |
| Effect of exchange rate changes on cash and cash equivalents | 552 | 929 | 338 |
| Net change in cash and cash equivalents | (417) | 33,364 | (89,060) |
| Cash and cash equivalents at the beginning of the year | 68,333 | 34,969 | 124,029 |
| Cash and cash equivalents at the end of the year | $ 67,916 | $ 68,333 | $ 34,969 |

*See accompanying notes to consolidated financial statements.*

**Mentor Graphics Corporation**
**Consolidated Statements of Stockholders' Equity**

| *In thousands* | Common Stock Shares | Common Stock Amount | Deferred Compensation | Retained Earnings | Accumulated Other Comprehensive Income | Comprehensive Income (Loss) | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|
| **Balance at December 31, 2001** | 64,706 | $245,672 | -- | $ 64,288 | $ 16,248 | | $ 326,208 |
| Net loss | -- | -- | -- | (14,314) | -- | $ (14,314) | (14,314) |
| Foreign currency translation adjustment, after tax of $1,374 | -- | -- | -- | -- | 6,870 | 6,870 | 6,870 |
| Unrealized gain on investments reported at fair value | -- | -- | -- | -- | 153 | 153 | 153 |
| Reclassification adjustment for investment gains included in net loss | -- | -- | -- | -- | (2,438) | (2,438) | (2,438) |
| Minimum pension liability, before tax benefit of $163 | -- | -- | -- | -- | (816) | (816) | (816) |
| Unrealized losses on derivatives | -- | -- | -- | -- | (3,398) | (3,398) | (3,398) |
| Comprehensive loss | -- | -- | -- | -- | -- | $ (13,943) | -- |
| Stock options and warrant issued in connection with acquisitions | -- | 14,479 | -- | -- | -- | | 14,479 |
| Deferred compensation for unvested stock options issued in connection with acquisitions | -- | -- | (6,460) | -- | -- | | (6,460) |
| Amortization of deferred compensation | -- | -- | 1,049 | -- | -- | | 1,049 |
| Forfeitures of unvested stock options issued in connection with acquisitions | -- | (650) | 650 | -- | -- | | -- |
| Stock issued under stock option and stock purchase plans | 1,923 | 17,663 | -- | -- | -- | | 17,663 |
| Tax benefit associated with the exercise of stock options | -- | 20,831 | -- | -- | -- | | 20,831 |
| Dividends to minority owners | -- | -- | -- | (107) | -- | | (107) |
| **Balance at December 31, 2002** | 66,629 | 297,995 | (4,761) | 49,867 | 16,619 | | 359,720 |
| Net income | -- | -- | -- | 7,933 | -- | $ 7,933 | 7,933 |
| Foreign currency translation adjustment, after tax of $1,414 | -- | -- | -- | -- | 8,316 | 8,316 | 8,316 |
| Minimum pension liability, before tax benefit of $20 | -- | -- | -- | -- | (119) | (119) | (119) |
| Unrealized gains on derivatives | -- | -- | -- | -- | 171 | 171 | 171 |
| Comprehensive income | -- | -- | -- | -- | -- | $ 16,301 | -- |
| Amortization of deferred compensation | -- | -- | 2,047 | -- | -- | | 2,047 |
| Stock issued under stock option and stock purchase plans | 3,398 | 22,625 | -- | -- | -- | | 22,625 |
| Forfeitures of unvested stock options issued in connection with acquisitions | -- | (113) | 113 | -- | -- | | -- |
| Tax benefit associated with the exercise of stock options | -- | 3,458 | -- | -- | -- | | 3,458 |
| Repurchase of common stock | (1,750) | (29,785) | -- | -- | -- | | (29,785) |
| **Balance at December 31, 2003** | 68,277 | 294,180 | (2,601) | 57,800 | 24,987 | | 374,366 |
| Net loss | -- | -- | -- | (20,550) | -- | $ (20,550) | (20,550) |
| Foreign currency translation adjustment, after tax of $823 | -- | -- | -- | -- | 4,840 | 4,840 | 4,840 |
| Minimum pension liability, after tax of $14 | -- | -- | -- | -- | 80 | 80 | 80 |
| Unrealized gains on derivatives | -- | -- | -- | -- | 1,144 | 1,144 | 1,144 |
| Comprehensive loss | -- | -- | -- | -- | -- | $ (14,486) | -- |
| Amortization of deferred compensation | -- | -- | 1,427 | -- | -- | | 1,427 |
| Stock issued under stock option and stock purchase plans | 3,646 | 19,907 | -- | -- | -- | | 19,907 |
| Forfeitures of unvested stock options issued in connection with acquisitions | -- | (1,158) | 666 | 492 | -- | | -- |
| Tax benefit associated with the exercise of stock options | -- | 950 | -- | -- | -- | | 950 |
| Adjust for dividends to minority owners | -- | -- | -- | 1,975 | | | 1,975 |
| Stock issued for acquisition of a business | 4,507 | 49,576 | -- | -- | -- | | 49,576 |
| **Balance at December 31, 2004** | 76,430 | $363,455 | $ (508) | $ 39,717 | $ 31,051 | | $ 433,715 |

*See accompanying notes to consolidated financial statements.*

**Mentor Graphics Corporation**
**Notes to Consolidated Financial Statements**
*All numerical references in thousands, except percentages, per share data and number of employees*

## 1. Nature of Operations

The Company is a supplier of electronic design automation (EDA) systems -- advanced computer software, emulation systems and intellectual property designs and databases used to automate the design, analysis and testing of electronic hardware and embedded systems software in electronic systems and components. The Company markets its products and services worldwide, primarily to large companies in the military/aerospace, communications, computer, consumer electronics, semiconductor, networking, multimedia and transportation industries. The Company licenses its products through its direct sales force and a channel of distributors and sales representatives. The Company was incorporated in Oregon in 1981 and its common stock is traded on the Nasdaq Stock Market under the symbol "MENT". In addition to its corporate offices in Wilsonville, Oregon, the Company has sales, support, software development and professional service offices worldwide.

## 2. Summary of Significant Accounting Policies

**Principles of Consolidation**
The consolidated financial statements include the financial statements of the Company and its wholly owned and majority-owned subsidiaries. All significant intercompany accounts and transactions are eliminated in consolidation.

The Company does not have off-balance sheet arrangements, financings or other relationships with unconsolidated entities or other persons, also known as variable interest entities. In the ordinary course of business, the Company leases certain real properties, primarily field office facilities, and equipment, as described in Note 17.

**Foreign Currency Translation**
Local currencies are the functional currencies for the Company's foreign subsidiaries except for Ireland, Singapore and Egypt where the United States dollar is used as the functional currency. Assets and liabilities of foreign operations, excluding Ireland, Singapore and Egypt, are translated to United States dollars at current rates of exchange, and revenues and expenses are translated using weighted average rates. Gains and losses from foreign currency translation are included as a separate component of stockholders' equity. The accounting records for the Company's subsidiaries in Ireland, Singapore and Egypt are maintained in United States dollars and accordingly no translation is necessary. Foreign currency transaction gains and losses are included as a component of other income and expense.

**Use of Estimates**
U.S. generally accepted accounting principles require management to make estimates and assumptions that affect the reported amount of assets, liabilities and contingencies at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates.

**Cash and Cash Equivalents**
Cash and cash equivalents include cash and certificates of deposit, commercial paper and other highly liquid investments with original maturities of ninety days or less. Cash equivalents totaled $36,049 and $46,899 at December 31, 2004 and 2003, respectively.

**Short-Term and Long-Term Investments**
The Company accounts for short-term and long-term investments in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities". Short-term investments include certificates of deposit, commercial paper and other highly liquid investments with original maturities in excess of 90 days and less than one year. At December 31, 2004 and 2003, the Company's short-term investments consisted entirely of corporate debt securities classified as held to maturity. The fair value of short-term investments was $26,426 and $2,996, as of December 31, 2004 and 2003, respectively, as compared to carrying values of $26,371 and $2,991 at December 31, 2004 and 2003, respectively. Long-term investments, included in other assets on the accompanying consolidated financial statements, include investments with original maturities in excess of one year and equity securities. The Company determines the appropriate classification of its investments at the time of purchase. Debt securities are classified as held to maturity when the Company has the positive intent and ability to hold the securities to maturity. Held to maturity securities are stated at cost, adjusted for amortization of premiums and discounts to maturity. Marketable securities not classified as held to maturity are classified as available for sale. Available for sale securities are carried at fair value based on quoted market prices. Unrealized gains and losses are reported, net of tax, in stockholders' equity as a component of accumulated other comprehensive income.

**Term Receivables**
The Company has long-term installment receivables that are attributable to multi-year, multi-element term license sales agreements. Balances under term agreements that are due within one year are included in trade accounts receivable and balances that are due more than one year from the balance sheet date are included in term receivables, long-term. The Company discounts the total product portion of the agreements to reflect the interest component of the transaction. The interest component of the

transaction is amortized to other income, net over the period in which payments are made and balances are outstanding. The discount rate is reset periodically considering current market interest rates.

**Valuation of Trade Accounts Receivable**
The Company maintains allowances for doubtful accounts on trade accounts receivable and term receivables, long-term for estimated losses resulting from the inability of its customers to make required payments. The Company regularly evaluates the collectibility of its trade accounts receivable based on a combination of factors. When it becomes aware of a specific customer's inability to meet its financial obligations, such as in the case of bankruptcy or deterioration in the customer's operating results or financial position, a specific reserve for bad debt is recorded to reduce the related receivable to the amount believed to be collectible. The Company also records unspecified reserves for bad debt for all other customers based on a variety of factors including length of time the receivables are past due, the financial health of the customers, the current business environment and historical experience. If circumstances related to specific customers change, estimates of the recoverability of receivables would be adjusted resulting in either additional selling expense or a reduction in selling expense in the period such determination was made.

**Fair Value of Financial Instruments and Concentrations of Credit Risk**
The Company places its cash equivalents and short-term investments with major banks and financial institutions. The Company's investment policy limits its credit exposure to any one financial institution. Concentrations of credit risk with respect to trade receivables are limited due to the large number of customers comprising the Company's customer base and their dispersion across different businesses and geographic areas.

The carrying amounts of cash equivalents, short-term investments, trade accounts receivable, term receivables, short-term borrowings, accounts payable and accrued liabilities approximate fair value because of the short-term nature of these instruments or as amounts have been appropriately discounted. Available for sale securities and foreign exchange forward and option contracts are recorded based on quoted market prices. The fair value of long-term notes payable was $294,023 and $301,456, as of December 31, 2004 and 2003, respectively, as compared to carrying values of $283,983 and $286,768 at December 31, 2004 and 2003, respectively. The fair value of long-term notes payable was based on the quoted market price or based on rates available to the Company for instruments with similar terms and maturities. The Company does not believe it is exposed to any significant credit risk or market risk on its financial instruments.

**Property, Plant and Equipment**
Property, plant and equipment are stated at cost. Expenditures for additions to property, plant and equipment are capitalized. Maintenance and repairs which do not improve or extend the life of the respective asset are expensed as incurred. Depreciation of buildings and land improvements is computed on a straight-line basis over lives of forty and twenty years, respectively. Depreciation of computer equipment and furniture is computed principally on a straight-line basis over the estimated useful lives of the assets, generally three to five years. Leasehold improvements are amortized on a straight-line basis over the lesser of the term of the lease or estimated useful lives of the improvements, generally three to ten years.

**Goodwill, Intangible Assets and Long-Lived Assets**
Goodwill represents the excess of the aggregate purchase price over the fair value of the tangible and intangible assets acquired from the Company's business combinations. Other intangible assets primarily include purchased technology, trademarks and customer relationships acquired in business combinations. All acquired goodwill is assigned to an enterprise-level reporting unit. Other intangible assets are amortized over their estimated lives. In-process research and development (R&D) is written-off immediately.

Under SFAS No. 144, the Company continues to periodically review long-lived assets, including intangible assets with definite lives, for impairment whenever events or changes in circumstances indicate the carrying amount of such assets may not be recoverable. Recoverability of an asset is determined by comparing its carrying amount, including any associated intangible assets, to the forecasted undiscounted net cash flows of the operation to which the asset relates. If the operation is determined to be unable to recover the carrying amount of its assets, then intangible assets are written down first, followed by the other long-lived assets of the operation, to fair value. Fair value is determined based on discounted cash flows or appraised values, depending upon the nature of the assets. In the event that, in the future, it is determined that the Company's intangible assets have been impaired, an adjustment would be made that would result in a charge for the write-down, in the period that determination was made.

As required by SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized, but are tested for impairment at least annually. The Company completed the transitional goodwill impairment test as of June 30, 2002 and the annual goodwill impairment test as of December 31, 2004 and 2003. There was no impairment at any date. The Company also reviewed the useful lives of its identifiable intangible assets and determined that the estimated lives as of the adoption date and December 31, 2004 are appropriate.

Purchased technology and other intangible asset costs are amortized over a three to five year period to system and software cost of revenues and operating expenses, respectively. Under SFAS No. 142, "Goodwill and Other Intangibles", effective on January 1, 2002, amortization of goodwill no longer occurs. Total purchased technology and other intangible asset amortization expenses were $14,210, $13,305 and $8,943 for the years ended December 31, 2004, 2003 and 2002, respectively.

As of December 31, 2004, the carrying value of goodwill was $333,806, purchased technology was $30,260 and other intangible assets was $9,678, net of accumulated amortization of $12,347, $34,090 and $5,203, respectively. The carrying value of non-amortizable other intangible assets was $400.

As of December 31, 2003, the carrying value of goodwill was $290,352, purchased technology was $31,274 and other intangible assets was $4,655, net of accumulated amortization of $12,347, $23,466 and $3,044, respectively. The Company reviewed its $4,080 of non-amortizable other intangible assets in 2003 and determined that these assets have an estimated remaining life of primarily five years; amortization of these assets commenced on January 1, 2003. The Company had no non-amortizable other intangible assets at December 31, 2003.

The Company estimates the aggregate amortization expense related to purchased technology and other intangible assets will be $15,161, $14,549, $7,793, $1,679 and $756 for each of the years ended December 31, 2005, 2006, 2007, 2008 and 2009, respectively.

**Income Taxes**

The Company uses the asset and liability method of accounting for income taxes. Under the asset and liability method, deferred income taxes are recognized for the future tax consequences attributable to temporary differences between the financial statement carrying amounts and tax balances of existing assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. Deferred tax assets are recognized for deductible temporary differences, net operating loss carryforwards and credit carryforwards if it is more likely than not that the tax benefits will be realized. For deferred tax assets that cannot be recognized under the more likely than not test, the Company has established a valuation allowance. In the event the Company was to determine that it would be able to realize its deferred tax assets in the future in excess of its net recorded amount, an adjustment to the deferred tax asset would increase either income or contributed capital, or decrease goodwill, in the period such determination was made. Also, if the Company was to determine that it would not be able to realize all or part of its net deferred tax assets in the future, an adjustment to increase the valuation allowance on such net deferred tax asset would be charged to expense in the period such determination was made.

**Derivative Financial Instruments**

The Company transacts business in various foreign currencies and has established a foreign currency hedging program to hedge certain foreign currency forecasted transactions and exposures from existing assets and liabilities. Derivative instruments held by the Company consist of foreign currency forward and option contracts. The Company enters into contracts with counterparties who are major financial institutions and believes the risk related to default is remote. Foreign currency transactions are executed in exchange-traded or over-the-counter markets for which quoted prices exist. Contracts generally have maturities that do not exceed one year. The Company does not hold or issue derivative financial instruments for trading purposes.

The accounting for changes in the fair value of a derivative depends upon whether it has been designated in a hedging relationship and on the type of hedging relationship. To qualify for designation in a hedging relationship, specific criteria must be met and the appropriate documentation maintained. Hedging relationships, if designated, are established pursuant to the Company's risk management policy and are initially and regularly evaluated to determine whether they are expected to be, and have been, highly effective hedges. If a derivative ceases to be a highly effective hedge, hedge accounting is discontinued prospectively, and future changes in the fair value of the derivative are recognized in earnings each period. Changes in the fair value of derivatives not designated in a hedging relationship are recognized in earnings each period. For derivatives designated as a hedge of a forecasted transaction (cash flow hedge), the effective portion of the change in fair value of the derivative is reported in accumulated other comprehensive income and reclassified into earnings in the period in which the forecasted transaction occurs. Amounts excluded from the effectiveness calculation and any ineffective portion of the change in fair value of the derivative are recognized currently in earnings. Gains or losses deferred in accumulated other comprehensive income associated with terminated derivatives and derivatives that cease to be highly effective remain in accumulated other comprehensive income until the forecasted transaction occurs. Forecasted transactions designated as the hedged item in a cash flow hedge are regularly evaluated to assess whether they continue to be probable of occurring. If the forecasted transaction is no longer probable of occurring, any gain or loss deferred in accumulated other comprehensive income is recognized in earnings currently.

The Company had $206,222 and $45,844 of notional value foreign currency forward and option contracts outstanding at December 31, 2004 and 2003, respectively. Notional amounts do not quantify risk or represent assets or liabilities of the Company, but are used in the calculation of cash settlements under the contracts. The fair value of foreign currency forward and option contracts was $3,264 and $11 at December 31, 2004 and 2003, respectively.

**Revenue Recognition**

The Company derives system and software revenue from the sale of licenses of software products and emulation hardware systems. The Company derives service and support revenue from annual support contracts and professional services, which includes consulting services, training services and other services.

For the sale of licenses of software products and related service and support, the Company recognizes revenue in accordance with Statement of Position (SOP) 97-2, "Software Revenue Recognition", as amended by SOP 98-9, "Modification of SOP 97-2, Software Revenue Recognition, With Respect to Certain Transactions". Revenue from perpetual license arrangements is recognized upon shipment, provided persuasive evidence of an arrangement exists, fees are fixed or determinable and collection is probable. Product revenue from term license installment agreements is recognized upon shipment and start of the license term, provided persuasive evidence of an arrangement exists, fees are fixed or determinable and collection is probable. The Company uses term license installment agreements 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. In a term license agreement in which the Company provides the customer with rights to unspecified or unreleased future products, revenue is recognized ratably over the license term.

The Company uses the residual method to recognize revenue when a license agreement includes one or more elements to be delivered at a future date if evidence of the fair value of all undelivered elements exists. If an undelivered element of the arrangement exists under the license arrangement, revenue is deferred based on vendor-specific objective evidence of the fair value of the undelivered element, as established by the price charged when such element is sold separately. If vendor-specific objective evidence of fair value does not exist for all undelivered elements, all revenue is deferred until sufficient evidence exists or all elements have been delivered.

Revenue from annual maintenance and support arrangements is deferred and recognized ratably over the term of the contract. Revenue from consulting and training is recognized when the services are performed.

For the sale of emulation hardware systems and related service and support, the Company recognizes revenue in accordance with SEC Staff Accounting Bulletin (SAB) No. 104, "Revenue Recognition", which supercedes SAB No. 101, "Revenue Recognition in Financial Statements". Revenue is recognized when the title and risk of loss have passed to the customer, there is persuasive evidence of an arrangement, delivery has occurred or services have been rendered, the sales price is fixed or determinable and collection is probable. When the terms of sale include customer acceptance provisions and compliance with those provisions cannot be demonstrated until customer use, revenue is recognized upon acceptance. A limited warranty is provided on emulation hardware systems generally for a period of ninety days. The Company maintains an accrued warranty reserve to provide for these potential future costs and evaluates its adequacy on a quarterly basis. Service and maintenance revenues are recognized over the service period.

**Software Development Costs**

The Company accounts for software development costs in accordance with SFAS No. 86, "Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed." Software development costs are capitalized beginning when a product's technological feasibility has been established by either completion of a detail program design or completion of a working model of the product and ending when a product is available for general release to customers. The period between the achievement of technological feasibility and the general release of the Company's products has historically been of short duration. As a result, such capitalizable software development costs were insignificant and have been charged to research and development expense in the accompanying consolidated statements of operations. Acquired technology costs of $3,634 were capitalized by the Company in 2004.

**Advertising Costs**

The Company expenses all advertising costs as incurred. Advertising expense was approximately $6,800, $6,900 and $7,200 for 2004, 2003 and 2002, respectively, and is included in marketing and selling expense in the accompanying consolidated statements of operations.

**Net Income (Loss) Per Share**

Basic net income (loss) per share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed using the weighted average number of common shares and dilutive potential common shares outstanding during the period. Dilutive common shares consist of employee stock options, purchase rights from Employee Stock Purchase Plans and warrants using the treasury stock method and common shares issued assuming conversion of the convertible subordinated notes, if dilutive.

**Accounting for Stock-Based Compensation**

The Company accounts for employee stock-based compensation in accordance with Accounting Principles Board (APB) Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. If the Company had accounted for its stock-based compensation plans in accordance with SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net income (loss) and net income (loss) per share would approximate the pro forma disclosures below:

| Year ended December 31, | 2004 | 2003 | 2002 |
|---|---|---|---|
| Net income (loss), as reported | $ (20,550) | $ 7,933 | $ (14,314) |
| Deduct: Total stock-based employee compensation expense determined under fair value based method, for all awards not previously included in net income, net of related tax benefit | (17,092) | (22,134) | (19,325) |
| Pro forma net loss | $ (37,642) | $ (14,201) | $ (33,639) |
| Basic net income (loss) per share – as reported | $ (0.28) | $ 0.12 | $ (0.22) |
| Basic net loss per share – pro forma | $ (0.52) | $ (0.21) | $ (0.51) |
| Diluted net income (loss) per share – as reported | $ (0.28) | $ 0.11 | $ (0.22) |
| Diluted net loss per share – pro forma | $ (0.52) | $ (0.21) | $ (0.51) |

**Transfer of Financial Assets**

The Company finances certain software license and service agreements with customers through the sale, assignment and transfer of the future payments under those agreements to financing institutions on a non-recourse basis. The Company records such transfers as sales of the related accounts receivable when it is considered to have surrendered control of such receivables under the provisions of SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities."

**New Accounting Pronouncements**

In October 2004, the EITF ratified its consensus on EITF No. 04-08, "The Effect of Contingently Convertible Debt on Diluted Earnings per Share". EITF No. 04-08 requires that contingently convertible debt instruments that become convertible on satisfaction of a market price condition be included in diluted earnings per share using the if-converted method, regardless of whether the market price condition has been met. The EITF is effective for reporting periods ending after December 15, 2004 and requires the retroactive restatement of earnings per share. Under the provisions of EITF No. 04-08, the Company's Debentures, which represent 4,700 potential shares of common stock, will be included in the calculation of diluted earnings per share, if dilutive, regardless of whether the contingent requirements have been met for conversion to common stock. The Company adopted EITF No. 04-08 in the fourth quarter of 2004. There was no impact on the Company's diluted earnings per share or earnings per share as stated in prior periods.

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 151, "Inventory Costs – An Amendment of ARB No. 43, Chapter 4". SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material and requires that such items be recognized as current-period charges. Additionally, SFAS No. 151 requires the allocation of fixed production overheads to inventory based on the normal capacity of the production facilities. Unallocated overheads must be recognized as an expense in the period incurred. SFAS No. 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 is not expected to have a material impact on the Company's financial position or results of operations.

In December 2004, the FASB issued FASB Staff Position (FSP) No. 109-2, "Accounting and Disclosure Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004". FSP provides guidance under FASB Statement No. 109, "Accounting for Income Taxes," with respect to recording the potential impact of the repatriation provisions of the American Jobs Creation Act of 2004 (the Jobs Act) on enterprises' income tax expense and deferred tax liability. The Jobs Act was enacted on October 22, 2004. FSP No. 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the Jobs Act on its plan for reinvestment or repatriation of foreign earnings for purposes of applying FASB Statement No. 109. The Company has not yet completed evaluating the impact of the repatriation provisions. Accordingly, as provided for in FSP No. 109-2, the Company has not adjusted its tax expense or deferred tax liability to reflect the repatriation provisions of the Jobs Act.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123R), which replaces SFAS No. 123, "Accounting for Stock-Based Compensation," and supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees". SFAS No. 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values beginning with the first interim or annual period after June 15, 2005, with early adoption encouraged. The pro forma disclosures previously permitted under SFAS No. 123 no longer will be an alternative to financial statement recognition. The Company is required to adopt SFAS No. 123R in the third quarter of 2005, beginning July 1, 2005. Under SFAS No. 123R, the Company must determine the appropriate fair value model to be used for valuing share-based payments, the amortization method for compensation cost and the transition method to be used at the date of adoption. The Company is evaluating the requirements of SFAS No. 123R and expects that the adoption of SFAS No. 123R will have a material impact on the Company's results of operations. The Company has not yet determined the method of adoption or the effect of adopting SFAS No. 123R, and it has not determined whether adoption will result in amounts that are similar to the current pro forma disclosures under SFAS No. 123.

In December 2004, the FASB issued SFAS No. 153, "Exchanges of Nonmonetary Assets – An Amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions". SFAS No. 153 eliminates the exception from fair value measurement for nonmonetary exchanges of similar productive assets and replaces it with an exception for exchanges that do not have commercial substance. SFAS No. 153 specifies that a nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on the Company's financial position or results of operations.

**3. Merger and Acquisition Related Charges**

During 2004, the Company acquired 0-In Design Automation Inc. (0-In), a provider of electronic design automation tools for integrated circuit and system-on-chip designs. The acquisition was an investment aimed at expanding the Company's product offering and increasing revenue growth which supported the premium paid over the fair market value of the individual assets. The outstanding shares of common stock and preferred stock of 0-In were converted into approximately 4,507 shares of the Company's common stock, of which approximately 541 shares have been deposited in an indemnity escrow account. The shares were valued at the closing price of $11.00 per share as reported on The NASDAQ Stock Market on September 1, 2004. 0-In stockholders and certain employees will receive future contingent earn-out payments based on the Company's revenues derived from 0-In products and technologies. The total purchase price including acquisition costs was $52,319. The Company recorded severance costs related to 0-In employees of $105 due to the overlap of employee skill sets as a result of the acquisition. In addition, the Company recorded costs for termination of a distributor contract of $282. The excess of tangible assets acquired over liabilities assumed was $1,001. The cost of the acquisition was allocated on the basis of the estimated fair value of assets and liabilities assumed. The purchase accounting allocations resulted in a charge for in-process R&D of $6,400, goodwill of $39,071, technology of $4,400, other identified intangible assets of $5,990, net of related deferred tax liability of $4,156. The technology is being amortized to cost of revenues over three years. The other identified intangible assets are being amortized to operating expenses over two to five years. The results of operations are included in the Company's consolidated financial statements from the date of acquisition forward.

Additionally, during the 2004, the Company acquired (i) Project Technology Inc., (ii) the remaining 49% ownership interest of its Korean distributor, Mentor Korea Co. Ltd. (MGK) for a total ownership interest of 100%, (iii) the parallel and serial ATA IP business division of Palmchip Corporation (Palmchip) and (iv) VeSys Limited. The acquisitions were investments aimed at expanding the Company's product offerings and increasing revenue growth. The aggregate purchase price including acquisition costs for these four acquisitions was $8,791. The aggregate excess of liabilities assumed over tangible assets acquired was $349. The minority interest recorded in connection with the original 51% ownership in MGK was $3,383, less dividends paid in prior years to minority shareholders of $1,975, reducing the acquisition cost to be allocated by a total of $1,408. The purchase accounting allocations resulted in a charge for in-process R&D of $1,300, goodwill of $4,022, technology of $1,510 and other identified intangible assets of $980, net of related deferred tax liability of $80. The technology is being amortized to cost of revenues over two to three years. The other identified intangible assets are being amortized to operating expenses over three years. In connection with the Palmchip acquisition, the Company concurrently licensed software to Palmchip under term licenses and entered into an agreement to provide services. Payment for these arrangements was incorporated into the purchase price of the acquisition and resulted in a reduction of cash paid to Palmchip of $1,208. The results of operations are included in the Company's consolidated financial statements from the date of acquisition forward.

The separate results of operations for the acquisitions during 2004 were not material compared to the Company's overall results of operations and accordingly pro-forma financial statements of the combined entities have been omitted.

During 2003, the Company acquired (i) the Technology Licensing Group business of Alcatel (Alcatel), (ii) Translogic Polska Sp z o.o. (Translogic), (iii) the distributorship, Mentor Italia S.r.l. (Mentor Italia), (iv) the business and technology of DDE-EDA A/S (DDE), and (v) First Earth Limited. The acquisitions were investments aimed at expanding the Company's product offering and increasing revenue growth. The aggregate purchase price including acquisition costs for these five acquisitions was $13,846. The aggregate excess of tangible assets acquired over liabilities assumed was $456. The purchase accounting allocations resulted in a charge for in-process research and development (R&D) of $1,710, goodwill of $7,230, technology of $3,910 and other identified intangible assets of $540. The technology is being amortized to cost of revenues over three years. The other identified intangible assets are being amortized to operating expenses over three years. In connection with the Alcatel acquisition, the Company concurrently licensed software to Alcatel under term licenses and entered into an agreement to provide services. Payment for these arrangements was incorporated into the purchase price of the acquisition and resulted in a reduction of cash paid to Alcatel of $3,804.

In addition, during 2003, the Company recorded a one-time charge to operations of $150 for the acquisition of the in-process R&D of New Design Paradigm, Limited, a developer and marketer of engineering-design software systems for the automotive and aerospace industries.

In 2002, the Company completed three business combinations which were accounted for as purchases. The Company acquired Accelerated Technology, Inc. (ATI) in February 2002, IKOS Systems, Inc. (IKOS) in March 2002 and Innoveda, Inc. (Innoveda) in May 2002. The acquisitions were investments aimed at expanding the Company's product offering and driving revenue growth which supported the premiums paid over the fair market value of the individual assets. The total purchase price including acquisition costs was $331,049, which included the fair value of options assumed totaling $14,118 and fair value of a warrant issued of $361. The excess of tangible assets acquired over liabilities assumed was $23,223. In 2004, the Company recorded an adjustment to increase the tangible assets acquired, and correspondingly decrease goodwill, by $659 as result of the utilization of IKOS deferred tax assets. In 2003, the Company recorded adjustments to decrease the tangible assets acquired, and correspondingly decrease goodwill, by $19,069 as a result of additional deferred tax assets identified in the preparation and filing of the final pre-acquisition IKOS tax return and changes to the balances of acquired assets and liabilities that were identified subsequent to the acquisition date for ATI and Innoveda. In addition, the Company recorded severance costs of $8,386 and costs of vacating certain leased facilities of $16,331. The cost of the acquisition was allocated on the basis of the estimated fair value of assets and liabilities assumed. The purchase accounting allocations resulted in a charge for in-process R&D of $28,700, goodwill of $273,849, technology of $36,400, deferred compensation relating to assumed unvested employee stock options of $6,460, other identified intangible assets of $7,130, net of related deferred tax liability of $19,996. The results of operations are included in the Company's consolidated financial statements from the date of acquisition forward.

Subsequent to the acquisitions in 2002, the Company reversed $1,921 of unamortized deferred compensation to common stock as a result of forfeitures of unvested stock options assumed in the acquisitions due to attrition and workforce reduction.

The Company uses an independent third party valuation firm to assist management in determining the value of the in-process R&D acquired in its business acquisitions. The value assigned to in-process R&D for the charges incurred in 2004 , 2003 and 2002 related to research projects for which technological feasibility had not been established. The value was determined by estimating the net cash flows from the sale of products resulting from the completion of such projects and discounting the net cash flows back to their present value. The rate used to discount the net cash flows was based on the weighted average cost of capital. Other factors considered were the inherent uncertainties in future revenue estimates from technology investments including the uncertainty surrounding the successful development of the acquired in-process technology, the useful life of the technology, the profitability levels of the technology and the stage of completion of the technology. The stage of completion of the products at the date of the acquisition were estimated based on R&D costs that had been expended as of the date of acquisition as compared to total R&D costs expected at completion. The percentages derived from this calculation were then applied to the net present value of future cash flows to determine the in-process charge. The nature of the efforts to develop the in-process technology into commercially viable products principally related to the completion of all planning, designing, prototyping, verification and testing activities that are necessary to establish that the product can be produced to meet its design specification, including function, features and technical performance requirements. The estimated net cash flows from these products were based on estimates of related revenues, cost of sales, R&D costs, selling, general and administrative costs and income taxes. These estimates are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur or that the Company will realize any anticipated benefits of the acquisition. The risks associated with acquired R&D are considered high and no assurance can be made that these products will generate any benefit or meet market expectations.

**4. Emulation Litigation Settlement and Other Special Charges**

Following is a summary of the major elements of the special charges including emulation litigation settlement:

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Emulation litigation settlement | $ (215) | $ 20,264 | $ -- |
| Excess leased facility costs | 1,946 | 10,034 | (5,110) |
| Employee severance | 5,655 | 4,000 | 12,023 |
| Terminated acquisitions | -- | 292 | 135 |
| Other | 1,827 | (206) | (864) |
| Emulation litigation settlement and other special charges | $ 9,213 | $ 34,384 | $ 6,184 |

During 2004, the Company recorded special charges of $9,213. The charges primarily consist of costs incurred for employee terminations and excess leased facility costs.

The Company rebalanced the workforce by 118 employees during 2004. This reduction primarily impacted the sales and research and development organizations. Employee severance costs of $5,655 included severance benefits, notice pay and outplacement services. The total rebalance charge represents the aggregate of numerous unrelated rebalance plans, none of which was individually material to the Company's financial position or results of operations. Termination benefits were communicated to the affected employees prior to year-end. The majority of these costs will be expended in the first half of 2005. There have been no significant modifications to the amount of these charges.

Excess leased facility costs of $1,946 in 2004 include $1,229 in adjustments to previously recorded non-cancelable lease payments primarily for the lease of one facility in North America. These adjustments are primarily a result of reductions to the estimated expected sublease income due to the real estate markets remaining at depressed levels longer than originally anticipated. Non-cancelable lease payments on these excess leased facilities will be expended over six years. The Company also recorded a $758 write-off of leasehold improvements for a facility lease in North America that was permanently abandoned. In addition, the Company reversed $41 related to the decision to utilize space that was previously abandoned for the lease of one facility in North America.

The Company acquired a defined benefit pension plan liability (Plan) in connection with an acquisition in 1999. The Company made the Plan dormant immediately after the acquisition, and then began the process to sever any ongoing obligation to the Plan. During this process, in 2004, a legally-mandated actuarial evaluation was performed which indicated that the Plan needed additional funding related to services rendered prior to the acquisition for which the Company received no benefit. The Company recorded special charges of $1,237 in 2004 when this liability was determined.

Other costs of $590 include costs incurred to restructure the organization other than employee rebalances and excess leased facility costs.

In addition, the Company reversed $215 of the remaining accrual related to the emulation litigation with Cadence Design Systems, Inc.

Accrued special charges are included in accrued liabilities and other long-term liabilities on the consolidated balance sheets. The following table shows changes in accrued special charges during 2004:

| | Accrued Special Charges at December 31, 2003 | 2004 Charges (excluding asset write-offs) | 2004 Payments | Accrued Special Charges at December 31, 2004 (1) |
|---|---|---|---|---|
| Emulation litigation settlement | $ 1,536 | $ (215) | $ 1,321 | $ -- |
| Employee severance and related costs | 2,681 | 5,655 | 4,265 | 4,071 |
| Lease termination fees and other facility costs | 10,034 | 1,188 | 4,198 | 7,024 |
| Other costs | - | 1,827 | 590 | 1,237 |
| Total | $ 14,251 | $ 8,455 | $ 10,374 | $ 12,332 |

(1) Of the $12,332 total accrued special charges at December 31, 2004, $6,127 represents the long-term portion of accrued lease termination fees and other facility costs. The remaining balance of $6,205 represents the short-term portion of accrued special charges.

During 2003, the Company recorded special charges of $34,384. The charges primarily consist of costs incurred for the settlement of emulation litigation, an accrual for excess leased facility costs and costs incurred for employee terminations.

Cadence Design Systems, Inc. (Cadence) and the Company announced in September 2003 that they had agreed to settle all outstanding litigation between the companies relating to emulation and acceleration systems. The companies also reached agreement that, for a period of seven years, neither will sue the other over patented emulation and acceleration technology. In connection with the settlement, the Company recorded emulation litigation settlement costs of $20,264, which included a cash settlement of $18,000 paid to Cadence, costs to make available certain of its products to the OpenAccess computing environment as specified in the settlement agreement and attorneys' fees.

Excess leased facility costs of $10,034 in 2003 consist of $4,925 in non-cancelable lease payments primarily for three facilities in North America. These facilities were permanently abandoned and the payments are net of estimated sublease income. Non-cancelable lease payments on these excess leased facilities will be expended over seven years. In addition, the Company recorded $4,608 in adjustments to previously recorded non-cancelable lease payments primarily for the leases of two facilities in North America. These adjustments are a result of reductions to the estimated expected sublease income primarily due to the real estate markets remaining at depressed levels longer than originally anticipated. Non-cancelable lease payments on these excess leased facilities will be expended over seven years. In addition, the Company recorded a $501 write-off of leasehold improvements for facility leases in Europe and in North America that were permanently abandoned.

The Company rebalanced the workforce by 126 employees during 2003. This reduction primarily impacted the sales and research and development organizations. Employee severance costs of $4,000 included severance benefits, notice pay and outplacement services. Termination benefits were communicated to the affected employees prior to year-end. These costs were expended in 2004. There were no significant modifications to the amount of these charges.

During 2002, the Company recorded special charges of $6,184. The charges primarily consist of costs incurred for employee terminations, partially offset by a net benefit from reduction of accrued excess leased facility costs. Additionally, a $515 benefit for the reversal of excess accruals related to acquisitions that occurred in prior years was included in special charges.

In addition to acquisition related terminations of 176, the Company rebalanced the workforce by 332 employees during 2002. This reduction primarily impacted the sales organization, research and development organization and, to a lesser extent, the consulting division. Employee severance costs of $12,023 included severance benefits, notice pay and outplacement services. Termination benefits were communicated to the affected employees prior to year-end. These costs were expended in 2002 and 2003. There were no significant modifications to the amount of these charges.

The Company recorded excess leased facility costs for leases of facilities in North America and Europe in the fourth quarter of 2001 based on the presumption that such facilities would be permanently abandoned. During 2002, the Company determined that a facility in North America was to be re-occupied as a result of requirements following acquisitions in 2002. At that time, the remaining accrual for $5,855 was reversed. In addition, the Company reduced its accrual for lease termination fees by $777 as a result of changes in assumptions regarding lease payments for an abandoned facility in Europe. In 2002, the Company also recorded $1,223 related to non-cancelable lease payments, net of sublease income, and a $299 write-off of assets and leasehold improvements for leases of facilities in North America, Europe and Japan that the Company had committed to permanently abandon in 2003. The majority of the non-cancelable lease payments on these excess leased facilities were expended during 2003.

During 2002, the Company recorded a benefit to special charges of $2,066 as a result of a reversal of a hold-back liability recorded as a part of the acquisition of the ECAD division of CADIX Incorporated in 2000. Cadix Incorporated relinquished its right to the hold-back amount in exchange for the Company's withdrawal of its filing of damage claims. In an unrelated matter, this benefit was partially offset by the Company's payment of $1,500 related to the settlement of disputed royalties. These settlements resulted in a net benefit to special charges of $566.

**5. Derivative Instruments and Hedging Activities**

The Company is exposed to fluctuations in foreign currency exchange rates. To manage the volatility relating to these exposures, exposures are aggregated on a consolidated basis to take advantage of natural offsets. For exposures that are not offset, the Company enters into short-term foreign currency forward and option contracts to partially offset these anticipated exposures. The primary exposures that do not currently have natural offsets are the Japanese yen where the Company is in a long position and the Euro where the Company is in a short position. The Company formally documents all relationships between foreign currency contracts and hedged items as well as its risk management objectives and strategies for undertaking various hedge transactions. All hedges designated as cash flow hedges are linked to forecasted transactions and the Company assesses, both at inception of the hedge and on an ongoing basis, the effectiveness of the foreign exchange contracts in offsetting changes in the cash flows of the hedged items. The effective portions of the net gains or losses on foreign currency contracts are reported as a component of accumulated other comprehensive income in stockholders' equity. Accumulated other comprehensive income associated with hedges of forecasted transactions is reclassified to the consolidated statement of operations in the same period as the forecasted transaction occurs. The Company discontinues hedge accounting prospectively when it is determined that a foreign currency contract is not highly effective as a hedge under the requirements of SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." Any gain or loss deferred through that date remains in accumulated other comprehensive income until the forecasted transaction occurs at which time it is reclassified to the consolidated statement of operations. To the extent the transaction is no longer deemed probable of occurring, hedge accounting treatment is discontinued prospectively and amounts deferred are reclassified to other income or expense.

The fair value of foreign currency forward and option contracts, recorded in other receivables in the consolidated balance sheet, was $3,264 and $11 at December 31, 2004 and 2003, respectively.

The following provides a summary of activity in accumulated other comprehensive income relating to the Company's hedging program:

| Year ended December 31, | 2004 | 2003 |
|---|---|---|
| Beginning balance | $ - | $ (171) |
| Changes in fair value of cash flow hedges | 2,199 | 671 |
| Net gain transferred to earnings | (1,055) | (500) |
| Net unrealized gain | $ 1,144 | $ - |

The remaining balance in accumulated other comprehensive income at December 31, 2004 represents a net unrealized gain on foreign currency contracts relating to hedges of forecasted revenues and expenses expected to occur during 2005. These amounts will be transferred to the consolidated statement of operations upon recognition of the related revenue and recording of the respective expenses. The Company expects substantially all of the balance in accumulated other comprehensive income to be reclassified to the consolidated statement of operations within the next year. The Company transferred $844 deferred gain and $773 deferred loss to system and software revenues relating to foreign currency contracts hedging revenues for the years ended December 31, 2004 and 2003, respectively. The Company transferred $211 and $1,273 deferred gain to operating expenses relating to foreign currency contracts hedging commission and other expenses for the years ended December 31, 2004 and 2003, respectively.

The Company enters into foreign currency contracts to offset the earnings impact relating to the variability in exchange rates on certain short-term monetary assets and liabilities denominated in non-functional currencies. These foreign exchange contracts are not designated as hedges. Changes in the fair value of these contracts are recognized currently in earnings in other income, net to offset the remeasurement of the related assets and liabilities.

In accordance with SFAS No. 133, the Company excludes changes in fair value relating to time value of foreign currency contracts from its assessment of hedge effectiveness. The Company recorded income relating to time value in other income, net of $1,116, $480 and $1,020 and recorded expense in interest expense of $512, $669 and $551 for the years ended December 31, 2004, 2003 and 2002, respectively.

## 6. Income Taxes

Domestic and foreign pre-tax income (loss) is as follows:

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Domestic | $ (10,203) | $ (27,494) | $ (18,985) |
| Foreign | 39,147 | 28,623 | 368 |
| Total | $ 28,944 | $ 1,129 | $ (18,617) |

The provision (benefit) for income taxes is as follows:

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Current: | | | |
| Federal | $ 5,349 | $ 4,635 | $ (1,695) |
| State | 1,402 | (1,996) | (401) |
| Foreign | 2,867 | 2,780 | 1,666 |
| Total current | 9,618 | 5,419 | (430) |
| Deferred: | | | |
| Federal and state | 35,397 | (14,153) | (1,828) |
| Foreign | 4,479 | 1,930 | (2,045) |
| Total deferred | 39,876 | (12,223) | (3,873) |
| Total | $ 49,494 | $ (6,804) | $ (4,303) |

The effective tax rate differs from the federal tax rate as follows:

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Federal tax | $ 10,130 | $ 395 | $ (6,516) |
| State tax, net of federal benefit | 1,565 | (2,666) | (2,398) |
| Foreign dividend, net of associated foreign tax credits | 36,650 | - | - |
| Impact of international operations | (8,787) | (8,300) | 1,256 |
| Write- off of in process research and development | 2,303 | 10 | 2,219 |
| Tax credits (excluding foreign tax credits) | (721) | - | (1,879) |
| Amortization of deferred tax charge on intercompany sale | 3,060 | 3,060 | 6,783 |
| Change in valuation allowance | 3,429 | - | - |
| Non-deductible meals and entertainment | 509 | 457 | 401 |
| Other, net | 1,356 | 240 | (4,169) |
| Provision (benefit) for income taxes | $ 49,494 | $ (6,804) | $ (4,303) |

The significant components of the deferred income tax provision (benefit) are as follows:

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Net changes in gross deferred tax assets and liabilities | $ 27,152 | $ (39,459) | $ 25,711 |
| Deferred tax assets reducing/(increasing) goodwill | (3,289) | 16,383 | (7,361) |
| Deferred tax assets reducing/(increasing) equity | | 3,458 | - |
| Deferred tax assets reducing/(increasing) deferred charge and other liabilities | (4,518) | 13,900 | - |
| Increase (decrease) in beginning-of-year balance of the valuation allowance for deferred tax assets | 20,531 | (6,505) | (22,223) |
| Total | $ 39,876 | $ (12,223) | $ (3,873) |

The tax effects of temporary differences and carryforwards which gave rise to significant portions of deferred tax assets and liabilities were as follows:

| **As of December 31,** | **2004** | **2003** |
|---|---|---|
| Deferred tax assets: | | |
| Depreciation of property, plant and equipment | $ 2,153 | $ 1,330 |
| Reserves and allowances | 4,543 | 3,008 |
| Accrued expenses not currently deductible | 14,331 | 15,809 |
| Net operating loss carryforwards | 23,117 | 29,615 |
| Tax credit carryforwards | 21,663 | 35,414 |
| Purchased technology and other intangible assets | 8,360 | 10,724 |
| Other, net | 5,785 | 8,734 |
| Total gross deferred tax assets | 79,952 | 104,634 |
| Less valuation allowance | (41,846) | (21,315) |
| Deferred tax assets | 38,106 | 83,319 |
| Deferred tax liabilities: | | |
| Intangible assets | (6,981) | (4,511) |
| Deferred tax liabilities | (6,981) | (4,511) |
| Net deferred tax assets | $ 31,125 | $ 78,808 |

The Company has established a valuation allowance for certain deferred tax assets, including those for a portion of net operating loss and tax credit carryforwards. Such a valuation allowance is recorded when it is more likely than not that some portion of the deferred tax assets will not be realized. Certain subsequent recognized tax benefits related to the valuation allowance for deferred tax assets as of December 31, 2004 will be allocated to contributed capital and goodwill in the amounts of approximately $12,210 and $12,692, respectively.

The amount of the valuation allowance has been determined based on management's estimates of taxable income by jurisdiction in which the Company operates over the periods in which the related deferred tax assets will be recoverable. During 2004, the Company determined it is uncertain whether the Company's United States entities will generate sufficient taxable income and foreign source income to utilize foreign tax credit carryforwards, research and experimentation credit carryforwards and net operating loss carryforwards before expiration. Accordingly, the Company recorded valuation allowances against those deferred tax assets for which realization is uncertain. There is a full valuation allowance on the state deferred tax assets due to the same uncertainties regarding future taxable United States income. The valuation allowance related to certain foreign deferred tax assets is based on historical losses in certain jurisdictions.

The provision for income taxes for 2004 includes tax expense of $36,650, net of associated foreign tax credits, provided on the declaration of a $120,000 dividend from a foreign subsidiary for which provisions of the American Jobs Creation Act of 2004 do not apply. Because the Company had sufficient net operating loss and tax credit carryforwards to offset the tax liability for tax return purposes, the Company incurred a federal cash tax liability of only approximately $2,200 for alternative minimum tax and a state cash tax liability of approximately $200 as a result of the dividend.

In 2002, the Company transferred certain technology rights acquired in the ATI, IKOS and Innoveda acquisitions to one of its wholly owned foreign subsidiaries in a transaction that was projected to generate approximately $110,000 of taxable gain for federal and state income tax purposes over the next three years, with approximately $65,000 recognized in 2002. Due to the intercompany nature of the transfer, the associated income tax expense was to be recorded over a three-year period, and $6,783 of expense was recorded in 2002. The remaining federal and state income tax expense of $25,463 was recorded as a deferred tax charge included in other assets to be amortized to the book provision for income taxes over the remaining years. The recognition of a taxable gain in the United States allowed the Company to utilize domestic deferred tax assets for which a valuation allowance had previously been taken. Accordingly, primarily as a result of the intercompany sale, the valuation allowance for deferred tax assets decreased by $22,223 in 2002, with $20,831 of the related benefit being applied directly to contributed capital as a tax benefit of stock option exercises.

In 2003, the Company reduced the amount payable by its foreign subsidiary for the transfer of IKOS technology rights by approximately $45,000. This was due to declining emulation revenue primarily attributable to lower prices paid by customers as a result of intense competition and the weakened economy. As a result of the corresponding decrease in the projected taxable gain, the deferred tax charge recorded in 2002 for this transaction was reduced by $17,940. The decrease in projected income tax expense from this transaction resulted in the restoration of $13,900 of deferred tax assets that were not utilized under the revised transaction**.** The amortization of deferred tax charge for 2003 and 2004 was $3,060. The remaining balance of the deferred tax charge as of December 31, 2004 was $1,403.

As of December 31, 2004, the Company, for federal income tax purposes, has net operating loss carryforwards of approximately $31,430, foreign tax credits of $2,539, research and experimentation credit carryforwards of $11,762, alternative minimum tax credits of $3,711 and child care credits of $300. As of December 31, 2004, the Company, for state income tax purposes, has net operating loss carryforwards totaling $98,218 from multiple jurisdictions and research and experimentation and other miscellaneous credits of $3,351. As of December 31, 2004, the Company has net operating losses in multiple foreign jurisdictions of $15,161. If not used by the Company to reduce income taxes payable in future periods, net operating loss carryforwards will expire between 2006 through 2023, the foreign tax credits will expire in 2009 through 2014, research and experimentation credit carryforwards between 2009 through 2024 and child care credits between 2023 and 2024. The alternative minimum tax credits do not expire.

The Company provides for United States income taxes on the earnings of foreign subsidiaries unless they are considered permanently invested outside of the United States. At December 31, 2004, the cumulative amount of earnings upon which U.S. income taxes have not been provided is approximately $140,854. Upon repatriation, some of these earnings would generate foreign tax credits which may reduce the federal tax liability associated with any future foreign dividend.

On October 22, 2004, the President signed the American Jobs Creation Act of 2004 (the "Act"). The Act creates a temporary incentive for United States corporations to repatriate accumulated income earned abroad by providing an 85 percent dividends received deduction for certain dividends from controlled foreign corporations. The deduction is subject to a number of limitations and uncertainty remains as to how to interpret numerous provisions in the Act. In December 2004, the FASB issued FASB Staff Position (FSP) No. 109-2, *Accounting and Disclosure Guidance for the foreign Repatriation within the American Jobs Creation Act of 2004 (FSP 109-2).* FSP 109-2 provides guidance for recording the potential impact of the repatriation provisions of the Act on an entity's income tax expense and deferred tax liability. The Company is not yet in a position to decide on whether, and to what extent, it might repatriate foreign earnings that have not yet been remitted to the United States. Based on the analysis to date, it is reasonably possible that the Company may repatriate some amount between zero to $140,854. Accordingly, the Company has not adjusted its tax expense or deferred tax liability to reflect the repatriation provisions of the

Act as the tax effects cannot be reasonably estimated. The Company expects to be in a position to finalize its assessment by the end of 2005.

The Company has reserves for taxes to address potential exposures involving the positions that could be challenged by taxing authorities, even though the Company believes that the positions taken on previously filed tax returns are appropriate. The tax reserves are reviewed as circumstances warrant and adjusted as events occur that affect the Company's potential liability for additional taxes. The Company is subject to income taxes in the United States and in numerous foreign jurisdictions and in the ordinary course of business, there are many transactions and calculations where the ultimate tax determination is uncertain.

During 2004, the Company settled an examination with the Internal Revenue Service for its United States federal income tax returns for the years 2000 and 2001. The results of this exam have been reflected in the deferred tax asset balances and taxes payable balances as of December 31, 2004. There was no impact on tax expense because, as a result of audit findings, an additional assessment of tax liability for the audit period had been adequately provided for in previous periods. See "Factors that may affect future results and financial condition" below. In addition, the Company is currently under examination by the IRS for its 2002 and 2003 federal income tax returns. While it is often difficult to predict the final outcome or the timing of resolution of any particular tax matter, the Company believes the tax reserves are adequate to cover any potential liabilities that could result from the current examinations.

## 7. Property, Plant and Equipment, Net

A summary of property, plant and equipment, net follows:

| **As of December 31,** | **2004** | **2003** |
|---|---|---|
| Computer equipment and furniture | $ 174,843 | $ 157,811 |
| Buildings and building equipment | 50,208 | 50,611 |
| Land and improvements | 13,138 | 14,178 |
| Leasehold improvements | 26,852 | 24,432 |
| | 265,041 | 247,032 |
| Less accumulated depreciation and amortization | (173,817) | (155,682) |
| Property, plant and equipment, net | $ 91,224 | $ 91,350 |

## 8. Short-Term Borrowings

On July 14, 2003, the Company renewed its syndicated, senior, unsecured credit facility that allows the Company to borrow up to $100,000. This facility is a three-year revolving credit facility, which terminates on July 14, 2006. Under this facility, the Company has the option to pay interest based on LIBOR plus a spread of between 1.25% and 2.00% or prime plus a spread of between 0% and 0.75%, based on a pricing grid tied to a financial covenant. As a result, the Company's interest expense associated with borrowings under this credit facility will vary with market interest rates. In addition, commitment fees are payable on the unused portion of the credit facility at rates between 0.35% and 0.50% based on a pricing grid tied to a financial covenant. The facility contains certain financial and other covenants, including financial covenants requiring the maintenance of specified liquidity ratios, leverage ratios and minimum tangible net worth. The Company's credit facility prohibits the payment of dividends. The Company had no borrowings against the credit facility during 2004 and had no balance outstanding at December 31, 2004 and 2003.

Other short-term borrowings include borrowings on multi-currency lines of credit, capital leases and other borrowings. Interest rates are generally based on the applicable country's prime lending rate, depending on the currency borrowed. Other short-term borrowings of $9,632 and $6,910 were outstanding under these facilities at December 31, 2004 and 2003, respectively.

## 9. Long-Term Notes Payable

In August 2003, the Company issued $110,000 of Floating Rate Convertible Subordinated Debentures (Debentures) due 2023 in a private offering pursuant to SEC Rule 144A. The Debentures have been registered with the SEC under the Securities Act of 1933. The Company pays interest on the Debentures quarterly in February, May, August and November, at a variable interest rate equal to 3-month LIBOR plus 1.65%. The effective interest rate for 2004 was 3.15%. The Debentures are convertible, under certain circumstances, into the Company's common stock at a conversion price of $23.40 per share, for a total of 4,700 shares. These circumstances generally include (a) the market price of the Company's common stock exceeding 120% of the conversion price, (b) the market price of the Debentures declining to less than 98% of the value of the common stock into which the Debentures are convertible, or (c) a call for redemption of the Debentures or certain other corporate transactions. The conversion price may also be adjusted based on certain future transactions. Some or all of the Debentures may be redeemed by the Company for cash on or after August 6, 2007. Some or all of the Debentures may be redeemed at the option of the holder for cash on August 6, 2010, 2013 or 2018.

In June 2002, the Company issued $172,500 of 6 7/8% Convertible Subordinated Notes (Notes) due 2007 in a private offering pursuant to SEC Rule 144A. The Notes have been registered with the SEC under the Securities Act of 1933. The Company pays interest on the Notes semi-annually in June and December. The Notes are convertible into 7,370 shares of the Company's common stock at a conversion price of $23.27 per share for the Notes remaining outstanding at December 31, 2004. Some or all of the Notes may be redeemed by the Company for cash on or after June 20, 2005. The Notes rank pari passu with the Debentures. In 2004, the Company purchased on the open market Notes with a principal balance of $1,000 for a total purchase price of $1,028. In connection with this purchase, the Company incurred before tax expenses for the early extinguishment of debt of $43. Expenses include the call premium on the Notes and the write-off of unamortized deferred debt issuance costs.

Other long-term notes payable include multi-currency notes payable and capital leases. Interest rates are generally based on the applicable country's prime lending rate, depending on the currency borrowed. Other long-term notes payable of $2,483 and $4,268 were outstanding under these agreements at December 31, 2004 and 2003, respectively.

### 10. Other Long-Term Liabilities

A summary of other long-term liabilities follows:

| **As of December 31,** | **2004** | **2003** |
|---|---|---|
| Lease termination fees and other facilities related costs | $ 16,705 | $ 20,919 |
| Employment related accruals | 1,966 | 1,470 |
| Other | 427 | 772 |
| Total other long-term liabilities | $ 19,098 | $ 23,161 |

### 11. Net Income (Loss) Per Share

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

| **Year Ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Net income (loss) | $ (20,550) | $ 7,933 | $ (14,314) |
| Weighted average shares used to calculate basic net income (loss) per share | 72,381 | 67,680 | 65,766 |
| Employee stock options and employee stock purchase plan | -- | 2,784 | -- |
| Weighted average common and potential common shares used to calculate diluted net income (loss) per share | 72,381 | 70,464 | 65,766 |
| Basic net income (loss) per share | $ (.28) | $ .12 | $ (.22) |
| Diluted net income (loss) per share | $ (.28) | $ .11 | $ (.22) |

Options and warrants to purchase 18,762, 8,583 and 16,947 shares of common stock were not included in the computation of diluted earnings per share for the years ended December 31, 2004, 2003 and 2002, respectively. The options and warrants were anti-dilutive either because the Company incurred a net loss or because the exercise price was greater than the average market price of the common shares for the respective periods. The effect of the conversion of the Company's Notes and Debentures for the years ended December 31, 2004, 2003 and 2002 was anti-dilutive. If the Notes had been dilutive, the Company's net income (loss) per share would have included additional earnings, primarily from the reduction of interest expense, of $10,794, $10,806 and $5,719 and additional incremental shares of 7,409, 7,412, and 4,320 for the years ended December 31, 2004, 2003 and 2002, respectively. If the Debentures had been dilutive, additional earnings of $3,305 and $1,263 and incremental shares of 4,700 and 1,906 would have been included in the calculation of net income per share for the years ended December 31, 2004 and 2003, respectively.

## 12. Incentive Stock

The Board of Directors has the authority to issue incentive stock in one or more series and to determine the relative rights and preferences of the incentive stock. On February 10, 1999, the Company adopted a Shareholder Rights Plan and declared a dividend distribution of one Right for each outstanding share of Common Stock, payable to holders of record on March 5, 1999. As long as the Rights are attached to the Common Stock, the Company will issue one Right with each new share of Common Stock so that all such shares will have attached Rights. Under certain conditions, each Right may be exercised to purchase 1/100 of a share of Series A Junior Participating Incentive Stock at a purchase price of $95, subject to adjustment. The Rights are not presently exercisable and will only become exercisable if a person or group acquires or commences a tender offer to acquire 15% of the Common Stock. If a person or group acquires 15% of the Common Stock, each Right will be adjusted to entitle its holder to receive, upon exercise, Common Stock (or, in certain circumstances, other assets of the Company) having a value equal to two times the exercise price of the Right or each Right will be adjusted to entitle its holder to receive, upon exercise, common stock of the acquiring company having a value equal to two times the exercise price of the Right, depending on the circumstances. The Rights expire on February 10, 2009 and may be redeemed by the Company for $0.01 per Right. The Rights do not have voting or dividend rights, and until they become exercisable, have no dilutive effect on the earnings of the Company.

## 13. Employee Stock and Savings Plans

The Company has three common stock option plans which provide for the granting of incentive and nonqualified stock options to key employees, officers and non-employee directors of the Company and its subsidiaries. The three stock option plans are administered by the Compensation Committee of the Board of Directors and permit accelerated vesting of outstanding options upon the occurrence of certain changes in control of the Company.

The Company also has a stock plan that provides for the sale of common stock to key employees of the Company and its subsidiaries. Shares can be awarded under the plan at no purchase price as a stock bonus and the stock plan also provides for the granting of nonqualified stock options.

In 2002, the Company assumed stock options of 1,078 and 1,088 granted to the former employees of IKOS and Innoveda, respectively. The options assumed were outside the Company’s plans but are administered as if issued under the plans. Assumed options have been adjusted to give effect to the conversion under the terms of the respective merger agreements. No additional stock options will be granted under the IKOS and Innoveda option plans.

In May 1989, the shareholders adopted the 1989 Employee Stock Purchase Plan (US ESPP) and reserved 1,400 shares for issuance. The shareholders have subsequently amended the US ESPP to reserve an additional 14,250 shares for issuance. In June 2002, the Board of Directors adopted the Foreign Subsidiary Employee Stock Purchase Plan, with substantially identical terms. A total of 1,900 shares have been reserved for issuance to foreign employees. The ESPPs provide for overlapping two-year offerings starting every six months on January 1 and July 1 of each year with purchases every six months during those offerings. Each eligible employee may purchase up to sixteen hundred shares of stock on each purchase date at prices no less than 85% of the lesser of the fair market value of the shares at the beginning of the two-year offering period or on the applicable purchase date. In September 2002, the Board of Directors authorized a special purchase date on September 30, 2002, and a special 27-month offering commencing on October 1, 2002 with purchases on January 1, 2003 and every six months thereafter. Employees purchased 2,829, 1,950 and 1,046 shares under the ESPPs in 2004, 2003 and 2002, respectively. At December 31, 2004, 4,902 shares remain available for future purchase under the ESPPs. The plans will expire upon either issuance of all shares reserved for issuance or at the discretion of the Board of Directors. In December 2004, the Board of Directors approved amendments to the ESPPs that increase the Company’s flexibility with respect to any termination of such plans.

SFAS No. 123 defines a fair value based method of accounting for employee stock options and similar equity instruments. As is permitted under SFAS No. 123, the Company elected to continue to account for its stock-based compensation plans under APB Opinion No. 25. Other than with respect to options assumed through acquisitions, no stock-based employee compensation cost is reflected in net income, as all options granted under the Company’s plans have an exercise price equal to the market value of the underlying common stock on the date of grant. The Company recorded compensation expense of $1,427, $2,047 and $1,049 in 2004, 2003 and 2002, respectively, for amortization of deferred compensation related to unvested stock options assumed through acquisitions. The Company has computed, for pro forma disclosure purposes, the value of all stock-based awards granted during 2004, 2003, and 2002 using the Black-Scholes option pricing model as prescribed by SFAS No. 123 using the following assumptions:

| **Stock Option Plans<br>Year ended December 31** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Risk-free interest rate | 3.5% | 3.2% | 3.8% |
| Dividend yield | 0% | 0% | 0% |
| Expected life (in years) | 4.4 | 4.3 | 4.1 |
| Volatility | 45% | 45% | 86% |

| **Employee Stock Purchase Plans<br>Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| Risk-free interest rate | 2.3% | 1.4% | 1.7% |
| Dividend yield | 0% | 0% | 0% |
| Expected life (in years) | 1.25 | 1.25 | 1.25 |
| Volatility | 45% | 45% | 86% |

The Company used expected volatility to estimate volatility for options granted during 2004 and 2003, and considers expected volatility to be more representative of prospective trends. Expected volatility is based on the option feature embedded in the Company's Debentures, which is comparable to employee stock options. In 2002, the Company used historical volatility. Using the Black-Scholes methodology, the total fair value of options granted during 2004, 2003 and 2002 was $11,759, $19,158 and $25,717, respectively, which would be amortized on a pro forma basis over the vesting period of the options. The total fair value of purchase rights under the ESPPs during 2004, 2003 and 2002 was $6,796, $4,955 and $3,606, respectively, which would be amortized on pro forma basis over the purchase period. The weighted average fair value of options granted during 2004, 2003 and 2002 was $5.08, $5.98 and $5.86 per share, respectively. The weighted average fair value of purchase rights under the ESPPs during 2004, 2003 and 2002 was $2.00, $1.87 and $2.47 per share, respectively. See Note 2, Summary of Significant Accounting Policies, for disclosure of the Company's pro forma net income (loss) and net income (loss) per share information.

The following table summarizes information about options outstanding and exercisable at December 31, 2004:

| | **Outstanding** | | | **Exercisable** | |
|---|---|---|---|---|---|
| **Range of Exercise Prices** | **Number of Shares** | **Weighted Average Contractual Life (Years)** | **Weighted Average Price** | **Number of Shares** | **Weighted Average Price** |
| $ 0.04 – 5.11 | 210 | 5.34 | $ 2.88 | 169 | $ 2.51 |
| $ 5.22 – 5.66 | 2,503 | 7.72 | $ 5.64 | 1,217 | $ 5.64 |
| $ 5.67 – 9.00 | 2,379 | 3.86 | $ 8.05 | 2,252 | $ 8.08 |
| $ 9.13 – 11.74 | 3,313 | 7.37 | $11.03 | 1,198 | $10.01 |
| $11.87 – 14.70 | 1,536 | 5.19 | $12.98 | 1,355 | $12.85 |
| $14.75 – 15.25 | 2,470 | 8.77 | $15.24 | 730 | $15.23 |
| $15.29 – 17.27 | 1,060 | 6.93 | $16.61 | 677 | $16.67 |
| $17.32 – 17.81 | 2,512 | 5.78 | $17.81 | 2,495 | $17.81 |
| $17.82 – 18.69 | 210 | 7.46 | $18.27 | 120 | $18.35 |
| $18.84 – 38.15 | 3,557 | 6.69 | $20.33 | 2,707 | $20.39 |
| $ 0.04 – 38.15 | 19,750 | 6.63 | $13.49 | 12,920 | $13.86 |

Options under all four plans generally expire ten years from the date of grant and become exercisable over four years from the date of grant or from the commencement of employment at prices generally not less than the fair market value at the date of grant. The excess of the fair market value of the shares at the date of grant over the option price, if any, is charged to earnings ratably over the vesting period. At December 31, 2004, 6,251 shares were available for future grant.

Stock options outstanding, the weighted average exercise price and transactions involving the stock option plans are summarized as follows:

| | Shares | Price |
|---|---|---|
| **Balance at December 31, 2001** | 14,442 | $ 14.40 |
| Granted | 4,390 | 9.06 |
| Assumed through acquisition | 2,166 | 13.60 |
| Exercised | (877) | 9.07 |
| Canceled | (1,889) | 16.53 |
| **Balance at December 31, 2002** | 18,232 | $ 13.05 |
| Granted | 3,201 | 14.86 |
| Exercised | (1,449) | 9.93 |
| Canceled | (829) | 15.08 |
| **Balance at December 31, 2003** | 19,155 | $ 13.50 |
| Granted | 2,316 | 12.29 |
| Exercised | (817) | 7.87 |
| Canceled | (904) | 15.68 |
| **Balance at December 31, 2004** | 19,750 | $ 13.49 |

The Company has an employee savings plan (the Savings Plan) that qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Under the Savings Plan, participating United States employees may defer a portion of their pretax earnings, up to the Internal Revenue Service annual contribution limit. The Company currently matches 50% of eligible employee's contributions, up to a maximum of 6% of the employee's earnings. Employer matching contributions vest over five years, 20% for each year of service completed. The Company's matching contributions to the Savings Plan were $5,251, $4,809, and $4,252 in 2004, 2003 and 2002, respectively.

## 14. Stock Repurchases

The Board of Directors has authorized the Company to repurchase shares of its common stock in the open market. There were no repurchases in 2004. In 2003, the Company used a portion of the proceeds from the sale of the Debentures to repurchase 1,750 shares of common stock for an aggregate purchase price of $29,785. There were no repurchases in 2002. The Company considers market conditions, alternative uses of cash and balance sheet ratios when evaluating share repurchases.

## 15. Common Stock Warrants

On February 22, 2002, as part of the purchase price for the acquisition of ATI, the Company issued warrants to purchase 50 shares of the Company's common stock for $20.77 per share, exercisable from February 15, 2006 until February 14, 2012. All warrants issued remain outstanding as of December 31, 2004.

## 16. Accumulated Other Comprehensive Income

The following table summarizes the components of accumulated other comprehensive income:

| As of December 31, | 2004 | 2003 |
|---|---|---|
| Foreign currency translation adjustment | $ 30,762 | $ 25,922 |
| Unrealized gain on derivatives | 1,144 | -- |
| Minimum pension liability | (855) | (935) |
| Accumulated other comprehensive income | $ 31,051 | $ 24,987 |

## 17. Commitments and Contingencies

**Leases**

The Company leases a majority of its field office facilities under non-cancelable operating leases. In addition, the Company leases certain equipment used in its research and development activities. This equipment is generally leased on a month-to-month basis after meeting a six-month lease minimum.

Future minimum lease payments under all non-cancelable operating leases are approximately as follows:

| Annual periods ending December 31, | |
|---|---|
| 2005 | $ 29,278 |
| 2006 | 23,088 |
| 2007 | 18,530 |
| 2008 | 16,689 |
| 2009 | 13,683 |
| Thereafter | 28,440 |
| Total | $ 129,708 |

Rent expense under operating leases was $35,403, $28,554 and $27,353 for the years ended December 31, 2004, 2003 and 2002, respectively.

The Company entered into agreements to sublease portions of its facility sites. Under terms of these agreements future rental receipts of $876, $144 and $120 are expected in 2005, 2006 and 2007, respectively.

**Indemnifications**

The Company's license and services agreements include a limited indemnification provision for claims from third-parties relating to the Company's intellectual property. Such indemnification provisions are accounted for in accordance with SFAS No. 5, "Accounting for Contingencies". The indemnification is limited to the amount paid by the customer. At December 31, 2004, the Company is not aware of any material liabilities arising from these indemnifications.

**Legal Proceedings**

From time to time the Company is involved in various disputes and litigation matters that arise from the ordinary course of business. These include disputes and lawsuits relating to intellectual property rights, licensing, contracts and employee relation matters. The Company believes that the outcome of current litigation, individually and in the aggregate, will not have a material affect on the Company's results of operations.

## 18. Other Income, Net

Other income, net is comprised of the following:

| Year ended December 31, | 2004 | 2003 | 2002 |
|---|---|---|---|
| Interest income | $ 8,159 | $ 5,679 | $ 6,653 |
| Gain on sale of investments | 1,403 | 2,390 | 2,438 |
| Minority interest in earnings | (7) | (281) | (703) |
| Foreign exchange loss | (499) | (1,481) | (199) |
| Other, net | (668) | (847) | (1,284) |
| Other income, net | $ 8,388 | $ 5,460 | $ 6,905 |

**19. Supplemental Cash Flow Information**

The following provides additional information concerning supplemental disclosures of cash flow activities:

| Year ended December 31, | 2004 | 2003 | 2002 |
|---|---|---|---|
| Cash paid for: | | | |
| Interest | $ 16,513 | $ 14,446 | $ 7,558 |
| Income taxes | $ 1,780 | $ 5,777 | $ 3,077 |
| Stock, stock warrant and stock options issued for purchase of businesses | $ 49,576 | $ -- | $ 14,479 |
| Equipment acquired with capital leases | $ 176 | $ 315 | $ 774 |

**20. Related Party Transactions**

Certain members of the Company's Board of Directors also serve on the Board of Directors of certain of the Company's customers. During 2004, aggregate revenues of $16,132, which represented 2.2% of the Company's total revenues, were recognized from these customers. Management believes the transactions between the Company and these customers were carried out on an arm's length basis.

**21. Segment Reporting**

SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information", requires disclosures of certain information regarding operating segments, products and services, geographic areas of operation and major customers. To determine what information to report under SFAS No. 131, the Company reviewed the Chief Operating Decision Makers' (CODM) method of analyzing the operating segments to determine resource allocations and performance assessments. The Company's CODMs are the Chief Executive Officer and the President.

The Company operates exclusively in the EDA industry. The Company markets its products primarily to customers in the communications, computer, semiconductor, consumer electronics, aerospace, and transportation industries. The Company sells and licenses its products through its direct sales force in North America, Europe, Japan and Pacific Rim, and through distributors where third parties can extend sales reach more effectively or efficiently. The Company's reportable segments are based on geographic area.

All intercompany revenues and expenses are eliminated in computing revenues and operating income. The corporate component of operating income represents research and development, corporate marketing and selling, corporate general and administration, special charges and merger and acquisition related charges. Reportable segment information is as follows:

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| **Revenues:** | | | |
| Americas | $ 306,911 | $ 331,307 | $ 305,542 |
| Europe | 199,417 | 188,657 | 157,679 |
| Japan | 131,107 | 100,737 | 81,757 |
| Pacific Rim | 73,521 | 54,967 | 51,201 |
| Total | $ 710,956 | $ 675,668 | $ 596,179 |
| **Operating Income (Loss):** | | | |
| Americas | $ 172,775 | $ 187,683 | $ 167,137 |
| Europe | 106,618 | 101,998 | 85,291 |
| Japan | 89,116 | 61,185 | 46,599 |
| Pacific Rim | 54,947 | 39,597 | 34,918 |
| Corporate | (384,281) | (377,570) | (347,771) |
| Total | $ 39,175 | $ 12,893 | $ (13,826) |
| **Depreciation and Amortization of Property, Plant and Equipment:** | | | |
| Americas | $ 16,076 | $ 15,424 | $ 14,422 |
| Europe | 4,959 | 5,155 | 5,297 |
| Japan | 1,294 | 1,080 | 1,008 |
| Pacific Rim | 2,089 | 1,487 | 699 |
| Total | $ 24,418 | $ 23,146 | $ 21,426 |
| **Capital Expenditures:** | | | |
| Americas | $ 13,195 | $ 14,652 | $ 13,013 |
| Europe | 5,183 | 5,772 | 4,668 |
| Japan | 2,310 | 319 | 459 |
| Pacific Rim | 3,735 | 2,789 | 2,269 |
| Total | $ 24,423 | $ 23,532 | $ 20,409 |
| **Identifiable Assets:** | | | |
| Americas | $ 701,973 | $ 692,219 | $ 548,927 |
| Europe | 200,454 | 170,755 | 191,276 |
| Japan | 79,193 | 50,802 | 43,165 |
| Pacific Rim | 40,287 | 26,912 | 21,480 |
| Total | $ 1,021,907 | $ 940,688 | $ 804,848 |

The Company segregates revenue into three categories of similar products and services. These categories include integrated circuit design, systems design and professional services. The integrated circuit design and systems design categories include both product and support revenues. Revenue information is as follows:

| **Year ended December 31,** | **2004** | **2003** | **2002** |
|---|---|---|---|
| **Revenues:** | | | |
| Integrated circuit design | $ 498,236 | $ 466,279 | $ 414,794 |
| Systems design | 184,798 | 184,476 | 156,021 |
| Professional services | 27,922 | 24,913 | 25,364 |
| Total | $ 710,956 | $ 675,668 | $ 596,179 |

**22. Quarterly Financial Information – Unaudited**

A summary of quarterly financial information follows:

| Quarter ended | March 31 | June 30 | September 30 | December 31 |
|---|---|---|---|---|
| **2004** | | | | |
| Total revenues | $ 164,405 | $ 169,642 | $ 161,960 | $ 214,949 |
| Gross margin | $ 137,282 | $ 143,436 | $ 136,353 | $ 186,328 |
| Operating income (loss) | $ 5,849 | $ 7,308 | $ (4,774) | $ 30,792 |
| Net income (loss) | $ 2,178 | $ (32,796) | $ (5,746) | $ 15,814 |
| Net income (loss) per share, basic | $ 0.03 | $ (0.47) | $ (0.08) | $ 0.21 |
| Net income (loss) per share, diluted | $ 0.03 | $ (0.47) | $ (0.08) | $ 0.20 |
| **2003** | | | | |
| Total revenues | $ 159,340 | $ 157,468 | $ 156,951 | $ 201,909 |
| Gross margin | $ 131,613 | $ 129,660 | $ 128,343 | $ 169,355 |
| Operating income (loss) | $ 8,057 | $ 7,096 | $ (20,142) | $ 17,882 |
| Net income (loss) | $ 3,599 | $ 4,074 | $ (12,790) | $ 13,050 |
| Net income (loss) per share, basic | $ 0.05 | $ 0.06 | $ (0.19) | $ 0.19 |
| Net income (loss) per share, diluted | $ 0.05 | $ 0.06 | $ (0.19) | $ 0.18 |

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Stockholders and Board of Directors
Mentor Graphics Corporation:

We have audited the accompanying consolidated balance sheets of Mentor Graphics Corporation and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2004. In connection with our audits of the consolidated financial statements, we also have audited financial statement Schedule II. These consolidated financial statements and financial statement Schedule II are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the 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 Mentor Graphics Corporation and subsidiaries as of December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the related financial statement Schedule II, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Mentor Graphics Corporation and subsidiaries internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 15, 2005 expressed an unqualified opinion on management's assessment of, and an adverse opinion on the effective operation of, internal control over financial reporting.

/s/ KPMG LLP

Portland, Oregon
March 15, 2005

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 9A. Controls and Procedures**

(1) *Management's Report on Internal Control Over Financial Reporting*

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness (within the meaning of PCAOB Auditing Standard No. 2) is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2004, and this assessment identified a material weakness in the Company's internal control over financial reporting related to the calculation of the Company's income tax provision. The key internal controls over financial reporting related to the calculation of the Company's income tax provision are (i) the development of the income tax accounting amounts using a detailed checklist for each step of the related calculations, and (ii) review and final approval of the resulting proposed entries by the Company's tax director.

The aforementioned internal controls did not operate effectively as of December 31, 2004, and, accordingly, the Company's income tax accounting calculations were found to be in error. Specifically, the Company recorded a valuation allowance on certain deferred tax assets and inappropriately reflected the related charge in the Company's 2004 statement of operations. This error was corrected by properly reflecting the charge in stockholders' equity.

In making its assessment of internal control over financial reporting, management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Because of the material weakness described above, management's conclusion is that the Company did not maintain effective internal control over financial reporting as of December 31, 2004.

The Company's independent registered public accounting firm, KPMG LLP, has issued an attestation report on management's assessment of the Company's internal control over financial reporting. That report appears below.

(2) *Remediation Steps to Address Material Weakness*

The Company has taken action to correct the material weakness in internal control over financial reporting by (i) adding review procedures to ensure completion of the steps identified by the detailed checklist prior completion of the income tax provision, (ii) providing personnel with access to additional training on SFAS No. 109, "Accounting for Income Taxes" and (iii) engaging an independent accounting firm to review its income tax accounting on a quarterly and annual basis, prior to the review or audit of the Company's financial statements by the Company's independent auditors.

(3) ***Changes in Internal Control Over Financial Reporting***

There has been no change in the Company's internal control over financial reporting that occurred during the last quarter of the period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

(4) *Evaluation of Disclosure Controls and Procedures*

The Company maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the Company's Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

The Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were ineffective as of the end of the period covered by this report due to the material weakness identified in Management’s Report on Internal Control Over Financial Reporting.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Stockholders and Board of Directors
Mentor Graphics Corporation:

We have audited management's assessment, included in the accompanying Management’s Report on Internal Control Over Financial Reporting (Item 9A.(1)), that Mentor Graphics Corporation did not maintain effective internal control over financial reporting as of December 31, 2004, because of the effect of a material weakness identified in management's assessment, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Mentor Graphics Corporation’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment:
Internal controls over financial reporting related to the calculation of the Company’s income tax provision related to (i) the development of the income tax accounting amounts using a detailed checklist for each step of the related calculations, and (ii) review and final approval of the resulting proposed entries by the Company’s tax director, did not operate effectively as of December 31, 2004, and, accordingly, the Company’s income tax accounting calculations were found to be in error. Specifically, the Company recorded a valuation allowance on certain deferred tax assets and inappropriately reflected the related charge in the Company’s 2004 statement of operations. This error was corrected by properly reflecting the charge in stockholders’ equity.

In our opinion, management's assessment that Mentor Graphics Corporation did not maintain effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, Mentor Graphics Corporation has not maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Mentor Graphics Corporation and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2004. The aforementioned material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2004 consolidated financial statements, and this report does not affect our report dated March 15, 2005, which expressed an unqualified opinion on those consolidated financial statements.

/s/KPMG LLP

Portland, OR
March 15, 2005

**Item 9B. Other Information**

*Executive Variable Incentive Plan*

On March 10, 2005, the Board of Directors approved the Company's Executive Variable Incentive Plan (the "Plan"). The Plan is intended to serve as the vehicle through which the Company's annual cash variable incentive programs for executive officers will operate. No change to the basic structure of those annual programs is anticipated as a result of adoption of the Plan. To make an award under the Plan for any year, the Compensation Committee shall establish or approve for each participant the performance goals for the year and the amount, or the formula for determining the amount, of cash bonus to be paid or accrued for the participant based on achievement of the performance goals for the year. The performance goals shall be one or more targeted levels of performance of the Company or any subsidiary, division or other unit of the Company with respect to one or more of the following objective measures: operating income, revenues, bookings, operating expenses or any of the foregoing before the effect of acquisitions, divestitures, accounting changes, and restructuring and special charges. Following the conclusion of any year, the Compensation Committee will certify the attainment of the performance goals and the resulting bonus calculations. On February 16, 2005, the Compensation Committee approved performance goals and bonus targets for executive officers for 2005 performance based on the objective measures set out above.

## Part III

**Item 10. Directors and Executive Officers of Registrant**

The information required by this item concerning the Company's Directors will be included under "Election of Directors" in the Company's 2005 Proxy Statement and is incorporated herein by reference. The information concerning the Company's Executive Officers is included herein on pages 8-9 under the caption "Executive Officers of Registrant." The information required by Item 405 of Regulation S-K will be included under "Section 16(a) Beneficial Ownership Reporting Compliance" in the Company's 2005 Proxy Statement and is incorporated herein by reference. The information required by Item 406 of Regulation S-K will be included under "Ethics Policies" in the Company's 2005 Proxy Statement and is incorporated herein by reference.

**Item 11. Executive Compensation**

The information required by this item will be included under "Compensation of Directors" and "Information Regarding Executive Officer Compensation" in the Company's 2005 Proxy Statement and is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management**

The information required by this item will be included under "Election of Directors", "Information Regarding Beneficial Ownership of Principal Shareholders and Management" and "Equity Compensation Plan Information" in the Company's 2005 Proxy Statement and is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions**

The information required by this item is not applicable to the Company.

## Item 14. Principal Accountant Fees and Services

The information required by this item will be included under “Independent Auditors” in the Company’s 2005 Proxy Statement and is incorporated by reference.

## Part IV

**Item 15. Exhibits and Financial Statement Schedules**

(a) 1 Financial Statements:

The following consolidated financial statements are included in Item 8:

| | **Page** |
|---|---|
| Consolidated Statements of Operations for the years ended December 31, 2004, 2003 and 2002 | 33 |
| Consolidated Balance Sheets as of December 31, 2004 and 2003 | 34 |
| Consolidated Statements of Cash Flows for the years ended December 31, 2004, 2003 and 2002 | 35 |
| Consolidated Statements of Stockholders' Equity for the years ended December 31, 2004, 2003 and 2002 | 36 |
| Notes to Consolidated Financial Statements | 37 |
| Report of Independent Registered Public Accounting Firm | 58 |

(a) 2 Financial Statement Schedule:

The schedule and report listed below are filed as part of this report on the pages indicated:

| | **Page** |
|---|---|
| Schedule II Valuation and Qualifying Accounts | 66 |

All other financial statement schedules have been omitted since they are not required, not applicable or the information is included in the Consolidated Financial Statements or Notes.

(a) 3 Exhibits

2. A. Agreement and Plan of Merger dated as of June 5, 2004, by and among the Company, Null Set Acquisition Corporation and 0-In Design Automation, Inc., and amendment thereto dated July 22, 2004. Incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on September 7, 2004.

3. A. 1987 Restated Articles of Incorporation, as amended. Incorporated by reference to Exhibit 3A to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30. 2004.

   B. Bylaws of the Company. Incorporated by reference to Exhibit 3.C to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2000 (2000 10-K).

4. A. Rights Agreement, dated as of February 10, 1999, between the Company and American Stock, Transfer & Trust Co. Incorporated by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed on February 19, 1999.

   B. Indenture dated June 3, 2002 between the Company and Wilmington Trust Company relating to 6 7/8% Convertible Subordinated Notes due 2007. Incorporated by reference to Exhibit 4.B to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.

   C. Resale Registration Rights Agreement dated June 3, 2002. Incorporated by reference to Exhibit 4.C to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2002.

   D. Indenture dated as of August 6, 2003 between the Company and Wilmington Trust Company related to Floating Rate Convertible Subordinated Debentures due 2023. Incorporated by reference to Exhibit 4.2 of the Company's Registration Statement on Form S-3 (Registration No. 333-109885).

   E. Registration Rights Agreement dated as of August 6, 2003. Incorporated by reference to Exhibit 4.4 of the Company's Registration Statement on Form S-3 (Registration No. 333-109885).

   F. Credit Agreement dated as of July 14, 2003 between the Company, Bank of America, N.A. as agent and the other lenders. Incorporated by reference to Exhibit 10.A to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003.

G. First Amendment to Credit Agreement dated as of October 21, 2003 between the Company, Bank of America, N.A. as agent and the other lenders. Incorporated by reference to Exhibit 10.I to the Company's Annual Report on Form 10-K for the year ended December 31, 2003.

10. *A. 1982 Stock Option Plan. Incorporated by reference to Exhibit 10.A to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004.

*B. Nonqualified Stock Option Plan. Incorporated by reference to Exhibit 10.C to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 1989.

*C. 1986 Stock Plan. Incorporated by reference to Exhibit 10.C to the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

*D. 1987 Non-Employee Directors' Stock Option Plan. Incorporated by reference to Exhibit 10.D to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2000.

*E. Form of Stock Option Agreement Terms and Conditions containing standard terms of stock options granted to employees under the Company's stock option plans. Incorporated by reference to Exhibit 10.A to the Company's Current Report on Form 8-K filed on November 2, 2004.

*F. Form of Amendment to Nonqualified Stock Options containing additional standard terms of nonqualified stock options granted to executives under the Company's stock option plans. Incorporated by reference to Exhibit 10.B to the Company's Current Report on Form 8-K filed on November 2, 2004.

*G. Executive Variable Incentive Plan.

*H. Form of Indemnity Agreement entered into between the Company and each of its executive officers and directors. Incorporated by reference to Exhibit 10.E to the Company's 1998 10-K.

*I. Form of Severance Agreement entered into between the Company and each of its executive officers.

21. List of Subsidiaries of the Company.

23. Consent of Independent Registered Public Accounting Firm.

31.1 Certification of Chief Executive Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of Chief Financial Officer of Registrant Pursuant to SEC Rule 13a-14(a)/15d-14(a), as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32 Certification of Chief Executive Officer and Chief Financial Officer of Registrant Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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* Management contract or compensatory plan or arrangement

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 16, 2005.

MENTOR GRAPHICS CORPORATION

By
/s/WALDEN C. RHINES

Walden C. Rhines
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons on behalf of the registrant on March 16, 2005, in the capacities indicated.

| | | |
|---|---|---|
| 1) | Principal Executive Officer:<br>/s/WALDEN C. RHINES<br>Walden C. Rhines | Chief Executive Officer |
| (2) | Principal Financial Officer:<br>/s/GREGORY K. HINCKLEY<br>Gregory K. Hinckley | President |
| (3) | Principal Accounting Officer:<br>/s/ANTHONY B. ADRIAN<br>Anthony B. Adrian | Vice President, Corporate Controller |
| (4) | Directors:<br>/s/WALDEN C. RHINES<br>Walden C. Rhines | Chairman of the Board |
| | /s/GREGORY K. HINCKLEY<br>Gregory K. Hinckley | Director |
| | /s/SIR PETER BONFIELD<br>Sir Peter Bonfield | Director |
| | /s/MARSHA B. CONGDON<br>Marsha B. Congdon | Director |
| | /s/JAMES R. FIEBIGER<br>James R. Fiebiger | Director |
| | /s/KEVIN C. MCDONOUGH<br>Kevin C. McDonough | Director |
| | /s/PATRICK B. McMANUS<br>Patrick B. McManus | Director |
| | /s/FONTAINE K. RICHARDSON<br>Fontaine K. Richardson | Director |

**SCHEDULE II**

**MENTOR GRAPHICS CORPORATION AND SUBSIDIARIES**
Valuation and Qualifying Accounts

| **In Thousands Description** | **Beginning Balance** | **Additions** | **Acquisitions of businesses** | **Deductions** | **Ending Balance** |
|---|---|---|---|---|---|
| **Year ended December 31, 2002** | | | | | |
| Allowance for doubtful accounts[1] | $3,273 | $725 | $1,056 | $1,202 | $3,852 |
| Accrued restructuring costs | $12,621 | $6,699 | $ -- | $8,250 | $11,070 |
| **Year ended December 31, 2003** | | | | | |
| Allowance for doubtful accounts[1] | $3,852 | $1,753 | $ -- | $1,456 | $4,149 |
| Accrued restructuring costs | $11,070 | $34,384 | $ -- | $31,203 | $14,251 |
| **Year ended December 31, 2004** | | | | | |
| Allowance for doubtful accounts[1] | $4,149 | $1,488 | $ -- | $365 | $5,272 |
| Accrued restructuring costs | $14,251 | $8,455 | $ -- | $10,374 | $12,332 |

(1) Deductions primarily represent accounts written off during the period

EXHIBIT 21

**List of Subsidiaries of the Company**

EXHIBIT 23

**Consent of Independent Registered Public Accounting Firm**

To the Stockholders and Board of Directors
Mentor Graphics Corporation:

We consent to the incorporation by reference in the Registration Statements on Form S-8 (Nos. 33-11291, 33-18259, 2-90577, 33-30036, 2-99251, 33-30774, 33-57147, 33-57149, 33-57151, 33-64717, 333-49579, 333-69223, 333-81991, 333-81993, 333-53236, 333-53238, 333-87364, 333-91266, 333-91272, 333-110916, 333-110917, 333-110919, 333-119244, 333-119245 and 333-119246) and on Form S-3 (Nos. 33-52419, 33-56759, 33-60129, 333-00277, 333-02883, 333-11601, 333-98869 and 333-109885) of Mentor Graphics Corporation and subsidiaries of our reports dated March 15, 2005, relating to the consolidated balance sheets of Mentor Graphics Corporation and subsidiaries as of December 31, 2004 and 2003, and the related consolidated statements of operations, cash flows and stockholders' equity and the related consolidated financial statement schedule for each of the years in the three-year period ended December 31, 2004, management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of internal control over financial reporting as of December 31, 2004, which reports appear in the December 31, 2004 annual report on Form 10-K of Mentor Graphics Corporation and subsidiaries.

Our report dated March 15, 2005, on management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of internal control over financial reporting as of December 31, 2004, expresses our opinion that Mentor Graphics Corporation did not maintain effective internal control over financial reporting as of December 31, 2004 because of the effect of a material weakness on the achievement of the objectives of the control criteria and contains an explanatory paragraph that states that internal controls over financial reporting related to the calculation of the Company's income tax provision related to (i) the development of the income tax accounting amounts using a detailed checklist for each step of the related calculations, and (ii) review and final approval of the resulting proposed entries by the Company's tax director, did not operate effectively as of December 31, 2004, and, accordingly, the Company's income tax accounting calculations were found to be in error.

KPMG LLP
Portland, Oregon
March 15, 2005

**Exhibit 31.1**

**CERTIFICATIONS**

I, Walden C. Rhines, certify that:

1. I have reviewed this annual report on Form 10-K of Mentor Graphics Corporation, the registrant;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: March 16, 2005

Walden C. Rhines
Chief Executive Officer

**Exhibit 31.2**

## CERTIFICATIONS

I, Gregory K. Hinckley, certify that:

1. I have reviewed this annual report on Form 10-K of Mentor Graphics Corporation, the registrant;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: March 16, 2005

____________________________________

Gregory K. Hinckley
Chief Financial Officer

**Exhibit 32**

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

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

(i) the Annual Report on Form 10-K of the Company for the year ended December 31, 2004 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

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

Dated: March 16, 2005

Walden C. Rhines
Chief Executive Officer

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

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

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

(i) the Annual Report on Form 10-K of the Company for the year ended December 31, 2004 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, of the Securities Exchange Act of 1934, as amended; and

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

Dated: March 16, 2005

Gregory K. Hinckley
Chief Financial Officer

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