

ANSYS INC  
Form 10-Q  
November 03, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

Commission File Number: 0-20853

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**ANSYS, Inc.**

(exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction)

of incorporation or organization)

**275 Technology Drive, Canonsburg, PA**  
(Address of principal executive offices)

**724-746-3304**

**04-3219960**  
(IRS Employer

Identification No.)

**15317**  
(Zip Code)

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(Registrant's telephone number, including area code)

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

Indicate by a check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2). (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares of the Registrant's Common Stock, par value \$.01 per share, outstanding as of October 31, 2006 was 38,526,640 shares.

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**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements:****ANSYS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands, except share information)****(Unaudited)**

|  | September 30,<br>2006 | December 31,<br>2005 |
|--|-----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |
| Current assets:  |                       |                      |
| Cash and cash equivalents  | \$ 101,618            | \$ 176,166           |
| Short-term investments   | 150                   | 18,066               |
| Accounts receivable, less allowance for doubtful accounts of \$3,131 and \$2,231, respectively | 27,816                | 19,134               |
| Other receivables and current assets   | 41,666                | 25,065               |
| Deferred income taxes  | 12,929                | 4,055                |
| Total current assets   | 184,179               | 242,486              |
| Property and equipment, net  | 24,430                | 6,362                |
| Capitalized software costs, net  | 747                   | 642                  |
| Goodwill   | 431,050               | 43,277               |
| Other intangibles, net   | 211,306               | 10,122               |
| Other long-term assets   | 2,842                 | 467                  |
| Deferred income taxes  |                       | 2,153                |
| Total assets   | \$ 854,554            | \$ 305,509           |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                       |                      |
| Current liabilities:   |                       |                      |
| Current portion of long-term debt and capital lease obligations                                | \$ 19,806             | \$                   |
| Accounts payable   | 3,026                 | 1,330                |
| Accrued bonuses  | 16,438                | 9,631                |
| Other accrued expenses and liabilities   | 28,791                | 19,677               |
| Deferred revenue   | 89,742                | 49,894               |
| Total current liabilities  | 157,803               | 80,532               |
| Long-term liabilities:   |                       |                      |
| Long-term debt and capital lease obligations, less current portion                             | 128,715               |                      |
| Deferred income taxes  | 49,054                |                      |
| Other long-term liabilities  | 1,375                 |                      |
| Total long-term liabilities  | 179,144               |                      |
| Commitments and contingencies  |                       |                      |
| Stockholders' equity:  |                       |                      |

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|   |                |                |
|---|----------------|----------------|
| Preferred stock, \$.01 par value; 2,000,000 shares authorized; zero issued and outstanding                          |                |                |
| Common stock, \$.01 par value; 150,000,000 shares authorized; 39,169,464 and 33,169,516 shares issued, respectively | 392            | 332            |
| Additional paid-in capital  | 342,432        | 59,543         |
| Retained earnings   | 181,063        | 179,171        |
| Treasury stock, at cost: 660,673 and 1,121,726 shares, respectively   | (12,696)       | (18,340)       |
| Accumulated other comprehensive income  | 6,416          | 4,271          |
| <b>Total stockholders' equity</b>   | <b>517,607</b> | <b>224,977</b> |
| <br>  |                |                |
| Total liabilities and stockholders' equity  | \$ 854,554     | \$ 305,509     |

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

**Table of Contents****ANSYS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(in thousands, except per share data)****(Unaudited)**

|  | <b>Three Months Ended</b> |                      | <b>Nine Months Ended</b> |                      |
|--|---------------------------|----------------------|--------------------------|----------------------|
|  | <b>September 30,</b>      | <b>September 30,</b> | <b>September 30,</b>     | <b>September 30,</b> |
|  | <b>2006</b>               | <b>2005</b>          | <b>2006</b>              | <b>2005</b>          |
| <b>Revenue:</b>                                  |                           |                      |                          |                      |
| Software licenses                                | \$ 42,213                 | \$ 20,978            | \$ 103,728               | \$ 61,247            |
| Maintenance and service                          | 27,904                    | 18,057               | 74,664                   | 53,068               |
| <b>Total revenue</b>                             | <b>70,117</b>             | <b>39,035</b>        | <b>178,392</b>           | <b>114,315</b>       |
| <b>Cost of sales:</b>                            |                           |                      |                          |                      |
| Software licenses                                | 1,748                     | 1,334                | 4,938                    | 3,747                |
| Amortization of software and acquired technology | 5,138                     | 877                  | 9,785                    | 2,665                |
| Maintenance and service                          | 10,434                    | 3,822                | 22,918                   | 11,476               |
| <b>Total cost of sales</b>                       | <b>17,320</b>             | <b>6,033</b>         | <b>37,641</b>            | <b>17,888</b>        |
| <b>Gross profit</b>                              | <b>52,797</b>             | <b>33,002</b>        | <b>140,751</b>           | <b>96,427</b>        |
| <b>Operating expenses:</b>                       |                           |                      |                          |                      |
| Selling, general and administrative              | 24,333                    | 10,708               | 58,192                   | 31,854               |
| Research and development                         | 13,295                    | 7,667                | 34,274                   | 22,486               |
| Amortization                                     | 2,314                     | 298                  | 4,018                    | 1,009                |
| In-process research and development              |                           |                      | 28,100                   |                      |
| <b>Total operating expenses</b>                  | <b>39,942</b>             | <b>18,673</b>        | <b>124,584</b>           | <b>55,349</b>        |
| <b>Operating income</b>                          | <b>12,855</b>             | <b>14,329</b>        | <b>16,167</b>            | <b>41,078</b>        |
| Interest (expense) income, net                   | (2,055)                   | 1,135                | (1,462)                  | 2,843                |
| Other income (expense), net                      | 412                       | 6                    | 335                      | (43)                 |
| <b>Income before income tax provision</b>        | <b>11,212</b>             | <b>15,470</b>        | <b>15,040</b>            | <b>43,878</b>        |
| <b>Income tax provision</b>                      | <b>2,840</b>              | <b>4,296</b>         | <b>13,148</b>            | <b>13,246</b>        |
| <b>Net income</b>                                | <b>\$ 8,372</b>           | <b>\$ 11,174</b>     | <b>\$ 1,892</b>          | <b>\$ 30,632</b>     |
| <b>Earnings per share - basic:</b>               |                           |                      |                          |                      |
| Basic earnings per share                         | \$ 0.22                   | \$ 0.35              | \$ 0.05                  | \$ 0.97              |
| Weighted average shares basic                    | 38,402                    | 31,851               | 35,610                   | 31,670               |
| <b>Earnings per share - diluted:</b>             |                           |                      |                          |                      |
| Diluted earnings per share                       | \$ 0.21                   | \$ 0.33              | \$ 0.05                  | \$ 0.91              |
| Weighted average shares diluted                  | 40,290                    | 33,922               | 37,527                   | 33,667               |

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



**Table of Contents****ANSYS, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(Unaudited)**

|  | <b>Nine Months Ended</b> |                      |
|--|--------------------------|----------------------|
|  | <b>September 30,</b>     | <b>September 30,</b> |
|  | <b>2006</b>              | <b>2005</b>          |
| <b>Cash flows from operating activities:</b>   |                          |                      |
| Net income   | \$ 1,892                 | \$ 30,632            |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |                          |                      |
| Depreciation and amortization  | 17,940                   | 6,159                |
| Deferred income tax benefit  | (6,825)                  | (899)                |
| Provision for bad debts  | 263                      | 575                  |
| Stock-based compensation expense   | 3,694                    |                      |
| In-process research and development  | 28,100                   |                      |
| Other  | 77                       |                      |
| <b>Changes in operating assets and liabilities:</b>                                      |                          |                      |
| Accounts receivable  | 2,468                    | 1,723                |
| Other receivables and other assets   | 6,468                    | 1,832                |
| Accounts payable, accrued expenses and liabilities                                       | (1,808)                  | 4,374                |
| Deferred revenue   | 8,119                    | 2,681                |
| <b>Net cash provided by operating activities</b>   | <b>60,388</b>            | <b>47,077</b>        |
| <b>Cash flows from investing activities:</b>   |                          |                      |
| Capital expenditures   | (3,718)                  | (3,463)              |
| Capitalization of internally developed software costs                                    | (408)                    | (270)                |
| Fluent acquisition payments, net of cash acquired  | (297,926)                |                      |
| Other acquisition payments, net of cash acquired   | (6,836)                  | (4,173)              |
| Purchases of short-term investments  | (6,079)                  | (34,865)             |
| Maturities of short-term investments   | 24,118                   | 80,188               |
| <b>Net cash (used in) provided by investing activities</b>                               | <b>(290,849)</b>         | <b>37,417</b>        |
| <b>Cash flows from financing activities:</b>   |                          |                      |
| Principal payments on long-term debt   | (51,115)                 |                      |
| Principal payments on long-term capital leases   | (415)                    |                      |
| Proceeds from long-term debt   | 198,000                  |                      |
| Loan issuance costs  | (1,940)                  |                      |
| Proceeds from issuance of common stock under Employee Stock Purchase Plan                | 1,191                    | 849                  |
| Proceeds from exercise of stock options  | 4,282                    | 4,394                |
| Repurchase of common stock   |                          | (7,492)              |
| Excess tax benefits from stock options   | 4,367                    |                      |
| <b>Net cash provided by (used in) financing activities</b>                               | <b>154,370</b>           | <b>(2,249)</b>       |
| Effect of exchange rate fluctuations on cash and cash equivalents                        | 1,543                    | (1,362)              |
| <b>Net (decrease)/increase in cash and cash equivalents</b>                              | <b>(74,548)</b>          | <b>80,883</b>        |
| Cash and cash equivalents, beginning of period   | 176,166                  | 83,547               |



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|  |            |            |
|--|------------|------------|
| Cash and cash equivalents, end of period                   | \$ 101,618 | \$ 164,430 |
| Supplemental disclosures of cash flow information:         |            |            |
| Cash paid during the period for interest                   | \$ 4,850   | \$         |
| Cash paid during the period for income taxes               | \$ 21,724  | \$ 10,109  |
| Supplemental disclosures of non-cash investing activities: |            |            |
| Capital lease obligations                                  | \$ 563     | \$         |

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

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**ANSYS, INC. AND SUBSIDIARIES**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2006**

**(Unaudited)**

**1. Organization**

ANSYS, Inc. (the Company or ANSYS) develops and globally markets engineering simulation software and technologies widely used by engineers and designers across a broad spectrum of industries, including aerospace, automotive, manufacturing, electronics, biomedical and defense.

**2. Summary of Significant Accounting Policies**

The accompanying unaudited condensed consolidated financial statements have been prepared by ANSYS, Inc. in accordance with accounting principles generally accepted in the United States of America for interim financial information for commercial and industrial companies and the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, the accompanying statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. The accompanying condensed consolidated financial statements should be read in conjunction with the Company's consolidated financial statements (and notes thereto) included in the Company's Annual Report on Form 10-K for the year ended December 31, 2005. The condensed consolidated December 31, 2005 balance sheet presented is derived from the audited December 31, 2005 balance sheet included in the most recent Form 10-K. In the opinion of management, all adjustments considered necessary for a fair presentation of the financial statements have been included, and all adjustments are of a normal and recurring nature. Operating results for the three and nine months ended September 30, 2006 are not necessarily indicative of the results that may be expected for any future period.

**Revenue Recognition:** Revenue is derived principally from the licensing of computer software products and from related maintenance contracts. The Company recognizes revenue in accordance with SOP 97-2, *Software Revenue Recognition*, and related interpretations. Revenue from perpetual licenses is classified as license revenue and is recognized upon delivery of the licensed product and the utility that enables the customer to request authorization keys, provided that acceptance has occurred and a signed contractual obligation has been received, the price is fixed and determinable, and collectibility of the receivable is probable. Revenue is recorded net of the distributor fee for sales through the ANSYS distribution network. Revenue for software lease licenses is classified as license revenue and is recognized over the period of the lease contract. The Company estimates the value of post-contract customer support (PCS) sold together with perpetual licenses based on separate sales of PCS. Revenue from PCS contracts is classified as maintenance and service revenue and is recognized ratably over the term of the contract. Revenue from training, support and other services is recognized as the services are performed.

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**Concentrations of Credit Risk:** The Company has a concentration of credit risk with respect to trade receivables due to the limited number of distributors through which the Company sells its products. The Company performs periodic credit evaluations of its customers' financial condition and generally does not require collateral.

In addition to the concentration of credit risk with respect to trade receivables, the Company's cash and cash equivalents are also exposed to concentration of credit risk. The Company maintains its cash accounts primarily in U.S. banks, which are insured by the F.D.I.C. up to \$100,000 per bank. The Company had cash balances on deposit with a U.S. bank at September 30, 2006 that exceeded the balance insured by the F.D.I.C. in the amount of approximately \$36.3 million. A significant portion of the Company's remaining U.S. cash balance is also uninsured. As a result of the Company's operations in international locations, it also has \$53.1 million of uninsured cash balances denominated in foreign currencies and held outside of the U.S.

**Stock-Based Compensation:** In December 2004, the FASB issued a revised version of FASB Statement No. 123, *Share-Based Payment* (Statement No. 123R). The statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost will be recognized over the period during which an employee is required to provide service in exchange for the award, typically the vesting period. Statement No. 123R also requires the benefits of tax deductions in excess of recognized compensation expense to be reported as a financing cash flow, rather than as an operating cash flow as prescribed under the prior accounting rules. This requirement reduces net operating cash flows and increases net financing cash flows in periods after adoption. The Company adopted Statement No. 123R using a modified prospective application in compliance with the implementation date on January 1, 2006. Under the modified prospective application, prior periods are not revised for comparative purposes. The valuation provisions of Statement No. 123R apply to new awards and to awards that were outstanding at the effective date and subsequently modified or cancelled.

On November 10, 2005, the FASB issued FASB Staff Position No. FAS 123R-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. The Company has elected to adopt the alternative transition method provided in this FASB Staff Position for calculating the tax effects of share-based compensation pursuant to Statement No. 123R. The alternative transition method includes a simplified method to establish the beginning balance of the additional paid-in capital pool related to the tax effects of employee share-based compensation, which is available to absorb tax deficiencies recognized subsequent to the adoption of Statement No. 123R.

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**Table of Contents***Share-Based Compensation Information*

The Company issues both nonqualified and incentive stock options; however, incentive stock options comprise a significant portion of outstanding stock options. The tax benefits associated with incentive stock options are unpredictable, as they are predicated upon an award recipient triggering an event that disqualifies the award and which then results in a tax deduction to the Company. These tax benefits are recorded at the time of the triggering event. The triggering events for each option holder are not easily projected. In order to estimate the tax benefits related to incentive stock options, the Company makes many assumptions and estimates, including the number of incentive stock options that will be exercised during the period by U.S. employees, the number of incentive stock options that will be disqualified during the period and the fair market value of the Company's stock price on the exercise dates. Each of these items is subject to significant uncertainty. Additionally, a significant portion of the tax benefits related to disqualified incentive stock options are accounted for as increases to equity (additional paid-in capital) rather than as reductions in income tax expense, especially in the periods most closely following the adoption date of Statement No. 123R. Although all such benefits continue to be realized through the Company's tax filings, this accounting treatment has the effect of increasing tax expense and reducing net income. For example, the Company realized a tax benefit of \$3.7 million during the first nine months of 2006 related to disqualified incentive stock options; however, only \$65,000 of such amount was recorded as a reduction in income tax expense. Although there are significant limitations in estimating the impact of Statement No. 123R, including those discussed above, the Company currently estimates that the adoption of Statement No. 123R will decrease 2006 operating income by approximately \$5.0 - \$5.5 million and net income by approximately \$4.1 - \$4.6 million, or approximately \$0.11 - \$0.12 per diluted share, including \$3.0 million or \$0.08 per diluted share, recorded in the nine-month period ended September 30, 2006.

There were no options granted during the three months ended September 30, 2006. The weighted-average fair value of options granted during the nine months ended September 30, 2006 was \$21.93 per share. The fair value of each option grant is estimated on the date of grant using the Black-Scholes options pricing model, which was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. The Company's options have characteristics significantly different from those of traded options, and changes in input assumptions can materially affect the fair value estimates. The fair values of options granted were estimated using the Black-Scholes pricing model with a weighted average risk-free interest rate of 5.04% with rates ranging from 4.73% to 5.10%. The interest rates used were determined by using the five-year Treasury Note yield at the date of grant. The following assumptions were also used to determine the fair value of each option grant: dividend yields of 0% weighted average expected volatility of 45% with expected volatilities ranging from 45% to 48%, and expected term of 5.1 years. The volatility was determined based on the historic volatility of the Company's stock during the preceding five years.

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As share-based compensation expense recognized in the Condensed Consolidated Statement of Income for the first nine months of fiscal 2006 is based on awards ultimately expected to vest, it should be reduced for estimated forfeitures. Forfeitures are estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately 0.8% in each of the three quarters of fiscal 2006 based on historical experience. The effect of pre-vesting forfeitures on the Company's recorded expense has historically been negligible due to the relatively low turnover of holders of stock options. In the Company's pro forma information required under Statement No. 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

Total share-based compensation expense, related to the Company's share-based awards, recognized for the three and nine months ended September 30, 2006 is as follows:

| <i>(in thousands)</i>                          | <b>Three<br/>Months<br/>Ended</b> | <b>Nine Months<br/>Ended</b>  |
|--|-----------------------------------|-------------------------------|
|  | <b>September 30,<br/>2006</b>     | <b>September 30,<br/>2006</b> |
| Cost of sales:                                 |                                   |                               |
| Software licenses                              | \$ 11                             | \$ 32                         |
| Maintenance and service                        | 46                                | 131                           |
| Operating expenses:                            |                                   |                               |
| Selling, general and administrative            | 862                               | 2,612                         |
| Research and development                       | 321                               | 919                           |
| Share-based compensation expense before taxes  | 1,240                             | 3,694                         |
| Related income tax benefits                    | (209)                             | (664)                         |
| Share-based compensation expense, net of taxes | \$ 1,031                          | \$ 3,030                      |

The Company did not record material share-based compensation expense during the three and nine months ended September 30, 2006 related to share-based awards granted during the first nine months of 2006. In addition, for the nine months ended September 30, 2006, the adoption of Statement No. 123R resulted in a reclassification to reduce net cash provided by operating activities with an offsetting increase in net cash provided by financing activities of \$4.4 million related to the incremental tax benefits from stock options exercised in the period.

**Table of Contents***Pro Forma Information for Periods Prior to January 1, 2006*

Prior to the adoption of Statement No. 123R, the Company had elected to account for stock-based compensation arrangements through the intrinsic value method under the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock-Based Compensation*. Under the intrinsic value method, compensation expense is measured as the excess, if any, of the market value of the underlying common stock over the amount the employee is required to pay on the date both the number of shares and the price to be paid are known. No compensation expense had been recognized in the consolidated statements of income as option grants generally were made with exercise prices equal to the fair value of the underlying common stock on the award date, which was typically the date of compensation measurement. Had compensation cost been determined based on the fair value at the date of grant, in accordance with the provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company's net income and basic and diluted earnings per share for the three and nine months ended September 30, 2005 would have been reduced to the pro forma amounts indicated below:

| <i>(in thousands, except per share data)</i>  | <b>Three<br/>Months<br/>Ended<br/>September 30,<br/>2005</b> | <b>Nine Months<br/>Ended<br/>September 30,<br/>2005</b> |
|---|--|---|
| Net income, as reported   | \$ 11,174  | \$ 30,632   |
| Add: Stock-based employee compensation expense included in net income, net of related tax effects   |  |   |
| Deduct: Stock-based employee compensation expense determined under the fair value-based method for all awards, net of related tax effects | (904)  | (2,701)   |
| Pro forma net income  | \$ 10,270  | \$ 27,931   |
| Earnings per share:   |  |   |
| Basic as reported   | \$ 0.35  | \$ 0.97   |
| Basic pro forma   | \$ 0.32  | \$ 0.88   |
| Diluted as reported   | \$ 0.33  | \$ 0.91   |
| Diluted pro forma   | \$ 0.30  | \$ 0.83   |

The weighted-average fair value of options granted during the three and nine months ended September 30, 2005 was \$19.65 per share and \$16.66 per share, respectively. The fair values of options granted were estimated using the Black-Scholes pricing model with a weighted average risk-free interest rate of 3.95% with rates ranging from 3.65% to 4.99%. The interest rates used were determined by using the five-year Treasury Note yield at the date of grant. The following assumptions were also used to determine the fair value of each option grant: dividend yields of 0%, expected volatility of 50%, and expected term of 5.1 years.

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**Reclassifications:** Certain reclassifications have been made to the 2005 condensed consolidated balance sheet, to the 2005 condensed consolidated statement of income to combine selling, general and administrative costs and to separately report interest (expense) income and other income and to the Goodwill and Intangible Assets footnote to conform to the 2006 presentation.

**3. Accumulated Other Comprehensive Income, net**

As of September 30, 2006 and December 31, 2005, accumulated other comprehensive income, as reflected on the Condensed Consolidated Balance Sheets, was comprised of foreign currency translation adjustments.

Comprehensive income for the three- and nine- month periods ended September 30, 2006 and 2005 was as follows:

| <i>(in thousands)</i> | Three Months Ended |               | Nine Months Ended |               |
|-----------------------|--------------------|---------------|-------------------|---------------|
|                       | September 30,      | September 30, | September 30,     | September 30, |
|                       | 2006               | 2005          | 2006              | 2005          |
| Comprehensive income  | \$ 7,987           | \$ 11,506     | \$ 4,037          | \$ 28,755     |

**4. Other Current Assets**

The Company reports accounts receivable related to the portion of annual lease licenses and software maintenance that has not yet been recognized as revenue as a component of other current assets. These amounts totaled \$30.3 million and \$21.0 million as of September 30, 2006 and December 31, 2005, respectively.

**Table of Contents****5. Earnings Per Share**

Basic earnings per share ( EPS ) amounts are computed by dividing earnings by the average number of common shares outstanding during the period. Diluted EPS amounts assume the issuance of common stock for all potentially dilutive equivalents outstanding. To the extent stock options are anti-dilutive, they are excluded from the calculation of diluted earnings per share. The details of basic and diluted earnings per share are as follows:

*(in thousands, except per share data)*

|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September 30,<br>2006 | September 30,<br>2005 | September 30,<br>2006 | September 30,<br>2005 |
| Net income  | \$ 8,372              | \$ 11,174             | \$ 1,892              | \$ 30,632             |
| Weighted average shares outstanding basic                           | 38,402                | 31,851                | 35,610                | 31,670                |
| Basic earnings per share  | \$ 0.22               | \$ 0.35               | \$ 0.05               | \$ 0.97               |
| Effect of dilutive securities:                                      |                       |                       |                       |                       |
| Shares issuable upon exercise of dilutive outstanding stock options | 1,888                 | 2,071                 | 1,917                 | 1,997                 |
| Weighted average shares outstanding diluted                         | 40,290                | 33,922                | 37,527                | 33,667                |
| Diluted earnings per share  | \$ 0.21               | \$ 0.33               | \$ 0.05               | \$ 0.91               |
| Anti-dilutive shares/options  | 20                    | 23                    | 20                    | 101                   |

**6. Acquisitions**

On January 5, 2005, the Company acquired Century Dynamics, Inc. (hereafter CDI ), for an initial purchase price of approximately \$5.1 million in cash. In addition, the agreement provided for a future cash payment contingent upon the attainment of certain 2005 performance criteria. This payment totaled \$4.5 million and was accounted for as an addition to both goodwill and other accrued expenses and liabilities in 2005. It was paid to the previous owners of CDI in the first quarter of 2006. The operating results of CDI have been included in ANSYS, Inc. s consolidated financial statements since the date of acquisition.

Had the acquisition occurred on January 1, 2005, the 2005 results would not be materially different from those presented in these consolidated financial statements. Accordingly, the Company has not presented pro forma information on revenue, net income or earnings per share.



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In October 2005, the Company acquired substantially all of the assets and certain liabilities of Harvard Thermal, Inc. (hereafter "HTI"), a leader in thermal analysis software tools, for an up-front purchase price of approximately \$1.3 million in cash and stock. In addition, the acquisition agreement provides for future payments of up to \$400,000, contingent upon the attainment of certain performance criteria, of which \$100,000 was recorded as an addition to goodwill during the first quarter of 2006 and paid primarily through the issuance of treasury stock. The operating results for HTI have been included with the Company's operating results from the date of acquisition.

Had the acquisition of HTI occurred on January 1, 2005, the 2005 results would not be materially different from those presented in these financial statements. Accordingly, the Company has not presented pro forma information on revenue, net income or earnings per share.

On May 1, 2006, ANSYS completed its acquisition of Fluent Inc. (hereafter "Fluent"), a global provider of CFD-based computer-aided engineering software and services. Under the terms of the merger agreement, ANSYS issued 5,999,948 shares of its common stock, valued at approximately \$274 million based on the average closing market price on the two days preceding and the two days following the announcement of the acquisition (February 16, 2006), and paid approximately \$315 million in cash to acquire Fluent. The total purchase price of approximately \$598 million includes approximately \$9 million in transaction fees. The Company used a combination of existing cash and \$198 million from committed bank financing to fund the transaction.

The acquisition of Fluent enhanced the breadth, functionality, usability and interoperability of the ANSYS portfolio of simulation solutions. The acquisition of Fluent is expected to increase operational efficiency and lower design and engineering costs for customers, and accelerate development and delivery of new and innovative products to the marketplace. In addition to the \$9 million in transaction-related costs, the Company incurred financing costs of \$1.9 million related to the long-term debt utilized to fund the acquisition.

The operating results of Fluent have been included in the Company's consolidated financial statements since the date of acquisition, May 1, 2006. The total purchase price was allocated to the foreign and domestic assets and liabilities of Fluent based upon management's estimates of the fair market values of the assets acquired and the liabilities assumed. These estimates are subject to change upon final valuation of Fluent's assets and liabilities. The preliminary allocation included approximately \$213.9 million to identifiable intangible assets (including \$88.0 million to developed software to be amortized over seven years, \$65.9 million to customer contracts and related relationships to be amortized over nine and a half years, and \$60.0 million to trade name) and \$385.2 million to goodwill, which is not tax-deductible. Fluent's trade name is one of the most recognized in the computer-aided engineering market. The trade name represents a reputation of superior technical capability and strong support service that has been recognized by Fluent's customers. Because the trade name continues to gain strength in the market today, as evidenced by Fluent's increased sales over the past several years, the Company expects the trade name to contribute to cash flows indefinitely and, accordingly, has assigned an indefinite life to the trade name.

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In valuing deferred revenue on the Fluent balance sheet as of the acquisition date, the Company applied the fair value provisions of Emerging Issues Task Force Issue No. 01-3 ( EITF No. 01-3 ), *Accounting in a Business Combination for Deferred Revenue of an Acquiree*. In accordance with EITF No. 01-3, acquired deferred revenue of approximately \$31.5 million was recorded on the opening balance sheet. This amount was approximately \$20.1 million lower than the historical carrying value. Although this purchase accounting requirement will have no impact on the Company's business or cash flow, it will adversely impact the Company's reported software license revenue under accounting principles generally accepted in the United States of America ( GAAP ), primarily for the first 12 months post-acquisition. The adverse impact on reported revenue for the quarter ended September 30, 2006 was approximately \$7.3 million and was approximately \$13.2 million for the period of May 1, 2006 through September 30, 2006. The expected adverse impact on reported revenue for the quarter ending December 31, 2006 is approximately \$5.1 million. The adverse impact on reported revenue for the year ending December 31, 2007 is expected to be approximately \$1.9 million.

The following table summarizes the preliminary fair values of the assets acquired and liabilities assumed at the date of acquisition:

(in thousands)

|   | At May 1, 2006 |
|---|----------------|
| Cash and other net tangible assets/liabilities  | \$ 25,706      |
| Goodwill  | 385,190        |
| Identifiable intangible assets                  | 213,900        |
| Net deferred tax liabilities                    | (54,450)       |
| In-process research and development             | 28,100         |
| <br>Total preliminary purchase price allocation | <br>\$ 598,446 |

The Company expensed in-process research and development (IPR&D) of \$28.1 million upon acquisition as it represents incomplete Fluent research and development projects that had not reached technological feasibility and had no alternative future use as of the acquisition date. Technological feasibility is established when an enterprise has completed all planning, designing, coding and testing activities that are necessary to establish that a product can be produced to meet its design specifications, including functions, features and technical performance requirements. The value assigned to IPR&D was determined by considering the importance of each project to the overall development plan, estimating costs to develop the purchased IPR&D into commercially viable products, estimating the resulting net cash flows from the projects when completed and discounting the net cash flows to their present values based on the percentage of completion of the IPR&D projects.

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The following unaudited pro forma information presents the 2006 and 2005 results of operations of the Company as if the acquisition had occurred on January 1, 2005. The unaudited pro forma results are not necessarily indicative of results that would have occurred had the acquisition been in effect for the periods presented, nor are they necessarily indicative of future results. These pro forma results exclude the impacts of IPR&D expense and the purchase accounting adjustment to deferred revenue that are discussed above.

(in thousands, except per share data)

|                     | Three Months Ended    |                       | Nine Months Ended     |                       |
|---------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                     | September 30,<br>2006 | September 30,<br>2005 | September 30,<br>2006 | September 30,<br>2005 |
| Total revenue       | \$ 77,382             | \$ 68,291             | \$ 235,366            | \$ 204,013            |
| Net income          | \$ 13,007             | \$ 8,738              | \$ 37,887             | \$ 25,021             |
| Earnings per share: |                       |                       |                       |                       |
| Basic               | \$ 0.34               | \$ 0.23               | \$ 1.06               | \$ 0.66               |
| Diluted             | \$ 0.32               | \$ 0.22               | \$ 1.01               | \$ 0.63               |

**7. Long-term Debt**

Borrowings consisted of the following:

(in thousands)

|   | September 30,<br>2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
| Term loan payable in quarterly installments with an original final maturity of March 31, 2008 | \$ 6,250              | \$                   |
| Term loan payable in quarterly installments with an original final maturity of March 31, 2011 | 140,635               |                      |
| Capitalized lease obligations   | 1,636                 |                      |
|   | 148,521               |                      |
| Less current portion  | (19,806)              |                      |
| Long-term debt and capital lease obligations, net of current portion                          | \$ 128,715            | \$                   |

On May 1, 2006, ANSYS and Fluent borrowed \$175.0 and \$23.0 million, respectively, from a syndicate of banks. The interest rate on the indebtedness associated with the transaction is equal to a margin based on the Company's consolidated leverage ratio (generally in the range of 0.50% to 1.25%), plus the then current rate based on (a) the British Bankers Association London Inter-Bank Offered Rate for dollar deposits (LIBOR) or (b) the higher of (i) the Bank of America prime rate and (ii) the Federal Funds rate plus 0.50%. The interest rates for the period from May 1, 2006 through June 30, 2006 and for the quarter ended September 30, 2006 were 6.08% and 6.50%, respectively, which were based on LIBOR + 1.00%. For the three and nine months ended September 30, 2006, the Company recorded interest expense related to the term loans (including the amortization of debt financing costs) of \$3.0 million and \$5.1 million, respectively.

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The interest rate is set for the quarter ending December 31, 2006 at 6.37% on \$86.9 million of the total outstanding balance, which was based on three-month LIBOR + 1.00%. For the remaining outstanding balance of \$60.0 million, the Company secured a fixed interest rate of 6.31% through September 28, 2007, which is based on one-year LIBOR + 1.00%.

On September 29, 2006, the Company made the required quarterly principal payments of \$5.9 million. In addition, the Company made prepayments of \$22.0 million and \$16.0 million during the quarters ended June 30, 2006 and September 30, 2006, respectively, which reduce, on a pro-rata percentage, future quarterly principal installments.

Both credit agreements include covenants related to the consolidated leverage ratio and the consolidated fixed charge coverage ratio, as well as certain restrictions on additional investments and indebtedness. As of September 30, 2006, the Company is in compliance with all affirmative and negative covenants as stated in the credit agreements.

### **8. Goodwill and Intangible Assets**

During the first quarter of 2006, the Company completed the annual impairment test for goodwill and intangible assets with indefinite lives, and determined these assets had not been impaired as of January 1, 2006. The Company tested the goodwill and identified intangible assets attributable to each of its reporting units utilizing estimated cash flow methodologies and market comparable information. No events occurred or circumstances changed during the nine months ended September 30, 2006 that would more likely than not reduce the fair value of the Company's reporting units below its carrying amount.

Identifiable intangible assets with finite lives are amortized on either a straight-line basis over their estimated useful lives or under the proportional cash flow method and are reviewed for impairment whenever events or circumstances indicate that the carrying amounts may not be recoverable.

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As of September 30, 2006 and December 31, 2005, the Company's intangible assets have estimated useful lives and are classified as follows:

| <i>(in thousands)</i>                       | September 30, 2006          |                             | December 31, 2005           |                             |
|---|-----------------------------|-----------------------------|-----------------------------|-----------------------------|
|   | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization | Gross<br>Carrying<br>Amount | Accumulated<br>Amortization |
| Amortized intangible assets:                |                             |                             |                             |                             |
| Core technology and trademarks (3-10 years) | \$ 107,398                  | \$ (20,496)                 | \$ 18,544                   | \$ (10,393)                 |
| Non-compete agreements (4-5 years)          | 3,256                       | (2,703)                     | 2,892                       | (2,531)                     |
| Customer lists (3-9/2 years)                | 68,356                      | (6,165)                     | 2,399                       | (2,344)                     |
| <b>Total</b>                                | <b>\$ 179,010</b>           | <b>\$ (29,364)</b>          | <b>\$ 23,835</b>            | <b>\$ (15,268)</b>          |
| Unamortized intangible assets:              |                             |                             |                             |                             |
| Trademarks                                  | \$ 61,660                   |                             | \$ 1,555                    |                             |

Amortization expense for the amortized intangible assets reflected above for the three months ended September 30, 2006 and September 30, 2005 was approximately \$7.4 million and \$1.0 million, respectively. Amortization expense for the amortized intangible assets reflected above for the nine months ended September 30, 2006 and September 30, 2005 was approximately \$13.5 million and \$3.3 million, respectively.

Amortization expense for the amortized intangible assets reflected above is expected to be approximately \$20.9 million, \$29.6 million, \$27.0 million, \$22.6 million and \$18.7 million for the years ending December 31, 2006, 2007, 2008, 2009 and 2010, respectively.

The changes in goodwill during the nine-month period ended September 30, 2006 are as follows:

*(in thousands)*

|                                   |                   |
|-----------------------------------|-------------------|
| Balance January 1, 2006           | \$ 43,277         |
| Acquisition of Fluent             | 385,190           |
| Other acquisition payments        | 1,750             |
| Currency translation and other    | 833               |
| <b>Balance September 30, 2006</b> | <b>\$ 431,050</b> |

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Revenue by geographic area for the three and nine months ended September 30, 2006 and 2005 is as follows:

| <i>(in thousands)</i> | Three Months Ended    |                       | Nine Months Ended     |                       |
|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
|                       | September 30,<br>2006 | September 30,<br>2005 | September 30,<br>2006 | September 30,<br>2005 |
| United States         | \$ 24,862             | \$ 13,416             | \$ 64,542             | \$ 37,821             |
| Canada                | 848                   | 975                   | 3,155                 | 3,248                 |
| United Kingdom        | 4,855                 | 2,848                 | 13,165                | 8,446                 |
| Germany               | 9,291                 | 5,916                 | 24,010                | 17,146                |
| Japan                 | 9,675                 | 5,000                 | 24,146                | 15,034                |
| Other European        | 13,433                | 6,715                 | 32,462                | 21,312                |
| Other International   | 7,153                 | 4,165                 | 16,912                | 11,308                |
| Total revenue         | \$ 70,117             | \$ 39,035             | \$ 178,392            | \$ 114,315            |

Property and equipment by geographic area is as follows:

| <i>(in thousands)</i>   | September 30,<br>2006 | December 31,<br>2005 |
|-------------------------|-----------------------|----------------------|
| United States           | \$ 15,714             | \$ 3,725             |
| Canada                  | 444                   | 426                  |
| United Kingdom          | 1,658                 | 1,326                |
| Germany                 | 1,521                 | 385                  |
| Japan                   | 785                   | 138                  |
| Other European          | 833                   | 249                  |
| Other International     | 3,475                 | 113                  |
| Total long-lived assets | \$ 24,430             | \$ 6,362             |

**10. Stock Repurchase Program**

In October 2001, the Company announced that its Board of Directors had amended its existing stock repurchase program to acquire up to an additional one million shares, or four million shares in total under the program that was initially announced in February 2000. Under this program, no shares were repurchased in the three- or nine-month periods ended September 30, 2006 and 114,695 shares and 206,477 shares were repurchased in the three- and nine-month periods ended September 30, 2005, respectively. As of September 30, 2006, 2.0 million shares remain authorized for repurchase under the program.

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**11. Stock Option and Grant Plans**

The Company has one stock option and grant plan – the Third Amended and Restated 1996 Stock Option and Grant Plan ( “Stock Plan” ). The Stock Plan, as amended, authorizes the grant of up to 12,700,000 shares of the Company’s common stock in the form of: (i) incentive stock options ( “ISOs” ), (ii) nonqualified stock options or (iii) the issuance or sale of common stock with or without vesting or other restrictions. Additionally, the Stock Plan permits (a) the grant of common stock upon the attainment of specified performance goals, (b) the grant of the right to receive cash dividends with the holders of the common stock as if the recipient held a specified number of shares of the common stock and (c) the grant of deferred stock awards.

The Stock Plan provides that: (i) the exercise price of an ISO must be no less than the fair value of the stock at the date of grant and (ii) the exercise price of an ISO held by an optionee who possesses more than 10% of the total combined voting power of all classes of stock must be no less than 110% of the fair market value of the stock at the time of grant. The Compensation Committee of the Board of Directors has the authority to set expiration dates no later than ten years from the date of grant (or five years for an optionee who meets the 10% criteria), payment terms and other provisions for each grant. Shares associated with unexercised options or reacquired shares of common stock become available for options or issuances under the Stock Plan. The Compensation Committee of the Board of Directors may, at its sole discretion, accelerate or extend the date or dates on which all or any particular award or awards granted under the Stock Plan may vest or be exercised. In the event of a merger, liquidation or sale of substantially all of the assets of the Company, the Board of Directors has the discretion to accelerate the vesting of the options granted under the Stock Plan, except that options granted to Independent Directors and certain key executives vest automatically. Under certain scenarios, other optionees may also automatically vest upon the occurrence of such an event. The Stock Plan also provides that in the event of a sale event in which the Company’s stockholders receive cash consideration, the Company may make or provide for a cash payment to participants holding options equal to the difference between the per share cash consideration and the exercise price of the option. In addition, the Stock Plan and the grants issued thereunder terminate upon the effectiveness of any such transaction or event, unless a provision is made in connection with such transaction for the assumption of grants theretofore made. Under the Stock Plan, at the discretion of the Compensation Committee, any option may include a “reload” feature. Such feature allows an optionee exercising an option to receive, in addition to the number of shares of common stock due on the exercise, an additional option with an exercise price equal to the fair market value of the common stock on the date such additional option is granted.

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In addition, the Stock Plan provided for the automatic grant of non-qualified options to Independent Directors. Under such provisions, each Independent Director received an annual grant to purchase 12,000 shares of common stock. These options vested in annual installments over four years, commencing with the date of grant, and expired ten years after the grant, subject to earlier termination if the optionee ceased to serve as a director. Recently, the Board of Directors modified the director compensation arrangements such that the Chairman of the Board of Directors, provided he or she is not an officer of the Company, and the non-affiliate Independent Directors will receive, at their option, a quarterly grant of (i) 900 deferred stock units, which are rights to receive shares of common stock upon termination of service as a director, or (ii) options to purchase 3,000 shares of common stock. The stock options have a vesting period of four years and expire after seven years and the deferred stock units are issued in arrears and vest immediately. The exercisability of unvested stock options will be accelerated upon the occurrence of a merger, liquidation or sale of substantially all of the assets of the Company.

The Company currently issues shares related to exercised stock options from its existing pool of treasury shares and currently has no specific policy to repurchase treasury shares as stock options are exercised.

Information regarding stock option transactions for the nine months ended September 30, 2006 is summarized below:

| <i>(options in thousands)</i>   | <b>Options</b> | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Term (years)</b> | <b>Aggregate<br/>Intrinsic Value<br/>(in<br/>thousands)</b> |
|---------------------------------|----------------|--|--|---|
| Outstanding, beginning of year  | 3,622          | \$ 14.05   |  |   |
| Granted                         | 20             | \$ 48.26   |  |   |
| Exercised                       | (425)          | \$ 10.08   |  |   |
| Forfeited                       | (7)            | \$ 22.69   |  |   |
| Outstanding, September 30, 2006 | 3,210          | \$ 14.77   | 5.58   | \$ 94,407   |
| Exercisable, September 30, 2006 | 2,239          | \$ 9.39  | 4.56   | \$ 77,917   |

The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. The total estimated grant date fair value of stock options that vested during the three and nine months ended September 30, 2006 was \$1.2 million and \$3.7 million, respectively. At September 30, 2006, total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was \$10.7 million, which is expected to be recognized over a weighted average period of 2.5 years. The total intrinsic value of stock options exercised during the three and nine months ended September 30, 2006 was \$6.4 million and \$16.1 million. The Company recorded cash received from the exercise of stock options of \$1.9 million and \$4.3 million, and related tax benefits of \$2.1 million and \$5.1 million during the three and nine months ended September 30, 2006.



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Information regarding stock options outstanding as of September 30, 2006 is summarized below:

| <i>(options in thousands)</i>   |                | <b>Options Outstanding</b> |                 | <b>Options Exercisable</b> |              |
|---------------------------------|----------------|----------------------------|-----------------|----------------------------|--------------|
|                                 |                | <b>Weighted</b>            | <b>Weighted</b> | <b>Weighted</b>            |              |
|                                 |                | <b>Average</b>             | <b>Average</b>  | <b>Average</b>             |              |
|                                 |                | <b>Remaining</b>           | <b>Exercise</b> | <b>Exercise</b>            |              |
|                                 |                | <b>Contractual</b>         | <b>Price</b>    | <b>Price</b>               |              |
| <b>Range of Exercise Prices</b> | <b>Options</b> | <b>Life (years)</b>        |                 | <b>Options</b>             | <b>Price</b> |
| \$3.00 - \$4.94                 | 397            | 1.94                       | \$ 4.15         | 397                        | \$ 4.15      |
| \$5.00 - \$9.89                 | 1,372          | 4.58                       | \$ 7.52         | 1,267                      | \$ 7.33      |
| \$11.13 - \$21.72               | 703            | 6.53                       | \$ 15.17        | 467                        | \$ 14.09     |
| \$31.09 - \$49.57               | 738            | 8.46                       | \$ 33.62        | 108                        | \$ 32.52     |

**12. Employee Stock Purchase Plan**

The Company's 1996 Employee Stock Purchase Plan (the "Purchase Plan") was adopted by the Board of Directors on April 19, 1996 and was subsequently approved by the Company's stockholders. The stockholders approved an amendment to the Purchase Plan on May 6, 2004 to increase the number of shares available for offerings to 800,000 shares. The Purchase Plan is administered by the Compensation Committee. Offerings under the Purchase Plan commence on each February 1 and August 1, and have a duration of six months. An employee who owns or is deemed to own shares of stock representing in excess of 5% of the combined voting power of all classes of stock of the Company may not participate in the Purchase Plan.

During each offering, an eligible employee may purchase shares under the Purchase Plan by authorizing payroll deductions of up to 10% of his cash compensation during the offering period. The maximum number of shares that may be purchased by any participating employee during any offering period is limited to 1,920 shares (as adjusted by the Compensation Committee from time to time). Unless the employee has previously withdrawn from the offering, his accumulated payroll deductions will be used to purchase common stock on the last business day of the period at a price equal to 85% of the fair market value of the common stock on the first or last day of the offering period, whichever is lower. Under applicable tax rules, an employee may purchase no more than \$25,000 worth of common stock in any calendar year. At September 30, 2006, 441,781 shares of common stock had been issued under the Purchase Plan of which 407,371 were issued as of December 31, 2005. The total estimated fair value of purchase rights outstanding under the Purchase Plan that vested during the three and nine months ended September 30, 2006 was \$126,000 and \$272,000, respectively.

**13. Contingencies and Commitments**

From time to time, the Company is involved in various investigations, claims and legal proceedings that arise in the ordinary course of business activities. Management believes, after consulting with legal counsel, that the ultimate liabilities, if any, resulting from such matters will not materially affect the Company's financial position, liquidity or results of operations.

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### **14. Recently Issued Accounting Pronouncements**

The Company adopted FASB Statement No. 123R, *Share Based Payment* ( Statement No. 123R ) as of January 1, 2006. The statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost is recognized over the period during which an employee is required to provide service in exchange for the award, typically the vesting period. Refer to additional disclosures regarding the adoption of this statement within Critical Accounting Policies above and in Notes 2 and 11 to the Condensed Consolidated Financial Statements.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. This interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation is effective for fiscal periods beginning after December 15, 2006. The Company is in the process of determining the impact of this Interpretation on its financial position and results of operations.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes framework for measuring fair value in generally accepted accounting principles and expands disclosure about fair value measurements. This statement is effective for fiscal periods beginning after November 15, 2007 and interim periods within those fiscal years. The Company is in the process of determining the impact of Statement No. 157 on its financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements in Current Year Financial Statements* ( SAB No. 108 ). SAB No. 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB No. 108 becomes effective during fiscal year 2007. The Company does not expect the adoption of SAB No. 108 to have an impact on its financial statements.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of

ANSYS, Inc.

Canonsburg, Pennsylvania

We have reviewed the accompanying condensed consolidated balance sheet of ANSYS, Inc. and subsidiaries as of September 30, 2006, and the related condensed consolidated statements of income for the three-month and nine-month periods ended September 30, 2006 and 2005, and of cash flows for the nine-month periods ended September 30, 2006 and 2005. These interim financial statements are the responsibility of the Corporation's management.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of ANSYS, Inc. and subsidiaries as of December 31, 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 1, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ Deloitte & Touche LLP  
Pittsburgh, Pennsylvania  
November 3, 2006

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**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

**Overview:**

ANSYS, Inc.'s (the Company) quarterly results for the three- and nine-month periods ended September 30, 2006 reflect revenue increases of 79.6% and 56.1%, respectively, basic and diluted earnings per share of \$0.22 and \$0.21, respectively, for the three month period ended September 30, 2006, and basic and diluted earnings per share of \$.05 for the nine month period ended September 30, 2006. These results were most significantly impacted by the May 2006 acquisition of Fluent Inc. (Fluent). The results of operations include the results of Fluent for the period from the date of the acquisition (May 1, 2006) through September 30, 2006. In addition to the impact from Fluent's operations, the nine-month period ended September 30, 2006 includes a \$28.1 million non-tax deductible charge related to Fluent's in process research and development.

The Company experienced higher revenues from both the Fluent acquisition and from the Company's software products and services owned prior to the Fluent acquisition, an improvement in margins relating to the non-Fluent operations, partially offset by additional costs related to the adoption of Statement No. 123R, *Share-Based Payment* (Statement No. 123R).

In connection with the acquisition of Fluent on May 1, 2006, the Company borrowed \$198.0 million (incurring interest expense) and used existing cash, cash equivalents and short-term investments (decreasing interest income).

ANSYS, Inc. develops and globally markets engineering simulation software and services widely used by engineers and designers across a broad spectrum of industries, including aerospace, automotive, manufacturing, electronics, biomedical and defense. Headquartered at Southpointe in Canonsburg, Pennsylvania, the Company and its subsidiaries employ approximately 1,430 people as of September 30, 2006 and focus on the development of open and flexible solutions that enable users to analyze designs directly on the desktop, providing a common platform for fast, efficient and cost-conscious product development, from design concept to final-stage testing and validation. The Company distributes its ANSYS®, ANSYS® Workbench®, CFX®, DesignSpace®, ICEM CFD®, AUTODYN®, ICEPAK® and FLUENT® products through a global network of channel partners and direct sales offices in strategic, global locations. It is the Company's intention to continue to maintain this mixed sales and distribution model.

The Company licenses its technology to businesses, educational institutions and governmental agencies. The growth in the Company's revenue is affected by the strength of the global economies, general business conditions, customer budgetary constraints and the competitive position of the Company's products. The Company believes that the features, functionality and integrated multiphysics capabilities of its software products are as strong as they have ever been. However, the software business is generally characterized by long sales cycles. These long sales cycles increase the difficulty of predicting sales for any particular quarter. As a result, the Company believes that its overall performance is best measured by fiscal year results rather than by quarterly results.

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The following discussion should be read in conjunction with the accompanying unaudited condensed consolidated financial statements and notes thereto for the three- and nine-month periods ended September 30, 2006 and 2005, and with the Company's audited financial statements and notes thereto for the year ended December 31, 2005 filed on Form 10-K with the Securities and Exchange Commission (SEC).

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, but not limited to, the following statements, as well as statements that contain such words as anticipates, intends, believes, plans and other similar expressions:

the Company's estimates regarding the expected adverse impact on reported revenue related to the purchase accounting treatment of deferred revenue

the Company's intentions related to investments in global sales and marketing, and research and development

increased exposure to volatility of foreign exchange rates

exposure to changes in domestic and foreign tax laws in future periods

plans related to future capital spending

the Company's intentions regarding its mixed sales and distribution model

the sufficiency of existing cash and cash equivalent balances to meet future working capital and capital expenditure requirements

the Company's estimates regarding the effect that Statement No. 123R will have on the net income of the Company for fiscal year 2006

management's assessment of the ultimate liabilities arising from various investigations, claims and legal proceedings

Forward-looking statements should not be unduly relied upon because they involve known and unknown risks, uncertainties and other factors, some of which are beyond the Company's control. The Company's actual results could differ materially from those set forth in forward-looking statements. Certain factors that might cause such a difference include risks and uncertainties detailed in the Management's Discussion and Analysis of Financial Condition and Results of Operations section in the 2005 Annual Report to Stockholders and any such changes to these factors have been included within Part II, Item 1A of this Form 10-Q.

**Table of Contents****Results of Operations****Three Months Ended September 30, 2006 Compared to Three Months Ended September 30, 2005**Revenue:

| <i>(in thousands, except percentages)</i> | Three Months Ended    |                       |                  |       |
|---|-----------------------|-----------------------|------------------|-------|
|   | September 30,<br>2006 | September 30,<br>2005 | Change<br>Amount | %     |
| Revenue:                                  |                       |                       |                  |       |
| Software licenses                         | \$ 42,213             | \$ 20,978             | \$ 21,235        | 101.2 |
| Maintenance and service                   | 27,904                | 18,057                | 9,847            | 54.5  |
| Total revenue                             | 70,117                | 39,035                | 31,082           | 79.6  |

The increase in revenue is primarily due to the following reasons:

Fluent-related revenue was \$27.3 million for the quarter ended September 30, 2006. Software license revenue was \$19.6 million and maintenance and service revenue was \$7.7 million

newly generated software license revenue of \$1.6 million

increase of \$2.4 million in product maintenance revenue, primarily associated with annual maintenance subscriptions sold in connection with new perpetual license sales in recent quarters

decrease of \$200,000 in engineering consulting revenue in the current period compared to the same period in the prior year

With respect to revenue, on average, for the third quarter of 2006, the U.S. Dollar was approximately 3.0% weaker, when measured against the Company's primary foreign currencies, than for the third quarter of 2005. The U.S. Dollar weakened against the British Pound, the Euro and the Canadian Dollar, while it strengthened against the Indian Rupee and the Japanese Yen. The overall weakening resulted in increased revenue and operating income during the 2006 third quarter, as compared with the corresponding 2005 third quarter, of approximately \$392,000 and \$56,000, respectively.

International and domestic revenues, as a percentage of total revenue, were 64.5% and 35.5%, respectively, in the quarter ended September 30, 2006 and 65.6% and 34.4%, respectively, in the quarter ended September 30, 2005.

A substantial portion of the Company's revenue is derived from annual lease and maintenance contracts. These contracts are generally renewed on an annual basis and have a high rate of customer renewal. In addition to the recurring revenue base associated with these contracts, a majority of customers purchasing new perpetual licenses also purchase related annual maintenance contracts. As a result of the significant recurring revenue base, the Company's annual lease and maintenance revenue growth rate in any period does not necessarily correlate to the growth rate of new annual lease and maintenance contracts sold during that period. To the extent the rate of customer renewal for these contracts remains at current levels, incremental annual lease contracts and maintenance contracts sold with new perpetual licenses will result in annual lease and maintenance revenue growth.

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In valuing deferred revenue on the Fluent balance sheet as of the acquisition date, the Company applied the fair value provisions of Emerging Issues Task Force Issue No. 01-3, *Accounting in a Business Combination for Deferred Revenue of an Acquiree*. In accordance with EITF No. 01-3, acquired deferred revenue of approximately \$31.5 million was recorded on the opening balance sheet. This amount was approximately \$20.1 million lower than the historical carrying value. Although this purchase accounting requirement will have no impact on the Company's business or cash flow, it will adversely impact the Company's reported software license revenue under accounting principles generally accepted in the United States of America (GAAP) for the first 12 months post-acquisition. The adverse impact on reported revenue for the quarter-ended September 30, 2006 was approximately \$7.3 million and was approximately \$13.2 million for the period of May 1, 2006 through September 30, 2006. The adverse impact on reported revenue for the quarter ending December 31, 2006 is expected to be approximately \$5.1 million. The adverse impact on reported revenue for the year ending December 31, 2007 is expected to be approximately \$1.9 million.

Cost of Sales and Gross Profit:

| <i>(in thousands, except percentages)</i>        | Three Months Ended September 30, |              |          |              | Change |       |
|--|----------------------------------|--------------|----------|--------------|--------|-------|
|  | 2006                             |              | 2005     |              | Amount | %     |
|  | Amount                           | % of Revenue | Amount   | % of Revenue |        |       |
| Cost of sales:                                   |                                  |              |          |              |        |       |
| Software licenses                                | \$ 1,748                         | 2.5          | \$ 1,334 | 3.4          | \$ 414 | 31.0  |
| Amortization of software and acquired technology | 5,138                            | 7.3          | 877      | 2.2          | 4,261  | 485.9 |
| Maintenance and service                          | 10,434                           | 14.9         | 3,822    | 9.8          | 6,612  | 173.0 |
| Total cost of sales                              | 17,320                           | 24.7         | 6,033    | 15.5         | 11,287 | 187.1 |
| Gross profit                                     | 52,797                           | 75.3         | 33,002   | 84.5         | 19,795 | 60.0  |

The change in cost of sales is due to the following primary reasons:

Fluent-related total cost of sales was \$10.9 million for the quarter ended September 30, 2006. Cost of goods sold was \$430,000, software amortization was \$4.2 million and the cost of providing technical support and engineering consulting services was \$6.3 million

increase in salaries and headcount related costs, including incentive compensation, of \$440,000

The improvement in the gross profit was a result of the increase in revenue offset by a smaller increase in related cost of sales.

**Table of Contents**Operating Expenses:

|   | Three Months Ended September 30,<br>2006 |                 | 2005      |                 | Change    |       |
|---|--|-----------------|-----------|-----------------|-----------|-------|
|   | Amount                                   | % of<br>Revenue | Amount    | % of<br>Revenue | Amount    | %     |
| <i>(in thousands, except percentages)</i> |  |                 |           |                 |           |       |
| Operating expenses:                       |  |                 |           |                 |           |       |
| Selling, general and administrative       | \$ 24,333                                | 34.7            | \$ 10,708 | 27.4            | \$ 13,625 | 127.2 |
| Research and development                  | 13,295                                   | 19.0            | 7,667     | 19.6            | 5,628     | 73.4  |
| Amortization                              | 2,314                                    | 3.3             | 298       | 0.8             | 2,016     | 676.5 |
| Total operating expenses                  | 39,942                                   | 57.0            | 18,673    | 47.8            | 21,269    | 113.9 |

Selling, General and Administrative: Fluent-related selling, general and administrative costs were \$12.6 million for the quarter ended September 30, 2006. Other costs which contributed to the increase were \$860,000 related to stock-based compensation expense associated with the 2006 adoption of Statement No. 123R and salary and headcount related costs, including incentive compensation, increased by \$600,000 as compared to the prior-year quarter. These costs were partially offset by a decrease in third party commissions of \$300,000.

The Company anticipates that it will continue to make investments throughout the remainder of 2006 in its global sales and marketing organization and its global business infrastructure to enhance major account sales activities and to support both its worldwide sales distribution and marketing strategies and the growth of the business in general.

Research and Development: Fluent-related research and development costs were \$4.3 million for the quarter ended September 30, 2006. Expenses increased \$320,000 during the third quarter of 2006 as a result of stock-based compensation expense associated with the 2006 adoption of Statement No. 123R. In addition, salary and headcount related costs, including incentive compensation, increased by \$870,000 as compared to the prior-year quarter. The Company has traditionally invested significant resources in research and development activities and intends to continue to make significant investments in this area, particularly as it relates to ongoing integration of the portfolio of software technologies it offers.

Amortization: Fluent-related amortization expense was \$2.2 million for the quarter ended September 30, 2006. Additionally, amortization expense decreased by \$200,000 as a result of certain customer lists and non-compete agreements that became fully amortized.



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**Interest (Expense) Income, net:** Net interest expense for the three months ended September 30, 2006 was \$2.1 million as compared with interest income for the three months ended September 30, 2005 of \$1.1 million. In connection with the acquisition of Fluent on May 1, 2006, the Company borrowed \$198.0 million and assumed certain capital leases. These borrowings incurred interest expense of \$3.0 million during the quarter ended September 30, 2006. In addition, interest income decreased \$200,000 due to a decrease in funds invested compared to the prior-year quarter as the Company used existing cash to partially fund the acquisition of Fluent.

**Other Income (Expense), net:** Other income increased from \$6,000 during the quarter ended September 30, 2005 to \$412,000 for the quarter ended September 30, 2006. The Fluent-related other income was \$300,000 for the quarter ended September 30, 2006 and related primarily to foreign currency exchange gains. The remaining net increase was the result of the following two factors:

**Foreign Currency Transaction** During the quarter ended September 30, 2006, excluding Fluent, the Company had a net foreign exchange loss of \$122,000 as compared with a loss of \$57,000 for the quarter ended September 30, 2005. Because the Company has significant operations in non-U.S. locations, the Company, for the foreseeable future, will have financial and operational exposure to volatility of foreign exchange rates. The Company is most impacted by movements among and between the Canadian Dollar, British Pound, Euro, Indian Rupee, Japanese Yen, Swedish Krona, Chinese Yuan and the U.S. Dollar.

**Other** Income from other non-operating transactions increased \$170,000 during the third quarter of 2006 compared to the same period in 2005.

**Income Tax Provision:** During the quarter ended September 30, 2006, the Company recorded income tax expense of \$2.8 million and had income before income tax provision of \$11.2 million. The Company's effective tax rate was 25.3% in the 2006 third quarter as compared to 27.8% in the 2005 third quarter. These rates are lower than the federal and state combined statutory rate as a result of export benefits, as well as the generation of research and experimentation credits. Additionally, Fluent has historically had an effective tax rate that has been higher than the Company's. Because Fluent's operating results from the date of acquisition reflect a net loss that is primarily related to acquisition-related amortization and the purchase accounting adjustments to deferred revenue, the related tax benefits on this loss have reduced the Company's overall effective tax rate in the quarter ended September 30, 2006.

During the third quarter of 2006, the Company filed its 2005 U.S. federal and state tax returns. In conjunction with the completion of these returns, the Company adjusted its estimate for 2005 taxes to reflect the actual results and recorded a \$413,000 tax benefit. The effect of this adjustment reduced the third quarter effective tax rate from 29.0% to 25.3%. During the third quarter of 2005, the Company filed its 2004 U.S. federal and state tax returns. In conjunction with the completion of these returns, the Company adjusted its estimate for 2004 taxes to reflect the actual results and recorded a \$500,000 tax benefit. The effect of this adjustment reduced the third quarter 2005 effective tax rate from 31.0% to 27.8%.

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*Net Income:* The Company's net income in the 2006 third quarter was \$8.4 million as compared to net income of \$11.2 million in the 2005 third quarter. Diluted earnings per share decreased from \$0.33 in the 2005 third quarter to \$0.21 in the 2006 third quarter. The weighted average shares used in computing diluted earnings per share were 40.3 million in the 2006 third quarter and 33.9 million in the 2005 third quarter.

**Table of Contents****Nine Months Ended September 30, 2006 Compared to Nine Months Ended September 30, 2005**Revenue:

| <i>(in thousands, except percentages)</i> | Nine Months Ended  |                    | Change    |      |
|---|--------------------|--------------------|-----------|------|
|   | September 30, 2006 | September 30, 2005 | Amount    | %    |
| Revenue:                                  |                    |                    |           |      |
| Software licenses                         | \$ 103,728         | \$ 61,247          | \$ 42,481 | 69.4 |
| Maintenance and service                   | 74,664             | 53,068             | 21,596    | 40.7 |
| Total revenue                             | 178,392            | 114,315            | 64,077    | 56.1 |

The increase in revenue is primarily due to the following reasons:

Fluent-related revenue was \$45.1 million for the period from the acquisition (May 1, 2006) through September 30, 2006. Software license revenue was \$30.4 million and maintenance and service revenue was \$14.7 million

newly generated software license revenue of \$12.1 million, including \$3.3 million related to an order with a long-standing major customer during the 2006 first quarter

increase of \$6.5 million in product maintenance revenue, primarily associated with annual maintenance subscriptions sold in connection with new perpetual license sales in recent quarters

revenue of \$633,000 related to the Company's biennial users' conference

decrease of \$300,000 in engineering consulting revenue in the current period compared to the same period in the prior year

With respect to revenue, on average, for the nine-month period of 2006, the U.S. Dollar was approximately 1.8% stronger, when measured against the Company's primary foreign currencies, than for the nine-month period of 2005. The U.S. Dollar strengthened against the British Pound, the Japanese Yen, the Indian Rupee and the Euro, while it weakened against the Canadian Dollar. The overall strengthening resulted in decreased revenue and operating income during the 2006 nine-month period, as compared with the corresponding 2005 period, of approximately \$800,000 and \$700,000, respectively.

International and domestic revenues, as a percentage of total revenue, were 63.8% and 36.2%, respectively, in the nine months ended September 30, 2006 and 66.9% and 33.1%, respectively, in the nine months ended September 30, 2005.

As previously mentioned above, in accordance with EITF No. 01-3, acquired deferred software revenue of approximately \$31.5 million was recorded on the Fluent opening balance sheet. This amount was approximately \$20.1 million lower than the historical carrying value. The adverse impact on reported revenue was approximately \$13.2 million for the period of May 1, 2006 through September 30, 2006. The adverse impact on reported revenue for the quarter ending December 31, 2006 is expected to be approximately \$5.1 million. The adverse impact on reported revenue for the year ending December 31, 2007 is expected to be approximately \$1.9 million.

**Table of Contents**Cost of Sales and Gross Profit:

| <i>(in thousands, except percentages)</i>        | Nine Months Ended September 30,<br>2006 |                 | 2005     |                 | Change   |       |
|--|---|-----------------|----------|-----------------|----------|-------|
|  | Amount                                  | % of<br>Revenue | Amount   | % of<br>Revenue | Amount   | %     |
| Cost of sales:                                   |   |                 |          |                 |          |       |
| Software licenses                                | \$ 4,938                                | 2.8             | \$ 3,747 | 3.3             | \$ 1,191 | 31.8  |
| Amortization of software and acquired technology | 9,785                                   | 5.5             | 2,665    | 2.3             | 7,120    | 267.2 |
| Maintenance and service                          | 22,918                                  | 12.8            | 11,476   | 10.0            | 11,442   | 99.7  |
| Total cost of sales                              | 37,641                                  | 21.1            | 17,888   | 15.6            | 19,753   | 110.4 |
| Gross profit                                     | 140,751                                 | 78.9            | 96,427   | 84.4            | 44,324   | 46.0  |

The change in cost of sales is due to the following primary reasons:

Fluent-related total cost of sales was \$17.7 million for the period from the acquisition (May 1, 2006) through September 30, 2006. Cost of goods sold was \$700,000, software amortization was \$7.0 million and the cost of providing technical support and engineering consulting services was \$10.0 million

increase in salaries and headcount related costs, including incentive compensation, of \$1.6 million

increase in third party software royalties of \$400,000

The improvement in the gross profit was a result of the increase in revenue offset by a smaller increase in related cost of sales.

**Table of Contents**Operating Expenses:

|   | Nine Months Ended September 30,<br>2006 |                 | 2005      |                 | Change    |       |
|---|---|-----------------|-----------|-----------------|-----------|-------|
|   | Amount                                  | % of<br>Revenue | Amount    | % of<br>Revenue | Amount    | %     |
| <i>(in thousands, except percentages)</i> |   |                 |           |                 |           |       |
| Operating expenses:                       |   |                 |           |                 |           |       |
| Selling, general and administrative       | \$ 58,192                               | 32.6            | \$ 31,854 | 27.8            | \$ 26,338 | 82.7  |
| Research and development                  | 34,274                                  | 19.2            | 22,486    | 19.7            | 11,788    | 52.4  |
| Amortization                              | 4,018                                   | 2.2             | 1,009     | 0.9             | 3,009     | 298.2 |
| In-process research & development         | 28,100                                  | 15.8            |           |                 | 28,100    |       |
| Total operating expenses                  | 124,584                                 | 69.8            | 55,349    | 48.4            | 69,235    | 125.1 |

Selling, General and Administrative: Fluent-related selling, general and administrative costs were \$21.9 million for the period from the acquisition (May 1, 2006) through September 30, 2006. Expenses increased \$2.6 million during the first nine months of 2006 as compared to the corresponding period in 2005 as a result of stock-based compensation expense recorded associated with the 2006 adoption of Statement No. 123R. The cost relating to the ANSYS biennial users conference during the second quarter of 2006 was \$550,000. In addition, salary and headcount related costs, including incentive compensation, increased by \$1.5 million during the nine months ended September 30, 2006 as compared to the nine months ended September 30, 2005.

The Company anticipates that it will continue to make investments throughout the remainder of 2006 in its global sales and marketing organization and its global business infrastructure to enhance major account sales activities and to support both its worldwide sales distribution and marketing strategies and the growth of the business in general.

Research and Development: Fluent-related research and development costs were \$7.2 million for the period from the acquisition (May 1, 2006) through September 30, 2006. Salary and headcount related costs, including incentive compensation, increased by \$3.5 million during the nine months ended September 30, 2006 as compared to the corresponding period of 2005. Expenses increased \$920,000 during the first nine months of 2006 as compared to the corresponding period in 2005 as a result of stock-based compensation expense associated with the 2006 adoption of Statement No. 123R during the first quarter of 2006. The Company has traditionally invested significant resources in research and development activities and intends to continue to make significant investments in this area, particularly as it relates to ongoing integration of the portfolio of software technologies it offers.

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**Amortization:** Fluent-related amortization was \$3.7 million for the period from the acquisition (May 1, 2006) through September 30, 2006. Additionally, amortization decreased by \$750,000 as a result of certain customer lists and non-compete agreements that became fully amortized.

**In-Process Research and Development:** This non-tax deductible charge represents the fair value assigned to incomplete Fluent research and development projects that had not reached technological feasibility and had no alternative future value when acquired on May 1, 2006.

**Interest (Expense) Income, net:** Net interest expense for the nine months ended September 30, 2006 was \$1.5 million as compared with interest income for the nine months ended September 30, 2005 of \$2.8 million. Funds invested received higher interest rates during 2006 as compared with 2005, resulting in increased interest income of \$900,000; however, in connection with the acquisition of Fluent on May 1, 2006, the Company borrowed \$198.0 million and assumed certain capital leases. These borrowings incurred interest expense of \$5.2 million during the period from the date of acquisition (May 1, 2006) through September 30, 2006.

**Other (Expense) Income, net:** Other expense for the nine months ended September 30, 2005 was \$43,000 as compared to other income of \$335,000 for the nine months ended September 30, 2006. The Fluent-related other income was \$220,000 for the period from acquisition (May 1, 2006) through September 30, 2006 and related primarily to foreign currency exchange gains. The remaining net increase was the result of the following two factors:

**Foreign Currency Transaction** - During the nine months ended September 30, 2006, excluding Fluent, the Company had a net foreign exchange loss of \$400,000 as compared with a loss of \$200,000 for the nine months ended September 30, 2005. Because the Company has significant operations in non-U.S. locations, the Company, for the foreseeable future, will have financial and operational exposure to volatility of foreign exchange rates. The Company is most impacted by movements among and between the Canadian Dollar, British Pound, Euro, Indian Rupee, Japanese Yen, Swedish Krona, Chinese Yuan and the U.S. Dollar.

**Other** - Income from other non-operating transactions increased \$400,000 during the first nine months of 2006 compared to the same period in 2005.

**Income Tax Provision:** The Company recorded income tax expense of \$13.1 million and had income before income tax provision of \$15.0 million for the nine months ended September 30, 2006. This represents an effective tax rate of 87.4%. In connection with the May 1, 2006 Fluent acquisition, the Company expensed a non-tax deductible charge related to in-process research and development of \$28.1 million. This non-tax deductible charge increased the Company's effective tax rate from 30.5% to 87.4% for the nine months ended September 30, 2006 as compared to 30.2% in the nine months ended September 30, 2005. These rates are lower than the federal and state combined statutory rate as a result of export benefits, as well as the generation of research and experimentation credits. Additionally, Fluent has historically had an effective tax rate that has been higher than the Company's. Because Fluent's operating results from the date of acquisition reflect a net loss that is primarily related to acquisition-related amortization and the purchase accounting adjustments to deferred revenue, the related tax benefits on this loss have reduced the Company's overall effective tax rate in the period ended September 30, 2006.

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During the third quarter of 2006, the Company filed its 2005 U.S. federal and state tax returns. In conjunction with the completion of these returns, the Company adjusted its estimate for 2005 taxes to reflect the actual results and recorded a \$413,000 tax benefit. The effect of this adjustment reduced the effective tax rate for the nine months ended September 30, 2006 from 90.2% to 87.4%. During the third quarter of 2005, the Company filed its 2004 U.S. federal and state tax returns. In conjunction with the completion of these returns, the Company adjusted its estimate for 2004 taxes to reflect the actual results and recorded a \$500,000 tax benefit. The effect of this adjustment reduced the effective tax rate for the nine months ended September 30, 2005 from 31.3% to 30.2%.

*Net Income:* The Company's net income for the nine months ended September 30, 2006 and September 30, 2005 was \$1.9 million and \$30.6 million, respectively. The net income is significantly impacted by the \$28.1 million non-tax deductible in-process research and development charge related to the Fluent acquisition. Diluted earnings per share results decreased from \$0.91 during the first nine months of 2005 to \$0.05 during the first nine months of 2006. The weighted average shares used in computing diluted earnings per share were 37.5 million and 33.7 million during the nine months ended September 30, 2006 and 2005, respectively.

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**Liquidity and Capital Resources**

As of September 30, 2006, the Company had cash, cash equivalents and short-term investments totaling \$101.8 million and working capital of \$26.4 million, as compared to cash, cash equivalents and short-term investments of \$194.2 million and working capital of \$162.0 million at December 31, 2005. The short-term investments are generally investment-grade and liquid, which allow the Company to minimize interest rate risk and to facilitate liquidity in the event an immediate cash need arises.

The significant differences which affect the condensed consolidated statements of cash flows related to stock-based compensation accounting under Statement No. 123R in the first nine months of 2006 and under APB No. 25 in the first nine months of 2005 are as follows:

a \$4.4 million excess tax benefit from stock options was reported as a financing activity in 2006, whereas all stock option-related tax benefits were reported as an operating activity in 2005

\$3.7 million in stock-based compensation expense was recorded in 2006 whereas such expense was not recorded in 2005. This amount was added as an adjustment to net income to arrive at cash provided by operating activities in 2006

The net \$13.3 million increase in operating cash flows between the nine months ended September 30, 2006 (\$60.4 million) and 2005 (\$47.1 million) was primarily related to:

an increase in net income, adjusted for non-cash charges and benefits, from \$36.5 million for the first nine months of 2005 to \$45.1 million for the first nine months of 2006, comprised primarily of the following:

a net income decrease from \$30.6 million in 2005 to \$1.9 million in 2006

a \$28.1 million non-tax deductible in-process research and development charge

new non-cash amortization charges of \$7.1 million related to developed software and \$3.7 million related to customer relationships

stock-based compensation charges of \$3.7 million

increased deferred tax benefits of \$5.9 million, primarily related to the amortization of non-tax deductible intangible assets acquired in the Fluent acquisition

changes in working capital whereby \$15.2 million was provided in the first nine months of 2006 as compared with \$10.6 million provided during the first nine months of 2005 as follows:

during the first nine months of September 2006 cash as provided by deferred revenue was \$8.1 million as compared with \$2.7 million during the first nine months of 2005. Deferred revenue from Fluent products provided cash of \$8.0 million between the period of May 1, 2006 to September 30, 2006



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during the first nine months of September 2006 cash as provided by other receivables and current assets was \$6.5 million as compared with \$1.8 million during the first nine months of 2005. This \$4.7 million net change is primarily the result of \$3.7 million of cash provided by Fluent

cash used through accounts payable, accrued expenses and liabilities was \$1.8 million during the nine months ended September 30, 2006 as compared with cash provided of \$4.4 million during the nine months ended September 30, 2005. This \$6.2 million net change between the comparable 2006 and 2005 periods was primarily attributable to the classification of tax benefits relating to stock options in 2006 as a financing activity rather than an operating activity, as well as increased domestic federal and state income tax payments

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The Company's investing activities used net cash of \$290.8 million for the nine months ended September 30, 2006 as compared with cash provided of \$37.4 million for the nine months ended September 30, 2005. In the nine-month period of 2006, the Company paid \$297.9 million, net of cash acquired, for Fluent. Net cash provided by maturities in excess of short-term investment purchases was \$18.0 million and \$45.3 million during the nine months ended September 30, 2006 and 2005, respectively. Total capital spending was \$3.7 million during the 2006 period and \$3.5 million during the 2005 period. The Company currently plans additional capital spending of approximately \$2.6 million to \$3.1 million throughout the remainder of 2006; however, the level of spending will be dependent upon various factors, including growth of the business and general economic conditions.

Financing activities provided cash of \$154.4 million in the nine months ended September 30, 2006 as compared with cash used of \$2.2 million during the nine months ended September 30, 2005. This increase in cash provided was primarily a net result of \$145.0 million as generated through \$198.0 million cash provided from term loans to finance the Fluent acquisition, partially offset by \$51.1 million in term loan principal payments and \$1.9 million in loan issuance costs. In addition, certain tax benefits related to stock-based compensation were reported in cash flows from financing activities during 2006, which in 2005 were reported within cash flows from operating activities.

The Company believes that existing cash and cash equivalent balances of \$101.6 million, together with short-term investment balances and cash generated from operations, will be sufficient to meet the Company's working capital and capital expenditure requirements through fiscal 2007. The Company's cash requirements in the future may also be financed through additional equity or debt financings. There can be no assurance that such financings can be obtained on favorable terms, if at all.

The Company continues to generate positive cash flows from operating activities and believes that the best use of its excess cash is to repay its long-term debt, to grow the business and, under certain conditions, to repurchase stock. Additionally, the Company has in the past and expects in the future to acquire or make investments in complementary companies, products, services and technologies. As previously discussed under Acquisitions in Note 6 to the Notes to the Condensed Consolidated Financial Statements, on May 1, 2006, the Company completed its acquisition of Fluent Inc., a global provider of CFD-based computer-aided engineering software and services. Any future acquisitions may be funded by available cash and investments, cash generated from operations, existing or additional credit facilities or from the issuance of additional securities.

The Company does not have any special purpose entities or off-balance sheet financing arrangements.

During the quarters ended September 30, 2006 and 2005, the Company had no borrowings under an uncommitted and unsecured \$10.0 million line of credit.

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The Company's significant contractual obligations as previously reported on the Company's Form 10-K as of December 31, 2005 are summarized below:

| <i>(in thousands)</i>              | Payments Due by Period |               |           |           |               |
|------------------------------------|------------------------|---------------|-----------|-----------|---------------|
|                                    | Total                  | Within 1 year | 2 3 years | 4 5 years | After 5 years |
| Long-term debt                     | \$                     | \$            | \$        | \$        | \$            |
| Corporate office lease             | 12,298                 | 1,241         | 2,481     | 2,859     | 5,717         |
| Other office leases                | 6,243                  | 1,852         | 2,663     | 1,665     | 63            |
| Unconditional purchase obligations | 4,693                  | 1,763         | 2,056     | 874       |               |
| Other long-term obligations        |                        |               |           |           |               |
| Total contractual obligations      | \$ 23,234              | \$ 4,856      | \$ 7,200  | \$ 5,398  | \$ 5,780      |

As a result of the acquisition of Fluent on May 1, 2006, the Company has experienced significant changes to its contractual obligations reported above. The changes are summarized as follows:

The Company borrowed \$198 million on May 1, 2006 to fund the acquisition. During the nine months ended September 30, 2006, the Company made the required principal payments of \$13.1 million and also made prepayments of \$38.0 million. Required principal payments for the quarter ending December 31, 2006 are \$4.7 million and for the years ending December 31, 2007, 2008, 2009, 2010 and 2011 are \$19.0 million, \$15.8 million, \$25.9 million, \$62.9 million and \$18.6 million, respectively.

The Company has paid interest expense relating to the debt of \$4.8 million during the nine months ended September 30, 2006. The interest rate is set for the quarter ending December 31, 2006 at 6.37% on \$86.9 million of the total outstanding balance, which was based on three-month LIBOR + 1.00%. For the remaining outstanding balance of \$60.0 million, the Company secured a fixed interest rate of 6.31% through September 28, 2007, which is based on one-year LIBOR + 1.00%. Assuming an interest rate of 6.37% for periods beyond these fixed rates and contractual quarterly principal payments are made with no additional prepayments, interest payments are expected to be \$2.3 million for the quarter ending December 31, 2006, and \$8.7 million, \$7.5 million, \$6.4 million, \$4.0 million and \$300,000 for the years ending December 31, 2007, 2008, 2009, 2010 and 2011, respectively.

Additional office lease obligations to be paid over various periods of \$11.9 million as of September 30, 2006.

Other long-term obligations to be paid over various periods of \$4.7 million as of September 30, 2006.

There were no other material changes to the Company's significant contractual obligations during the nine months ended September 30, 2006.

**Critical Accounting Policies and Estimates**

Except as stated below, no other significant changes have occurred to the Company's critical accounting policies and estimates as previously reported within the Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's most recent Form 10-K.

The Company grants options to purchase its common stock to its employees and directors under the Company's stock option plans. Eligible employees can also purchase shares of the Company's common stock at 85% of the lower of the fair market value on the first or last day of each six-month offering period under the Company's employee stock purchase plan. The benefits provided under these plans are share-based payments subject to the provisions of revised Statement of Financial

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Accounting Standards No. 123 (Statement No. 123R). Effective January 1, 2006, the Company used the fair value method to apply the provisions of Statement No. 123R with a modified prospective application which provides for certain changes to the method for valuing share-based compensation. Prior to this adoption, the Company had elected to account for stock-based compensation arrangements through the intrinsic value method under the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock-Based Compensation*. Under the intrinsic value method, compensation expense is measured as the excess, if any, of the market value of the underlying common stock over the amount the employee is required to pay on the date both the number of shares and the price to be paid are known. No compensation expense had generally been recognized in the consolidated statements of income as option grants generally were made with exercise prices equal to the fair value of the underlying common stock on the award date, which was typically the date of compensation measurement.

The valuation provisions of Statement No. 123R apply to new awards and to awards that are outstanding on the effective date and subsequently modified or cancelled. Under the modified prospective application, prior periods are not revised for comparative purposes. Share-based compensation expense recognized under Statement No. 123R for the first nine months of fiscal 2006 was \$3.7 million. As of September 30, 2006, total unrecognized estimated compensation expense related to non-vested stock options granted prior to that date was \$10.7 million, which is expected to be recognized over a weighted average period of 2.5 years. Net stock options, after forfeitures and cancellations, granted during each of the three months ended September 30, 2006 and September 30, 2005 represented 0.00% and 0.29% of outstanding shares as of the beginning of each fiscal quarter, respectively. Net stock options, after forfeitures and cancellations, granted during each of the nine months ended September 30, 2006 and September 30, 2005 represented 0.04% and 1.42% of outstanding shares as of the beginning of each fiscal year, respectively. Net stock options, after forfeitures and cancellations, granted during the three months ended September 30, 2006 and September 30, 2005 represented 0.00% and 0.29% of outstanding shares as of the end of each fiscal quarter, respectively. Total stock options granted during the nine months ended September 30, 2006 and September 30, 2005 represented 0.03% and 1.40% of outstanding shares as of the end of September 30 for each fiscal period, respectively.

Upon adoption of Statement No. 123R, the value of each share-based award was estimated on the date of grant using the Black-Scholes option-pricing model (Black-Scholes model), which is the same model that was used for the pro forma information required to be disclosed under Statement No. 123. The determination of the fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the Company's expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rates and expected dividends. The table below presents the assumptions used in calculating the compensation expense recorded within the Company's Condensed Consolidated Statement of Income in compliance with Statement No. 123R as of September 30, 2006 and those used in presenting the pro forma information included within the footnotes of the Company's Form 10-Q as of September 30, 2005. The interest rates used were determined by using the five-year Treasury Note yield at the date of grant.

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|   | Compensation Expense  | Pro Forma Disclosure  |
|---|-----------------------|-----------------------|
| Assumption used in Black-Scholes option-pricing model | September 30, 2006    | September 30, 2005    |
| Risk-free interest rate                               | 5.04% (4.73 to 5.10%) | 3.95% (3.65 to 4.99%) |
| Expected dividend yield                               | 0%                    | 0%                    |
| Expected volatility                                   | 45% (45 to 48%)       | 50%                   |
| Expected term   | 5.1 years             | 5.1 years             |

The Company issues both nonqualified and incentive stock options; however, incentive stock options comprise a significant portion of outstanding stock options. The tax benefits associated with incentive stock options are unpredictable, as they are predicated upon an award recipient triggering an event that disqualifies the award and which then results in a tax deduction to the Company. Statement No. 123R requires that these tax benefits be recorded at the time of the triggering event. The triggering events for each option holder are not easily projected. In order to estimate the tax benefits related to incentive stock options, the Company makes many assumptions and estimates, including the number of incentive stock options that will be exercised during the period by U.S. employees, the number of incentive stock options that will be disqualified during the period and the fair market value of the Company's stock price on the exercise dates. Each of these items is subject to significant uncertainty. Additionally, a significant portion of the tax benefits related to disqualified incentive stock options are accounted for as increases to equity (additional paid-in capital) rather than as reductions in income tax expense, especially in the periods most closely following the adoption date of Statement No. 123R. Although all such benefits continue to be realized through the Company's tax filings, this accounting treatment has the effect of increasing tax expense and reducing net income. For example, the Company realized a tax benefit of \$3.7 million during the nine months ended September 30, 2006 related to disqualified incentive stock options; however, only \$65,000 of such amount was recorded as a reduction in income tax expense. Although there are significant limitations in estimating the impact of Statement No. 123R, including those discussed above, the Company currently estimates that the adoption of Statement No. 123R will decrease 2006 net income by \$4.1 - \$4.6 million in 2006, or approximately \$0.11 - \$0.12 per diluted share.

If factors change and the Company employs different assumptions in the application of Statement No. 123R in future periods, the compensation expense that the Company will record under Statement No. 123R may differ significantly from what the Company has recorded in the current period. Therefore, it is important for investors to be aware of the high degree of subjectivity involved when using option pricing models to estimate share-based compensation under Statement No. 123R. Option-pricing models were developed for use in estimating the value of traded options that have no vesting or hedging restrictions, are fully transferable and do not cause dilution. Because the Company's share-based payments have characteristics significantly different from those of freely traded options and because changes in the input assumptions can materially affect the Company's estimates of fair values, in the Company's opinion, existing valuation models, including the Black-Scholes models, may not provide reliable measures of the fair values of the Company's share-based compensation. Consequently, there is a risk that the Company's estimates of the fair values of the Company's share-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those share-based payments in the future. Certain share-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in the Company's financial statements. Alternatively, value may be realized from these instruments that is significantly in excess of the fair values originally estimated on the grant date and reported in the Company's financial statements.

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There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values. Although the fair value of employee share-based awards is determined in accordance with Statement No. 123R and the Securities and Exchange Commission's Staff Accounting Bulletin No. 107 (SAB 107) using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

Estimates of share-based compensation expenses are significant to the Company's financial statements, but these expenses are based on the aforementioned option valuation model and will never result in the payment of cash by the Company. For this reason, and because the Company does not view share-based compensation as related to its operational performance, management excludes estimated share-based compensation expense when evaluating the underlying business performance.

The guidance in Statement No. 123R and SAB 107 is relatively new, and best practices are not well established. The application of these principles may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that the Company will adopt different valuation models in the future. This may result in a lack of consistency in future periods and may materially affect the fair value estimate of share-based payments. It may also result in a lack of comparability with other companies that use different models, methods and assumptions.

**Recently Issued Accounting Pronouncements**

The Company adopted FASB Statement No. 123R, *Share Based Payment* (Statement No. 123R) as of January 1, 2006. The statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. The cost is recognized over the period during which an employee is required to provide service in exchange for the award, typically the vesting period. Refer to additional disclosures regarding the adoption of this statement within Critical Accounting Policies above and in Notes 2 and 11 to the Condensed Consolidated Financial Statements.

In July 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*. This interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation is effective for fiscal periods beginning after December 15, 2006. The Company is in the process of determining the impact of this Interpretation on its financial position and results of operations.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes framework for measuring fair value in generally accepted accounting principles and expands disclosure about fair value measurements. This statement is effective for fiscal periods beginning after November 15, 2007 and interim periods within those fiscal years. The Company is in the process of determining the impact of Statement No. 157 on its financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements in Current Year Financial Statements* (SAB No. 108). SAB No. 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year's financial statements are materially misstated. SAB No. 108 becomes effective during fiscal year 2007. The Company does not expect the adoption of SAB No. 108 to have an impact on its financial statements.

**Table of Contents****Item 3. Quantitative and Qualitative Disclosures About Market Risk**

**Interest Income Rate Risk.** Changes in the overall level of interest rates affect the interest income that is generated from the Company's cash and short-term investments. For the three and nine months ended September 30, 2006, total interest income was \$900,000 and \$3.7 million, respectively. Cash and cash equivalents consist primarily of highly liquid investments such as time deposits held at major banks, money market mutual funds and other securities with remaining maturities of three months or less. The Company considers investments backed by government agencies or U.S. financial institutions to be highly liquid and, accordingly, classifies such investments as short-term investments.

**Interest Expense Rate Risk.** The Company entered into two credit agreements with variable interest rates as of May 1, 2006 for a total of \$198 million. Borrowings outstanding as of September 30, 2006 totaled \$146.9 million. Interest expense related to the term loans (including the amortization of debt financing costs) for the three and nine months ended September 30, 2006 was \$3.0 million and \$5.1 million, respectively. Based on the effective interest rates and outstanding borrowings at September 30, 2006, a 50 basis point increase in interest rates on the Company's borrowings would not impact the Company's interest expense for the quarter ending December 31, 2006 and would increase the Company's interest expense by approximately \$500,000 for the year ending December 31, 2007.

| <i>(in thousands)</i>   | September 30,<br>2006 | Effective<br>Interest Rate |
|---|-----------------------|----------------------------|
| Term loan payable in quarterly installments with an original final maturity of March 31, 2008 | \$ 6,250              | 6.37%                      |
| Term loan payable in quarterly installments with an original final maturity of March 31, 2011 | 140,635               | 6.34%                      |
| Total borrowings subject to variable interest rate fluctuations                               | \$ 146,885            |                            |

In the third quarter of 2006, the Company elected to fix the interest rate on \$60 million of the term loan for a period of twelve months. The annual rate of 6.31%, based on one-year LIBOR + 1.00%, will be effective through September 28, 2007. The interest rate for the remaining balance is set quarterly and is based on the Company's consolidated leverage ratio and generally ranges from LIBOR + (0.50% - 1.25%) or, at the Company's election, Prime Rate + (0.00% - 0.25%).

**Foreign Currency Transaction Risk.** As the Company continues to expand its business presence in international regions, the portion of its revenue, expenses, cash, accounts receivable and payment obligations denominated in foreign currencies continues to increase. As a result, changes in currency exchange rates from time to time may affect the Company's financial position, results of operations and cash flows. On average, for the quarter ended September 30, 2006, the U.S. Dollar was approximately 3.0% weaker, when measured against the Company's primary foreign currencies, than for the third quarter of 2005. The U.S. Dollar weakened against the British Pound, the Euro, and the Canadian Dollar, while it strengthened against the Indian Rupee and the Japanese Yen. The overall weakening resulted in increased revenue and operating income during the 2006 third quarter, as compared with the corresponding 2005 third quarter, of approximately \$392,000 and \$56,000, respectively.

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With respect to revenue, on average, for the nine-month period of 2006, the U.S. Dollar was approximately 1.8% stronger, when measured against the Company's primary foreign currencies, than for the nine-month period of 2005. The U.S. Dollar strengthened against the British Pound, the Japanese Yen, the Indian Rupee and the Euro, while it weakened against the Canadian Dollar. The overall strengthening resulted in decreased revenue and operating income during the 2006 nine-month period, as compared with the corresponding 2005 period, of approximately \$800,000 and \$700,000, respectively.

As a result of the Fluent acquisition, the Company will also be exposed to fluctuations in the Swedish Krona and the Chinese Yuan.

Based on the nature of the Company's business, it has no direct exposure to commodity price risk.

No other material change has occurred in the Company's market risk subsequent to December 31, 2005.

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

***Evaluation of Disclosure Controls and Procedures.*** As required by Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934, the Company has evaluated, with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, the effectiveness of the design and operation of its disclosure controls and procedures as of the end of the period covered by this report. Based on such evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that such disclosure controls and procedures were functioning effectively to provide reasonable assurance that the information required to be disclosed by the Company in reports filed or submitted under the Exchange Act was recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules.

Disclosure controls and procedures are the Company's controls and other procedures that are designed to ensure that information required to be disclosed by the Company in the reports that the Company files or submits under the Exchange Act, such as this quarterly report, are recorded, processed, summarized and reported within the time periods specified in the SEC's rule. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.



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The Company has a Disclosure Review Committee to assist in the quarterly evaluation of the Company's internal disclosure controls and procedures and in the review of the Company's periodic filings under the Exchange Act. The membership of the Disclosure Review Committee consists of the Company's Chief Executive Officer, Chief Financial Officer, Controller, General Counsel, Treasurer, Vice President of Sales and Support, Vice President of Human Resources, Vice President of Marketing and Business Unit General Managers, as well as certain other members of Fluent financial management. This committee is advised by external counsel, particularly on SEC-related matters. Additionally, other members of the Company's global management team advise the committee with respect to disclosure via a sub-certification process.

The Company believes, based on its knowledge, that 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 Company as of, and for, the periods presented in this report. The Company is committed to both a sound internal control environment and to good corporate governance.

From time to time, the Company reviews the disclosure controls and procedures, and may from time to time make changes aimed at enhancing their effectiveness and to ensure that the Company's systems evolve with its business.

***Changes in Internal Controls.*** The Company is in the process of extending its internal controls to its acquisition of Fluent Inc., including controls primarily related to revenue recognition, financial review, income tax accounting and financial reporting. There were no other changes in the Company's internal controls or in other factors that materially affected, or are reasonably likely to materially affect the Company's internal controls over financial reporting during the quarter ended September 30, 2006.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company is subject to various legal proceedings from time to time that arise in the ordinary course of business. These proceedings currently include customary audit activities by various taxing authorities among other matters. Each of these matters is subject to various uncertainties, and it is possible that these matters may be resolved unfavorably to the Company. Management believes, after consulting with legal counsel, that the ultimate liabilities, if any, resulting from such legal proceedings will not materially affect the Company's financial position, liquidity or results of operations.

**Item 1A. Risk Factors**

The Company cautions investors that its performance (and, therefore, any forward-looking statement) is subject to risks and uncertainties. Various important factors may cause the Company's future results to differ materially from those projected in any forward-looking statement. These factors were disclosed, but not limited to, the items within the Company's most recent Form 10-K, Part I, Item 1A. No material changes have occurred during the nine months ended September 30, 2006 to the risk factors previously presented, except as disclosed below.

***Risks Associated with Acquisitions.*** The Company has consummated and may continue to consummate certain acquisitions, including the second quarter 2006 acquisition of Fluent Inc., in order to support the Company's long-term strategic direction, strengthen its competitive position, expand its customer base, provide greater scale to increase its investments in research and development to accelerate innovation, provide increased capabilities to its existing products, supply new products and services or enhance its distribution channels. In the future, the Company may not be able to identify suitable acquisition candidates or, if suitable candidates are identified, the Company may not be able to complete the business combination on commercially acceptable terms. Business acquisitions may result in devotion of significant management and financial resources.

In addition, for companies acquired, limited experience will exist for several quarters following the acquisition regarding how the acquired company's sales pipelines will convert into sales or revenues and the conversion rate post-acquisition may be quite different from the historical conversion rate. Because a substantial portion of the Company's software license revenue is completed in the latter part of a quarter, and its cost structure is largely fixed in the short term, revenue shortfalls may have a negative impact on the Company's profitability. A delay in a small number of large new software license transactions could cause the Company's quarterly new software license revenues to fall significantly short of its predictions.

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Acquisitions present many risks, and the Company may not realize the financial and strategic goals that were contemplated at the time of any transaction. An acquisition program is an important element of the Company's corporate strategy. The difficulties of integrating companies and acquired assets include, among others:

consolidating operations, where appropriate;

integrating newly acquired businesses or product lines into a uniform financial reporting system;

coordinating sales, distribution and marketing functions;

establishing or expanding sales, distribution and marketing functions in order to accommodate newly acquired businesses or product lines;

preserving important licensing, research and development, supply, distribution, marketing, customer and other relationships;

minimizing diversion of management's attention from ongoing business concerns; and

coordinating geographically separate organizations.

The Company expects to continue to acquire companies, products, services and technologies. Risks that may be encountered in acquisitions include:

the acquisition may not further the Company's business strategy, or the Company may pay more than it is worth;

the Company may not realize the anticipated increase in its revenues if a larger than predicted number of customers decline to renew annual leases or software license updates and product support or, if the Company is unable to sell the acquired products to its customer base;

the Company may have difficulty incorporating the acquired technologies or products with its existing product lines and maintaining uniform standards, controls, procedures and policies;

the Company may incur unanticipated costs;

the Company may significantly increase its interest expense, leverage and debt service requirements if it incurs debt to pay for an acquisition;

the Company may have higher than anticipated costs in continuing support and development of acquired products;

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the Company may have multiple and overlapping product lines that are offered, priced and supported differently, which could cause customer confusion and delays;

the Company's relationship with current and new employees, customers, partners and distributors could be impaired;

the Company may assume pre-existing contractual relationships which it otherwise would not have entered into and exiting or modifying such relationships may be costly to the Company and disruptive to customers;

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the Company may not be able to implement the appropriate controls and procedures to ensure the acquired entity is in compliance with Sarbanes-Oxley;

the Company may not be able to ensure successful systems integration for both sales and financial applications;

the Company's due diligence process may fail to identify technical problems, such as issues with the acquired company's product quality or product architecture or unlicensed use of technology, including, for example, improperly incorporated open source code;

the Company may have legal and tax exposures or lose anticipated tax benefits as a result of unforeseen difficulties in legal entity merger integration activities;

the Company may face contingencies related to product liability, intellectual property, financial disclosures and accounting practices or internal controls;

the acquisition may result in litigation from terminated employees or third parties;

the Company's ongoing business may be disrupted and management's attention may be diverted by transition or integration issues;

the Company may enter lines of business or geographies in which it has no or limited prior experience;

the Company may be unable to obtain timely approvals from governmental authorities under competition and antitrust laws;

the Company may use significant amounts of its existing cash balances to complete the acquisition, thus, reducing interest income and liquidity;

to the extent that the Company issues a significant amount of equity securities in connection with future acquisitions, existing stockholders may be diluted and earnings per share may decrease; and

acquisitions may result in the creation of certain intangible assets, including goodwill, the write-down of which may result in a significant charge to earnings.

These factors could have a material, adverse effect on the Company's business, results of operations, financial condition or cash flows, particularly in the case of a larger acquisition or number of acquisitions.

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***Disruption of Operations or Infrastructure Failures.*** A significant portion of the Company's software development personnel, source code and computer equipment is located at operating facilities in the United States, Canada and Europe. The occurrence of a natural disaster or other unforeseen catastrophe, such as infection of the avian influenza with key personnel, at any of these facilities could cause interruptions in the Company's operations, services and product development activities. Additionally, if the Company experiences problems that impair its business infrastructure, such as a computer virus, telephone system failure or an intentional disruption of its information technology systems by a third party, these interruptions could have a material, adverse effect on the Company's business, financial condition, results of operations, cash flows and the ability to meet financial reporting timelines. Further, because the Company's sales are not generally linear during any quarterly period, the potential adverse effects resulting from any of the events described above or any other disruption of the Company's business could be accentuated if it occurs close to the end of a fiscal quarter.

***Indebtedness Incurred in Connection with the Acquisition of Fluent Inc.*** In partial consideration for the Company's acquisition of Fluent Inc., the Company incurred long-term debt from committed bank financing of approximately \$198 million. This indebtedness is material in relation to prior levels of indebtedness as the Company did not have any prior outstanding debt. The incurrence of indebtedness, among other things, could:

make it difficult for the Company to obtain any necessary future financing for working capital, capital expenditures, debt service requirements or other purposes;

limit the Company's flexibility in planning for, or reacting to changes in, its business; and

make the Company more vulnerable in the event of a downturn in its business.

If the Company incurs new indebtedness in the future, the related risks that it now faces could intensify. Whether the Company is able to make required payments on its outstanding indebtedness and to satisfy any other future debt obligations will depend on its future operating performance and its ability to obtain additional debt or equity financing.

***Substantial Overhang of Common Stock.*** In connection with the acquisition of Fluent, the Company issued 5,999,948 shares of the Company's common stock. On August 4, 2006, the Company filed a Registration Statement on Form S-3 registering an aggregate of 5,999,948 shares of common stock for re-sale, including 3,815,323 shares to funds affiliated with Willis Stein. These shares were subject to a lock-up whereby the selling stockholders agreed to certain limitations on sales or transfers, which ended November 1, 2006. The holders of such securities also have rights to participate in or to require the Company to file registration statements with the SEC for resale of their common stock.

Sales of substantial numbers of shares under the registration statement, and the overhang from the possibility of such sales, may depress the price of the Company's common stock and may cause or exacerbate volatility in the Company's stock price. The Company cannot predict the effect, if any, that future sales of shares of our common stock into the market will have on the market price of our common stock.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

(a) Exhibits.

| <b>Exhibit No.</b> | <b>Exhibit Title</b>  |
|--------------------|---|
|                    | <b>Articles of Incorporation and By-laws</b>  |
| 3.3                | Certificate of Amendment to the Company's Restated Certificate of Incorporation as filed with the Secretary of State of the State of Delaware (filed as Exhibit 3.1 to the Company's Current Report on Form 8-K, dated June 15, 2006, and incorporated herein by reference).  |
|                    | <b>Material Contracts</b>   |
| 10.1               | Credit Agreement, dated as of May 1, 2006, by and among ANSYS, Inc., each lender from time to time party thereto, Bank of America, N.A., as Administrative Agent, National City Bank of Pennsylvania, as Syndication Agent, and Keybank National Association, Citizens Bank of Pennsylvania and LaSalle Bank National Association, as Co-Documentation Agents (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K, dated May 1, 2006, and incorporated herein by reference). |
| 10.2               | Subsidiary Guarantee Agreement by and among the domestic subsidiaries of ANSYS, Inc., in favor of Bank of America, N.A., as Administrative Agent, and each lender from time to time party to the Credit Agreement (filed as Exhibit 10.2 to the Company's Current Report on Form 8-K, dated May 1, 2006, and incorporated herein by reference).   |
| 10.3               | Credit Agreement, dated as of May 1, 2006, by and among Fluent Inc., the lenders party thereto, and Bank of America, N.A., as Administrative Agent (filed as Exhibit 10.3 to the Company's Current Report on Form 8-K, dated May 1, 2006, and incorporated herein by reference).  |
| 10.4               | Third Amended and Restated 1996 Stock Option and Grant Plan (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K, dated June 15, 2006, and incorporated herein by reference).*  |
| 10.5               | Deferred Stock Award or Non-Qualified Stock Option Election Form (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K, dated June 30, 2006, and incorporated herein by reference).*   |

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| <b>Exhibit No.</b> | <b>Exhibit Title</b>   |
|--------------------|--|
| 10.6               | Form of Deferred Stock Unit Agreement under the Third Amended and Restated ANSYS, Inc. 1996 Stock Option and Grant Plan (filed as Exhibit 10.2 to the Company's Current Report on Form 8-K, dated June 30, 2006, and incorporated herein by reference).* |
| 10.7               | Indemnification Agreement, dated July 25, 2006, between ANSYS, Inc. and Daniel H. Blumenthal (filed as Exhibit 10.1 to the Company's Current Report on Form 8-K, dated July 25, 2006, and incorporated herein by reference).                             |
| 10.8               | Incentive Stock Option Agreement under the Third Amended and Restated ANSYS, Inc. 1996 Stock Option and Grant Plan.  |
| 10.9               | Non-qualified Stock Option Agreement for Company Employees under the Third Amended and Restated ANSYS, Inc. 1996 Stock Option and Grant Plan.  |
| 10.10              | Incentive Stock Option Agreement under the Third Amended and Restated ANSYS, Inc. 1996 Stock Option and Grant Plan.  |
| 10.11              | Non-qualified Stock Option Agreement for Company Employees under the Third Amended and Restated ANSYS, Inc. 1996 Stock Option and Grant Plan.  |
| 10.12              | Non-qualified Stock Option Agreement for Directors under the Third Amended and Restated ANSYS, Inc. 1996 Stock Option and Grant Plan.  |
| 15                 | Independent Accountants' Letter Regarding Unaudited Financial Information.   |
| 31.1               | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2               | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1               | Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.  |
| 32.2               | Certification 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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\* *Indicates management contract or compensatory plan, contract or arrangement*



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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**ANSYS, Inc.**

Date: November 3, 2006

By: /s/ James E. Cashman, III  
James E. Cashman, III  
President and Chief Executive Officer

Date: November 3, 2006

By: /s/ Maria T. Shields  
Maria T. Shields  
Chief Financial Officer