This 3DAdvisors Report Covers:
✓ **Insider Trading**: Insider Trading Behavior
✓ **Accounting**: Quality of Earnings Issues
Governance: Corporate Governance Issues

Insiders Waste No Time Selling Into Good News Rally
Synopsys, Inc. (NASDAQ:SNPS) Update

June 11, 2004

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Synopsys, Inc. is a supplier of electronic design automation (EDA) software to the global electronics industry. During the fiscal year ended October 31, 2002, the Company offered customers a comprehensive suite of products used in the logic synthesis and functional verification phases of chip design, including a broad array of reusable design building blocks. It also offered a set of physical synthesis and physical design products and a number of physical verification products. The Company offers its customers products required to design a chip from concept to the point at which it is handed to the manufacturer for fabrication, as well as an array of design building blocks. It also offers a range of professional services, including turnkey design services, design assistance and methodology consulting. It is organized into four product development groups: Integrated Circuit Implementation, Verification Technology, Nanometer Analysis and Test and Intellectual Property and Design Services.

Summary of 3DAdvisors Findings for SNPS

- **Insider Trading:** Insiders waste no time selling into good news rally
- **Accounting:** Revenue recognition offers ample opportunities for manipulation
- **Accounting:** Deferred revenue trends worth monitoring
- **Accounting:** Stock repurchases appear driven by high level of option exercises
- **Other:** Miscellaneous noteworthy items

Discussion of 3DAdvisors Findings

Synopsys had caught our eye back in February (see our SNPS report dated 02/04/04) when our monitoring of insider selling by nine of the eleven named Company executive officers reached significant proportions. At that time, we noted how a number of key individuals had converged to sell late last year. Some of them, such as **Vicki Andrews**, Sr. V.P. Worldwide Sales, who reduced her actionable holdings by 52%, had punched out of major pieces of their holdings. In addition to the specious trading behavior, our review of the Company at that time also focused on the significant leeway the Company has in the *application* of revenue recognition based on the type of customer contracts it enters into. Finally, we also became intrigued that, following the aforementioned round of insider sales, the Company changed its 2004 guidance a bit, back-loading its booking expectations towards the second half of the year. We had also noticed how deferred revenue growth had begun to show some sequential declines in Q3 and Q4 of 2003.

On February 23rd, Synopsys shares fell when the Company lowered revenue guidance for its fiscal second quarter ended April 30. The shares, which had been trading in the $36 to $38 range, promptly fell to trade lower, in the $30 area, before ultimately drifting lower-again to the mid $20's. Synopsys shares subsequently received a boost when, on May 19th, the Company raised guidance for the second half of the year and called off its plans for the somewhat controversial Monolithic System acquisition. The shares, which had fallen as low as $24.50 in earlier weeks, rallied back to their current $30 range on the news, which apparently was enough of a rally to entice insiders to dump another chunk of their holdings. Since a number of the sellers had been letting stock go late last year, at higher prices, their willingness to sell at successively lower prices is trading behavior that always gets our attention. Despite the new guidance, they were not apparently willing to wait around for any further appreciation in the shares.

<u>Insider Trading: Insiders waste no time selling into good news rally</u>

SNPS shares rallied after the Company reported better than expected second quarter results and raised full-year guidance after the close on May 19th. Insiders wasted no time selling into the rally. In all, from May 24th through June 4th, seven insiders sold 419,788 shares between $29.10 and $30.36. Most of the selling was by mid-level executives; mostly segment GM's that have front line operating responsibilities and whose trading behavior we monitor closely. We found this selling noteworthy considering their history of infrequent selling and willingness to accept lower prices after the issue's February decline.

Figure 1. SNPS Stock Chart, November 3, 2003 to June 10, 2004. Blue diamond is the date of our first SNPS Report; Shaded blue area is where recent round of insider selling took place. Source: Reuters and Vickers.

As we noted in our last report, Synopsys has a very complex option picture. Whether by design or not, it is exceptionally difficult to get your arms around the actionable position (common stock plus exercisable options) for any insider at the Company. Most companies grant options once a year, whereas Synopsys issues multiple grants throughout the year with varying exercise prices and expiration dates. The one consistency is that they have a ten year life and begin vesting three months after the grant date at a rate of 1/48 each month (3/48 on the first vesting period). Computing their holdings becomes complicated since the Proxy only lists one collective figure for the annual grants rather than breaking down each awarded series. We prevailed at calculating the holdings reductions by examining all Form 4 filings for each insider. Based on our work, it is evident that, starting late last year, insiders began clearing out their options. The multiple series exercising is interesting considering most Synopsys execs that have been with the Company for over five years hold at least fifteen different options series, many of which have been vested for a long time and not in danger of expiration anytime soon.

- **Rex Jackson (43) General Counsel –** Jackson has been with the company only since February of 2003. His recent sale, of 19,181 shares, is his first. He was quick to act after the stock moved, selling the shares on May 24th. Analysis of his actions is most interesting. He joined the company in Q1 of 2003 and has been granted a number of options with the typical Synopsis early vesting traits. His first options began vesting in March of 2004. By late May, 18,750 of his options were vested and exercisable at $20.005 each. The options ($20.005 strike price) he exercised, in doing so, were not set to expire until 2013. On May 24th, he cleared out of the entire 18,750-share option position plus the remaining 431 shares he held, **clearing out 100% of his actionable position**. Thanks to the generous vesting schedules, each month, another 1,250 of those $20.005's will vest until June of 2006, but that's for only a total of 45,000 shares. His remaining options remain either under water, or just on the surface (at current prices) and are for much smaller share amounts.

- **Manoj Gandhi (43)** – Senior V.P. and GM, Verification Group. Gandhi was one of the sellers in the December round, having sold 33,500 shares between $32 and roughly $34. Gandhi traditionally holds few Synopsys shares, choosing instead to hold his position in the form of options and that position has been dropping significantly. He is once again joining the convergence of selling insiders, as he sold 26,000 shares between May 27th and June 4th, only this time at lower prices ($29.45 to $29.95). What's caught our attention is Gandhi's aggressive option exercising. Back in December he exercised eight option series with expiration dates ranging between February 2010 and February 2013. His recent activity included the exercising of eight series of non-expiring options (expiration dates: 2/10, 3/10, 6/10, 8/10, 8/11, 8/12, 12/12, 2/13), five of which had strike prices over $20. Since December, **Gandhi has reduced his actionable position by 51%**.

- **Raul Camposano (58)** – Senior V.P., CTO. Back in the late '90's we had become familiar with Camposano's consistent selling pattern. Then his sales disappeared until December 2003, when we earlier reported his 70,000-share sale at $33. His selling has now persisted following the issue's earlier weakness – on June 4th he sold 30,000 shares at $29. Since December **he has now sold 30%** of his actionable position (common stock and exercisable options).

- **Steven Walske (51)** – Director. Walske, who is both the lead independent director and Chairman of the Compensation Committee, has been an infrequent seller since joining the board in 1991. He sold 60,000 shares in November 1996 at $23, which preceded significant weakness over the ensuing five months (the issue dropped from $23 to $12), and again in June 2003, selling 66,000 shares at $30. More recently **he disposed of 24%** of his holdings with a 48,832-share sale on June 2nd. Walske exercised three series of non-expiring options (expiration dates: 2/09, 3/10, 8/10) with strike prices between $18 and $23. This is the first transaction that we've seen him exercise multiple option series. We should note that he didn't sell all the options he exercised.

- **Deirdre Hanford (age not disclosed)** – Senior V.P., Worldwide Application Services. Hanford is one of the more seasoned executives, having joined the Company nearly twenty years ago. Throughout her career she has been an infrequent seller, only having surfaced in November/December 1999 and December 2003 to sell a combined 20,000 shares at prices between $31 and $35. Last December, she had sold 5,000 shares at prices just below $34. She has surfaced once more, selling 30,000 shares, her highest-ever total, in early June at prices in the $30 range. The fact that she is willing to sell more shares, at lower prices than in December, is very telling to us.

- **Sanjiv Kaul (age not disclosed)** – Senior V.P., New Ventures Group. On May 7th Kaul resigned from the Company to accept a CEO position at an undisclosed semiconductor firm. In cases such as these we are not surprised to see the individual cashing out some shares. Kaul, however, is selling quite aggressively in the face of the upward guidance and does not seem to want to wait and see whether the shares reach their levels of last February. Between May 24th and June 4th he sold 274,447 shares at roughly $30. Kaul exercised nearly all of his exercisable options to execute the sales. Since December, **he has now sold 85%** of his ownership stake in the Company, a sizeable reduction even if he has made a decision to leave.

Accounting: Revenue recognition offers ample opportunities for manipulation

The accounting behavior that stands out for us, with regards to Synopsys's revenue recognition practices, is the fact that the *application* of multiple revenue recognition schemes can take place at various points all the way down to specific customer orders. It is clear that Synopsys is in a position to negotiate with customers the nature of the order with a view toward how the revenue is going to be recognized. This may not be an easy task when negotiating with a new customer but may be when dealing with Intel, Synopsys's largest customer. Of course, it must be noted that Intel's CFO **Andy Bryant** sits on the Synopsys board.

Opportunity indeed. Intel accounted for more than 10% of Synopsys's orders and revenues for the both Q1 and Q2 of 2004. It so happens that in Q1, a seasonably light booking quarter for the Company, 57% of Synopsys's license orders were for up-front licenses, which is nearly double the 25% average the Company shoots for. When asked, in the Q1 conference call, whether the largest up front order came from Intel, the answer was "yes". Given the back-loaded nature of Synopsys's current year, the upfront timing for the Q1's largest order could easily have played a role in boosting near-term revenue during a period when guidance (for Q2) had been pulled back.

Table 1. Percentage of Revenue From Upfront Versus Time-Based Contracts. Source: SNPS SEC Filings

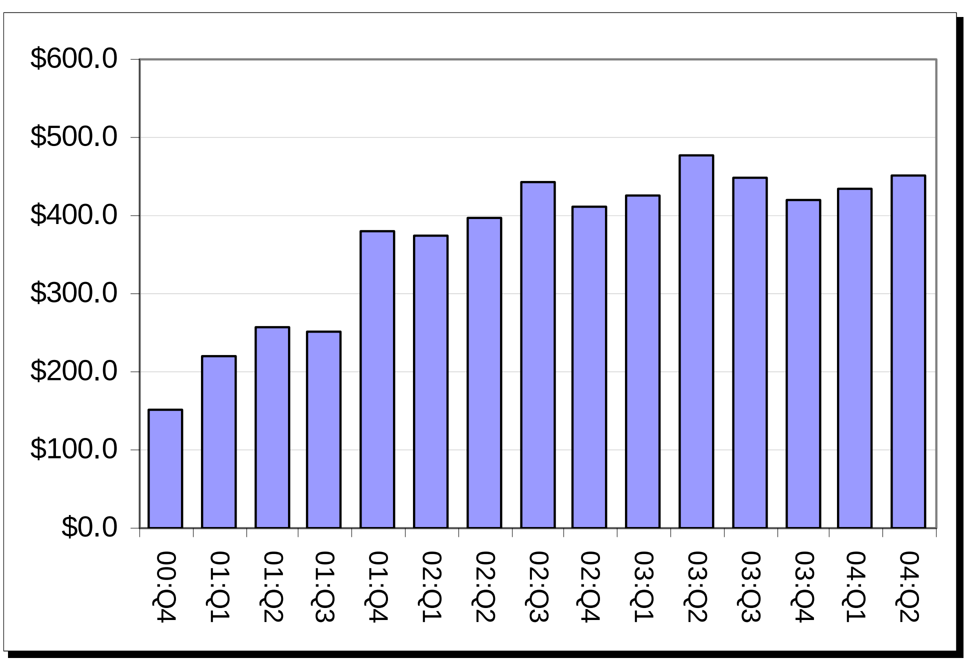
	2004:Q2	2004:Q1	2003:Q4	2003:Q3	2003:Q2	2003:Q1
Upfront	32%	57%	33%	21%	26%	15%
Time-Based	68%	43%	67%	79%	74%	85%

Certainly, in many cases, perhaps at the option of the Company, timing of revenue recognition depends not upon the nature of the product, or delivery of the service, but rather it depends upon the payment terms negotiated with the customer.

Accounting: Deferred revenue trends worth monitoring

Deferred Revenues have shown some sequential dips in recent quarters, and the Company has been quick with prepared answers when asked about it. The first decline, between Q2 and Q3 of 2003, was explained away quickly by the Company as being "due to a higher percentage of orders being invoiced quarterly in advance as opposed to annual in advance." When Deferred Revenues declined again in Q4, no questions were raised during the conference call. Deferred revenue rose slightly in Q1, and again in Q2, but not enough bring it above levels reached in 2003. At $452 million as of 4/30/04 (Q2), Deferred Revenues remain below the $477.3 million level reached during Q2 of 2003.

Figure 2. SNPS Deferred Revenue (Millions $). Source: SNPS SEC Filings



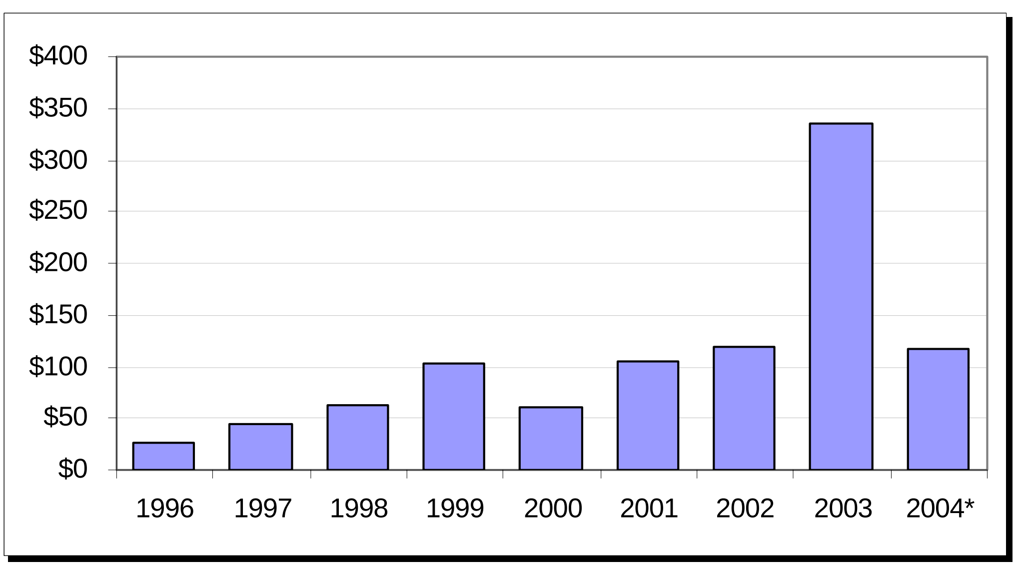
Accounting: Stock repurchases appear driven by high level of option exercises

Synopsys's aggressive options programs are most likely driving the need for share repurchases to avoid dilution. The Company has a very large exposure to potential options expensing. In Q2 of 2004 for instance, the reported $0.19 per share earnings would have been reduced to just $0.06 if options expensing were in the picture. The potential dilution factor related to options is clearly driving the need for recent repurchases, most of which seem to be occurring in response to a higher number of options being exercised by employees as opposed to decreases in the price of Synopsys shares. In Q1, for instance, the Company bought 4.58 million shares at an average price of $35.13 each. In Q2, Synopsys paid $35.59 per share in buying 2.2 million shares. This repurchase activity correlates with the high level of option exercises by company employees over the past few quarters.

So in the past two quarters, Synopsys has burnt through $238 million to repurchase shares, most of which were purchased right at four-year highs, shares that were trading almost 30% lower by the end of February. This recent activity has exhausted almost half of the current repurchase obligation which currently has $262 million left.

Employee option exercise activity is running at all-time high levels. Through Q2 of 2004, employees have spent $118 million to exercise options. This exceeds the totals for any year prior to 2003 when $335 million was spent on option exercises. As you probably know, it has been our experience, in observing insider behavior for 22 years, that most option exercises are accompanied by sales of all or most of the underlying shares and this has proven to be the case with Synopsys over the years. It continues to be our view that, in addition to regular Section 16 insider sales, broad-based employee stock sales at the Company are running at record levels.

Figure 3. Cash Received From Employee Stock Option Exercises (Millions $). Source: SNPS SEC Filings.



* Cash received through Q2

Other: Noteworthy miscellaneous items

- Customer Contract Intangible Assets. Due to the acquisitions of both Avant! and Numerical, Synopsys still carries about $86 million in Customer Relationship assets in Intangible Assets (net of accumulated depreciation) as of Q2, 2004. We acknowledge the fact that in a business such as Synopsys's, customers once imbedded in R&D projects, are not likely to switch products in min-stream. We find it interesting however, the fact that most of SNPS's new term contracts are for less than three years. This makes the six-year amortization schedule used for Avant! and Numerical customer relationships seem rather long. It seems that the majority of this asset has well over four years remaining before being fully amortized.

- We are surprised to see that Intel's **Andy Bryant** remains on the Synopsys board. With so much of their business going to Intel, and with the attendant revenue recognition timing opportunities, we would have thought this relationship to have changed by now.