ANSYS INC
Form 10-Q
August 04, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

OR

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

Commission File Number: 0-20853

ANSYS, Inc.

(exact name of registrant as specified in its charter)

Delaware	**04-3219960**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
275 Technology Drive, Canonsburg, PA	**15317**
(Address of principal executive offices)	**(Zip Code)**

724-746-3304

(Registrant s telephone number, including area code)

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 x 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 x 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 x

The number of shares of the Registrant s Common Stock, par value $.01 per share, outstanding as of July 31, 2006 was 38,343,706 shares.

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ANSYS, INC. AND SUBSIDIARIES

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PART I UNAUDITED FINANCIAL INFORMATION

Item 1. Financial Statements:

ANSYS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share information)

(Unaudited)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 102,648	$ 176,166
Short-term investments	461	18,066
Accounts receivable, less allowance for doubtful accounts of $3,131 and $2,231, respectively	29,937	19,134
Other receivables and current assets	46,149	25,065
Deferred income taxes	12,253	4,055
Total current assets	191,448	242,486
Property and equipment, net	24,252	6,362
Capitalized software costs, net	799	642
Goodwill	430,823	43,277
Other intangibles, net	218,513	10,122
Other long-term assets	3,059	467
Deferred income taxes		2,153
Total assets	$ 868,894	$ 305,509
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	$ 24,361	$
Accounts payable	2,514	1,330
Accrued bonuses	11,166	9,631
Other accrued expenses and liabilities	33,185	19,677
Deferred revenue	95,394	49,894
Total current liabilities	166,620	80,532
Long-term liabilities:		
Long-term debt and capital lease obligations, less current portion	146,191	
Deferred income taxes	51,406	
Other long-term liabilities	1,375	
Total long-term liabilities	198,972	
Commitments and contingencies		
Stockholders equity:		

Preferred stock, $.01 par value; 2,000,000 shares authorized; zero issued or 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	338,670	59,543
Retained earnings	172,691	179,171
Treasury stock, at cost: 861,445 and 1,121,726 shares, respectively	(15,252)	(18,340)
Accumulated other comprehensive income	6,801	4,271
Total stockholders equity	503,302	224,977
Total liabilities and stockholders equity	$ 868,894	$ 305,509

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

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ANSYS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Revenue:				
Software licenses	$ 34,763	$ 19,794	$ 61,515	$ 40,269
Maintenance and service	27,501	17,862	46,760	35,011
Total revenue	62,264	37,656	108,275	75,280
Cost of sales:				
Software licenses	1,700	1,160	3,190	2,413
Amortization of software and acquired technology	3,739	881	4,647	1,788
Maintenance and service	8,014	3,796	12,484	7,654
Total cost of sales	13,453	5,837	20,321	11,855
Gross profit	48,811	31,819	87,954	63,425
Operating expenses:				
Selling, general and administrative	22,020	10,600	33,859	21,146
Research and development	11,622	7,506	20,979	14,819
Amortization	1,576	385	1,704	711
In-process research and development	28,100		28,100	
Total operating expenses	63,318	18,491	84,642	36,676
Operating (loss) income	(14,507)	13,328	3,312	26,749
Interest (expense) income, net	(919)	984	593	1,708
Other (expense) income, net	(263)	62	(77)	(49)
(Loss) income before income tax provision	(15,689)	14,374	3,828	28,408
Income tax provision	3,704	4,599	10,308	8,950
Net (loss) income	$ (19,393)	$ 9,775	$ (6,480)	$ 19,458
Earnings per share - basic:				
Basic earnings per share	$ (0.53)	$ 0.31	$ (0.19)	$ 0.62
Weighted average shares basic	36,306	31,667	34,214	31,579
Earnings per share - diluted:				
Diluted earnings per share	$ (0.53)	$ 0.29	$ (0.19)	$ 0.58
Weighted average shares diluted	36,306	33,782	34,214	33,688

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

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ANSYS, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(Unaudited)

	Six Months Ended June 30, 2006	June 30, 2005
Cash flows from operating activities:		
Net (loss) income	$ (6,480)	$ 19,458
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation and amortization	8,658	4,132
Deferred income tax benefit	(3,017)	(749)
Provision for bad debts	217	319
Stock-based compensation expense	2,454	
Write-off of in-process research and development	28,100	
Other	(20)	
Changes in operating assets and liabilities:		
Accounts receivable	513	3,123
Other receivables and current assets	2,168	1,208
Accounts payable, accrued expenses and liabilities	(8,507)	(450)
Deferred revenue	13,947	5,877
Net cash provided by operating activities	38,033	32,918
Cash flows from investing activities:		
Capital expenditures	(1,798)	(2,693)
Capitalization of internally developed software costs	(375)	(249)
Fluent acquisition payments, net of cash acquired	(295,528)	
Other acquisition payments, net of cash acquired	(5,863)	(4,173)
Purchases of short-term investments	(6,073)	(24,865)
Maturities of short-term investments	24,116	70,188
Net cash (used in) provided by investing activities	(285,521)	38,208
Cash flows from financing activities:		
Principal payments on long-term debt	(29,250)	
Principal payments on long-term capital leases	(159)	
Proceeds from long-term debt	198,000	
Loan issuance costs	(1,940)	
Proceeds from issuance of common stock under Employee Stock Purchase Plan	490	338
Proceeds from exercise of stock options	2,336	2,614
Repurchase of common stock		(3,055)
Excess tax benefits from stock options	2,646	
Net cash provided by (used in) financing activities	172,123	(103)
Effect of exchange rate fluctuations on cash and cash equivalents	1,847	(1,246)

Net (decrease)/increase in cash and cash equivalents	(73,518)	69,777
Cash and cash equivalents, beginning of period	176,166	83,547
Cash and cash equivalents, end of period	$ 102,648	$ 153,324
Supplemental disclosures of cash flow information:		
Cash paid during the period for interest	$ 2,028	$
Cash paid during the period for income taxes	$ 16,644	$ 7,934
Supplemental disclosures of non-cash investing activities:		
Capital lease obligations	$ 486	$

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

June 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 six months ended June 30, 2006 are not necessarily indicative of the results that may be expected for any future period.

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.

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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 June 30, 2006 that exceeded the balance insured by the F.D.I.C. in the amount of approximately $39.0 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 $52.0 million 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 revised 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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Share-Based Compensation Information under Statement No. 123R.

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 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 $2.7 million during the first six months of 2006 related to disqualified incentive stock options; however, only $46,000 of such amount was recorded as a reduction in income tax expense. Although there are significant limitations in estimating the impact of Statement 123R, including those discussed above, the Company currently estimates that the adoption of Statement 123R will decrease 2006 operating income by approximately $5.1 $5.6 million and net income by approximately $4.1 $4.6 million, or approximately $0.10 - $0.12 per diluted share, including $2.0 million or $0.06 per diluted share, recorded in the six-month period ended June 30, 2006.

The weighted-average fair value of options granted during the three and six months ended June 30, 2006 was $22.28 per share and $21.93 per share, respectively. 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%. 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 45%, 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 Operations for the first six months of fiscal 2006 is based on awards ultimately expected to vest, it should be reduced for estimated forfeitures. Statement 123R requires forfeitures to be 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 both the first and second quarter 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 six months ended June 30, 2006 is as follows:

(in thousands)	Three Months Ended June 30, 2006	Six Months Ended June 30, 2006
Cost of sales:		
Software licenses	$ 10	$ 21
Maintenance and service	43	85
Operating Expenses:		
Selling, general and administrative	876	1,750
Research and development	301	598
Share-based compensation expense before taxes	1,230	2,454
Related income tax benefits	(214)	(455)
Share-based compensation expense, net of taxes	$ 1,016	$ 1,999

The Company did not record material share-based compensation expense during the three and six months ended June 30, 2006 related to share-based awards granted during the first six months of 2006. In addition, for the six months ended June 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 $2.6 million related to the incremental tax benefits from stock options exercised in the period.

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Pro Forma Information under SFAS No. 123 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 are made with exercise prices equal to the fair value of the underlying common stock on the award date, which is 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 six months ended June 30, 2005 would have been reduced to the pro forma amounts indicated below:

	Three Months Ended June 30,		Six Months Ended June 30,	
(in thousands, except per share data)		**2005**		**2005**
Net income, as reported	$	9,775	$	19,458
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		(932)		(1,797)
Pro forma net income	$	8,843	$	17,661
Earnings per share:				
Basic as reported	$	0.31	$	0.62
Basic pro forma	$	0.28	$	0.56
Diluted as reported	$	0.29	$	0.58
Diluted pro forma	$	0.26	$	0.52

The weighted-average fair value of options granted during the three and six months ended June 30, 2005 was $15.54 per share and $15.85 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 3.69%. 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 operations to combine selling, general and administrative costs, and to separately report interest income and other income, and to the Goodwill and Intangible Assets footnote to conform to the 2006 presentation.

3. Accumulated Other Comprehensive (Loss) Income, net

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

Comprehensive (loss) income for the three- and six- month periods ended June 30, 2006 and 2005 was as follows:

	Three Months Ended		Six Months Ended	
(in thousands)	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Comprehensive (loss) income	$ (17,138)	$ 8,339	$ (3,950)	$ 17,249

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 $35.1 million and $21.0 million as of June 30, 2006 and December 31, 2005, respectively.

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5. (Loss) Earnings Per Share

Basic (loss) earnings per share (EPS) amounts are computed by dividing (loss) 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 loss per share. For the three- and six- month periods ended June 30, 2006, the loss per share calculations exclude common stock equivalents related to stock options, and the basic loss per share is equal to the diluted loss per share. The details of basic and diluted (losses) earnings per share are as follows:

	Three Months Ended		Six Months Ended	
(in thousands, except per share data)	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Net (loss) income	$ (19,393)	$ 9,775	$ (6,480)	$ 19,458
Weighted average shares outstanding basic	36,306	31,667	34,214	31,579
Basic (loss) earnings per share	$ (0.53)	$ 0.31	$ (0.19)	$ 0.62
Effect of dilutive securities:				
Shares issuable upon exercise of dilutive outstanding stock options		2,115		2,109
Weighted average shares outstanding diluted		33,782		33,688
Diluted (loss) earnings per share	$ (0.53)	$ 0.29	$ (0.19)	$ 0.58
Anti-dilutive shares/options	2,104		2,053	252

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 $385.5 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.

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 $33.7 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

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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 June 30, 2006 was $5.9 million. The expected adverse impact on reported revenue for the quarters ending September 30, 2006 and December 31, 2006 is approximately $7.2 million and $5.2 million, respectively.

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	$ 25,371
Goodwill	385,525
Identifiable intangible assets	213,900
Net deferred tax liabilities	(54,450)
In-process research and development	28,100
Total preliminary purchase price allocation	$ 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.

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.

	Three Months Ended		**Six Months Ended**	
(in thousands, except per share data)	**June 30, 2006**	**June 30, 2005**	**June 30, 2006**	**June 30, 2005**
Total revenue	$ 78,701	$ 68,318	$ 157,984	$ 135,722
Net income	$ 11,458	$ 8,769	$ 24,529	$ 16,283
Earnings per share:				
Basic	$ 0.30	$ 0.23	$ 0.64	$ 0.43
Diluted	$ 0.28	$ 0.22	$ 0.61	$ 0.41

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7. Long-term Debt

Borrowings consisted of the following:

(in thousands)	June 30, 2006	December 31, 2005
Term loan payable in quarterly installments with an original final maturity of March 31, 2008	$ 13,125	$
Term loan payable in quarterly installments with an original final maturity of March 31, 2011	155,625	
Capitalized lease obligations	1,802	
	170,552	
Less current portion	(24,361)	
Long-term debt and capital lease obligations, net of current portion	$ 146,191	$

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 rate for the period from May 1, 2006 through June 30, 2006 was set at 6.08%, which was based on LIBOR + 1.00%. The interest rate set for the quarter ending September 30, 2006 is 6.49875%, which was based on LIBOR + 1.00%. For the three and six months ended June 30, 2006, the Company had recorded interest expense of $2.2 million.

On June 30, 2006, the Company made the required quarterly principal payments of $7,250,000. In addition, the Company made a prepayment of $22 million, which reduces, 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 June 30, 2006, the Company is in compliance with all affirmative and negative covenants as stated in the credit agreements.

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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 six months ended June 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.

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

	June 30, 2006		**December 31, 2005**	
(in thousands)	**Gross Carrying Amount**	**Accumulated Amortization**	**Gross Carrying Amount**	**Accumulated Amortization**
Amortized intangible assets:				
Core technology and trademarks (3 10 years)	$ 107,359	$ (15,369)	$ 18,544	$ (10,393)
Non-compete agreements (4 5 years)	3,119	(2,657)	2,892	(2,531)
Customer lists (3 9½ years)	68,353	(3,937)	2,399	(2,344)
Total	$ 178,831	$ (21,963)	$ 23,835	$ (15,268)
Unamortized intangible assets:				
Trademarks	$ 61,645		$ 1,555	

Amortization expense for the amortized intangible assets reflected above for the three months ended June 30, 2006 and June 30, 2005 was approximately $5.2 million and $1.1 million, respectively. Amortization expense for the amortized intangible assets reflected above for the six months ended June 30, 2006 and June 30, 2005 was approximately $6.1 million and $2.2 million, respectively.

Amortization expense for the amortized intangible assets reflected above is expected to be approximately $20.8 million, $29.5 million, $26.9 million, $22.6 million and $18.7 million for the years ending December 31, 2006, 2007, 2008, 2009 and 2010, respectively.

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

(in thousands)	
Balance January 1, 2006	$ 43,277
Acquisition of Fluent	385,525
Other acquisition payments	1,137
Currency translation and other	884
Balance June 30, 2006	$ 430,823

9. Geographic Information

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

	Three Months Ended		**Six Months Ended**	
(in thousands)	**June 30, 2006**	**June 30, 2005**	**June 30, 2006**	**June 30, 2005**
United States	$ 21,875	$ 12,470	$ 39,680	$ 24,405
Canada	1,058	1,201	2,307	2,273
United Kingdom	5,248	2,788	8,310	5,598
Germany	8,035	5,386	14,719	11,230
Japan	9,133	4,566	14,471	10,034
Other European	11,504	7,645	19,029	14,597
Other International	5,411	3,600	9,759	7,143
Total revenue	$ 62,264	$ 37,656	$ 108,275	$ 75,280

Long-lived assets (excluding deferred tax assets) by geographic area are as follows:

(in thousands)	**June 30, 2006**	**December 31, 2005**
United States	$ 648,444	$ 37,470
Canada	5,765	6,041
United Kingdom	7,752	7,521
Germany	4,082	3,473
Japan	1,880	862
Other European	6,131	5,225
Other International	3,392	278
Total long-lived assets	$ 677,446	$ 60,870

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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 six-month periods ended June 30, 2006 or 2005. As of June 30, 2006, 2.0 million shares remain authorized for repurchase under the program.

11. Stock Option and Grant Plans

The Company has two stock option and grant plans the 1994 Stock Option and Grant Plan (1994 Stock Plan) and the Third Amended and Restated 1996 Stock Option and Grant Plan (1996 Stock Plan). The 1994 and 1996 Stock Plans, as amended, authorize the grant of up to 1,736,220 and 12,700,000 shares, respectively, 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 1996 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. No further grants may be made under the 1994 Stock Plan.

The 1994 and 1996 Stock Plans provide 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 1996 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 1994 and 1996 Stock Plans 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 1994 and 1996 Stock Plans, 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 1996 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 1994 and 1996 Stock Plans 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 1996 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 1996 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 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 six months ended June 30, 2006 is summarized below:

(options in thousands)	**Options**	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Term (years)**	**Aggregate Intrinsic Value (in thousands)**
Outstanding, beginning of year	3,622	$ 14.05		
Granted	20	$ 48.26		
Exercised	(243)	$ 9.63		
Forfeited	(2)	$ 21.51		
Outstanding, June 30, 2006	3,397	$ 14.57	5.79	$ 112,972
Exercisable, June 30, 2006	2,409	$ 9.39	4.81	$ 92,603

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 six months ended June 30, 2006 was $1.2 million and $2.5 million, respectively. At June 30, 2006, total unrecognized estimated compensation cost related to non-vested stock options granted prior to that date was $11.8 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 six months ended June 30, 2006 was $2.7 million and $9.6 million. The Company recorded cash received from the exercise of stock options of $637,000 and $2.3 million, and related tax benefits of $790,000 and $3.0 million during the three and six months ended June 30, 2006.

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

(options in thousands)	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Options	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
\$3.00 - \$4.94	420	2.17	\$ 4.13	419	\$ 4.13
\$5.00 - \$9.89	1,452	4.78	\$ 7.47	1,346	\$ 7.28
\$11.13 - \$21.72	777	6.79	\$ 15.19	535	\$ 14.17
\$31.09 - \$49.57	748	8.71	\$ 33.59	109	\$ 32.27

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 June 30, 2006, 423,139 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 six months ended June 30, 2006 was \$75,000 and \$146,000, 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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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 June 30, 2006, and the related condensed consolidated statements of operations for the three and six-month periods ended June 30, 2006 and 2005, and of cash flows for the six-month periods ended June 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

August 4, 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 six-month periods ended June 30, 2006 reflect revenue increases of 65.3% and 43.8%, respectively, and basic and diluted losses per share of $0.53 and $0.19. These results were most significantly impacted by the May 2006 acquisition of Fluent Inc. The results of operations include the results of Fluent for the period from the date of the acquisition (May 1, 2006) through June 30, 2006. In addition to the impact from Fluent s operations, the results include 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, and an improvement in margins relating to these operations, partially offset by the adverse impact of foreign currency fluctuations and the prospective adoption of SFAS No. 123R, *Accounting for Stock-Based Compensation* .

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 1,400 people 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.

The following discussion should be read in conjunction with the accompanying unaudited condensed consolidated financial statements and notes thereto for the three- and six-month periods ended June 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.

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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
- 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.

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Results of Operations

Three Months Ended June 30, 2006 Compared to Three Months Ended June 30, 2005

Revenue:

(in thousands, except percentages)	Three Months Ended June 30, 2006	2005	Change Amount	%
Revenue:				
Software licenses	**$ 34,763**	$ 19,794	$ 14,969	75.6
Maintenance and service	**27,501**	17,862	9,639	54.0
Total revenue	**62,264**	37,656	24,608	65.3

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

- Fluent-related revenue was $17.7 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Software license revenue was $10.7 million and maintenance and service revenue was $7.0 million
- newly generated software license revenue of $4.3 million
- increase of $2.1 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 $100,000 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 second quarter of 2006, the U.S. Dollar was approximately 0.8% stronger, when measured against the Company s primary foreign currencies, than for the second quarter of 2005. The U.S. Dollar strengthened against the British Pound, the Japanese Yen and the Indian Rupee, while it weakened against the Euro and Canadian Dollar. The overall strengthening resulted in decreased revenue and operating income during the 2006 second quarter, as compared with the corresponding 2005 second quarter, of approximately $100,000 and $200,000, respectively.

International and domestic revenues, as a percentage of total revenue, were 64.9% and 35.1%, respectively, in the quarter ended June 30, 2006 and 66.9% and 33.1%, respectively, in the quarter ended June 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

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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.

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 $33.7 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 was approximately $5.9 million for the period from acquisition (May 1, 2006) through June 30, 2006. The expected adverse impact on reported revenue for the quarters ending September 30, 2006 and December 31, 2006 is approximately $7.2 million and $5.2 million, respectively.

Cost of Sales and Gross Profit:

	Three Months Ended June 30,					
	2006		**2005**		**Change**	
(in thousands, except percentages)	**Amount**	**% of Revenue**	**Amount**	**% of Revenue**	**Amount**	**%**
Cost of sales:						
Software licenses	**$ 1,700**	**2.7**	$ 1,160	3.1	$ 540	46.6
Amortization of software and acquired technology	**3,739**	**6.0**	881	2.3	2,858	324.4
Maintenance and service	**8,014**	**12.9**	3,796	10.1	4,218	111.1
Total cost of sales	**13,453**	**21.6**	5,837	15.5	7,616	130.5
Gross profit	**48,811**	**78.4**	31,819	84.5	16,992	53.4

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

Fluent-related total cost of sales was $6.8 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Cost of goods sold was $310,000, software amortization was $2.8 million and the cost of services sold relating to providing technical support and engineering consulting services was $3.7 million

increase in salaries and headcount related costs, including incentive compensation, of $490,000

increase in third party software royalties of $210,000

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

Operating Expenses:

	Three Months Ended June 30,					
	2006		2005		Change	
(in thousands, except percentages)	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Operating expenses:						
Selling, general and administrative	**$ 22,020**	**35.4**	$ 10,600	28.1	$ 11,420	107.7
Research and development	**11,622**	**18.7**	7,506	19.9	4,116	54.8
Amortization	**1,576**	**2.5**	385	1.0	1,191	309.4
In-process research & development	**28,100**	**45.1**			28,100	
Total operating expenses	**63,318**	**101.7**	18,491	49.1	44,827	242.4

Selling, General and Administrative: Fluent-related selling, general and administrative costs were $9.2 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Expenses increased $880,000 during the second quarter of 2006 as a result of stock-based compensation expense associated with the 2006 adoption of Statement No. 123R. The cost relating to the ANSYS biennial users conference during the quarter ended June 30, 2006 was $550,000. In addition, salary and headcount related costs, including incentive compensation, increased by $530,000 as compared to the prior-year quarter.

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 $2.8 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Expenses increased $300,000 during the second 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 $960,000 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 $1.5 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Additionally, amortization expense decreased by $200,000 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 fair value assigned to the 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 three months ended June 30, 2006 was $919,000 as compared with interest income for the three months ended June 30, 2005 of $984,000. Funds invested received higher interest rates during 2006 as compared with 2005; however, in connection with the acquisition of Fluent on May 1, 2006, the Company borrowed $198.0 million and assumed certain capital leases which incurred interest expense of $2.2 million during the quarter ended June 30, 2006.

Other (Expense) Income, net: Other income decreased from net income of $62,000 during the quarter ended June 30, 2005 to a net expense of $263,000 for the quarter ended June 30, 2006. The Fluent-related other expense was $85,000 for the period from acquisition (May 1, 2006) through June 30, 2006 and related to foreign currency exchange losses. The remaining net decrease was the result of the following two factors:

Foreign Currency Transaction - During the quarter ended June 30, 2006, the Company had a net foreign exchange loss of $370,000 as compared with a gain of $25,000 for the quarter ended June 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 $160,000 during the second quarter of 2006 compared to the same period in 2005.

Income Tax Provision: During the quarter ended June 30, 2006, the Company recorded income tax expense of $3.7 million and had a loss before income tax provision of $15.6 million. The Company expensed a non-tax deductible charge related to in-process research and development in connection with the Fluent acquisition of $28.1 million. Excluding this in-process research and development charge, the Company s effective tax rate was 29.8% in the 2006 second quarter as compared to 32.0% in the 2005 second 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 June 30, 2006.

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Net (Loss) Income: The Company s net loss in the 2006 second quarter was $19.4 million as compared to net income of $9.8 million in the 2005 second quarter. The net loss 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 decreased from earnings of $0.29 in the 2005 second quarter to a loss of $0.53. The weighted average shares used in computing diluted earnings per share were 36.3 million in the 2006 second quarter and 33.8 million in the 2005 second quarter. For the three months ended June 30, 2006, the loss per share calculations exclude common stock equivalents related to stock options because their inclusion would be anti-dilutive.

Six Months Ended June 30, 2006 Compared to Six Months Ended June 30, 2005

Revenue:

	Six Months Ended June 30,		Change	
(in thousands, except percentages)	2006	2005	Amount	%
Revenue:				
Software licenses	**$ 61,515**	$ 40,269	$ 21,246	52.8
Maintenance and service	**46,760**	35,011	11,749	33.6
Total revenue	**108,275**	75,280	32,995	43.8

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

- Fluent-related revenue was $17.7 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Software license revenue was $10.7 million and maintenance and service revenue was $7.0 million
- newly generated software license revenue of $10.5 million, including $3.3 million related to an order with a long-standing major customer during the 2006 first quarter
- increase of $4.2 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 $100,000 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 six-month period of 2006, the U.S. Dollar was approximately 4.0% stronger, when measured against the Company s primary foreign currencies, than for the six-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 six-month period, as compared with the corresponding 2005 period, of approximately $1.2 million and $800,000, respectively.

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International and domestic revenues, as a percentage of total revenue, were 63.4% and 36.6%, respectively, in the six months ended June 30, 2006 and 67.6% and 32.4%, respectively, in the six months ended June 30, 2005.

As previously mentioned above, in accordance with EITF No. 01-3, acquired deferred software revenue of approximately $33.7 million was recorded on the opening balance sheet. This amount was approximately $20.1 million lower than the historical carrying value. The adverse impact on reported revenue was approximately $5.9 million for the period from acquisition (May 1, 2006) through June 30, 2006. The expected adverse impact on reported revenue for the quarters ending September 30, 2006 and December 31, 2006 is approximately $7.2 million and $5.2 million, respectively.

Cost of Sales and Gross Profit:

	Six Months Ended June 30,					
	2006		2005		Change	
(in thousands, except percentages)	Amount	% of Revenue	Amount	% of Revenue	Amount	%
Cost of sales:						
Software licenses	**$ 3,190**	**3.0**	$ 2,413	3.2	$ 777	32.2
Amortization of software and acquired technology	**4,647**	**4.3**	1,788	2.4	2,859	159.9
Maintenance and service	**12,484**	**11.5**	7,654	10.2	4,830	63.1
Total cost of sales	**20,321**	**18.8**	11,855	15.7	8,466	71.4
Gross profit	**87,954**	**81.2**	63,425	84.3	24,529	38.7

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

- Fluent-related total cost of sales was $6.8 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Cost of goods sold was $310,000, software amortization was $2.8 million and the cost of services sold relating to providing technical support and engineering consulting services was $3.7 million

- increase in salaries and headcount related costs, including incentive compensation, of $1.2 million

- increase in third party software royalties of $450,000

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

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Operating Expenses:

	Six Months Ended June 30, 2006		2005		Change	
(in thousands, except percentages)	**Amount**	**% of Revenue**	**Amount**	**% of Revenue**	**Amount**	**%**
Operating expenses:						
Selling, general and administrative	**$ 33,859**	**31.3**	$ 21,146	28.1	$ 12,713	60.1
Research and development	**20,979**	**19.4**	14,819	19.7	6,160	41.6
Amortization	**1,704**	**1.6**	711	0.9	993	139.7
In-process research & development	**28,100**	**25.9**			28,100	
Total operating expenses	**84,642**	**78.2**	36,676	48.7	47,966	130.8

Selling, General and Administrative: Fluent-related selling, general and administrative costs were $9.2 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Expenses increased $1.8 million during the first six 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 $900,000 during the six months ended June 30, 2006 as compared to the six months ended June 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 $2.8 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Salary and headcount related costs, including incentive compensation, increased by $2.6 million during the six months ended June 30, 2006 as compared to the corresponding period of 2005. Expenses increased $600,000 during the first six 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.

Amortization: Fluent-related amortization was $1.5 million for the period from the acquisition (May 1, 2006) through June 30, 2006. Additionally, amortization decreased by $400,000 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 fair value assigned to the 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 Income, net: Net interest income for the six months ended June 30, 2006 was $593,000 as compared with the six months ended June 30, 2005 of $1.7 million. Funds invested received higher interest rates during 2006 as compared with 2005; however, in connection with the acquisition of Fluent on May 1, 2006, the Company borrowed $198.0 million and assumed certain capital leases which incurred interest expense of $2.2 million during the period from the date of acquisition (May 1, 2006) through June 30, 2006.

Other (Expense) Income, net: The other expense increased from $49,000 during the six months ended June 30, 2005 to $77,000 for the six months ended June 30, 2006. The Fluent-related other expense was $85,000 for the period from acquisition (May 1, 2006) through June 30, 2006 and related to foreign currency exchange losses. The remaining net decrease was the result of the following two factors:

Foreign Currency Transaction - During the six months ended June 30, 2006, the Company had a net foreign exchange loss of $315,000 as compared with a loss of $100,000 for the six months ended June 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 $250,000 during the first six months of 2006 compared to the same period in 2005.

Income Tax Provision: The Company recorded income tax expense of $10.3 million and had income before income tax provision of $3.8 million for the six months ended June 30, 2006. This represents an effective tax rate of 169%. 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. Excluding this in-process research and development charge, the Company s effective tax rate was 32.3% in the six months ended June 30, 2006 as compared to 31.5% in the six months ended June 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 quarter ended June 30, 2006.

Net (Loss) Income: The Company s net loss for the six months ended June 30, 2006 was $6.5 million as compared to net income of $19.5 million for the six months ended June 30, 2005. The net loss is significantly impacted by the $28.1 million non-tax deductible in-process research and development charge related to the Fluent acquisition. Diluted (loss) earnings per share results decreased from earnings of $0.58 in the first half of 2005 to a loss of $0.19 in the first half of 2006. The weighted average shares used in computing diluted earnings per share were 34.2 million and 33.7 million during the six months ended June 30, 2006 and 2005, respectively. For the six months ended June 30, 2006, the loss per share calculations exclude common stock equivalents related to stock options and the basic loss per share is equal to the diluted loss per share.

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Liquidity and Capital Resources

As of June 30, 2006, the Company had cash, cash equivalents and short-term investments totaling $103.1 million and working capital of $24.8 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 six months of 2006 and under APB No. 25 in the first six months of 2005 were as follows:

- a $2.6 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

- $2.5 million 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 $5.1 million increase in operating cash flows between the six months ended June 30, 2006 ($38.0 million) and 2005 ($32.9 million) was primarily related to:

- changes in net income and non-tax charges
  - net income decreased from $19.5 million in 2005 to a net loss of $6.5 million in 2006 primarily because of accounting related to the Fluent acquisition as follows:
    - a $28.1 million non-tax deductible in-process research and development charge
    - new non-cash amortization charges for the period from the Fluent acquisition (May 1, 2006 through June 30, 2006) of $2.8 million related to developed software and $1.5 million related to customer relationships
  - the classification of tax benefits relating to stock options in 2006 as a financing activity rather than an operating activity, as discussed above
- offset by changes in working capital whereby $8.1 million was provided in the first six months of 2006 as compared with $9.8 million provided during the first six months of 2005
  - during the first six months of 2006 cash as provided by deferred revenue was $13.9 million as compared with $5.9 million during the first six months of 2005. Deferred revenue from Fluent products provided cash of $9.6 million between the period of May 1, 2006 to June 30, 2006
  - cash used through accounts payable, accrued expenses and liabilities was $8.5 million during the six months ended June 30, 2006 as compared with the cash used of $450,000 during the six months ended June 30, 2005. This $8.1 million net change between the comparable 2006 and 2005 periods was primarily attributable to an increase of $8.7 million of estimated income tax

payments, which were $16.6 million and $7.9 million during the six months ended June 30, 2006 and 2005, respectively

The Company s investing activities used net cash of $285.5 million for the six months ended June 30, 2006 as compared with cash provided of $38.2 million for the six months ended June 30, 2005. In the six month period of 2006, the Company paid $295.5 million, net of cash acquired, for Fluent. Net cash

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provided by maturities in excess of short-term investment purchases was $18.0 million and $45.3 million during the six months ended June 30, 2006 and 2005, respectively. Total capital spending was $1.8 million during the 2006 period and $2.7 million during the 2005 period. The Company currently plans additional capital spending of approximately $5.0 million to $6.0 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 $172.1 million in the six months ended June 30, 2006 as compared with cash used of $100,000 during the six months ended June 30, 2005. This increase in cash provided was primarily a net result of $166.8 million as generated through $198.0 million cash provided from term loans to finance the Fluent acquisition, partially offset by the $29.3 million term loan principal payments and the $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 $102.6 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 the remainder of fiscal 2006. 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 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 June 30, 2006 and 2005, the Company had no borrowings under an uncommitted and unsecured $10.0 million line of credit.

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As a result of the acquisition of Fluent on May 1, 2006, the Company has experienced significant changes to its contractual obligations as previously reported on the Company s Form 10-K. The Company s revised contractual obligations are summarized below:

		Payments Due by Period As of December 31, 2005			
(in thousands)	**Total**	**Within 1 year**	**2 3 years**	**4 5 years**	**After 5 years**
Long-term debt	**$ 198,000**	$ 21,750	$ 49,375	$ 105,000	$ 21,875
Corporate office lease	**12,298**	1,241	2,481	2,859	5,717
Other office leases	**17,664**	4,317	6,877	4,200	2,270
Unconditional purchase obligations	**5,801**	1,971	2,556	1,274	
Other long-term obligations	**4,661**	1,648	2,695	315	3
Total contractual obligations	**$ 238,424**	$ 30,927	$ 63,984	$ 113,648	$ 29,865

There were no other material changes to the Company s significant contractual obligations during the six months ended June 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 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 has generally been recognized in the consolidated statements of income as option grants generally are made with exercise prices equal to the fair value of the underlying common stock on the award date, which is 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

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prospective application, prior periods are not revised for comparative purposes. Share-based compensation expense recognized under Statement No. 123R for the first six months of fiscal 2006 was $2.5 million. As of June 30, 2006, total unrecognized estimated compensation expense related to non-vested stock options granted prior to that date was $11.8 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 June 30, 2006 and June 30, 2005 represented 0.04% and 0.21% of outstanding shares as of the beginning of each fiscal quarter, respectively. Net stock options, after forfeitures and cancellations, granted during each of the six months ended June 30, 2006 and June 30, 2005 represented 0.05% and 1.12% of outstanding shares as of the beginning of each fiscal year, respectively. Total stock options granted during the three months ended June 30, 2006 and June 30, 2005 represented 0.04% and 0.21% of outstanding shares as of the end of each fiscal quarter, respectively. Total stock options granted during the six months ended June 30, 2006 and June 30, 2005 represented 0.05% and 1.11% of outstanding shares as of the end of June 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 June 30, 2006 and those used in presenting the pro forma information included within the footnotes of the Company s Form 10-Q as of June 30, 2005. The interest rates used were determined by using the five-year Treasury Note yield at the date of grant.

	Compensation Expense	**Pro Forma Disclosure**
Assumption used in Black-Scholes option-pricing model	**June 30, 2006**	**June 30, 2005**
Risk-free interest rate	5.04%	3.69%
Expected dividend yield	0%	0%
Expected volatility	45%	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

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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 $2.7 million during the six months ended June 30, 2006 related to disqualified incentive stock options; however, only $46,000 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 $0.10 - $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. 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.

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Recently Issued and Adopted 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.

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.

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Item 3. Quantitative and Qualitative Disclosures Regarding 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 six months ended June 30, 2006, total interest income was $1.3 million and $2.8 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 June 30, 2006 totaled $168.8 million. Interest expense for the three and six months ended June 30, 2006 was $2.2 million. Based on the effective interest rates and outstanding borrowings at June 30, 2006, a 50 basis point increase in interest rates on the Company s borrowings would increase the Company s interest expense by approximately $850,000 annually.

(in thousands)	June 30, 2006	Effective Interest Rate
Term loan payable in quarterly installments with an original final maturity of March 31, 2008	$ 13,125	6.49875%
Term loan payable in quarterly installments with an original final maturity of March 31, 2011	155,625	6.49875%
Total borrowings subject to variable interest rate fluctuations	$ 168,750	

The interest rate for both agreements 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 June 30, 2006, the U.S. Dollar was 0.8% stronger, when measured against the Company s primary foreign currencies, than for the quarter ended June 30, 2005. The U.S. Dollar strengthened against the British Pound, the Japanese Yen and the Indian Rupee, while it weakened against the Euro and Canadian Dollar. As a result of these fluctuations, the net adverse impact on revenue and operating income during the second quarter of 2006, as compared with the second quarter of 2005, was $100,000 and $200,000, respectively.

On average, for the six months ended June 30, 2006, the U.S. Dollar was 4.0% stronger, when measured against the Company s primary foreign currencies, than for the six months ended June 30, 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. As a result of these

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fluctuations, the net adverse impact on revenue and operating income during the six months ended June 30, 2006, as compared with the same period in 2005, was $1.2 million and $800,000, 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 effective to ensure that the information required to be disclosed by the Company in reports filed or submitted under the Exchange Act was 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.

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.

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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. Otherwise, there were no 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 June 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. 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 six months ended June 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;

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;

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

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- 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.

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

None.

Item 3. Defaults Upon Senior Securities

None.

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

At the Annual Meeting of Stockholders of the Company held on June 15, 2006, four proposals were considered and voted upon.

First, the stockholders of the Company elected Peter J. Smith, Bradford C. Morely and Patrick J. Zilvitis as Class I Directors of the Company to hold office until the 2009 Annual Meeting of Stockholders and until such Directors successors are duly elected and qualified. The votes were as follows:

Class I Director	Votes For	Votes Withheld
Peter J. Smith	32,203,323	3,909,631
Bradford C. Morley	35,247,662	865,292
Patrick J. Zilvitis	35,153,884	959,070

Second, the stockholders approved the amendment to the Company s Restated Certificate of Incorporation to increase the total number of authorized shares of Common Stock by 100,000,000 shares, from 50,000,000 shares to 150,000,000. The votes were as follows:

Votes For	Votes Against	Votes Abstain
29,771,840	6,325,459	15,655

Third, the stockholders approved the amendment to the Second Amended and Restated ANSYS, Inc. 1996 Stock Option and Grant Plan, as amended to increase the number of shares available for offering thereunder by 2,000,000 shares, from 10,700,000 shares to 12,700,000 shares, to remove the Company s ability to grant discount options in lieu of cash compensation, and to provide that the Company may cash out options in connection with a sale of the Company in which the Company s stockholders receive cash consideration. The votes were as follows:

Votes For	Votes Against	Votes Abstain
25,631,823	8,742,849	167,743

Fourth, the stockholders ratified the selection of Deloitte & Touche LLP as the Company s independent public accountants. The votes were as follows:

Votes For	Votes Against	Votes Abstain
35,872,263	230,145	10,546

Item 5. Other Information

None.

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Item 6. Exhibits

(a) Exhibits.

Exhibit No.	Exhibit Title
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).
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).*
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).*

Exhibit No.	Exhibit Title
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).
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.

* *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: August 4, 2006	By:	/s/ James E. Cashman, III James E. Cashman, III President and Chief Executive Officer
Date: August 4, 2006	By:	/s/ Maria T. Shields Maria T. Shields Chief Financial Officer

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TYLE="font-size: 8pt">	2017	9,747	12,184	18,989	1,191	3,648	773	1,877	48,409	2016	9,764	14,412	18,155	1,191	3,384
R. Dunsmore	2017	9,181	11,476	18,152	2,206	3,126	-	600	44,741	2016	8,293	10,696	16,235		

(1) For Mr. Scovill, Mr. Hoose, and Mrs. Scott, perquisites and other personal benefits include the estimated personal use portion of the cost of a company-supplied automobile. For Mr. Scovill, Mr. Hoose, Mrs. Scott and Mr. Dunsmore, perquisites include a personal reimbursement for cell phones which are used primarily, but not exclusively, for business purposes. For Mr. Scovill and Mr. Hoose, perquisites include the cost of club memberships, which were used primarily, but not exclusively, for business purposes. For Mr. Scovill, in 2015, perquisites include a relocation allowance.

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Grants of Plan-Based Awards

The following table sets forth information concerning awards granted to the named executive officers for the year ended December 31, 2017 under the 1995 Stock Incentive Plan.

Name	Grant Date	Board/ Committee Action Date	All Other Stock Awards: Number of Shares of Stock or Units (#)	Grant Date Fair Value of Stock and Option Awards
J. Bradley Scovill	1/4/2017	12/15/2016	4,620	119,981
Mark A. Hughes	1/4/2017	12/15/2016	2,002	51,992
Harold F. Hoose	1/4/2017	12/15/2016	1,973	51,239
Deborah E. Scott	1/4/2017	12/15/2016	1,463	37,994
Stan R. Dunsmore	1/4/2017	12/15/2016	1,309	33,995

The grant date fair market value of stock awards is computed in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification (the "ASC") topic 718, "Compensation—Stock Compensation," excluding the effect of estimated forfeitures. The value used for restricted stock awards is based on the market value of the stock at the grant date. The market value per share of the January 4, 2017 awards is $25.97.

Restricted stock awards to NEOs under the Stock Incentive Plan in 2017 provided for vesting over a three-year term, with vesting for half of the shares dependent on satisfactory performance (time vesting) and vesting for half of the shares based on time vesting and upon the Corporation meeting an ROAE performance ratio, as defined. In 2017, the Corporation did not meet the performance condition defined in the awards, as the Corporation's ROAE was in the 37th percentile of the defined Peer Group's results for the 12-month period ended September 30, 2017. The minimum level for satisfying the performance condition defined in the 2017 awards was an ROAE at the 50th percentile of the Peer Group's results. Accordingly, in the first quarter 2018, the following forfeitures of restricted stock awarded in 2017 occurred: Mr. Scovill - 770 shares; Mr. Hughes - 334 shares; Mr. Hoose - 329 shares; Mrs. Scott - 244 shares; and Mr. Dunsmore - 218 shares. In the first quarter 2018, the following forfeitures of restricted stock awarded in 2016 occurred: Mr. Scovill - 816 shares; Mr. Hughes - 411 shares; Mr. Hoose - 395 shares; Mrs. Scott - 301 shares; and Mr. Dunsmore - 244 shares.

Outstanding Equity Awards at Fiscal Year-End

The following table sets forth information with respect to outstanding stock options and non-vested stock awards as of December 31, 2017 for the named executive officers.

	Option Awards			**Stock Awards**	
Name	**Number of Securities Underlying Unexercised Options (#) Exercisable**	**Option Exercise Price ($)**	**Option Expiration Date**	**Number of Shares or Units of Stock That Have Not Vested (#)**	**Market Value of Shares or Units of Stock That Have Not Vested ($)**
J. Bradley Scovill	-	-	-		
				9,609	$ 230,616
Total:	0		**Total:**	9,609	$ 230,616
Mark A. Hughes	3,725	19.880	1/5/2019		
	5,953	15.060	1/4/2021		
	8,730	18.540	1/4/2022		
	8,763	19.210	1/3/2023		
	5,024	20.450	1/3/2024		
				5,350	$ 128,400
Total:	32,195		**Total:**	5,350	$ 128,400
Harold F. Hoose, III	2,650	19.880	1/5/2019		
	3,931	15.060	1/4/2021		
	5,455	18.540	1/4/2022		
	5,622	19.210	1/3/2023		
	3,521	20.450	1/3/2024		
				4,668	$ 112,032
Total:	21,179		**Total:**	4,668	$ 112,032
Deborah E. Scott	2,700	19.880	1/5/2019		
	5,845	18.540	1/4/2022		
	5,811	19.210	1/3/2023		
	3,355	20.450	1/3/2024		

				3,508	$ 84,192
Total:	17,711		**Total:**	3,508	$ 84,192
Stan R. Dunsmore	-	-	-		
				3,006	$ 72,144
Total:	0		**Total:**	3,006	$ 72,144

Option Exercises and Stock Vested

The following table sets forth information concerning the exercise of stock options granted, and the value realized on the vesting of restricted stock, under the 1995 Stock Incentive Plan during 2017 for each of the named executive officers.

	Option Awards		Stock Awards	
Name	**Number of Shares Acquired on Exercise (#)**	**Value Realized on Exercise ($)**	**Number of Shares Acquired on Vesting (#)**	**Value Realized On Vesting ($)**
J. Bradley Scovill	-	-	2,542	$ 62,245
Mark A. Hughes	4,170	25,833	1,542	$ 38,699
Harold F. Hoose, III	-	-	1,149	$ 29,782
Deborah E. Scott	7,371	49,857	908	$ 23,535
Stan R. Dunsmore	-	-	987	$ 25,583

Pension Benefits

The following table sets forth information with respect to pension benefits for the fiscal year ended December 31, 2017 for each of the named executive officers.

Name	**Plan Name**	**Number of Years Credited Service (#)**	**Present Value of Accumulated Benefit ($)(2)**	**Payments During Last Fiscal Year ($)**
Stan R. Dunsmore	Citizens Trust Company Pension Plan(1)	20	$ 205,076	$ 0

(1) Mr. Dunsmore is a participant in the Citizens Trust Company Pension Plan, a tax-qualified defined benefit plan. This plan covers certain employees who were employed by Citizens Trust Company on December 31, 2002, when the plan was amended to discontinue admittance of any future participant and to freeze benefit accruals. The Corporation acquired Citizens Bancorp, Inc. and its wholly-owned subsidiary, Citizens Trust Company, effective May 1, 2007.

(2) The present value of accumulated benefit is presented as of December 31, 2017, which is the measurement date the Corporation uses for financial reporting purposes.

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Nonqualified Deferred Compensation

Name	Executive Contributions in Last Fiscal Year to Deferred Compensation Plan ($)	Employer Contributions in Last Fiscal Year to Supplemental Executive Retirement Plan (SERP) ($) (1)	Aggregate Earnings in Last Fiscal Year in Deferred Compensation Plan ($) (2)	Aggregate Earnings in Last Fiscal Year in SERP ($) (2)	Aggregate Withdrawals/ Distributions ($)	Aggregate Balance at Last Fiscal Year End in Deferred Compensation Plan ($) (3)	Aggregate Balance at Last Fiscal Year End in SERP ($)(4)
J. Bradley Scovill	200,300	87,889	59,538	44,821	-	390,394	307,105
Mark A. Hughes	-	27,118	-	27,459	-	-	243,887
Harold F. Hoose, III	-	10,780	-	11,849	-	-	90,224
Deborah E. Scott	37,751	18,989	10,533	21,292	-	95,381	190,050
Stan R. Dunsmore	2,500	18,152	668	10,912	-	4,791	59,492

(1) The amounts shown as employer contributions to the SERP are also reported as compensation to the named executive officer in the Summary Compensation Table.

(2) Earnings amounts shown represent the net change to the named executive officer’s account in 2017 for the aggregate gains and losses on the plan investments in the Deferred Compensation Plan and the SERP. The amounts shown are not considered above market or preferential earnings and are not reported as compensation in the Summary Compensation Table.

(3) The aggregate balance in the Deferred Compensation Plan has not been reported in prior Corporation Proxy Statements.

(4) The aggregate balance at last fiscal year end (December 31, 2017) in the SERP, excluding 2017 employer contributions and aggregate earnings, has been reported in the Pension Benefits Table in prior Corporation Proxy Statements.

Supplemental Executive Retirement Plan. The Corporation maintains a Supplemental Executive Retirement Plan ("SERP") to provide a supplemental retirement income to designated key employees. The Board of Directors determines employees eligible to participate, as well as the amount of the Corporation's annual contribution to each participant's account, if any. The annual contribution is deposited into each participant's account held in a trust account at the Bank. While the Bank's Trust and Financial Management Group manages the trust assets, each participant may direct the investment of the funds credited to their account. All assets in the trust are subject to the claims of the Bank's creditors in the event of insolvency. The Board of Directors may terminate the SERP at any time.

Historically, the Corporation's annual contribution has been based on a formula designed to provide an annual benefit equal to 20% of the individual's highest five-year average compensation, and assumes retirement at age 65. In determining the annual contribution amounts, the Corporation assumes interest rates of 8% for preretirement and 6% for postretirement and utilizes a standard mortality table. The actual amount available to be distributed to a participant at separation of service depends upon the return on the investment of the funds held in the account over time. The actual investment returns do not impact the Corporation's determination of the annual contribution. Investment returns are allocated to participant accounts daily based on units held of each investment.

Amounts credited to a participant's account do not vest until the earlier of: (i) the participant reaching age 55 with 5 years of participation in the SERP; (ii) the death of the participant; (iii) the disability of the participant; or (iv) a change in control of the Corporation as defined in the SERP.

Upon vesting, amounts credited to a participant's account are payable, at the election of the participant, in monthly or annual installments.

Deferred Compensation Plan. In December 2015, the Corporation established a nonqualified Deferred Compensation Plan that allows selected officers, beginning in 2016, the option to defer receipt of up to 100% of base salary plus any non-equity incentive plan compensation. The Compensation Committee of the Board of Directors determines employees eligible to participate ("Participants"). The Deferred Compensation Plan does not provide for Corporation contributions.

Participants are given an annual opportunity to elect, by entering into a Participation Agreement with the Corporation, to defer the receipt of eligible compensation by a dollar amount or percentage specified in the Participation Agreement. Participant contributions are deposited into each Participant's account held in a trust account at the Bank. While the Bank's Trust and Financial Management Group manages the trust assets, each Participant may direct the investment of the funds credited to their account. All assets in the trust are subject to the claims of the Bank's creditors in the event of insolvency. The Board of Directors may amend or terminate the Plan at any time; provided, however, that no such amendment or termination shall reduce the balance in any Participant's account nor affect the terms of the Plan relating to the payment of any account.

Participants are fully vested in their accounts at all times. Upon separation from service, amounts credited to a participant's account are payable, at the election of the participant, in monthly or annual installments.

CEO Pay Ratio

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, the SEC adopted a rule requiring annual disclosure of the ratio of the median employee's annual total compensation to the total compensation of the principal executive officer ("PEO"). This ratio is commonly referred to as the "CEO Pay Ratio." The Corporation's PEO is Mr. Scovill, the President and Chief Executive Officer ("CEO").

For 2017, the annual total compensation of our CEO was 19.7 times that of the Corporation's median employee, based on annual total compensation of $767,141 for Mr. Scovill and $39,013 for the median employee, detailed as follows:

	President and CEO	Median Employee
Salary	$408,000	$ 36,870
Bonus	-	500
Stock Awards	119,981	-
Non-Equity Incentive Plan Compensation	98,024	-
All Other Compensation	141,136	1,643
Total	$767,141	$ 39,013

The median employee was identified using a listing of all employees as of December 31, 2017, and calculating the median amount of total 2017 compensation as it would be reported based on the IRS instructions for Box 5, Medicare wages and tips. Actual amounts reported on Box 5 for 2017 were used for all employees who were employed throughout the entire year. We further annualized pay for those individuals not employed for a full year in 2017. As applicable, compensation reported on Box 5 included the amount paid in 2017 for salary, bonus, dividends on restricted stock and non-equity incentive plan (cash) awards, along with any amount deferred by the employee to the Savings & Retirement Plan (a 401(k) plan) and the imputed value of the cost of group term life insurance and certain perquisites. Compensation reported on Box 5 also included any amounts that vested in 2017 for SERP benefits and for stock awards (based on the market value of the stock on the vesting date). Compensation deferred at the election of the Corporation's officers, and the amount of employer contributions to the ESOP and Savings & Retirement Plan, were excluded from Box 5.

This pay ratio is a reasonable estimate calculated in a manner consistent with SEC rules based on our payroll and employment records and the methodology described above. The SEC rules for identifying the median compensated employee and calculating the pay ratio based on that employee's annual total compensation allow companies to adopt a variety of methodologies, to apply certain exclusions, and to make reasonable estimates and assumptions that reflect their compensation practices. As such, the pay ratio reported by other companies may not be comparable to the pay ratio reported above, as other companies may have different employment and compensation practices and may utilize different methodologies, exclusions, estimates and assumptions in calculating their own pay ratios.

Employment Agreements

The Corporation and the Bank have entered into employment agreements with Mr. Scovill, Mr. Hughes, Mr. Hoose and Mrs. Scott (collectively, the "Employment Agreements"). The employment agreement with Mr. Scovill has an effective date of March 2, 2015, and the employment agreements with Mr. Hughes, Mr. Hoose, and Mrs. Scott were effective September 19, 2013. The following summarizes the material terms of the Employment Agreements.

The employment agreement with Mr. Scovill provided for an initial three (3) year term at an initial annual base salary of $380,000. In June 2017, the Corporation and Bank, and Mr. Scovill, entered into an amendment to the employment agreement which extended the end date of the initial term by one (1) year to March 1, 2019. After the initial term, as amended, the agreement will be automatically renewed for successive twelve (12) month terms, unless either the Corporation or Mr. Scovill gives written notice of non-renewal at least ninety (90) days prior to the next renewal date. Under this agreement, Mr. Scovill received a grant of Corporation restricted common stock equal in value at the time of grant to approximately $100,000. The shares of restricted stock vested ratably over a three (3) year period. The agreement also provided a signing bonus in the amount of $100,000, $50,000 of which was paid approximately sixty (60) days after Mr. Scovill's start date of March 2, 2015 and $50,000 of which was paid approximately one hundred eighty (180) days after the start date. If Mr. Scovill had voluntarily terminated employment with the Bank, other than a termination for "Good Reason," as defined in the agreement, within eighteen (18) months of receipt of either $50,000 installment payment, Mr. Scovill had agreed to reimburse the Bank for the full amount of the cash bonus payments actually received. The agreement also provided that Mr. Scovill would be eligible to receive an equity award under the Corporation's 1995 Stock Incentive Plan for calendar year 2015 equal in value to $100,000 as of the date of grant. The equity award may be comprised of a combination of stock options and restricted stock, each of which will have a time vest and a performance vest component. For calendar years after 2015, based on approval by the Corporation's Board of Directors, Mr. Scovill would be eligible to receive such stock based incentives as are granted to Mr. Scovill under the Corporation's 1995 Stock Incentive Plan consistent with Mr. Scovill's responsibilities and the performance of the Corporation and Mr. Scovill. The agreement also provides that Mr. Scovill would be eligible to participate in the Corporation's Supplemental Executive Retirement Plan. Other features of the employment agreement with Mr. Scovill are included in the summary of descriptions of the Employment Agreements that follow.

The initial term of the Employment Agreement with Mr. Hughes expired September 19, 2016, and has been renewed through September 19, 2019. The Employment Agreement with Mr. Hughes provides that the term of the agreement shall be automatically renewed on each September 19th for successive three (3) year terms, unless either the Corporation or the executive gives written notice of nonrenewal at least 90 days prior to the next renewal date. The Employment Agreements of Mr. Hoose and Mrs. Scott had an initial expiration date of September 30, 2015, and have been extended through September 30, 2018. The Employment Agreements of Mr. Hoose and Mrs. Scott provide that the term of each agreement shall be automatically extended an additional twelve (12) months, unless written notice of nonrenewal is provided no later than July 19, 2017 and by July 19th of each successive calendar year thereafter.

Under the Employment Agreements, each executive is eligible to receive annual incentive payments and stock based incentives as determined by the Compensation Committee, which may, but need not be, issued under any incentive plan maintained by the Company, and is eligible to participate in any retirement plan, deferred compensation plan, welfare benefit plan or other benefit program in which full-time employees of the Bank are eligible to participate.

The Employment Agreements also provide each executive with reimbursement of business expenses and paid vacation in accordance with Corporation or Bank policies and procedures and, with respect to Mr. Scovill and Mr. Hoose, use of a Bank owned automobile and a country club membership. Mrs. Scott's Employment Agreement also provides for the use of a Bank owned automobile.

Each Employment Agreement contains customary nondisclosure and mutual nondisparagement provisions and, in the case of Mr. Scovill and Mr. Hughes, a twenty-four (24) month non-competition and non-solicitation covenant and, in the case of Mr. Hoose and Mrs. Scott, an eighteen (18) month non-competition and non-solicitation covenant, in each case applicable within thirty-five (35) miles of any office of the Corporation or the Bank after voluntary or involuntary termination of the executive’s employment with the Corporation and the Bank.

Each Employment Agreement also provides that the executive may terminate his or her employment for “good reason” (as defined in the agreement) after notice to the Corporation or the Bank within thirty (30) days after the initial existence of the condition giving rise to the right to terminate and the failure of the Corporation or Bank to cure the situation within thirty (30) days after receipt of such notice.

Additionally, each Employment Agreement provides for a lump sum payment to the executive in the event of a termination of employment by the Corporation without “cause” (as defined in the agreement) or by the executive for “good reason” (as defined in the agreement) following a “change in control” (as defined in the agreement) or absent a change in control, such payment to be equal to the sum of the highest annual base salary earned by the executive during the immediately preceding three (3) years, plus the highest cash bonus and other incentive compensation earned with respect to one of the three preceding years, plus (for Mr. Hughes, Mr. Hoose and Mrs. Scott) the highest value of stock options and other stock incentives awarded to the executive in one of the immediately preceding three years, multiplied by a predetermined factor depending on the executive and whether the executive was terminated following a change in control. Additionally, each of the Employment Agreements provides for the continuation of the executive’s participation in the Bank’s life, disability, medical/health insurance and other welfare benefits in effect during the one (1) year period preceding the termination of employment (or a cash payment representing the value of such benefits). The factor applicable to each of the executives for purposes of determining the lump sum payment and the time period for which benefits are to be continued are set forth in the following table.

The employment agreements in effect on December 31, 2017 do not provide for an excise tax gross-up pursuant to Section 280G of the Internal Revenue Code. In the event any payments to our named executive officers would otherwise constitute a parachute payment under Section 280G of the Internal Revenue Code, the payments will be limited to the greater of (i) the dollar amount which can be paid to such named executive officer without triggering an excise tax under Section 4999 of the Internal Revenue Code or (ii) the greatest after-tax dollar amount after taking into account any excise tax incurred under Section 4999 of the Internal Revenue Code with respect to such parachute payments.

	Multiplier Factor		Benefits Continuation Period	
Executive	Change in Control	Absent a Change in Control	Change in Control	Absent a Change in Control
J. Bradley Scovill	2.99X	1.0X	3 Years	1 Year
Mark A. Hughes	2.99X	1.0X	3 Years	1 Year
Harold F. Hoose, III	1.5X	0.5X	18 Months	6 Months
Deborah E. Scott	1.5X	0.5X	18 Months	6 Months

Change in Control Agreements

The Corporation and Bank have entered into Change in Control Agreements (the “Agreements”) with Mr. Dunsmore and certain other officers (each an “Employee”). The purpose of the Agreements is to retain and secure key employees and encourage their continued attention and dedication to their assigned duties without the distraction of potential disturbing circumstances arising from the possibility of a change in control of the Corporation or Bank.

The Change in Control Agreements provide for a lump sum severance benefit in the event that certain events take place after there is a “change in control”, as defined in the Agreement, of the Corporation, or for a period of twenty-four (24) months thereafter. The Agreements do not provide for any payment in the event that the Employee remains employed for more than twenty-four (24) months following the change in control.

Under the Agreements, the term “termination” means the termination of the employment of the Employee either by the Corporation for any reason other than death, disability, or “cause”, or by resignation of the Employee upon the occurrence of one or more of the following events: a significant change in the Employee’s authorities or duties; a reduction in annual salary or a material reduction in benefits; the relocation of the Employee’s office to a location more than 35 miles from the location of the Employee’s office immediately prior to the employment period; the inability of the Employee to exercise the authorities, powers, functions or duties associated with the Employee’s position; or the failure of the Corporation to obtain a satisfactory agreement from any successor to assume and agree to perform the Agreement in the same manner and extent as if no succession had taken place.

In the event of a termination, the Agreements provide severance benefits of (i) Employer-paid group medical insurance continuation premiums for a period of eighteen (18) months after the date of termination; and (ii) a lump sum payment in cash no later than thirty (30) business days after the date of termination equal to the sum of the Employee’s unpaid salary, accrued vacation pay and unreimbursed business expenses through and including the date of termination; and an amount equal to one times the Employee’s base salary in effect immediately prior to the date of termination. Each Agreement contains customary non-disclosure provisions and a twelve (12) month non-solicitation covenant following termination of employment.

The Agreements terminate each December 31, but are automatically extended for additional one-year periods unless written notice is provided by the Corporation or Employee that such party does not wish to extend the term. If a change in control occurs during the original or extended term of the Agreements, the term shall continue for a period of twenty-four (24) months and end upon the expiration of such twenty-four (24) month period.

Potential Payments upon Termination or Change in Control

The table that follows provides quantitative information regarding contracts, agreements, plans or arrangements that provide for payments to a named executive officer upon termination of employment. The table does not include information with respect to contracts, agreements, plans or arrangements to the extent they do not discriminate in scope, terms, or operation, in favor of executive officers or the Corporation and that are available generally to all salaried employees.

As of December 31, 2017: Name	Cash ($)	Supplemental Executive Retirement Plan Benefit ($)	Health and Welfare Benefits ($)	Value of Restricted Stock Subject to Acceleration ($)	Payment Under Split Dollar Bank Owned Life Insurance Program (1)	Citizens Trust Company Pension Plan (2)
Termination Due to Retirement						
J. Bradley Scovill	-	-	-	-	-	-
Mark A. Hughes	-	243,887	-	-	-	-
Harold F. Hoose, III	-	-	-	-	-	-
Deborah E. Scott	-	190,050	-	-	-	-
Stan Dunsmore	-	-	-	-	-	184,700
Termination Due to Disability						
J. Bradley Scovill	-	307,105	-	-	-	-
Mark A. Hughes	-	243,887	-	-	-	-
Harold F. Hoose, III	-	90,224	-	-	-	-
Deborah E. Scott	-	190,050	-	-	-	-
Stan Dunsmore	-	59,492	-	-	-	184,700
Termination Without Cause or for Good Reason - Before a Change in Control						
J. Bradley Scovill	625,785	-	9,473	-	-	-
Mark A. Hughes	410,907	243,887	13,256	-	-	-
Harold F. Hoose, III	165,065	-	7,213	-	-	-
Deborah E. Scott	145,815	190,050	4,388	-	-	-
Stan Dunsmore	-	-	-	-	-	184,700
Termination Due to Death						
J. Bradley Scovill	-	307,105	-	-	-	-
Mark A. Hughes	-	243,887	-	-	-	-
Harold F. Hoose, III	-	90,224	-	-	-	-
Deborah E. Scott	-	190,050	-	-	-	-
Stan Dunsmore	-	59,492	-	-	561,000	84,000
Termination Without Cause or for Good Reason - Upon or After a Change in Control						

J. Bradley Scovill	1,871,097	307,105	28,419	230,616	-	-
Mark A. Hughes	1,228,612	243,887	39,768	128,400	-	-
Harold F. Hoose, III	495,194	90,224	21,638	112,032	-	-
Deborah E. Scott	437,445	190,050	13,164	84,192	-	-
Stan Dunsmore	187,000	59,492	19,884	72,144	-	184,700

(1) The amount represents the death benefit payable under the former Citizens Trust Company Supplemental Life Insurance Plan for Executive Officers.

(2) The amounts reflect the estimated lump sum value that would be paid by the Citizens Trust Company Pension Plan.

Indemnification Agreements

On April 20, 2004, the shareholders of the Corporation authorized the Corporation to enter into indemnification agreements (the "Indemnification Agreements") with the directors of the Corporation and the Bank and certain officers of the Bank, as designated by the Board of Directors. The primary purpose of the Indemnification Agreements is to ensure the ability of the Corporation and Bank to continue to attract and retain responsible, competent and otherwise qualified directors and officers. Indemnification Agreements have been entered into with all Directors of the Bank and the Corporation, as well as the Corporation's and Bank's Executive Officers as named on pages 6-9.

The Indemnification Agreements provide to covered directors and officers the most advantageous of any combination of benefits under (i) the benefits provided by the Bylaws of the Corporation in effect as of the date the agreements were entered into; (ii) the benefits provided by the Bylaws, the Articles of Incorporation or their equivalent of the Corporation in effect at the time indemnification expenses are incurred by an indemnitee; (iii) the benefits allowable under Pennsylvania law in effect on the date of the agreements; (iv) the benefits allowable under the law of the jurisdiction under which the Corporation exists at the time indemnifiable expenses are incurred by an indemnitee; (v) the benefits available under a liability insurance policy obtained by the Corporation and its subsidiaries in effect on the date of the agreements; (vi) the benefits available under a liability insurance policy obtained by the Corporation and its subsidiaries, in effect at the time the indemnifiable expenses are incurred by an indemnitee; and (vii) such other benefits as are or may otherwise be available to the indemnitee.

The Corporation is not obligated to, nor has it agreed to provide funding for its obligations under the agreements. The Corporation is obligated, however, to pay its obligations under the agreements from general assets or insurance. The agreements do require the Corporation to continue to purchase D&O Coverage for so long as it is available on a commercially reasonable basis.

The indemnification available pursuant to the agreements is subject to a number of exclusions. No indemnification is required under the agreements with respect to any claim as to which it is finally proven by clear and convincing evidence in a court of competent jurisdiction that the covered person acted or failed to act with deliberate intent to cause injury to the Corporation or a subsidiary thereof or with reckless disregard for the Corporation’s best interest. The Corporation is also not required to make any payment finally determined by a court to be unlawful or any payment required under Section 16(b) of the Securities and Exchange Act of 1934, as amended. In addition, any claim (or part thereof) against an indemnitee which falls within the prohibitions of 12 C.F.R. §7.5217 (i.e., a prohibition on indemnification or insurance coverage for expenses, penalties or other payments incurred in connection with an action by a banking regulatory agency which results in a final order assessing monetary penalties or requiring affirmative action in the form of payment to the bank) is excluded from indemnification under the agreements.

Compensation of Directors

The following table summarizes the compensation paid by the Corporation and Bank to directors for the fiscal year ended December 31, 2017, other than J. Bradley Scovill who did not receive compensation as a director.

DIRECTOR COMPENSATION (1)(2)(3)

Fees

Name	Earned or Paid in **Cash (4)** ($)	Stock **Awards (5)** ($)	Total ($)
Dennis F. Beardslee	41,000	19,997	60,997
Jan E. Fisher	49,700	19,997	69,697
R. Bruce Haner	51,600	19,997	71,597
Susan E. Hartley	41,500	19,997	61,497
Leo F. Lambert	57,100	19,997	77,097
Terry L. Lehman	39,900	19,997	59,897
Edward H. Owlett, III	48,000	19,997	67,997
Frank G. Pellegrino	37,000	19,997	56,997
Leonard Simpson	53,200	19,997	73,197
Aaron K. Singer	22,300	0	22,300
James E. Towner	48,400	19,997	68,397
Ann M. Tyler	20,100	0	20,100

(1) The columns disclosing option awards, non-equity incentive plan compensation, changes in pension value and nonqualified deferred compensation earnings, and other forms of compensation have been omitted from the table because no director earned any compensation during 2017 of a type required to be disclosed in those columns.

(2) As of December 31, 2017, non-employee directors except Director Singer each owned 770 shares of common stock awarded pursuant to the Independent Directors Stock Incentive Plan (described below) for which transfer restrictions had not yet lapsed. For the Directors, those shares had a value of $18,480 based on the closing price of the Corporation's common stock on December 29, 2017 (the last business day of the year). Director Singer was not a Director at the time of the 2017 restricted stock award.

(3) Effective January 2, 2018, the Corporation awarded 826 shares of restricted stock under the Independent Director Stock Incentive Plan to each director. The value of the restricted stock was $24.21 per share, based on the market price of the Corporation's stock on January 3, 2018, and vest over (1) one year. The awards made in January 2018 are not included in the table.

(4) Includes annual cash retainer, Chairman or Committee chair retainer (if any) and attendance fees.

(5) The amount shown in the "Stock Awards" column equals the value of restricted stock awards of 770 shares, determined based on the grant date fair market value of $25.97 per share. Director Tyler forfeited her 2017 award upon her retirement from the Board in April 2017.

Director Fees. Compensation of the Board of Directors is established by the Board upon recommendation of the Compensation Committee. In developing its recommendations for 2017, the Compensation Committee considered information provided by Pearl Meyer.

Non-employee directors receive cash compensation for their service as directors in accordance with the following fee schedule. Employee directors are not entitled to additional compensation for board or committee service.

Annual Fees:	
Cash Retainer (all Directors, including Chairman)	$20,000
Chairman of the Board	$15,000
Committee Chairman:	
Audit Committee	$5,000
Compensation Committee	$5,000
All Other Committees	$4,000
Per-Meeting Attendance Fees:	
Board meetings (all Directors)	$1,000
Committee meetings	
Audit Committee	$600
Executive Committee	$600
All Other Committees	$500

Compensation Committee meeting fees are included in the Executive Committee meeting fee amount listed above. A director who, by invitation, attends a meeting of a committee of which he or she is not a regular member will be paid the same attendance fee as is payable to members of that committee. Attendance fees are not doubled in the event of joint meetings of the Corporation and Bank Boards.

Independent Directors Stock Incentive Plan. In addition to cash fees, non-employee directors may also receive compensation in the form of Corporation common stock or stock options under the Independent Directors Stock Incentive Plan. This plan permits awards of nonqualified stock options and/or restricted stock to non-employee directors. A total of 135,000 shares of common stock may be issued under the Independent Directors Stock Incentive Plan. The recipient's right to exercise stock options under this plan vests immediately and expires 10 years from the date of grant. The exercise prices of all stock options awarded under the Independent Directors Stock Incentive Plan are equal to the fair market value on the grant date. Restricted stock awards issued under the plan through December 31, 2017 vest ratably over one (1) year. As of December 31, 2017, a balance of 17,396 shares remains available for issuance under the Independent Directors Stock Incentive Plan.

PROPOSAL 2 — APPROVAL AND ADOPTION OF THE SECOND AMENDMENT TO THE CITIZENS & NORTHERN CORPORATION INDEPENDENT DIRECTORS STOCK INCENTIVE PLAN

On February 15, 2018, the Board of Directors of the Corporation adopted the Second Amendment to the Citizens & Northern Corporation Independent Directors Stock Incentive Plan (the "Stock Incentive Plan") in order to insure that there are sufficient shares available for future awards. The Stock Incentive Plan was originally adopted by the Board of Directors on February 15, 2001 and approved by the stockholders on April 17, 2001. The First Amendment to the Stock Incentive Plan was adopted by the Board of Directors on February 28, 2008 and approved by the stockholders on April 15, 2008.

The purposes of the Plan are to aid the Corporation in attracting, retaining, motivating, and compensating Non-Employee Directors and to enable them to increase their ownership of Stock. The Plan is beneficial to the Corporation and its stockholders since it allows Non-Employee Directors of the Board to have a greater personal financial stake in the Corporation through the ownership of Stock, in addition to underscoring their common interest with stockholders in increasing the value of the Stock on a long-term basis.

As adopted, the Stock Incentive Plan permits awards of nonqualified stock options and/or restricted stock to non-employee directors (i.e., members of the Corporation's Board of Directors who are not officers and employees of the Corporation or any subsidiary thereof). The maximum number of shares of the Common Stock issuable under the Stock Incentive Plan was initially fixed at Fifty Thousand (50,000) shares, and increased to Seventy-Five Thousand (75,000) shares as a result of the 3- for- 2 stock dividend on April 21, 2003, then increased to One Hundred Thirty-Five Thousand (135,000) shares as a result of the First Amendment.

The Board of Directors directed and ordered that the Second Amendment to the Stock Incentive Plan be submitted to the stockholders of the Corporation for their approval and adoption at the 2018 Annual Meeting of Stockholders to be held on April 19, 2018. The following is a brief summary of the Second Amendment adopted by the Board of Directors on February 15, 2018 (a copy of the full text of the Second Amendment to the Citizens & Northern Corporation Independent Directors Stock Incentive Plan is attached as Exhibit A to this Proxy Statement):

- Increase in the number of shares issuable under the Stock Incentive Plan from One Hundred Thirty-Five Thousand (135,000) shares to Two Hundred Thirty-Five Thousand (235,000) shares.

The Second Amendment is being submitted to the stockholders of the Corporation for their approval. The affirmative vote of a majority of the votes cast, in person or by proxy, by shareholders entitled to vote at the Annual Meeting on this proposal is necessary for the adoption of the amendment.

The Board of Directors recommends a vote "FOR" approval and adoption of the Second Amendment to the Citizens & Northern Corporation Independent Directors Stock Incentive Plan.

PROPOSAL 3 — ADVISORY NON-BINDING VOTE ON EXECUTIVE COMPENSATION

The Corporation is required to provide its shareholders with a separate, non-binding advisory vote on the compensation paid to the Corporation's named executive officers pursuant to the policies and procedures employed by the Corporation, as described in the Compensation Discussion and Analysis (CD&A) and tabular disclosure regarding named executive officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement.

For the reasons set forth in this Proxy Statement, we believe that our compensation policies and procedures are centered on a pay-for-performance culture, are competitive in our marketplace, and are strongly aligned with the long-term interests of our shareholders, and that the compensation paid to our executives is consistent with such policies and procedures.

This proposal, commonly known as a "Say-on-Pay" proposal, gives you as a shareholder the opportunity to endorse or not endorse our executive pay program and policies through the following resolution:

“Resolved, that the shareholders approve the compensation paid to the Named Executive Officers of the Corporation pursuant to the policies and procedures employed by the Corporation, as described in the Compensation Discussion and Analysis and tabular disclosure regarding Named Executive Officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement.”

Because your vote is advisory, it will not be binding upon the Board. However, the Compensation Committee will take into account the outcome of the vote when considering future executive compensation arrangements.

The Board of Directors recommends a vote “FOR” approval of the compensation paid to the Named Executive Officers of the Corporation pursuant to the policies and procedures employed by the Corporation, as described in the Compensation Discussion and Analysis and tabular disclosure regarding the Named Executive Officer compensation (together with the accompanying narrative disclosure) in this Proxy Statement.

PROPOSAL 4 — RATIFICATION OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Baker Tilly Virchow Krause, LLP (“Baker Tilly”), formerly ParenteBeard, LLC (“ParenteBeard”) has been the independent registered public accounting firm appointed by the Corporation to audit its financial statements since 1979, and was selected by the Board as the independent registered public accounting firm for the Corporation for the fiscal year ending December 31, 2018. No member of the firm or any of its associates has a material financial interest in the Corporation. A representative of Baker Tilly is expected to be present at the Annual Meeting to answer appropriate questions from shareholders and will be afforded an opportunity to make any statement that the firm desires.

The affirmative vote of a majority of the votes cast at the meeting, in person or by proxy, is required to ratify the appointment of Baker Tilly as the Corporation’s independent registered public accounting firm. Abstentions and broker non-votes will have no effect in calculating the votes on this matter.

The Board of Directors recommends a vote “FOR” ratification of the appointment of Baker Tilly Virchow Krause, LLP as the Corporation’s independent registered public accounting firm for the fiscal year ending December 31, 2018.

Fees of Independent Public Accountants

The following table sets forth information concerning fees paid to independent public accountants for the years ended December 31, 2017 and 2016. All services provided by Baker Tilly in 2017 and 2016 were pre-approved by the Audit Committee, consistent with the limits provided for in the Audit Committee Charter.

	Fiscal Years Ended December 31,	
	2017	**2016**
Audit Fees		
Audit of Annual financial statements and Audit of internal control over financial reporting and reviews of Quarterly financial statements	$206,975	$193,750
Audit-Related Fees		
Audits of employee benefit plans	18,408	17,260
Tax Fees		
Preparation of Corporation tax return	20,035	19,708
Aggregate of all fees billed to the Corporation	$245,418	$230,718

Audit Committee Report

On February 15, 2018, the Audit Committee of the Board of Directors reviewed and discussed with management the audited financial statements dated December 31, 2017. The Audit Committee also discussed with Baker Tilly, the independent registered public accounting firm of the Corporation, the matters required to be discussed with those charged with governance pursuant to the Public Company Accounting Oversight Board Auditing Standard AS 1301(Communications with Audit Committees).

The Audit Committee has received from Baker Tilly, the written disclosure and the letter required by PCAOB Rule 3526 (Communication with Audit Committees Concerning Independence) and has discussed Baker Tilly’s independence with its representatives. These items relate to that firm’s independence from the Corporation.

Based on its review and discussions referred to above, the Committee has recommended to the Board of Directors that the audited financial statements be included in the Corporation’s Annual Report on Form 10-K for the fiscal year ended December 31, 2017 for filing with the Securities and Exchange Commission.

Audit Committee

Edward H. Owlett, III, Chairman	Terry L. Lehman
R. Bruce Haner	Aaron K. Singer
Leo F. Lambert	James E. Towner

ANNUAL REPORT ON FORM 10-K

A copy of the Corporation's Annual Report on Form 10-K for the year ended December 31, 2017, as filed with the SEC, was made available to shareholders with this proxy statement. The Annual Report on Form 10-K is also available at www.cnbankpa.com.

A paper copy of the Annual Report on Form 10-K will be furnished to shareholders free of charge upon written request. Such requests should be directed to the Treasurer of Citizens & Northern Corporation at 90-92 Main Street, Wellsboro, PA, 16901, or by phone at 570-724-3411.

OTHER MATTERS

The management of the Corporation does not intend to bring any other matters before the Annual Meeting and is not presently informed of any other business which others may bring before such meeting. However, if any other matters should properly come before such meeting or any adjournment thereof, it is the intention of the persons named in the accompanying proxy to vote on such matters as they, in their discretion, determine.

EXHIBIT A

SECOND AMENDMENT TO THE

CITIZENS & NORTHERN CORPORATION

INDEPENDENT DIRECTORS STOCK INCENTIVE PLAN

1. Purpose. The purpose of this Second Amendment to the Citizens & Northern Corporation Independent Directors Stock Incentive Plan (the "Amendment") is to adopt a change to the Plan as a result of a recommendation by the Executive Committee of the Board of Directors ("Board") of Citizens & Northern Corporation. All terms, conditions and provisions of the Plan unless specifically modified herein are valid and enforceable.

2. Amended Provision. Paragraph 5 of the Citizens & Northern Corporation Independent Directors Stock Incentive Plan is amended to increase the number of issuable shares from 135,000 to 235,000, thereby modifying the first sentence thereof to provide as follows:

Subject to adjustments as provided in Section 11 of this Plan, the total number of shares of Stock which may be issued as Awards under the Plan is two hundred thirty five thousand (235,000).

3. Effective Date. This Second Amendment shall become effective as of the date it is adopted by the Board, so long as the stockholders of Citizens & Northern Corporation approve it within twelve (12) months after the date of the Board's adoption.

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ANNUAL MEETING OF STOCKHOLDERS OF CITIZENS & NORTHERN CORPORATION April 19, 2018 GO GREEN e-Consent makes it easy to go paperless. With e-Consent, you can quickly access your proxy material, statements and other eligible documents online, while reducing costs, clutter and paper waste. Enroll today via www.astfinancial.com to enjoy online access. NOTICE OF INTERNET AVAILABILITY OF PROXY MATERIAL: The Notice of Meeting, proxy statement and proxy card are available at http://www.astproxyportal.com/ast/11697/ Please sign, date and mail your proxy card in the envelope provided as soon as possible. Please detach along perforated line and mail in the envelope provided. 20430303000000000000 6 041918 PLEASE SIGN, DATE AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE. PLEASE MARK YOUR VOTE IN BLUE OR BLACK INK AS SHOWN HERE 1. ELECTION OF CLASS I DIRECTORS. FOR ALL NOMINEES WITHHOLD AUTHORITY FOR ALL NOMINEES FOR ALL EXCEPT (See instructions below) NOMINEES: Bobbi J. Kilmer Terry L. Lehman Frank G. Pellegrino James E. Towner INSTRUCTIONS: To withhold authority to vote for any individual nominee(s), mark "FOR ALL EXCEPT" and fill in the circle next to each nominee you wish to withhold, as shown here: To change the address on your account, please check the box at right and indicate your new address in the address space above. Please note that changes to the registered name(s) on the account may not be submitted via this method. 2. TO APPROVE AND ADOPT THE SECOND AMENDMENT TO THE CITIZENS & NORTHERN CORPORATION INDEPENDENT DIRECTORS STOCK INCENTIVE PLAN. FOR AGAINST ABSTAIN 3. TO APPROVE, IN AN ADVISORY (NON-BINDING) VOTE, THE COMPENSATION OF THE COMPANY'S NAMED EXECUTIVE OFFICERS AS DISCLOSED IN THE PROXY STATEMENT. FOR AGAINST ABSTAIN 4. RATIFICATION OF THE APPOINTMENT OF THE FIRM OF BAKER TILLY VIRCHOW KRAUSE, LLP AS THE CORPORATION'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE YEAR ENDING DECEMBER 31, 2018. FOR AGAINST ABSTAIN 5. OTHER MATTERS. In their discretion, to vote with respect to any other matters that may properly come before the Meeting or any adjournments thereof. WHEN PROPERLY EXECUTED, THIS PROXY WILL BE VOTED AS DIRECTED HEREIN BY THE STOCKHOLDER. UNLESS OTHERWISE INDICATED, THIS PROXY WILL BE VOTED FOR THE ELECTION AS DIRECTORS OF THE NOMINEES LISTED IN PROPOSAL 1 AND FOR PROPOSALS 2, 3 AND 4. PLEASE MARK, SIGN, DATE AND RETURN THIS PROXY CARD PROMPTLY USING THE ENCLOSED POSTAGE-PAID ENVELOPE. Signature of Stockholder Date: Signature of Stockholder Date: Note: Please sign exactly as your name or names appear on this Proxy. When shares are held jointly, each holder should sign. When signing as executor, administrator, attorney, trustee or guardian, please give full title as such. If the signer is a corporation, please sign full corporate name by duly authorized officer, giving full title as such. If signer is a partnership, please sign in partnership name by authorized person.

ANNUAL MEETING OF STOCKHOLDERS OF CITIZENS & NORTHERN CORPORATION April 19, 2018 PROXY VOTING INSTRUCTIONS INTERNET - Access “www.voteproxy.com” and follow the on-screen instructions or scan the QR code with your smartphone. Have your proxy card available when you access the web page. TELEPHONE - Call toll-free 1-800-PROXIES (1-800-776-9437) in the United States or 1-718-921-8500 from foreign countries from any touch-tone telephone and follow the instructions. Have your proxy card available when you call. Vote online/phone until 11:59 PM EST on April 18, 2018. MAIL - Sign, date and mail your proxy card in the envelope provided as soon as possible. IN PERSON - You may vote your shares in person by attending the Annual Meeting. GO GREEN - e-Consent makes it easy to go paperless. With e-Consent, you can quickly access your proxy material, statements and other eligible documents online, while reducing costs, clutter and paper waste. Enroll today via www.astfinancial.com to enjoy online access. COMPANY NUMBER ACCOUNT NUMBER NOTICE OF INTERNET AVAILABILITY OF PROXY MATERIAL: The Notice of Meeting, proxy statement and proxy card are available at http://www.astproxyportal.com/ast/11697/ Please detach along perforated line and mail in the envelope provided IF you are not voting via telephone or the Internet. 20430303000000000000 6 041918 PLEASE SIGN, DATE AND RETURN PROMPTLY IN THE ENCLOSED ENVELOPE. PLEASE MARK YOUR VOTE IN BLUE OR BLACK INK AS SHOWN HERE 1. ELECTION OF CLASS I DIRECTORS. FOR ALL NOMINEES WITHHOLD AUTHORITY FOR ALL NOMINEES FOR ALL EXCEPT (See instructions below) NOMINEES: Bobbi J. Kilmer Terry L. Lehman Frank G. Pellegrino James E. Towner INSTRUCTIONS: To withhold authority to vote for any individual nominee(s), mark “FOR ALL EXCEPT” and fill in the circle next to each nominee you wish to withhold, as shown here: To change the address on your account, please check the box at right and indicate your new address in the address space above. Please note that changes to the registered name(s) on the account may not be submitted via this method. 2. TO APPROVE AND ADOPT THE SECOND AMENDMENT TO THE CITIZENS & NORTHERN CORPORATION INDEPENDENT DIRECTORS STOCK INCENTIVE PLAN. FOR AGAINST ABSTAIN 3. TO APPROVE, IN AN ADVISORY (NON-BINDING) VOTE, THE COMPENSATION OF THE COMPANY’S NAMED EXECUTIVE OFFICERS AS DISCLOSED IN THE PROXY STATEMENT. FOR AGAINST ABSTAIN 4. RATIFICATION OF THE APPOINTMENT OF THE FIRM OF BAKER TILLY VIRCHOW KRAUSE, LLP AS THE CORPORATION’S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE YEAR ENDING DECEMBER 31, 2018. FOR AGAINST ABSTAIN 5. OTHER MATTERS. In their discretion, to vote with respect to any other matters that may properly come before the Meeting or any adjournments thereof. WHEN PROPERLY EXECUTED, THIS PROXY WILL BE VOTED AS DIRECTED HEREIN BY THE STOCKHOLDER. UNLESS OTHERWISE INDICATED, THIS PROXY WILL BE VOTED FOR THE ELECTION AS DIRECTORS OF THE NOMINEES LISTED IN PROPOSAL 1 AND FOR PROPOSALS 2, 3 AND 4. PLEASE MARK, SIGN, DATE AND RETURN THIS PROXY CARD PROMPTLY USING THE ENCLOSED POSTAGE-PAID ENVELOPE. Signature of Stockholder Date: Signature of Stockholder Date: Note: Please sign exactly as your name or names appear on this Proxy. When shares are held jointly, each holder should sign. When signing as executor, administrator, attorney, trustee or guardian, please give full title as such. If the signer is a corporation, please sign full corporate name by duly authorized officer, giving full title as such. If signer is a partnership, please sign in partnership name by authorized person.

CITIZENS & NORTHERN CORPORATION PROXY SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS FOR ANNUAL MEETING OF STOCKHOLDERS TO BE HELD APRIL 19, 2018 The undersigned hereby appoints Dennis F. Beardslee and Leonard Simpson, and each or either of them, as the attorneys and proxies of the undersigned, with full power of substitution in each, to vote all shares of the common stock of Citizens & Northern Corporation which the undersigned would be entitled to vote if personally present at the Annual Meeting of Stockholders to be held on Thursday, April 19, 2018, at 2:00 P.M. (local time), at the Deane Center, 104 Main Street, Wellsboro, Pennsylvania 16901, and at any adjournments thereof, and to vote as follows: (Continued and to be signed on the reverse side.) 14475

Important Notice of Availability of Proxy Materials for the Shareholder Meeting of CitiZenS & northern CorPoration To Be Held On: April 19, 2018 at 2:00 p.m. Local time Location of Meeting The Deane Center 104 Main Street, Wellsboro Pennsylvania 16901 ComPanY nUmBer aCCoUnt nUmBer ControL nUmBer This communication presents only an overview of the more complete proxy materials that are available to you on the Internet. We encourage you to access and review all of the important information contained in the proxy materials before voting. If you want to receive a paper or e-mail copy of the proxy materials you must request one. There is no charge to you for requesting a copy. To facilitate timely delivery please make the request as instructed below before 4/9/18. Please visit http://www.astproxyportal.com/ast/11697/, where the following materials are available for view: • Annual Highlights • Notice of Annual Meeting of Stockholders • Proxy Statement • Form of Electronic Proxy Card • Annual Report on Form 10-K TO REQUEST MATERIAL: TELEPHONE: 888-Proxy-NA (888-776-9962) and 718-921-8562 (for international callers) E-MAIL: info@astfinancial.com WEBSITE: https://us.astfinancial.com/OnlineProxyVoting/ProxyVoting/RequestMaterials TO VOTE: onLine: To access your online proxy card, please visit www.voteproxy.com and follow the on-screen instructions or scan the QR code with your smartphone. You may enter your voting instructions at www.voteproxy.com up until 11:59 PM Eastern Time on April 18, 2018. in PerSon: You may vote your shares in person by attending the Annual Meeting. teLePhone: To vote by telephone, please visit www.voteproxy.com to view the materials and to obtain the toll free number to call. maiL: You may request a card by following the instructions above. 1. ELECTION OF CLASS I DIRECTORS. nomineeS: Bobbi J. Kilmer Terry L. Lehman Frank G. Pellegrino James E. Towner Please note that you cannot use this notice to vote by mail. 2. TO APPROVE AND ADOPT THE SECOND AMENDMENT TO THE CITIZENS & NORTHERN CORPORATION INDEPENDENT DIRECTORS STOCK INCENTIVE PLAN. 3. TO APPROVE, IN AN ADVISORY (NON-BINDING) VOTE, THE COMPENSATION OF THE COMPANY'S NAMED EXECUTIVE OFFICERS AS DISCLOSED IN THE PROXY STATEMENT. 4. RATIFICATION OF THE APPOINTMENT OF THE FIRM OF BAKER TILLY VIRCHOW KRAUSE, LLP AS THE CORPORATION'S INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM FOR THE YEAR ENDING DECEMBER 31, 2018. 5. OTHER MATTERS. In their discretion, to vote with respect to any other matters that may properly come before the Meeting or any adjournments thereof.