WIND RIVER SYSTEMS INC
Form 10-Q
March 19, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended July 31, 2006

or

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______

Commission file number 001-33061

WIND RIVER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-2873391**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

500 Wind River Way, Alameda, California 94501

(Address of principal executive offices, including zip code)

(510) 748-4100

(Registrant s telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

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

As of March 1, 2007, there were 85,418,924 shares of the Registrant s $0.001 par value common stock outstanding.

Table of Contents

WIND RIVER SYSTEMS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JULY 31, 2006

TABLE OF CONTENTS

Unless stated otherwise, references in this report to Wind River, we, our, us or the Company refer to Wind River Systems, Inc., a Delaware corporation, and its consolidated subsidiaries.

Table of Contents

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

WIND RIVER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended July 31,		Six Months Ended July 31,	
	2006	2005	2006	2005
Revenues, net:				
Product	$ 32,101	$ 32,818	$ 58,944	$ 62,862
Subscription	24,184	17,982	45,844	34,348
Service	17,425	15,945	33,898	31,296
Total revenues, net	73,710	66,745	138,686	128,506
Cost of revenues (1):				
Product	713	1,609	1,492	3,231
Subscription	3,825	2,922	7,827	5,671
Service	11,422	9,675	22,011	18,485
Amortization of purchased intangibles	379	131	512	262
Total cost of revenues	16,339	14,337	31,842	27,649
Gross profit	57,371	52,408	106,844	100,857
Operating expenses (1):				
Selling and marketing	28,399	23,973	56,018	48,170
Product development and engineering	18,319	16,895	35,868	33,669
General and administrative	8,434	5,685	16,547	11,454
Amortization of other intangibles	33	24	128	47
Total operating expenses	55,185	46,577	108,561	93,340
Income (loss) from operations	2,186	5,831	(1,717)	7,517
Other income (expense):				
Interest income	2,151	1,470	4,108	2,973
Interest expense	(634)	(749)	(1,252)	(1,884)
Other expense, net	(9)	(362)	(97)	(226)
Total other income, net	1,508	359	2,759	863
Income before income taxes	3,694	6,190	1,042	8,380
Provision for income taxes	566	521	34	907
Net income	$ 3,128	$ 5,669	$ 1,008	$ 7,473

Net income per share:				
Basic	$ 0.04	$ 0.07	$ 0.01	$ 0.09
Diluted	$ 0.04	$ 0.06	$ 0.01	$ 0.08
Shares used in per share calculation:				
Basic	85,548	84,426	85,660	84,068
Diluted	86,503	90,119	87,048	89,637

(1) Costs and expenses for the three and six months ended July 31, 2006 include the impact of the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, on February 1, 2006. See Note 11 to these condensed consolidated financial statements for additional information.

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

Table of Contents

WIND RIVER SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

(Unaudited)

	July 31, 2006	January 31, 2006 (1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 67,837	$ 59,279
Short-term investments	44,472	44,013
Accounts receivable, net	56,471	65,803
Prepaid and other current assets	13,443	13,224
Total current assets	182,223	182,319
Investments	103,878	115,584
Property and equipment, net	77,205	78,514
Goodwill	108,703	91,840
Other intangibles, net	4,414	1,883
Other assets	12,970	13,104
Total assets	$ 489,393	$ 483,244
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,727	$ 5,674
Accrued liabilities	12,319	12,260
Accrued compensation	16,455	16,190
Income taxes payable	499	2,249
Deferred revenues	89,656	84,505
Convertible subordinated notes	42,151	42,151
Total current liabilities	162,807	163,029
Long-term deferred revenues	12,045	13,760
Other long-term liabilities	4,489	3,008
Total liabilities	179,341	179,797
Stockholders' equity:		
Preferred stock, par value $0.001, 2,000 shares authorized, 1,250 designated as Series A Junior Participating, 750 undesignated; no shares issued and outstanding		
Common stock, par value $0.001, 325,000 shares authorized; 88,331 and 87,632 shares issued as of July 31, 2006 and January 31, 2006, respectively; 85,251 and 85,762 shares outstanding as of July 31, 2006 and January 31, 2006, respectively	88	88
Additional paid-in-capital	812,737	798,501
Treasury stock, 3,080 and 1,870 shares at cost as of July 31, 2006 and January 31, 2006, respectively	(46,233)	(35,466)
Accumulated other comprehensive loss	(3,551)	(5,679)
Accumulated deficit	(452,989)	(453,997)

Total stockholders' equity	310,052	303,447
Total liabilities and stockholders' equity	$ 489,393	$ 483,244

(1) See Note 1 to these condensed consolidated financial statements for corrections to stockholders equity.

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

Table of Contents

WIND RIVER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended July 31, 2006	Six Months Ended July 31, 2005
Cash flows from operating activities:		
Net income	$ 1,008	$ 7,473
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,261	4,690
Amortization of bond issuance costs	168	179
Stock-based compensation expense	11,038	
401(K) common stock match	1,070	927
Realized loss from repurchase of convertible subordinated notes		401
Realized loss from sales of available-for-sale securities, net	198	262
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	10,751	9,848
Accounts payable	(3,899)	(1,361)
Accrued liabilities	(1,031)	(4,671)
Accrued compensation	(332)	(3,552)
Income taxes payable	(1,750)	(647)
Deferred revenues	1,958	4,681
Other assets and liabilities	565	(763)
Net cash provided by operating activities	25,005	17,467
Cash flows from investing activities:		
Acquisitions of property and equipment	(2,700)	(3,231)
Acquisition, net of cash acquired	(17,345)	
Purchase of investments	(41,230)	(19,098)
Sales of investments	346	13,118
Maturities of investments	52,297	14,561
Net cash provided by (used in) investing activities	(8,632)	5,350
Cash flows from financing activities:		
Issuance of common stock	5,238	12,444
Repurchase of common stock	(13,878)	
Repurchase of convertible subordinated notes		(32,840)
Repayment of loan	(75)	
Net cash used in financing activities	(8,715)	(20,396)
Effect of exchange rate changes on cash and cash equivalents	900	(404)
Net increase in cash and cash equivalents	8,558	2,017
Cash and cash equivalents at beginning of period	59,279	22,312

Cash and cash equivalents at end of period	$ 67,837	$ 24,329

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

Table of Contents

WIND RIVER SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Note 1: The Company and Summary of Significant Accounting Policies

The Company. Wind River Systems, Inc. (Wind River or the Company) is a global leader in Device Software Optimization (DSO). Wind River s software is used to develop, run and manage devices better, faster, at lower cost and more reliably. Wind River s software and development tools are used to optimize the functionality of devices as diverse as digital imaging products, automobile braking systems, Internet routers, avionics control panels and factory automation equipment. Wind River offers customers DSO solutions to enhance product performance, standardize designs across projects and throughout the enterprise, reduce research and development costs, and shorten product development cycles.

Wind River markets its products and services in North America, EMEA (comprising Europe, the Middle East and Africa), Japan and the Asia Pacific region, primarily through its own direct sales organization, which consists of sales persons and field engineers. Wind River also licenses distributors, primarily in international regions, to serve customers in regions not serviced by its direct sales force. Wind River was incorporated in California in February 1983 and reincorporated in Delaware in April 1993.

Basis of Presentation. Wind River has prepared the condensed consolidated financial statements included herein, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to such rules and regulations. However, Wind River believes that the disclosures are adequate to ensure the information presented is not misleading. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in Wind River s Annual Report on Form 10-K for the fiscal year ended January 31, 2006 filed with the SEC on April 17, 2006.

Wind River believes that all necessary adjustments, which consist of normal recurring items, have been included in the accompanying consolidated financial statements to state fairly the results of the interim periods. The results of operations for the interim periods presented are not necessarily indicative of the operating results to be expected for any subsequent interim period or for Wind River s fiscal year ending January 31, 2007.

The condensed consolidated financial statements include the financial information of Wind River and its subsidiaries. All significant inter-company accounts and transactions have been eliminated.

Use of Estimates. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Specifically, estimates are used for, but not limited to, the accounting for stock-based compensation, the allowance for doubtful accounts, sales returns and other allowances, valuation of investments, goodwill and purchased intangibles, deferred tax assets and liabilities and income taxes and any associated valuation allowance or reserves, percentage of completion accounting, accrued compensation and other accruals, and the outcome of litigation and other contingencies. Wind River bases its estimates on historical experience and various other assumptions that are believed to be reasonable based on the specific circumstances. Wind River s management has discussed these estimates with the Audit Committee of the Board of Directors. These estimates and assumptions form the basis for making judgments about the carrying value of certain assets and liabilities. Actual results could differ from these estimates.

Impact of Stock Option Review. In May 2006, the Audit Committee of the Board of Directors commenced a voluntary review of the Company s historical stock option granting practices and the related accounting. Subsequently, in September 2006, the Board of Directors appointed a Special Committee, comprised of a subset of the Audit Committee, which engaged independent legal counsel and accounting consultants to assist the Special Committee in its review. The review covered the timing and pricing of all stock option grants made under the Company s stock option plans since its initial public offering in 1993. Based on the results of its review, the Special Committee concluded that the Company did not engage in intentional misrepresentation of consolidated financial statements or fraudulent misconduct in the granting of stock options. However, due to certain errors identified in the course of the review, the accounting measurement dates for certain historical stock option grants differed from the actual grant dates.

As a result of revising the accounting measurement dates for these stock option grants, the Company identified errors totaling approximately $6.8 million, net of tax benefits of $1.2 million, related to stock-based compensation expenses incurred primarily in fiscal year 1995 through fiscal year 2004. The impact of these errors, net of tax was $146,000, $270,000, $576,000, $616,000, $526,000, $588,000, $1.5 million, $1.6 million, $518,000, and $396,000 for fiscal years 1995 through fiscal years 2004, respectively. While these errors were not material to any previously filed financial statements, the Company concluded that correcting the aggregate error of approximately $6.8 million would be material to its consolidated statements of operations for the six months ended July 31, 2006, as well as its expected full year results, and accordingly, prior period accumulated deficit and additional paid-in-capital have been restated to record the cumulative

Table of Contents

non-cash stock-based compensation expense in this Form 10-Q. Financial statements of prior periods will also be adjusted, as necessary, in subsequent filings. Additional paid-in-capital and accumulated deficit were adjusted as of January 31, 2006 as follows (in thousands):

	January 31, 2006	
	As Reported	Adjusted
Additional paid-in-capital	$ 791,709	$ 798,501
Accumulated deficit	$ (447,205)	$ (453,997)

Recent Accounting Pronouncements. In June 2006, the Financial Accounting Standards Board (FASB) ratified Emerging Issues Task Force (EITF) Issue No. 06-2, *Accounting for Sabbatical Leave and Other Similar Benefits Pursuant to FASB Statement No. 43, Accounting for Compensated Absences* (EITF 06-2). Under EITF 06-2, compensation costs associated with sabbaticals are accrued over the requisite service period, assuming certain conditions are met. EITF 06-2 will be effective beginning in the first quarter of fiscal 2008. The Company is evaluating the impact that this statement will have on its consolidated financial statements.

In June 2006, the FASB ratified EITF No. 06-3, *How Sales Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement* (EITF 06-3). The standard requires an entity to disclose its accounting policy regarding presentation of taxes within the statement of operations (i.e. gross or net presentation). If taxes included in gross revenues are significant, an entity should disclose the amount of such taxes in each period for which a statement of operations is presented. EITF 06-3 will be effective beginning in the first quarter of fiscal 2008. Based on its current evaluation of the standard, the Company does not expect the adoption of EITF 06-3 will have a significant impact on its consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes- an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 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. FIN 48 will be effective beginning in the first quarter of fiscal 2008. The Company is evaluating the impact this statement will have on its consolidated financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 provides accounting guidance on the definition of fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 will be effective beginning in the first quarter of fiscal 2009. The Company is evaluating the impact that this statement will have on its consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 provides guidance on how the effects of the carryover or reversal of prior year financial statement misstatements should be considered in quantifying a current year misstatement. SAB 108 describes two approaches for assessing the materially of misstatements: the rollover approach, which quantifies misstatements based on the amount of error originating in the current year income statement, and the iron curtain approach, which quantifies misstatements based on the effects of correcting the cumulative effect existing in the balance sheet at the end of the current year. If, under either approach, misstatements are deemed material, registrants are required to adjust their financial statements, including correcting prior year financial statements, even if such correction was and continues to be immaterial to the prior year financial statements. SAB 108 will be effective beginning in the fourth quarter of fiscal 2007. The Company plans to adopt SAB 108 in the fourth quarter and at present believes that the adoption will not have a material effect on the Company s consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115* (SFAS 159). SFAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. The objective of SFAS 159 is to provide opportunities to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply hedge accounting provisions. SFAS 159 also establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 will be effective in the first quarter of fiscal 2009. The Company is evaluating the impact that this statement will have on its consolidated financial statements.

Note 2: Business Combinations

Acquisition of Interpeak

On March 20, 2006, Wind River acquired Interpeak AB (Interpeak), a privately held Swedish company, for approximately $18.3 million, comprised of $17.8 million in cash consideration, plus direct acquisition costs. Interpeak provides networking, security, and mobility middleware software that enables devices to connect to the internet. Wind River accounted for this acquisition as a non-taxable purchase and, in accordance with SFAS No. 141, *Business Combinations* (SFAS 141), the total consideration was allocated to the intangible assets and tangible assets and liabilities acquired, based on their estimated fair values.

Table of Contents

The following table reflects the preliminary allocation of the total purchase price of $18.3 million as of the date of purchase (in thousands):

Net current assets	$ 526
Property and equipment	15
Developed technology	1,400
Core technology	700
Maintenance contracts	500
Direct customer relationships	200
Distribution agreements	200
Goodwill	15,643
Deferred tax liability	(840)
Total purchase price	$ 18,344

In performing the purchase price allocation of acquired intangible assets, Wind River considered its intention for the future use of the assets, analyses of historical financial performance, and estimates of the future performance of Interpeak, amongst other factors. Wind River used the income valuation approach in determining fair value using discount rates of 20% to 22%. The goodwill of $15.6 million represents Wind River s assigned value for the long-term potential of the integration of Interpeak into Wind River s overall product strategy. The estimated useful economic lives of the identifiable intangible assets acquired in the Interpeak acquisition are three years for the developed and core technology and the distribution agreements, five years for the direct customer relationships and four years for the maintenance contracts. The final purchase price allocation will depend primarily upon the finalization of the valuation of acquired intangible assets.

The condensed consolidated financial statements include the operating results of Interpeak from the date of acquisition. Pro forma results of operations have not been presented because the effect of the acquisition was not material to the consolidated statement of operations, balance sheets, or cash flows of Wind River.

Goodwill and Intangibles

The following table summarizes the Company s goodwill and other intangible assets (in thousands):

	January 31, 2006	July 31, 2006		
	Net	Gross Carrying Amount	Accumulated Amortization	Net
Goodwill	$ 91,840	108,703		108,703
Developed and core technology and patents	1,578	32,700	(29,413)	3,287
Customer relationships, contracts, and agreements	305	16,528	(15,401)	1,127
Total	$ 93,723	$ 157,931	$ (44,814)	$ 113,117

Goodwill and other intangibles, net, increased primarily as a result of the Company s acquisition of Interpeak. The estimated weighted-average useful economic life of the other intangible assets as of July 31, 2006 is approximately three years.

The Company assesses goodwill for impairment in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), which requires that goodwill be tested for impairment at the reporting unit level at least annually or more frequently upon the occurrence of certain events, as defined by SFAS 142. The Company operates as one reporting unit and reviews goodwill for impairment at least annually during the second quarter of each fiscal year. The Company completed its annual goodwill impairment review during the second quarter of fiscal 2007 and the results of the review did not indicate an impairment.

Note 3: Derivative Financial Instruments

Wind River enters into foreign currency forward exchange contracts to manage foreign currency exposures related to certain non-functional currency related inter-company and other balances. Transaction gains and losses on the contracts and the assets and liabilities are recognized each period in other income (expense), net. As of July 31, 2006, Wind River had outstanding contracts with the following terms (currency amounts and USD equivalents in thousands):

Buy / Sell:	**Sell**	**Buy**	**Sell**	**Buy**	**Buy**
Currency:	GBP(£)	EURO(€)	JPY(¥)	CAD(CAD$)	SEK(kr)
Amount:	1,200	11,800	100,000	8,300	25,000
Rate:	0.5372	0.7809	114.69	1.1267	7.2179
USD Equivalent:	$ 2,234	$ 15,111	$ 872	$ 7,367	$ 3,464
Maturity Date:	8/31/2006	8/31/2006	8/31/2006	8/31/2006	8/31/2006

8

Table of Contents

Wind River does not enter into derivative financial instruments for trading or speculative purposes. As of July 31, 2006, the difference between the fair value and carrying value of the above contracts was not significant.

Note 4: Deferred Revenues

Deferred revenues consist of the following (in thousands):

	July 31, 2006	January 31, 2006
Current deferred revenues:		
Subscription	$ 60,947	$ 52,156
Maintenance and other	28,709	32,349
Total current deferred revenues	89,656	84,505
Long-term deferred revenues:		
Subscription	11,436	13,181
Maintenance and other	609	579
Total long-term deferred revenues	12,045	13,760
Total deferred revenues	$ 101,701	$ 98,265

Deferred subscription revenues represent customer billings and payments made in advance for software licensed over a subscription period. Subscription periods vary from annual to multi-year and are classified as such. Long-term deferred revenues represent the portion of multi-year contracts that are due to be recognized as revenue in a time period greater than one year from the balance sheet date. Maintenance and other deferred revenues primarily include deferred service and maintenance revenues. Deferred maintenance revenues represent customer billings and payments made in advance for annual support contracts. Maintenance is typically billed on a per annum basis in advance and revenue is recognized ratably over the maintenance period. Deferred service revenues include pre-payments for software consulting and other product services, including software license transactions that are not separable from consulting services. Revenue for these services is recognized as the services are performed.

Note 5: Restructuring

Included within general and administrative expenses are restructuring costs of $237,000 and $422,000 for the three and six months ended July 31, 2005. As of January 31, 2006 and July 31, 2006, the restructuring accrual, included within accrued liabilities on the consolidated balance sheets was approximately $899,000 and $591,000, respectively. The net decrease of $308,000 during the six months ended July 31, 2006 is primarily attributable to the reversal of certain accruals related to a change in estimated legal and other costs of $158,000 and cash payments of $147,000 to settle certain outstanding restructuring liabilities. The Company expects to pay the remaining obligations related to workforce reductions by the fourth quarter of fiscal 2007. Remaining lease obligations related to vacated facilities will be paid over the remaining lease terms, which expire in fiscal 2012.

Note 6: Convertible Subordinated Notes

In December 2001, Wind River issued $150.0 million of 3.75% convertible subordinated notes. The notes are unsecured and subordinate to all existing and future senior debt. The notes mature on December 15, 2006, unless earlier redeemed or converted. Interest on the notes is payable in cash semi-annually in arrears during June and December of each year. The notes may be converted, at the option of the holder, into Wind River s common stock at any time at the then-current conversion price, initially $24.115 per share. Wind River is entitled to redeem all or a portion of the notes for cash at the redemption price of 100% of the principal amount.

During fiscal 2005 and 2006, Wind River repurchased $107.8 million of the notes on the open market at an aggregate price of $108.2 million.

As of July 31, 2006, $42.2 million of the convertible subordinated notes (convertible into 1.7 million shares of the Company s common stock) remained outstanding, and are disclosed as a current liability on the condensed consolidated balance sheet. See Note 14, Subsequent Events, for additional information regarding the final settlement of these subordinated notes in December 2006.

Note 7: Provision for Income Taxes

The Company had a provision for income taxes of $566,000 and $521,000 for the three months ended July 31, 2006 and 2005, respectively, and $34,000 and $907,000 for the six months ended July 31, 2006 and 2005, respectively. The provision is based on estimates of the Company s expected liability for domestic and foreign income taxes and foreign withholding taxes incurred during the year, and is calculated by applying the estimated annual effective tax rate to the income before provision for income taxes, adjusted for any discrete items.

Table of Contents

Deferred income taxes are recorded in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS 109) and are determined based on the differences between financial reporting and the tax basis of assets and liabilities using the tax rates of laws in effect when the differences are expected to reverse. SFAS 109 provides for recognition of deferred tax assets if the realization of such assets is more likely than not to occur. With the exception of certain international jurisdictions, Wind River has determined that it is more likely than not that its remaining deferred tax assets will not be realized, due to uncertainties relating to its ability to utilize its deferred tax assets, primarily net operating losses carried forward and research and development tax credits, before they expire. Accordingly, the Company has deferred tax assets of $7.1 million related to certain international jurisdictions and a full valuation allowance against the remainder of its deferred tax assets as of July 31, 2006.

Should Wind River determine that it would be able to realize its deferred tax assets in the foreseeable future, an adjustment to the remaining deferred tax assets would cause a material increase to income in the period such determination is made. Significant management judgment is required in determining the period in which the reversal of a valuation allowance should occur. Wind River considers all available evidence, both positive and negative, such as historical levels of income and future forecasts of taxable income amongst other items in determining whether a full or partial release of a valuation allowance is required. In addition, the assessments sometimes require the Company to schedule future taxable income in accordance with SFAS 109 to assess the appropriateness of a valuation allowance which further requires the exercise of significant management judgment. The Company will continue to evaluate the ability to realize, by jurisdiction, its deferred tax assets and related valuation allowances on a quarterly basis. See Note 14, Subsequent Events, for additional information.

Note 8: Comprehensive Income (Loss)

The following are the components of comprehensive income (loss) (in thousands):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2006	2005	2006	2005
Net income	$ 3,128	$ 5,669	$ 1,008	$ 7,473
Other comprehensive income (loss):				
Foreign currency translation adjustments	422	(10)	1,802	(93)
Unrealized gain (loss) on investments	277	(317)	128	(943)
Realized loss included in net income	136	137	198	262
Other comprehensive income (loss)	835	(190)	2,128	(774)
Total comprehensive income	$ 3,963	$ 5,479	$ 3,136	$ 6,699

Note 9: Net Income per Share Computation

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. For purposes of computing basic net income per share, the weighted average number of outstanding shares of common stock excludes unvested restricted stock awards. Diluted earnings per share is computed by dividing net income for the period by the weighted average number of common shares outstanding during the period and all dilutive potential common shares outstanding during the period. Dilutive potential common shares consist of convertible subordinated notes (using the if-converted method), unvested restricted stock awards, outstanding options and shares issuable under the Company s employee stock purchase plan (using the treasury stock method).

Table of Contents

The following table provides a reconciliation of the numerators and denominators of the basic and diluted per share computations (in thousands, except per share amounts):

	Three Months Ended July 31,		Six Months Ended July 31,	
	2006	2005	2006	2005
Numerator:				
Net income	$ 3,128	$ 5,669	$ 1,008	$ 7,473
Denominator:				
Weighted average common shares outstanding- basic	85,548	84,426	85,660	84,068
Effect of dilutive potential common shares	955	5,693	1,388	5,569
Weighted average common shares outstanding- diluted	86,503	90,119	87,048	89,637
Net income per share				
Basic	$ 0.04	$ 0.07	$ 0.01	$ 0.09
Diluted	$ 0.04	$ 0.06	$ 0.01	$ 0.08

The effect of the assumed conversion of the 3.75% convertible subordinated notes for 1.7 million shares of common stock is antidilutive for both the three and six months ended July 31, 2006 and 2005, and is therefore excluded from the above computation. The above computation also excludes all anti-dilutive outstanding options, restricted stock awards and shares issuable under the Company s employee stock purchase plan, which amounted to approximately 13.1 million and 11.6 million shares, respectively, for the three and six months ended July 31, 2006, and 729,000 and 871,000 shares, respectively, for the three and six months ended July 31, 2005.

Note 10: Common Stock

Common Stock

In June 2002, the Board of Directors authorized a stock repurchase program (the 2002 Repurchase Plan) to enable Wind River to acquire up to $30.0 million of outstanding common stock in the open market or through negotiated transactions for a period of two years. The Board of Directors extended the stock repurchase program for an additional two years in June 2004, and in June 2006, the Board extended the program to allow for the repurchase of the remaining balance of the $30.0 million authorized plan. Since the inception of the plan in fiscal 2003 through fiscal 2006, the Company repurchased 1.4 million shares at an aggregate purchase price of $10.0 million with the repurchased shares being recorded as treasury stock on a last-in, first-out basis.

During the three and six months ended July 31, 2006, Wind River repurchased 1.1 million shares at an aggregate purchase price of $9.7 million and 1.5 million shares at an aggregate purchase price of $13.9 million, respectively. The repurchased shares were recorded as treasury stock on a last-in, first-out basis. As of July 31, 2006, the Company may yet repurchase up to $6.5 million of outstanding common stock under the 2002 Repurchase Plan.

In conjunction with the 2002 Repurchase Plan, the Board of Directors authorized the transfer of up to 300,000 shares of common stock from treasury stock each year for replenishment of the Employee Stock Purchase Plan (ESPP). The authorization is effective for five years, commencing in 2003. For the six months ended July 31, 2006 and in fiscal 2006, 2005 and 2004, the 2002 Repurchase Plan provided 300,000 shares for issuance to employees under the ESPP.

Restricted Stock

In connection with the acquisition of Interpeak on March 20, 2006, Wind River agreed to grant 192,367 restricted shares of Wind River common stock to certain founders of Interpeak. The restrictions will lapse one year from the acquisition date, subject to their continued employment with Wind River during the one-year period. The total value of the restricted stock, based on the average closing price of its common stock two days before, two days after, and on the date of the acquisition was $2.4 million. The total amount is being recorded as compensation expense over the period of the restriction as services are provided and approximately $605,000 and $881,000 of expense has been recognized during the three and six months ended July 31, 2006, respectively.

Note 11: Stock-Based Compensation

Equity Incentive Plans

Prior to fiscal 2006, Wind River had four main stock option plans: the 1987 Equity Incentive Plan, the 1998 Equity Incentive Plan, the 1998 Non-Officer Stock Option Plan and 1995 Non-Employee Directors Stock Option Plan (together, the Predecessor Plans).

On June 8, 2005, the stockholders of Wind River approved a new plan, the Wind River Systems, Inc. 2005 Equity Incentive Plan (the 2005 Equity Plan) that had been previously adopted by the Board subject to stockholder approval. The 2005 Equity Plan provides for the award of stock options, stock appreciation rights, restricted stock, restricted stock units, performance units and deferred stock units to eligible employees, including consultants and directors. Subject to the terms of the 2005 Equity Plan, the plan

Table of Contents

administrator has the authority to select the employees, consultants, and directors who will receive the equity awards, determine the terms and conditions of the awards (for example, the exercise price and vesting schedule), and interpret the provisions of the 2005 Equity Plan and outstanding awards. Generally, Wind River s practice is to grant all options with exercise prices of at least 100% of the fair market value and a term of 7 years. Options generally become exercisable as to 25% of the option shares one year from the date of grant and then ratably over the following 36 months (1/48th per month). The 2005 Equity Plan replaces the Predecessor Plans and no further awards will be granted under those plans. As of July 31, 2006, approximately 3.8 million shares were available for grant under the Company s stock option plans.

Under the terms of the 2005 Equity Plan, all non-employee directors of Wind River automatically will be granted, as of the date they are appointed or elected to the Board of Directors, a nonqualified stock option to purchase 50,000 shares under the 2005 Equity Plan. These initial grants vest as to 25% of the covered shares on each anniversary of the grant date, so as to become 100% vested on the four-year anniversary of the grant date thereafter, provided that the individual remains a service provider through each vesting date. In addition, on April 1st of each year, each non-employee director is automatically granted options to purchase 15,000 shares. These options vest in four equal annual installments but become fully vested on the first anniversary of the date of grant so long as the director attended at least 75% of the meetings of the Board and any committee on which the director serves that were held during that year. Under the 2005 Equity Plan, these options automatically terminate on the first anniversary of the grant date if the director fails to attend the requisite number of meetings.

Employee Stock Purchase Plan

In 1993, Wind River adopted the 1993 Employee Stock Purchase Plan (the ESPP) under which 4.5 million shares of common stock have been reserved for issuance. Eligible employees may purchase a limited number of shares of Wind River common stock at a discount of up to 15% of the fair market value at the lower of certain plan-defined dates. Wind River issued 259,000 and 161,000 shares under the ESPP during the six months ended July 31, 2006 and 2005, respectively. As of July 31, 2006, approximately 1.3 million shares were available for issuance under the ESPP. See Note 14, Subsequent Events for additional information regarding the Company s ESPP.

Impact of the Adoption of SFAS 123R

On February 1, 2006, Wind River adopted SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases related to the Company s ESPP, based on estimated fair values. SFAS 123R supersedes Wind River s previous accounting under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), for periods beginning in fiscal year 2007. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123R. The provisions of SAB 107 have been applied in the adoption of SFAS 123R.

Wind River adopted SFAS 123R using the modified prospective transition method, which required the application of the accounting standard as of February 1, 2006, the first day of fiscal year 2007. The consolidated financial statements as of and for the three and six months ended July 31, 2006 reflect the impact of SFAS 123R. In accordance with the modified prospective transition method, the Company s consolidated financial statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123R.

SFAS 123R requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the consolidated statement of operations. Prior to the adoption of SFAS 123R, Wind River accounted for stock-based awards to employees using the intrinsic value method in accordance with APB 25 as allowed under SFAS No. 123, *Accounting for Stock-Based Compensation* (SFAS 123).

Stock-based compensation expense recognized in the consolidated statement of operations for the three and six months ended July 31, 2006 includes compensation expense for share-based payment awards granted prior to, but not yet vested as of February 1, 2006, based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for share-based payment awards granted subsequent to February 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. In conjunction with the adoption of SFAS 123R, the Company continued its method of attributing the value of stock-based compensation using a straight-line single option method. As stock-based compensation expense recognized in the consolidated statement of operations for three and six months ended July 31, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures based on historical experience. SFAS 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. In the pro forma information previously required under SFAS 123 for the periods prior to fiscal year 2007, Wind River accounted for forfeitures as they occurred.

On November 10, 2005, the FASB issued Staff Position No. FAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. Effective upon issuance, this FSP describes an alternative transition method for calculating

12

Table of Contents

the tax effects of stock-based compensation pursuant to SFAS 123R. The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123R. Wind River elected to adopt this standard.

The impact on the results of operations of recording stock-based compensation under SFAS 123R for the three and six months ended July 31, 2006 was as follows (in thousands):

	Three Months Ended July 31, 2006	Six Months Ended July 31, 2006
Cost of net revenues	$ 619	$ 1,193
Selling and marketing expenses	1,383	2,827
Product development and engineering expenses	785	1,610
General and administrative expenses	2,278	4,527
Total stock-based compensation expense	$ 5,065	$ 10,157

Valuation Assumptions

Wind River uses the Black-Scholes option pricing model to determine the fair value of stock options consistent with the provisions of SFAS 123R, SAB 107 and the Company s prior period pro forma disclosures of net income (loss). The fair value of each option grant is estimated on the date of grant and is affected by the Company s stock price and a number of highly complex and subjective variables including, but are not limited to, the expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise and cancellation behaviors.

The Company used the following weighted-average valuation assumptions to estimate the fair value of options granted during the three and six months ended July 31, 2006 and 2005:

	Three Months Ended		Six Months Ended	
	July 31,		July 31,	
	2006	2005	2006	2005
Risk-free interest rate	5.03% -5.21%	4.14%	4.65% -5.21%	4.14%
Expected life (in years)	3.6 - 4.0	3.98	3.6 - 7.0	3.98
Expected volatility	52.1% -56.5%	74.7%	52.1% -56.9%	74.7%
Dividend yield	0%	0%	0%	0%

The computation of expected volatility for the three and six months ended July 31, 2006 is based on a combination of historical and market-based implied volatility from traded options on Wind River common stock. Prior to fiscal year 2007, the computation of expected volatility was based on historical volatility. The computation of expected lives during the three and six months ended July 31, 2006 and 2005 was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The range provided for the three and six months ended July 31, 2006 results from the behavior patterns of separate groups of employees that have similar historical experience. The interest rate for periods within the contractual life of the award is based on the U.S. Treasury yield curve in effect at the time of grant.

The weighted average fair value of stock option awards granted during the three and six months ended July 31, 2006 was $4.24 and $5.56, respectively, and the weighted average fair value of stock option awards granted during the three and six months ended July 31, 2005 was $9.19 and $8.86, respectively.

The fair value of employees stock purchase rights under Wind River s ESPP was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions for the three and six months ended July 31, 2006 and 2005:

	Three and Six Months Ended	
	July 31,	
	2006	2005
Risk-free interest rate	5.27%	3.37%
Expected life (in years)	0.5	0.5
Expected volatility	38.7%	48.1%
Dividend yield	0%	0%

Table of Contents

The weighted average fair value of common stock purchase rights granted under the ESPP during both the three and six months ended July 31, 2006 was $2.37, as compared to $4.55 during both the three and six months ended July 31, 2005.

Stock-Based Payment Award Activity

The following table summarizes activity under the Company s equity incentive plans for the six months ended July 31, 2006 (in thousands, except exercise prices and contractual terms):

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Outstanding at February 1, 2006	15,638	$ 10.64		
Granted				