

WIND RIVER SYSTEMS INC
Form 10-Q
December 12, 2005
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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 October 31, 2005

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 0-21342

WIND RIVER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

94-2873391
(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

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

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

As of November 30, 2005, there were 84,948,280 shares of the registrant's common stock outstanding.

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WIND RIVER SYSTEMS, INC.

FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED OCTOBER 31, 2005

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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****(Unaudited)**

	Three Months Ended		Nine Months Ended	
	October 31,		October 31,	
	2005	2004	2005	2004
(In thousands, except per share amount)				
Revenues, net:				
Product	\$ 31,445	\$ 32,230	\$ 94,307	\$ 90,205
Subscription	18,450	12,387	52,798	34,224
Service	17,712	15,378	49,008	47,776
Total revenues, net	67,607	59,995	196,113	172,205
Cost of revenues:				
Product	1,957	1,690	5,188	4,210
Subscription	2,939	2,876	8,610	8,361
Service	10,119	7,581	28,604	24,344
Amortization of purchased intangibles	133	309	395	1,630
Total cost of revenues	15,148	12,456	42,797	38,545
Gross profit	52,459	47,539	153,316	133,660
Operating expenses:				
Selling and marketing	23,418	23,038	71,588	66,622
Product development and engineering	16,193	15,010	49,862	44,341
General and administrative	5,613	5,324	16,645	15,723
Amortization of other purchased intangibles	23	230	70	527
Restructuring charges	765	313	1,187	2,370
Impairment of assets	313		313	
Total operating expenses	46,325	43,915	139,665	129,583
Income from operations	6,134	3,624	13,651	4,077
Other income (expense):				
Interest income	1,523	1,629	4,496	4,982
Interest expense	(616)	(1,768)	(2,500)	(5,560)

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Other income (expense), net	(239)	(531)	(465)	(54)
Total other income (expense)	668	(670)	1,531	(632)
Income before provision for income taxes	6,802	2,954	15,182	3,445
Provision for income taxes	1,071	690	1,978	1,640
Net income	\$ 5,731	\$ 2,264	\$ 13,204	\$ 1,805
Net income per share:				
Basic	\$ 0.07	\$ 0.03	\$ 0.16	\$ 0.02
Diluted	\$ 0.06	\$ 0.03	\$ 0.15	\$ 0.02
Shares used in per share calculation:				
Basic	85,016	82,391	84,415	81,909
Diluted	89,408	86,290	89,606	85,412

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

Table of Contents**WIND RIVER SYSTEMS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(Unaudited)**

	October 31,	January 31,
	2005	2005
	(In thousands, except par value)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 36,430	\$ 22,312
Short-term investments	43,715	24,605
Accounts receivable, net	54,334	62,266
Prepaid and other current assets	12,054	12,504
Total current assets	146,533	121,687
Investments	117,884	147,877
Property and equipment, net	78,652	79,771
Goodwill	91,991	92,021
Other intangibles, net	2,020	2,484
Other assets	7,857	8,414
Total assets	\$ 444,937	\$ 452,254
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 1,930	\$ 3,328
Accrued liabilities	11,847	16,205
Accrued restructuring costs	1,337	1,404
Accrued compensation	16,599	19,210
Income taxes payable	2,262	2,512
Deferred revenues	74,362	65,615
Total current liabilities	108,337	108,274
Convertible subordinated notes	42,151	75,000
Long-term deferred revenues	13,428	11,492
Other long-term liabilities	2,680	1,543
Total liabilities	166,596	196,309
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 or outstanding		
Common stock, par value \$0.001, 325,000 shares authorized; 86,876 and 85,128 shares issued as of October 31, 2005 and January 31, 2005, respectively; 84,866 and 83,366 shares outstanding as of October 31, 2005 and January 31, 2005, respectively	87	85
Additional paid-in-capital	784,012	769,953
Treasury stock, 2,010 and 1,762 shares at cost as of October 31, 2005 and January 31, 2005, respectively	(36,154)	(31,972)
Accumulated other comprehensive loss	(6,308)	(5,621)
Accumulated deficit	(463,296)	(476,500)

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Total stockholders' equity	278,341	255,945
Total liabilities and stockholders' equity	\$ 444,937	\$ 452,254

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****(Unaudited)**

	Nine Months Ended	
	October 31,	
	2005	2004
	(In thousands)	
Cash flows from operating activities:		
Net income	\$ 13,204	\$ 1,805
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	7,209	9,069
Amortization of bond issuance costs	263	804
Non-cash compensation, including 401(k) match	1,334	1,378
Realized loss from repurchase of convertible subordinated notes	401	
Realized loss (gain) from sales of available-for-sale securities	321	(185)
Non-cash restructuring charge	446	184
Impairment of assets	313	
Changes in assets and liabilities:		
Accounts receivable	6,460	(7,088)
Accounts payable	(1,350)	(1,386)
Accrued restructuring costs	(513)	(1,157)
Accrued liabilities	(4,092)	5,133
Accrued compensation	(2,217)	2,642
Income taxes payable	(250)	(429)
Deferred revenues	12,493	18,444
Other assets and liabilities	(207)	(2,610)
Net cash provided by operating activities	33,815	26,604
Cash flows from investing activities:		
Acquisitions of property and equipment, net	(4,696)	(4,136)
Capitalized software development costs		(449)
Purchase of investments	(33,705)	(158,293)
Sales of investments	13,894	53,611
Maturities of investments	29,578	66,895
Release of restricted investments		45,167
Net cash provided by investing activities	5,071	2,795
Cash flows from financing activities:		
Issuance of common stock	13,540	12,882
Repurchase of convertible subordinated notes	(32,840)	
Acquisition of treasury stock	(4,995)	
Repayment related to term loan		(40,000)
Net cash used in financing activities	(24,295)	(27,118)

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Effect of exchange rate changes on cash and cash equivalents	(473)	61
Net increase in cash and cash equivalents	14,118	2,342
Cash and cash equivalents at beginning of period	22,312	32,254
Cash and cash equivalents at end of period	\$ 36,430	\$ 34,596

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

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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) is a global leader in Device Software Optimization (DSO). Wind River 's software is used to develop and run 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, Europe (including the Middle East and Africa, EMEA), 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 unaudited condensed consolidated financial statements included herein, 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. These unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements and the notes thereto included in Wind River 's Annual Report on Form 10-K for the fiscal year ended January 31, 2005 filed with the SEC on April 18, 2005.

Wind River believes that all necessary adjustments, which consisted of normal recurring items, have been included in the accompanying 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, 2006. During fiscal 2006, Wind River adjusted its method of allocation of certain costs across all revenue types. This re-allocation of costs has no impact on revenues, overall gross margin or net income for any period presented. Certain other insignificant amounts have been reclassified to conform to the current year presentation.

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 the allowance for doubtful accounts, sales returns and other allowances, restructuring costs, valuation of investments, goodwill and purchased intangibles, income taxes and deferred taxes and associated valuation allowances, revenue recognition, accrued compensation, stock-based compensation and the outcome of litigation and other

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contingencies. Wind River bases its estimates on historical experience and various other assumptions that are believed to be reasonable based on the specific circumstances. These estimates and assumptions form the basis for making judgments about the carrying value of certain assets and liabilities that are not readily apparent from other sources. Actual results could differ from those estimates and could affect future operating results.

Stock-Based Compensation. Wind River issues stock options to its employees and outside directors and provides employees the right to purchase stock pursuant to stock option and employee stock purchase programs. Wind River accounts for its stock-based compensation plans under the intrinsic value method of accounting as defined by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25) and related interpretations. Wind River applies the disclosure provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based Compensation* (SFAS No. 123), as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure an Amendment of SFAS No. 123*. For pro-forma disclosures, the estimated fair value of the options is amortized over the vesting period, typically four years, and the estimated fair value of the stock purchases under the employee stock purchase programs are amortized over the six-month purchase period.

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Wind River accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*. Wind River uses the Black-Scholes option-pricing model to value options granted to non-employees.

Pro Forma Disclosures. Under SFAS No. 123, the fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions used for grants made during the three and nine months ended October 31, 2005 and 2004:

	Three and Nine Months Ended October 31,	
	2005	2004
Risk free interest rate	4.48%	3.10%
Expected volatility	74.5%	81.8%
Expected option life (in years)	3.55	4.06
Expected dividends		

The weighted average fair value per share of employee options granted during the three months ended October 31, 2005 and 2004 was \$7.01 and \$7.18, respectively, and the weighted average fair value per share of options granted during the nine months ended October 31, 2005 and 2004 was \$7.61 and \$6.13, respectively.

The fair value of employees' stock purchase rights under Wind River's 1993 Employee Stock Purchase Plan (the Purchase Plan) was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions used for purchases made during the three and nine months ended October 31, 2005 and 2004:

	Three and Nine Months Ended October 31,	
	2005	2004
Risk free interest rate	3.37%	1.91%
Expected volatility	48.1%	56.8%
Expected option life (in years)	0.5	0.5
Expected dividends		

The weighted average fair value of the common stock purchase rights granted under the Purchase Plan during both the three and nine months ended October 31, 2005 was \$4.55, as compared to a weighted average fair value of \$3.60 per share during both the three and nine months ended October 31, 2004.

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Had compensation expense under these arrangements been determined pursuant to SFAS No. 123 as amended by SFAS No. 148, Wind River's net income (loss) and net income (loss) per share for the three and nine months ended October 31, 2005 and 2004 would have been as follows:

	Three Months Ended		Nine Months Ended	
	October 31,		October 31,	
	2005	2004	2005	2004
(In thousands, except per share amounts)				
Net income:				
As reported	\$ 5,731	\$ 2,264	\$ 13,204	\$ 1,805
Less: Stock-based compensation expense determined under fair-value-based method for all awards	5,165	4,781	16,168	12,443
Pro forma net income (loss)	\$ 566	\$ (2,517)	\$ (2,964)	\$ (10,638)
As reported net income per share:				
Basic	\$ 0.07	\$ 0.03	\$ 0.16	\$ 0.02
Diluted	\$ 0.06	\$ 0.03	\$ 0.15	\$ 0.02
Pro forma net income (loss) per share:				
Basic	\$ 0.01	\$ (0.03)	\$ (0.04)	\$ (0.13)
Diluted	\$ 0.01	\$ (0.03)	\$ (0.04)	\$ (0.13)

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The pro forma amounts include compensation expense related to employee stock option grants and stock purchase rights. The effects of applying SFAS No. 123 on pro forma disclosures of net income (loss) per share in the three and nine months ended October 31, 2005 and 2004 may not be representative of the pro forma effects on net income (loss) per share in future fiscal periods. See *Recent Accounting Pronouncements* below.

Recent Accounting Pronouncements. In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment*, (SFAS No. 123R), that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using the intrinsic value method as prescribed by APB No. 25, *Accounting for Stock Issued to Employees*, and generally requires that such transactions be accounted for using a fair-value-based method and recognized as expenses. The statement requires companies to assess the most appropriate model to calculate the value of the options. Wind River currently uses the Black-Scholes option pricing model to value options and is currently assessing which model it may use in the future under the statement and may deem an alternative model to be the most appropriate. The use of a different model to value options may result in a different fair value than the use of the Black-Scholes option-pricing model. In addition, there are a number of other requirements under the new standard that will result in differing accounting treatment than currently required. These differences include, but are not limited to, the accounting for the tax benefit on employee stock options and for stock issued under Wind River's employee stock purchase plan. In addition to the appropriate fair value model to be used for valuing share-based payments, Wind River will also be required to determine the transition method to be used at date of adoption. The allowed transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS No. 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The effective date of the new standard for Wind River's consolidated financial statements is the first quarter of fiscal 2007. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to the adoption of SFAS No. 123R.

Upon adoption of SFAS No. 123R and SAB 107, these statements will have a significant impact on Wind River's consolidated financial statements, specifically its statement of operations and earnings per share on a quarterly and annual basis, as Wind River will be required to expense the fair value of its stock option grants and stock purchases under its employee stock purchase plan rather than disclose the impact on its consolidated net income within its footnotes as is its current practice. The amounts disclosed herein are not necessarily indicative of the amounts that will be expensed upon the adoption of SFAS No. 123R and SAB 107. Compensation expense calculated under SFAS No. 123R and SAB 107 may differ materially from amounts currently disclosed based on changes in the fair value of Wind River's common stock, changes in the number of options granted or the terms of such options, the treatment of tax benefits and changes in interest rates or other factors. In addition, upon adoption of SFAS No. 123R, Wind River may choose to use a different valuation model to value the compensation expense associated with its employee stock options.

In June 2005, the Financial Accounting Standards Board (FASB) completed its review of Emerging Issues Task Force (EITF) Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1). EITF 03-1 provides accounting guidance regarding the determination of when an impairment of debt and marketable equity securities and investments accounted for under the cost method should be considered other-than-temporary and recognized in income. EITF 03-1 also requires certain quantitative and qualitative disclosures for debt and marketable equity securities classified as available-for-sale or held-to-maturity under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 115), that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. The FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment but has issued FASB Staff Position (FSP) 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (FSP 115-1 and 124-1), which nullifies the accounting guidance on the determination of whether an investment is other-than-temporarily impaired as set forth in EITF 03-1. FSP 115-1 and 124-1 are effective on a prospective basis for other-than-temporary impairments on certain investments in reporting periods beginning after December 15, 2005. EITF 03-1 was effective December 31, 2003 and will remain in effect until the adoption of FSP 115-1 and 124-1. Wind River has complied with its disclosure requirements, which were presented in Wind River's Annual Report on Form 10-K for the fiscal year ended January 31, 2005. Wind River does not anticipate that the adoption of FSP 115-1 and 124-1 will have a material impact on its results of operations, cash flows, or financial position.

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In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements* (SFAS No. 154). This statement changes the requirements for the accounting for and reporting of a change in accounting

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principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS No.154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements. Wind River does not believe adoption of SFAS No. 154 will have a material effect on Wind River's results of operations, cash flows, or financial position.

Note 2: Derivative Financial Instruments

Wind River may enter into foreign currency forward exchange contracts to manage foreign currency exposures related to certain non-functional currency related inter-company and other balances. Additionally, Wind River may adjust its foreign currency hedging position by taking out additional contracts or by terminating or offsetting existing forward contracts. These adjustments may result from changes in the underlying non-functional currency exposures or from fundamental shifts in the economics of particular exchange rates. Realized gains and losses on terminated forward contracts, or on contracts that are offset, are recognized in income in the period of contract termination or offset. Wind River's ultimate realized gain or loss with respect to currency fluctuations will depend on the currency exchange rates and other factors in effect as the contracts mature. As of October 31, 2005, Wind River had outstanding contracts with the following terms:

Buy / Sell:	Sell	Buy	Sell	Buy	Buy
Currency:	GBP(£)	EURO()	JPY(¥)	CAD(CAD\$)	SEK(kr)
Amount:	1,800,000	11,400,000	130,000,000	600,000	18,000,000
Rate:	0.5603	0.8205	115.05	1.1767	7.7995
USD Equivalent:	\$ 3,212,640	\$ 13,893,180	\$ 1,129,944	\$ 509,914	\$ 2,307,840
Maturity Date:	11/30/2005	11/30/2005	11/30/2005	11/30/2005	11/30/2005

Contract amounts are representative of the expected amounts to be paid under the terms of these instruments. Wind River does not enter into derivative financial instruments for trading or speculative purposes. As of October 31, 2005, the fair value of the above contracts was not significant.

Note 3: Deferred Revenues

Deferred revenues consist of the following:

	As of	As of
	October 31,	January 31,
	2005	2005
	(In thousands)	
Current deferred revenues:		
Subscription	\$ 46,611	\$ 40,910

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Maintenance and other	27,751	24,705
	<u> </u>	<u> </u>
Total current deferred revenues	74,362	65,615
Long-term deferred revenues:		
Subscription	12,583	11,067
Maintenance and other	845	425
	<u> </u>	<u> </u>
Total long-term deferred revenues	13,428	11,492
	<u> </u>	<u> </u>
Total deferred revenues	\$ 87,790	\$ 77,107
	<u> </u>	<u> </u>

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. 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 include primarily deferred service revenues and maintenance revenues. Deferred service revenues include pre-payments for software consulting and other product services, including software license transactions that are not disaggregated from consulting services. Revenue for these services is recognized as the services are performed. 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.

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Wind River accounts for goodwill in accordance with the provisions of SFAS No. 142. Accordingly, the balance of goodwill of \$92.0 million at both October 31, 2005 and January 31, 2005 is not amortized but is evaluated for impairment annually as well as when circumstances indicate a possible impairment. The annual impairment assessment was performed during the second quarter of fiscal 2006. The primary methods used to determine the fair values for SFAS No. 142 *Goodwill and Other Intangible Assets* (SFAS No. 142) impairment purposes were the income and market approach. The income approach provides an estimation of the fair value of a reporting unit based on the discounted cash flows derived from the reporting unit's estimated remaining life plus any residual value. The market approach indicates the fair value of a reporting unit based upon a comparison to publicly-traded companies in similar lines of business. The assumptions supporting the income approach, including the discount rate, which was assumed to be 14% for fiscal 2006 compared to 17% for fiscal 2005, were determined using Wind River's best estimates as of the impairment review. Wind River completed its evaluation under both methods and concluded that goodwill was not impaired at June 30, 2005, as the fair value of the reporting unit exceeded its carrying value, including goodwill. There were no events or circumstances from the date of the annual impairment assessment through October 31, 2005 that indicated a further assessment was necessary. The reduction in goodwill between January 31, 2005 and October 31, 2005 of \$30,000 is related to an adjustment to the purchase price associated with the acquisition of the ScopeTools business unit of RTI in the fourth quarter of fiscal 2005.

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Note 6: Convertible Subordinated Notes and Other Borrowings

In December 2001, Wind River issued \$150.0 million of 3.75% convertible subordinated notes due December 2006. 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 on June 15 and December 15 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 may redeem all or a portion of the notes for cash at the redemption price of 100.75% of the principal amount between December 15, 2004 and December 15, 2005 and 100.0% of the principal amount beginning December 15, 2005 and thereafter.

During fiscal 2005, Wind River repurchased \$75.0 million of the notes on the open market at an aggregate price of \$75.4 million. Additionally, Wind River expensed \$1.0 million in related bond issuance costs, resulting in a total recognized loss on the repurchase of \$1.4 million.

In March 2005, Wind River repurchased an additional \$20.0 million of its 3.75% convertible subordinated notes in the open market at an aggregate price of \$20.1 million. Wind River expensed \$257,000 in related bond issuance costs, resulting in a total recognized loss on the additional repurchase of \$312,000.

In June 2005, Wind River repurchased an additional \$12.8 million of its 3.75% convertible subordinated notes in the open market at an aggregate price of \$12.8 million, purchased at a nominal discount. Wind River expensed \$153,000 in related bond issuance costs, resulting in a total recognized loss on the repurchase of \$89,000. As of October 31, 2005, \$42.2 million in convertible subordinated notes (convertible into 1.7 million shares) remained outstanding.

In April 2003, in connection with the termination of the synthetic leases associated with Wind River's headquarters facility, Wind River entered into a loan facility with a financial institution in the aggregate principal amount of \$57.4 million, consisting of a non-revolving loan commitment of \$37.4 million and a term loan of \$20.0 million, of which \$40.0 million was borrowed during fiscal year 2004. During the second quarter of fiscal 2005, Wind River repaid all outstanding borrowings under the loan facility, releasing \$46.3 million held in restricted investments in connection with the loan facility and leaving the original facility of \$17.5 million available through October 2005. On April 29, 2005, Wind River elected to terminate the loan facility.

Note 7: Provision for Income Taxes

Wind River recorded a tax provision of \$1.1 million and \$690,000 for the three months ended October 31, 2005 and 2004, respectively, and \$2.0 million and \$1.6 million for the nine months ended October 31, 2005 and 2004, respectively. The Company realized net tax benefits of approximately \$101,000 and \$715,000 for the nine months ended October 31, 2005 and 2004, respectively, due primarily to the finalization of foreign tax audits. Wind River's quarterly tax provision is based on estimates of its expected liability for domestic and foreign income and withholding taxes that will be incurred during the year. The Company's effective tax rate is lower than the statutory rate due to a number of factors, including the utilization of various tax attributes not previously benefited such as net operating losses and tax credits. Wind River's tax rate may also vary based on its results and the mix of income or loss amongst the domestic and foreign tax jurisdictions in which it operates.

Deferred income taxes are recorded in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS No. 109) and are determined based on the differences between financial reporting and the tax basis of assets and liabilities using the tax rates and laws in effect when the differences

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are expected to reverse. SFAS No. 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 Germany, Wind River has determined that it is more likely than not that its deferred tax assets in the remaining jurisdictions will not be realized, due primarily to uncertainties related to the Company's ability to utilize its net operating losses carried forward and foreign tax credits, before they expire. Accordingly, Wind River has recorded a deferred tax asset of \$631,000 and \$682,000 related to its Germany subsidiary and a full valuation allowance against the remainder of its deferred tax assets at October 31, 2005 and January 31, 2005, respectively.

Should Wind River determine that it would be able to realize its deferred tax assets in the foreseeable future, an adjustment to its deferred tax assets would cause a material increase to income in the period such determination was made. Significant management judgment is required in determining the period in which the reversal of a valuation allowance should occur. In the third quarter of fiscal 2006, Wind River considered 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 partial or full release of its valuation allowance was required. Wind River concluded that a release of its valuation allowance was not yet appropriate.

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The valuation allowance at January 31, 2005, Wind River's last fiscal year end, was \$76.6 million. Wind River estimates that when this valuation allowance is released, approximately \$51.4 million will result in an income tax benefit to the statement of operations and approximately \$25.2 million relating to stock option exercises and related tax credits will be credited directly to additional paid in capital. Wind River will continue to evaluate the realizability of our deferred tax assets and related valuation allowances on a quarterly basis.

Note 8: Comprehensive Income (Loss)

Comprehensive income (loss) is defined as the change in equity of a company during a period from transactions and other events and circumstances, excluding transactions resulting from investments by owners and distributions to owners. The difference between net income (loss) and comprehensive income (loss) results from foreign currency translation adjustments, mark-to-market adjustments and unrealized gains and losses on available-for-sale securities.

Comprehensive income (loss) for the three and nine months ended October 31, 2005 and 2004 is as follows:

	Three Months Ended		Nine Months Ended	
	October 31,		October 31,	
	2005	2004	2005	2004
	(In thousands)			
Net income:	\$ 5,731	\$ 2,264	\$ 13,204	\$ 1,805
Other comprehensive income (loss):				
Foreign currency translation adjustments	201	167	108	350
Unrealized gain (loss) on investments	(173)	209	(1,116)	(2,090)
Reclassification adjustment for (gain) loss included in net income	59	80	321	(185)
Other comprehensive income (loss):	87	456	(687)	(1,925)
Total comprehensive income (loss):	\$ 5,818	\$ 2,720	\$ 12,517	\$ (120)

Note 9: Net Income Per Share Computation

In accordance with SFAS No. 128, *Earnings Per Share*, the calculation of shares used in basic and diluted net income per share computation is presented below:

	Three Months Ended	Nine Months Ended
	October 31,	October 31,

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fiscal 2003. In June 2004, the Board of Directors extended the term of the existing share repurchase program for an additional two years through June 2006. In addition, the Board approved the purchase of 300,000 shares each year for replenishment of the Employee Stock Purchase Plan (ESPP). In the three months ended October 31, 2005, Wind River repurchased 408,700 shares of Wind River's common stock for an aggregate total purchase price of approximately \$5.0 million with the repurchased shares being recorded as Treasury Stock. For the nine months ended October 31, 2005, the share repurchase program provided 160,658 shares for issuance to employees in June 2005 under the ESPP yielding total proceeds of approximately \$1.9 million.

Note 11: Stock Based Compensation Plan

On June 8, 2005, the stockholders of Wind River approved 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 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. The 2005 Equity Plan will terminate ten years from the date of adoption by the Board. The 2005 Equity Plan replaces the 1987 Equity Incentive Plan, 1995 Non-Employee Directors Stock Option Plan, the 1998 Non-Officer Stock Option Plan and the 1998 Equity Incentive Plan (the Predecessor Plans). No further awards will be granted under the Predecessor Plans. A maximum of 6,250,000 shares of Common Stock are available for issuance under the 2005 Equity Plan, plus any shares subject to any outstanding options under the Predecessor Plans that subsequently expire unexercised up to a maximum of an additional 2,500,000 shares.

Note 12: Commitments and Contingencies

Litigation

From time to time, Wind River is subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of patents and other intellectual property rights. Management believes the outcome of Wind River's outstanding legal proceedings, claims and litigation will not have a material adverse effect on Wind River's business, results of operations, cash flows or financial condition. However, such matters involve complex questions of fact and law and could involve significant costs and the diversion of resources to defend. Additionally, the results of litigation are inherently uncertain, and an adverse outcome is at least reasonably possible. Quarterly, Wind River reviews the status of each significant matter and assesses our potential financial exposure. If the potential loss from any claim or legal proceeding is considered probable and the amount can be reasonably estimated, we accrue a liability for the estimated loss. As additional information becomes available, Wind River reassesses the potential liability related to its pending claims and litigation and may revise its estimates. Such revisions in the estimates of the potential liabilities could have a material impact on our consolidated results of operations, cash flows, or financial position.

On June 7, 2004, Wind River filed a complaint against Green Hills Software, Inc. (Green Hills), a direct competitor, in the Superior Court of California, County of Alameda. The action was transferred to the Superior Court of California, County of Santa Barbara. The subsequently amended complaint requested \$25,000 in damages due to breach by Green Hills of a cooperative marketing and technology agreement entered into between the parties in October 1992. Green Hills subsequently filed an answer and cross-complaint in that action. On January 18, 2005, Green Hills filed a complaint against Wind River in the United States District Court for the Central District of California alleging, among other things, that Wind River violated antitrust and unfair competition laws by allegedly refusing to license its VxWorks product to Green Hills and refusing to market VxWorks separately from the integrated development environment for VxWorks. Green Hills requested an award for damages and injunctive relief on these matters. On June 10, 2005, Wind River and Green Hills entered into a non-monetary settlement

agreement regarding the above-described claims. Each party's request for dismissal without prejudice of its respective complaint or cross-complaint in the above-described state claims was dismissed on June 20, 2005. Green Hill's request for dismissal without prejudice of its complaint in the above-described federal claims was dismissed on July 7, 2005.

Guarantees

In the normal course of business, Wind River may agree to indemnify its customers against legal claims that Wind River's software products infringe certain third-party intellectual property rights. In the event of such a claim, Wind River is generally obligated to defend its customer against the claim and to either settle the claim at Wind River's expense or pay damages that the customer is legally required to pay to the third-party claimant. In addition, in the event of an infringement, Wind River may agree to refund the cost of the software. To date, Wind River has not been required to make any payment resulting from infringement claims asserted against our customers. In a limited number of circumstances, Wind River may also agree to indemnify customers against legal claims that open source software, which is included in certain Wind River

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products, infringes upon certain third-party intellectual property rights. These guarantees are recorded at their fair value; however, to date the value of these guarantees has not been significant. Some agreements may not limit the time within which an indemnification claim can be made. It is not possible to determine the maximum potential amount under these indemnification agreements due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement. Historically, payments made by Wind River, if any, under these agreements have not had a material impact on Wind River's consolidated results of operations, cash flows, or financial position.

Note 13: Segment and Geographic Information

Wind River reports in one industry segment—technology for device operating systems and provides the disclosures required in accordance with SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*. The Wind River business is principally managed on a consolidated basis. Wind River markets its products and related services to customers in four geographic regions: North America (the United States and Canada), EMEA, Japan and Asia Pacific. Internationally, Wind River markets its products and services primarily through its subsidiaries and various distributors. Revenues are generally attributed to geographic areas based on the country in which the customer is domiciled.

Revenue and long-lived asset information by region is presented below:

	Revenues				Long-lived Assets	
	Three Months Ended		Nine Months Ended		As of	As of
	October 31,		October 31,		Oct. 31,	Jan. 31,
	2005	2004	2005	2004	2005	2005
	(In thousands)					
North America (1)	\$ 37,220	\$ 33,268	\$ 107,562	\$ 93,839	\$ 79,554	\$ 80,684
EMEA	15,478	13,155	44,853	40,209	4,183	4,758
Japan	9,438	9,481	27,445	24,816	2,356	2,406
Asia Pacific	5,471	4,091	16,253	13,341	416	337
Total	\$ 67,607	\$ 59,995	\$ 196,113	\$ 172,205	\$ 86,509	\$ 88,185

(1) Represents revenue and long-lived assets primarily in the United States.

Revenue information on a product, subscription and services basis is presented below:

Three Months Ended	Nine Months Ended
October 31,	October 31,

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	2005	2004	2005	2004
	(In thousands)			
Perpetual license revenues	\$ 11,440	\$ 12,221	\$ 33,253	\$ 39,006
Production license revenues	20,005	20,009	61,054	51,199
Subscription revenues	18,450	12,387	52,798	34,224
Maintenance revenues	8,108	9,555	25,110	29,219
Other service revenues	9,604	5,823	23,898	18,557
Total	\$ 67,607	\$ 59,995	\$ 196,113	\$ 172,205

No single customer accounted for more than 10% of Wind River's total revenues, net in the three and nine months ended October 31, 2005 and 2004, respectively.

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

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains statements that we believe are, or may be considered to be, forward-looking statements within the meaning of various provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. These forward-looking statements generally can be identified by use of statements that include words such as could, may, believe, expect, anticipate, intend, plan, seek, estimate, foresee, project and similar expressions and are found in the sections below entitled Overview, Liquidity and Capital Resources, Results of Operations and Factors That May Affect Our Future Results or the Market Price of Our Stock and elsewhere in this Quarterly Report. These forward-looking statements include, but are not limited to, statements related to our expected business, results of operations, future financial position, business strategy, including our adoption of an open source strategy, our shift to an enterprise licensing model and the continued shift of our customers to our Wind River Platforms, our ability to increase our revenues, including deferred revenues, our financing plans and capital requirements, our investments, our expenses and tax liability, the effect of recent accounting pronouncements, debt service and principal repayment obligations, cash flows, forecasted trends relating to our services or the markets in which we operate and similar matters and include statements based on current expectations, estimates, forecasts and projections about the economies and markets in which we operate and our beliefs and assumptions regarding these economies and markets. Factors that could cause or contribute to such differences include but are not limited to the success of Wind River's implementation of its new and current business models, products and market strategies, a decline in the rate of adoption of our enterprise license model, the impact of timing on our reported revenue based on our enterprise license model, adoption of our open source strategy, the ability of our customers to sell products that include our software, our ability to address new markets and complex technologies by delivering successful, new products on a timely basis, the impact of competitive products and pricing, the success of our strategic relationships, charges for restructuring and other costs and other risk factors detailed in this Quarterly Report on Form 10-Q and in Wind River's Annual Report on Form 10-K for the fiscal year ended January 31, 2005 (2005 Form 10-K), its Quarterly Reports on Form 10-Q and other periodic filings with the Securities and Exchange Commission (SEC).

These forward-looking statements are based on current expectations and involve known and unknown risks and uncertainties that may cause the results, levels of activity, performance or achievements of Wind River or its industry to be materially different from those expressed or implied by the forward-looking statements. You should carefully review the risk factors described in the Factors That May Affect Our Future Results or the Market Price of Our Stock section below and in other documents we file from time to time with the SEC, including our 2005 Form 10-K, and the other quarterly and other reports we file. We do not intend to update any of the forward-looking statements contained in this report to reflect any future events or developments unless required by law.

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes included elsewhere in this report.

Overview

Wind River is a global leader in Device Software Optimization (DSO). Our software is used to develop and run devices better, faster, at a lower cost and more reliably. Our 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.

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For additional information about our business and operating model, please see Executive Operating and Financial Summary under Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2005 Form 10-K.

Recent Operating Results

Our total revenues were \$67.6 million and \$60.0 million for the three months ended October 31, 2005 and 2004, respectively, and \$196.1 million and \$172.2 million for the nine months ended October 31, 2005 and 2004, respectively. Our net income was \$5.7 million and \$2.3 million or a net income of \$0.06 and \$0.03 per diluted share in the three months ended October 31, 2005 and 2004, respectively, and \$13.2 million and \$1.8 million or a net income of \$0.15 and \$0.02 per diluted share for the nine months ended October 31, 2005 and 2004, respectively.

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Our total deferred revenue increased to \$87.8 million at October 31, 2005 from \$77.1 million at January 31, 2005, primarily as a result of our growth in subscription deferred revenue. Of the total deferred revenue balance at October 31, 2005 and January 31, 2005, \$13.4 million and \$11.5 million, respectively, relates to deferred revenue classified as long-term. This deferred revenue relates to the portion of multi-year contracts that is due to be recognized as revenue in a time period greater than one year from the balance sheet date.

We generated cash flow from operations of \$33.8 million and \$26.6 million in the nine months ended October 31, 2005 and 2004, respectively. We repurchased \$12.8 million and \$20.0 million of our 3.75% convertible subordinated notes in June 2005 and March 2005, respectively. We also repurchased 408,700 shares of our common stock for an aggregate purchase price of approximately \$5.0 million during the nine months ended October 31, 2005.

Critical Accounting Policies and Estimates

Management's discussion and analysis of our financial condition and results of operations are based upon our condensed consolidated financial statements, which were prepared in accordance with accounting principles generally accepted in the United States, or GAAP. GAAP requires us 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. Note 2, Summary of Significant Accounting Policies in notes to consolidated financial statements in our 2005 Form 10-K describes our significant accounting policies which are reviewed by us on a regular basis and which are also reviewed by senior management with the Audit Committee of our Board of Directors.

An accounting policy is deemed by us to be critical if it requires an accounting estimate to be made based on assumptions about matters that are uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact the financial statements. The policies and estimates that we believe are most critical to an understanding of our financial results and condition and that require a higher degree of judgment and complexity are:

Revenue recognition;

Estimating sales returns and other allowances, and allowance for doubtful accounts;

Valuation of long-lived assets, including goodwill and purchased intangibles;

Restructuring charges;

Accounting for income taxes;

Stock-based compensation; and

Litigation contingencies.

For a more comprehensive discussion of these critical accounting policies, please see Critical Accounting Policies and Estimates, under Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations in our 2005 Form 10-K.

Results of Operations for the Three and Nine Months Ended October 31, 2005 and 2004

Revenues

We recognize revenues from three sources: (1) product revenues, (2) service revenues and (3) subscription revenues, net of sales returns and other allowances. Product revenues consist of revenues from production licenses (sometimes referred to as royalties), and fees for stand-alone software and software programming tools sold under our perpetual licensing model and from sales of our hardware. Service revenues are derived from fees from professional services, which include design and development fees, software maintenance contracts, and customer training and consulting. Subscription revenues consist of revenues from the licensing of products and services under our enterprise licensing model, such as our Wind River Platforms which include items such as development tools, an operating system, various protocols and interfaces and maintenance and support services such as installation and training, which are licensed over a limited period of time, typically 12 months.

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	Three Months Ended		Percentage of		Nine Months Ended		Percentage of	
	October 31,		Total Revenues, net		October 31,		Total Revenues, net	
	2005	2004	2005	2004	2005	2004	2005	2004
	(In thousands, except percentages)							
Product revenues	\$ 31,445	\$ 32,230	47%	54%	\$ 94,307	\$ 90,205	48%	52%
Subscription revenues	18,450	12,387	27	20	52,798	34,224	27	20
Service revenues	17,712	15,378	26	26	49,008	47,776	25	28
Total revenues, net	\$ 67,607	\$ 59,995	100%	100%	\$ 196,113	\$ 172,205	100%	100%

Total revenues increased 13% in the three months ended October 31, 2005 compared to the three months ended October 31, 2004 and increased 14% in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004. This was primarily due to higher customer demand for our software, in particular subscription revenues, and for the nine months ended October 31, 2005, production license revenues.

Our product and service revenues, which include maintenance revenues, have also been affected as the result of the continued transition of some of our customers to our Wind River Platforms. Fees from the Wind River Platforms are recorded as subscription revenue ratably over the license term, which is typically one year. In contrast, under our perpetual model, a significant percentage of the transaction fee is recognized in the quarter the transaction is completed. This has impacted, and will continue to impact, our revenues in the short-term as customers transition to the Wind River Platforms. Deferred revenues grew by \$10.7 million from \$77.1 million at January 31, 2005 to \$87.8 million at October 31, 2005, primarily due to an increase in subscription related sales.

Product Revenues. Product revenues are comprised of perpetual license revenues, including hardware revenues, and production license revenues from perpetual and subscription licensing. The table below sets forth information for such components.

	Three Months Ended		Percentage of		Nine Months Ended		Percentage of	
	October 31,		Total Revenues, net		October 31,		Total Revenues, net	
	2005	2004	2005	2004	2005	2004	2005	2004
	(In thousands, except percentages)							
Perpetual license revenues	\$ 11,440	\$ 12,221	17%	20%	\$ 33,253	\$ 39,006	17%	22%
Production license revenues	20,005	20,009	30	34	61,054	51,199	31	30
Total product revenues	\$ 31,445	\$ 32,230	47%	54%	\$ 94,307	\$ 90,205	48%	52%

Perpetual license revenues declined 6% or \$781,000 in the three months ended October 31, 2005 compared to the three months ended October 31, 2004 and 15% or \$5.8 million in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004. This decline was primarily due to the transition to our Wind River Platforms, which are accounted for as subscription revenues. We expect

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perpetual license revenues to continue to decline as the transition to our Wind River Platforms continues.

Production license revenues remained unchanged in the three months ended October 31, 2005 compared to the three months ended October 31, 2004 and increased 19% or \$9.9 million in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004. The increase in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004 was primarily due to our customers focus in the networking and consumer devices segments, further improvement in our execution of our revenue assurance program, which includes increased monitoring of customer license compliance and improvement in our customer's own quarterly reporting processes.

Subscription Revenues. Subscription revenues increased 49% or \$6.1 million in the three months ended October 31, 2005 compared to the three months ended October 31, 2004 and 54% or \$18.6 million in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004. These increases in subscription revenues resulted primarily from the continued transition of a number of our customers from our traditional perpetual licensing model to our Wind River Platforms under the enterprise license model, also known as our subscription model, and increasing volumes of subscription business with these customers. We expect that subscription revenues will continue to increase both in absolute dollars and as a percentage of revenue in the future. The transition of customers to our enterprise license model will continue to affect the level of our overall revenues because we recognize fees under this business model ratably as opposed to our perpetual model where a significant proportion of the fee is recognized at the time the transaction is completed.

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Service Revenues. Service revenues are derived from fees for professional services, which include design and development fees, software maintenance contracts, customer training and consulting.

	Three Months Ended		Percentage of		Nine Months Ended		Percentage of	
	October 31,		Total Revenues, net		October 31,		Total Revenues, net	
	2005	2004	2005	2004	2005	2004	2005	2004
	(In thousands, except percentages)							
Maintenance revenues	\$ 8,108	\$ 9,555	12%	16%	\$ 25,110	\$ 29,219	13%	17%
Other service revenues	9,604	5,823	14	10	23,898	18,557	12	11
Total service revenues	\$ 17,712	\$ 15,378	26%	26%	\$ 49,008	\$ 47,776	25%	28%

Maintenance revenues declined 15% or \$1.4 million in the three months ended October 31, 2005 compared to the three months ended October 31, 2004 and decreased 14% or \$4.1 million in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004. The decline is primarily due to the continued transition of our customers to our Wind River Platforms, which include maintenance as a part of the subscription fee. We expect maintenance revenues will continue to decline as our customers continue to transition to our Wind River Platforms. Other service revenues, which consist of professional services and training, increased 65% or \$3.8 million in the three months ended October 31, 2005 compared to the three months ended October 31, 2004 and 29% or \$5.3 million in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004 primarily due to increased demand. In the three months ended October 31, 2005, we generated \$2.5 million in revenue from fixed-price services contracts compared to \$2.2 million in the three months ended October 31, 2004 and \$7.8 million in the nine months ended October 31, 2005 compared to \$3.9 million in the nine months ended October 31, 2004. Fixed-price services contracts are accounted for under the percentage-of-completion method of accounting. Time and materials services contracts are recognized as services are performed.

Revenues by Geography

	Three Months Ended		Percentage of		Nine Months Ended		Percentage of	
	October 31,		Total Revenues, net		October 31,		Total Revenues, net	
	2005	2004	2005	2004	2005	2004	2005	2004
	(In thousands, except percentages)							
North America	\$ 37,220	\$ 33,268	55%	55%	\$ 107,562	\$ 93,839	55%	55%
EMEA	15,478	13,155	23	22	44,853	40,209	23	23
Japan	9,438	9,481	14	16	27,445	24,816	14	14
Asia Pacific	5,471	4,091	8	7	16,253	13,341	8	8
Total revenues, net	\$ 67,607	\$ 59,995	100%	100%	\$ 196,113	\$ 172,205	100%	100%

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Revenues from international sales increased 14% to \$30.4 million in the three months ended October 31, 2005 from \$26.7 million in the three months ended October 31, 2004 and 13% to \$88.6 million in the nine months ended October 31, 2005 from \$78.4 million in the nine months ended October 31, 2004. The overall increase was primarily due to a 12% and 15% increase in North America and an 18% and 12% increase in revenues from EMEA for the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004, respectively. The increases in revenues in each geographic area over these periods resulted primarily from higher customer demand for our software, both domestically and internationally. The impact of foreign exchange rate movements did not have a significant impact on international revenues during the three and nine months ended October 31, 2005. International revenues accounted for 45% of total revenues for the three months ended October 31, 2005 and 2004, and 45% and 46% of total revenues for the nine months ended October 31, 2005 and 2004, respectively. We expect international sales to continue to represent a significant portion of our revenues, although the actual percentage may fluctuate from period to period. Our international sales are generally denominated in United States Dollar, Euro, United Kingdom Sterling or Japanese Yen.

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Our deferred revenues consist of the following:

	As of	As of		
	Oct. 31,	Jan. 31,	Dollar	Percentage
	2005	2005	Change	Change
(In thousands, except percentages)				
Current deferred revenues:				
Subscriptions	\$ 46,611	\$ 40,910	\$ 5,701	14%
Maintenance and other	27,751	24,705	3,046	12
Total current deferred revenues	74,362	65,615	8,747	13
Long-term deferred revenues:				
Subscriptions	12,583	11,067	1,516	14
Maintenance and other	845	425	420	99
Total long-term deferred revenues	13,428	11,492	1,936	17
Total deferred revenues	\$ 87,790	\$ 77,107	\$ 10,683	14%

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. 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 include primarily deferred service revenues and maintenance revenues. Deferred service revenues include pre-payments for software consulting and other product services, including software license transactions that are not segmented from consulting services. Revenue for these services is recognized as the services are performed. 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.

The growth in subscription deferred revenues results from the continued transition from our traditional perpetual licensing model to our Wind River Platforms enterprise license model and increasing business activity levels for this business model. The growth in deferred revenues for subscriptions during the nine months ended October 31, 2005 corresponds to the 34% increase in subscription revenue for the nine months ended October 31, 2005 as compared to the nine months ended January 31, 2005. The growth in deferred revenues for maintenance and other during the nine months ended October 31, 2005 relates primarily to the additional deferred consulting services revenue, due to timing differences between customer billings and revenue recognition.

Cost of Revenues

Three Months Ended	Percentage of	Nine Months Ended	Percentage of
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	October 31,		Total Revenues, net		October 31,		Total Revenues, net	
	2005	2004	2005	2004	2005	2004	2005	2004
	(In thousands, except percentages)							
Product	\$ 1,957	\$ 1,690	3%	3%	\$ 5,188	\$ 4,210	3%	2%
Subscription	2,939	2,876	4	5	8,610	8,361	4	5
Service	10,119	7,581	15	13	28,604	24,344	15	14
Amortization of purchased intangibles	133	309		1	395	1,630		1
Total cost of revenues	\$ 15,148	\$ 12,456			\$ 42,797	\$ 38,545		
Gross margin	\$ 52,459	\$ 47,539			\$ 153,316	\$ 133,660		
Gross margin percentage	78%	79%			78%	78%		

The general increase in overall costs of products and services, excluding amortization of purchased intangibles, was primarily attributable to personnel related costs. During fiscal 2006, we adjusted the method of allocation of certain costs across all revenue types. This re-allocation of costs has no impact on revenues, overall gross margin or net income for any period presented.

Cost of Product. Product-related costs consist primarily of salaries and benefits for employees involved in production, other direct production costs, amortization of capitalized software development costs, royalty payments to third parties for the use of their software, and shipping costs. The increase in absolute dollars of cost of product in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was \$267,000 and \$978,000, respectively. The increase was primarily due to increased hardware costs and manufacturing and distribution costs offset by a

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decrease in third party royalty costs due primarily to the acquisition of the ScopeTools business unit of Real-Time Operations, Inc. (RTI) in the fourth quarter of fiscal 2005 consequently eliminating certain royalty expenses following the acquisition. Product-related cost of revenues may be affected in the future by costs of distribution related to the introduction of new products, royalty costs for use of third-party software in our products and by the amortization of capitalized software development costs.

Cost of Subscription. Subscription-related costs consist primarily of salaries and benefits for employees, other direct production costs, amortization of capitalized software development costs, royalty payments to third parties for the use of their software, shipping costs and costs of providing subscription-related maintenance and support services. The increase in absolute dollars of cost of subscription in the three months ended October 31, 2005 compared to the three months ended October 31, 2004 was \$63,000 and the increase in absolute dollars of the cost of subscription to the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004 was \$249,000. Subscription-related maintenance and support service costs were \$1.9 million and \$5.6 million in the three and nine months ended October 31, 2005 compared to \$1.8 million and \$5.0 million in the three and nine months ended October 31, 2004, respectively. Subscription-related production costs were \$785,000 and \$2.2 million in the three and nine months ended October 31, 2005 compared to \$907,000 and \$2.5 million in the three and nine months ended October 31, 2004. The increase in absolute dollars in subscription costs in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004 was primarily due to the increase in subscription revenue. The decrease in subscription costs as a percentage of subscription revenues in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was primarily related to a lower utilization of support services. We expect costs of subscriptions to continue to fluctuate as a percentage of subscription revenue based on the level of sales of our Wind River Platforms and the continued transition of existing customers from our perpetual based licensing to the enterprise license model. Cost of subscriptions may be affected in the future by the direct production costs, amortization of capitalized software development costs, costs of distribution, royalty costs for use of third party software in our products, and the costs of providing subscription-related maintenance and support services.

Cost of Service. Service-related cost of revenues consist primarily of personnel related costs associated with providing services, including consulting services, to customers and the infrastructure to manage a services organization, as well as costs to recruit, develop and retain services professionals. The increase in absolute dollars of cost of service in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was \$2.5 million and \$4.3 million, respectively. The increase in absolute dollars of service costs in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was primarily due to an increase in full-time employees and use of outside consultants for our professional services. The increase in service costs as a percentage of service revenues in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was primarily related to a lower utilization of support services associated with our subscription business. We expect cost of services to continue to fluctuate as a percentage of service revenue based on our ability to fully utilize our professional services organization.

Amortization of Purchased Intangibles. Amortization of purchased intangibles relates to amortization of completed technology acquired through purchase transactions. The decrease in amortization in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was due to a lower amortizable base of purchased intangible assets during the respective periods. In January 2005, we acquired the assets and obligations of the ScopeTools business unit of RTI and recorded \$2.1 million in completed technology which is expected be amortized to cost of revenue over a four-year period on a straight-line basis.

Operating Expenses

We allocate the total costs for information technology, facilities and fixed asset depreciation to each of the functional areas based on worldwide headcount data. Information technology allocated costs includes salaries, employee-related costs, outside consulting costs for projects, communication costs, hardware and software maintenance contracts costs and depreciation expense for fixed assets. Facilities allocated costs include facility rent for the corporate offices as well as shared function offices, property taxes, depreciation expenses for office furniture and other department operating costs. Fixed asset depreciation allocated costs include straight-line depreciation expense on buildings, leasehold improvements, computer equipment, software, furniture and office equipment.

The general increase in absolute dollars in selling and marketing, product development and engineering and general and administrative costs, relates primarily to increases in personnel expenses, consulting expenses and general operating expenses.

Selling and Marketing. Selling and marketing expenses consist primarily of product and other marketing related expenses, compensation related expenses, sales commissions, facility costs and travel costs.

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	Three Months Ended			Nine Months Ended		
	October 31,		Percentage	October 31,		Percentage
	2005	2004		2005	2004	
	(In thousands, except percentages)					
Selling and marketing	\$ 23,418	\$ 23,038	2%	\$ 71,588	\$ 66,622	7%
As a percentage of net revenues	35%	38%		37%	39%	

The increase in absolute dollars of selling and marketing expenses in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was \$380,000 and \$5.0 million, respectively. In the three months ended October 31, 2005 compared to the three months ended October 31, 2004, sales commission costs increased by \$831,000 due to the increase in revenue and salaries and related fringe benefit costs increased by \$328,000 due to increased headcount in the sales organization. These increases were partially offset by certain operating efficiencies as well as a decrease in bad debt expense of \$426,000, due primarily to the collection of accounts receivables that had previously been written off because of collectibility issues. In the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004, salaries and related fringe benefit costs increased by \$1.8 million due to increased headcount in the sales organization and sales commissions increased by \$2.0 million due to the increase in revenue. In addition, advertising increased by \$805,000, due to increased investment in marketing expenditures to strengthen the Wind River brand and travel expense increased by \$943,000. Selling and marketing costs declined as a percentage of revenues for the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004, due to the fixed elements of selling and marketing costs being spread over a higher revenue base. We expect an increase in selling and marketing expenses in absolute dollars in both the short- and long-term as we continue to focus on long-term growth in the areas of sales and marketing personnel and marketing and advertising programs.

Product Development and Engineering Expenses. Product development and engineering expenses consist primarily of payroll related expenses, facility costs and consulting fees for our product research and development organization.

	Three Months Ended			Nine Months Ended		
	October 31,		Percentage	October 31,		Percentage
	2005	2004		2005	2004	
	(In thousands, except percentages)					
Product development and engineering	\$ 16,193	\$ 15,010	8%	\$ 49,862	\$ 44,341	12%
As a percentage of net revenues	24%	25%		25%	26%	

The increase in absolute dollars of product development and engineering expenses in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was \$1.2 million and \$5.5 million, respectively. This increase was primarily due to increases in overall expenditures in research and development programs to ensure that our products continue to meet our customer demands. During the three months ended October 31, 2005 compared to the three months ended October 31, 2004, salaries and related fringe benefit costs increased by \$182,000 and external consultant costs increased by \$523,000. These increases were partially offset by a decrease in engineering incentive program expense of \$298,000 and savings in other areas. During the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004, salaries and related fringe benefit costs increased by \$3.1 million due to increased headcount and external consultant costs increased by \$1.8 million. These increases were partially offset by a decrease of \$1.1 million in engineering incentive program expense in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004. In accordance with SFAS No. 86

Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed, we capitalized \$449,000 in the three and nine months ended October 31, 2004. There were no capitalized costs in the three and nine months ended October 31, 2005. Additionally, we received \$553,000 and \$1.2 million in the three months ended October 31, 2005 and 2004, respectively, and \$1.6 million and \$3.2 million in the nine months ended October 31, 2005 and 2004, respectively, of funded research and development which offset our gross research and

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development expenses. In the short-term, dollars received for funded research and development accounted for as an offset to gross product development and engineering expenses may vary depending on the timing and nature of work performed under these programs. In the long-term, we expect the dollars received for funded research and development to be reduced significantly as our programs wind down. We expect that product development and engineering expenses in absolute dollars will not increase significantly in the short-term.

General and Administrative Expenses. General and administrative expenses consist primarily of compensation-related expenses, facilities-related expenses and external fees for professional services, such as legal and accounting.

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	Three Months Ended			Nine Months Ended		
	October 31,		Percentage Change	October 31,		Percentage Change
	2005	2004		2005	2004	
(In thousands, except percentages)						
General and administrative	\$ 5,613	\$ 5,324	5%	\$ 16,645	\$ 15,723	6%
As a percentage of net revenues	8%	9%		8%	9%	

The increase in absolute dollars of general and administrative expenses in the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was \$289,000 and \$922,000, respectively. The increase in the three months ended October 31, 2005 compared to the three months ended October 31, 2004, was primarily due to an increase in salary and benefit costs of \$236,000 and facility and information technology costs of \$511,000 partially offset by a decrease in external consultant costs of \$359,000. Legal expenses increased \$828,000 in the nine months ended October 31, 2005 compared to nine months ended October 31, 2004 primarily due to outside counsel fees associated with legal proceedings and claims. We believe that general and administrative expenses will increase modestly in the short-term. We expect an increase in absolute dollars in the long-term, as we invest in worldwide staff and infrastructure in the areas of information systems and finance and administration.

Amortization of Other Intangibles

	Three Months Ended			Nine Months Ended		
	October 31,		Percentage Change	October 31,		Percentage Change
	2005	2004		2005	2004	
(In thousands, except percentages)						
Amortization of other intangibles	\$ 23	\$ 230	(90)%	\$ 70	\$ 527	(87)%
As a percentage of net revenues	%	%		%	%	

The decrease in amortization of other intangibles for the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004 was due to a lower amortizable base of other intangible assets during the respective periods. In January 2005, we acquired the assets and obligations of the ScopeTools business unit of RTI and recorded \$400,000 in other intangible assets, which are being amortized to operating expenses over a two to seven year period on a straight-line basis.

Restructuring Charges and Impairment of Assets. During the three and nine months ended October 31, 2005, we recorded additional restructuring charges in accordance with SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities* (SFAS No. 146), associated with the elimination of seven and eleven positions, respectively, primarily in the area of engineering, totaling \$214,000 and \$806,000, respectively. In addition, during both the three and nine months ended October 31, 2005, we completed a transaction to sublease a portion of our facilities in Swindon, U.K. In accordance with SFAS No. 146, we recorded a restructuring charge of \$446,000 related to the estimated loss from the sublease, net of expected sublease income. During the nine months ended October 31, 2005, we recorded a charge of \$379,000 associated with employee litigation as a result of previous restructurings and revised estimates downward for actual experience in the amount of \$145,000 associated with excess facilities and \$299,000 for employee-related items, including outplacement fee and judgments rendered in employee litigation. In accordance with SFAS No. 144 *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS No. 144) we also recorded an impairment charge of \$313,000 related to the Swindon leasehold improvements. These costs have been classified as operating expenses. For a further discussion of factors that may affect the success of the restructuring program, see Factors That May Affect Our Future Results or the Market Price of Our Stock Our restructuring plans may not enable us to achieve long-term profitability or achieve our business objectives.

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As of October 31, 2005, our restructuring liabilities related to our prior restructuring programs totaled approximately \$1.3 million. The following table summarizes our restructuring liabilities as of October 31, 2005:

	Consolidation			
	Work Force	of Excess		Total
	Reduction	Facilities	Other	
(In thousands)				
Restructuring liabilities as of January 31, 2005	\$ 246	\$ 406	\$ 752	\$ 1,404
Cash charges	806		379	1,185
Non cash charges		446		446
Reversals	(160)	(145)	(139)	(444)
Total charges	646	301	240	1,187
Cash payments	(568)	(261)	(414)	(1,243)
Non-cash write-offs		(11)		(11)
Restructuring liabilities as of October 31, 2005	\$ 324	\$ 435	\$ 578	\$ 1,337

We expect the workforce reductions to be paid out by the second quarter of fiscal 2007 and consolidation of excess facilities to be paid out by the third quarter of fiscal 2012. The other restructuring liability as at October 31, 2005 relates primarily to ongoing employee litigation.

Goodwill. We account for goodwill in accordance with the provisions of SFAS No. 142. Accordingly, the balance of goodwill of \$92.0 million at both October 31, 2005 and January 31, 2005 is not amortized but is evaluated for impairment annually as well as when circumstances indicate a possible impairment. The annual impairment assessment was performed during the second quarter of fiscal 2006. The primary methods used to determine the fair values for SFAS No. 142 impairment purposes were the income and market approach. The income approach provides an estimation of the fair value of a reporting unit based on the discounted cash flows derived from the reporting unit's estimated remaining life plus any residual value. The market approach indicates the fair value of a reporting unit based upon a comparison to publicly-traded companies in similar lines of business. The assumptions supporting the income approach, including the discount rate, which was assumed to be 14% for fiscal 2006 compared to 17% for fiscal 2005, were determined using our best estimates as of the impairment review. We completed our evaluation under both methods and concluded that goodwill was not impaired at June 30, 2005, as the fair value of the reporting unit exceeded its carrying value, including goodwill. There were no events or circumstances from the date of the annual impairment assessment through October 31, 2005 that indicated a further assessment was necessary. The reduction in goodwill between January 31, 2005 and October 31, 2005 of \$30,000 is related to an adjustment to the purchase price associated with the acquisition of the ScopeTools business unit of RTI in the fourth quarter of fiscal 2005.

Other Income (Expense)

Three Months Ended	Percentage of	Nine Months Ended	Percentage of
October 31,	Total Revenues, net	October 31,	Total Revenues, net

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	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>	<u>2005</u>	<u>2004</u>
	(In thousands, except percentages)							
Interest income	\$ 1,523	\$ 1,629	2%	3%	\$ 4,496	\$ 4,982	2%	3%
Interest expense	(616)	(1,768)	(1)	(3)	(2,500)	(5,560)	(1)	(3)
Other income (expense), net	(239)	(531)		(1)	(465)	(54)		
Total other income (expense)	\$ 668	\$ (670)	1%	(1)%	\$ 1,531	\$ (632)	1%	%

Interest Income. Interest income declined 7% or \$106,000, in the three months ended October 31, 2005 compared to the three months ended October 31, 2004, and declined 10% or \$486,000, in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004. The decrease in interest income was primarily due to lower invested balances, primarily due to the payments of our long-term debt. The average annualized yield for the three months ended October 31, 2005 was 3.41% compared to 2.76% for the three months ended October 31, 2004, and 3.39% in the nine months ended October 31, 2005 compared to 2.72% for the nine months ended October 31, 2004. Cash and cash equivalents, and investments totaled \$198.0 million and \$253.7 million as of October 31, 2005 and October 31, 2004, respectively.

Interest Expense. Interest expense decreased by 65% or \$1.2 million, in the three months ended October 31, 2005 as compared to the three months ended October 31, 2004, and 54% or \$2.9 million, in the nine months ended October 31, 2005 as compared to the nine months ended October 31, 2004 due to a reduction in outstanding debt in the three and nine month

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comparable periods. We pay interest on our outstanding 3.75% convertible subordinated notes semi-annually and record the amortization of certain issuance costs associated with these notes as other expense. In March 2005, we repurchased \$20.0 million of our convertible subordinated notes and as a result, recorded a \$312,000 expense related to the premium paid and the write-off of the related bond issuance costs. In June 2005, we repurchased an additional \$12.8 million of our convertible subordinated notes and as a result, recorded an \$89,000 expense related to the discount and the related write-off of bond issuance costs.

Other Income (Expense), Net. Other income (expense) increased by \$292,000 for the three months ended October 31, 2005 compared with the three months ended October 31, 2004 and decreased \$411,000 for the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004, respectively. Foreign currency losses decreased by \$113,000 and \$184,000 in the three and nine months ended October 21, 2005 compared to the three and nine months ended October 31, 2004, respectively, due to the strengthening of the dollar and other income increased by \$103,000 and decreased by \$698,000 during the three and nine months ended October 31, 2005 compared to the three and nine months ended October 31, 2004, respectively. Other income (expense) includes dividends received and gain on sale of investments of \$356,000 and \$513,000 in the nine months ended October 31, 2005 and 2004, respectively.

Provision For Income Taxes.

We recorded a tax provision of \$1.1 million and \$690,000 for the three months ended October 31, 2005 and 2004, respectively, and \$2.0 million and \$1.6 million for the nine months ended October 31, 2005 and 2004, respectively. We realized net tax benefits of approximately \$101,000 and \$715,000 for the nine months ended October 31, 2005 and 2004, respectively, due primarily to the finalization of foreign tax audits. Our quarterly tax provision is based on estimates of its expected liability for domestic and foreign income and withholding taxes that will be incurred during the year. Our effective tax rate is lower than the statutory rate due to a number of factors, including the utilization of various tax attributes previously not benefited such as net operating losses and tax credits. Our tax rate may also vary based on its results and the mix of income or loss amongst the domestic and foreign tax jurisdictions in which it operates.

Deferred income taxes are recorded in accordance with SFAS No. 109, *Accounting for Income Taxes* (SFAS No. 109) and are determined based on the differences between financial reporting and the tax basis of assets and liabilities using the tax rates and laws in effect when the differences are expected to reverse. SFAS No. 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 Germany, we determined that it is more likely than not that its deferred tax assets in the remaining jurisdictions will not be realized, due primarily to uncertainties related to the Company's ability to utilize its net operating losses carried forward and foreign tax credits, before they expire. Accordingly, we recorded a deferred tax asset of \$631,000 and \$682,000 related to our Germany subsidiary and a full valuation allowance against the remainder of its deferred tax assets at October 31, 2005 and January 31, 2005.

Should we determine that we would be able to realize our deferred tax assets in the foreseeable future, an adjustment to our deferred tax assets would cause a material increase to income in the period such determination was made. Significant management judgment is required in determining the period in which the reversal of a valuation allowance should occur. In the third quarter of fiscal 2006, we considered 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 partial or full release of our valuation allowance was required. We concluded that a release of our valuation allowance was not yet appropriate.

The valuation allowance at January 31, 2005, our last fiscal year end, was \$76.6 million. We estimate that when this valuation allowance is released, approximately \$51.4 million will result in an income tax benefit to the statement of operations and approximately \$25.2 million relating to stock option exercises and related tax credits will be credited directly to additional paid in capital. We will continue to evaluate the realizability of our deferred tax assets and related valuation allowances on a quarterly basis.

Liquidity and Capital Resources

As of October 31, 2005, we had working capital of approximately \$38.2 million, and cash, cash equivalents and investments of approximately \$198.0 million, which included \$36.4 million of cash and cash equivalents, \$43.7 million of short-term investments and \$117.9 million of long-term investments. We invest primarily in highly liquid, investment-grade instruments. We have debt service and principal repayment obligations, which could affect our liquidity, cash reserves and ability to obtain additional financing if we need or want to do so.

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Our consolidated statements of cash flows are summarized below:

	Nine Months Ended	
	October 31,	
	2005	2004
	(In thousands)	
Net cash provided by operating activities	\$ 33,815	\$ 26,604
Net cash provided by investing activities	5,071	2,795
Net cash used in financing activities	(24,295)	(27,118)

Operating activities primarily include the net income for the periods under consideration, non-cash charges such as depreciation and amortization expense and changes in assets and liabilities. In the nine months ended October 31, 2005, our operating activities provided net cash of \$33.8 million compared to \$26.6 million in the nine months ended October 31, 2004.

Net cash provided by operating activities for the nine months ended October 31, 2005, consisted of cash provided by operations of \$23.5 million and an increase in cash of \$10.3 million arising from changes in assets and liabilities, primarily related to a decrease in accounts receivable and an increase in deferred revenues. The decrease in accounts receivable, net, of \$6.5 million was primarily due to strong cash collections and the increase in deferred revenue of \$12.5 million was due primarily to the further customer adoption of our Wind River Platforms under the enterprise license model, which is a subscription-based model. Under this model, customers typically pay for the associated subscription fees upfront under our standard business terms whereas revenue is recognized ratably over the term of the subscription period, typically one year. These increases to cash provided by operations were offset by decreases in accrued liabilities and accrued compensation of \$4.1 million and \$2.2 million, respectively.

Net cash provided by operating activities for the nine months ended October 31, 2004, consisted of cash provided by operations of \$13.1 million and an increase in cash of \$13.5 million arising from changes in assets and liabilities. The increase in accounts receivable, net, of \$7.1 million was primarily due to increased business and the increase in deferred revenue of \$18.4 million was due primarily to the customer adoption of our Wind River Platforms under the enterprise license model, which is a subscription-based model.

Cash from operations includes net income of \$13.2 million and \$1.8 million offset primarily by depreciation and amortization of \$7.2 million and \$9.1 million in the nine months ended October 31, 2005 and 2004, respectively. Our operating cash flows depend heavily on the level of our sales. To a large extent our sales depend on general economic conditions affecting us and our customers, as well as the timing of new product introductions and other competitive factors and our ability to control expenses successfully.

Our investing activities provided net cash of \$5.1 million and \$2.8 million in the nine months ended October 31, 2005 and October 31, 2004, respectively. Investing activities generally relate to the purchase of investments, business acquisitions and equipment purchases, partially offset by cash provided from the sale and maturity of investments. Acquisitions of property and equipment totaled \$4.7 million and \$4.1 million for the nine months ended October 31, 2005 and 2004, respectively. The majority of the change in the periods was related to activity with our investments. During the nine months ended October 31, 2004, the net decrease in our restricted investments was due to the release of the

restricted investments that had been held as collateral for our facility term loan.

Our financing activities used net cash of \$24.3 million and \$27.1 million in the nine months ended October 31, 2005 and 2004, respectively. During the nine months ended October 31, 2005, and 2004, we received \$13.5 million and \$12.9 million respectively, from the issuance of common stock from employee stock option exercises. Additionally, in the nine months ended October, 2005, we repurchased convertible subordinated notes with a cash outlay of \$32.8 million. Additionally, in the nine months ended October 31, 2004, we repaid the entire balance of \$40.0 million of our term loan. We have a share repurchase program that authorizes the purchase of up to \$30 million in shares of common stock to manage future dilution from employee incentive plans including options. During the three months ended October 31, 2005, we repurchased 408,700 shares for an aggregate cost of approximately \$5.0 million. As of October 31, 2005, there were \$20.4 million remaining authorized for repurchase of common stock under the program; however, the timing of the repurchases and number of shares repurchased, if any, will depend upon market conditions and other factors.

Convertible Subordinated Notes

In December 2001, we issued \$150.0 million of 3.75% convertible subordinated notes due December 2006. 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 on June 15 and December 15 of each

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year. The notes may be converted, at the option of the holder, into our common stock at any time at the then-current conversion price, initially \$24.115 per share. We may redeem all or a portion of the notes for cash at the redemption price of 100.75% of the principal amount between December 15, 2004 and December 15, 2005 and 100.0% of the principal amount beginning December 15, 2005 and thereafter.

During fiscal 2005, we repurchased \$75.0 million of the notes on the open market at an aggregate price of \$75.4 million. Additionally, we expensed \$1.0 million in related bond issuance costs, resulting in a total recognized loss on the repurchase of \$1.4 million.

In March 2005, we repurchased an additional \$20.0 million of its 3.75% convertible subordinated notes in the open market at an aggregate price of \$20.1 million. We expensed \$257,000 in related bond issuance costs, resulting in a total recognized loss on the additional repurchase of \$312,000.

In June 2005, we repurchased an additional \$12.8 million of its 3.75% convertible subordinated notes in the open market at an aggregate price of \$12.8 million, purchased at a nominal discount. We expensed \$153,000 in related bond issuance costs, resulting in a total recognized loss on the repurchase of \$89,000. As of October 31, 2005, \$42.2 million in convertible subordinated notes (convertible into 1.7 million shares) remained outstanding.

The indenture under which the notes were issued provides that an event of default will occur if (i) we fail to pay principal or premium on the notes, (ii) we fail to pay interest on the notes and fail to cure such non-payment within 30 days, (iii) we fail to perform any other covenant required of us in the indenture and the failure is not cured or waived within 60 days, or (iv) we or one of our significant subsidiaries fails to pay, at final maturity or upon acceleration, any indebtedness for money borrowed in an outstanding principal amount in excess of \$35.0 million, including lease commitments, and the indebtedness is not discharged, or the default is not cured, waived or rescinded within 60 days after written notice is provided in accordance with the terms of the indenture. If any of these events of default occurs, either the trustee or the holders of at least 25% of the outstanding notes may declare the principal amount of the notes to be due and payable. In addition, an event of bankruptcy, insolvency or reorganization (involving us or any of our significant subsidiaries) will constitute an event of default under the indenture and, in that case, the principal amount of the notes will automatically become due and payable.

In the event of a change in control, the bondholders may require us to purchase our notes at 100% of the principal amount, plus accrued interest; this purchase could be completed in cash, our common stock or common stock of the parent corporation of the acquiring corporation, if publicly traded, or a combination thereof.

Commitments

In April 2003, in connection with the termination of the synthetic leases for our headquarters facility, we entered into a loan facility with a financial institution in the aggregate principal amount of \$57.4 million, consisting of a non-revolving loan commitment of \$37.4 million and a term loan of \$20.0 million. As of April 29, 2005, we elected to terminate the loan facility.

Contractual Obligations

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As of October 31, 2005, our future financial commitments, including interest payments, were as set forth in the table below:

	Payments due by period				
	Total	Less than			More than
		1 year (2)	1-3 years	3-5 years	5 years
	(In thousands)				
Convertible subordinated notes (1)	\$ 42,151	\$	\$ 42,151	\$	\$
Contractual interest on convertible subordinated notes	2,371	790	1,581		
Operating lease payments	18,922	1,701	11,177	4,766	1,278
Estimated operating sublease income	(646)	(19)	(464)	(163)	
	\$ 62,798	\$ 2,472	\$ 54,445	\$ 4,603	\$ 1,278

- (1) Consists of \$42.2 million, 3.75% convertible subordinated notes. See Convertible Subordinated Notes above.
- (2) For the three months ending January 31, 2006.
- (3) The decrease in contractual operating lease commitments from those disclosed in our Annual Report on Form 10-K for the year ended January 31, 2005 reflects management's intent to exercise break-date clauses contained in several operating leases.

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In fiscal 2005, we implemented the first phase of the next version of our enterprise resource planning system. In connection with the implementation, we incurred an aggregate of \$3.9 million of external costs in fiscal 2005. Of these costs, \$2.5 million were capitalized during fiscal 2005. In addition, \$450,000 remaining outstanding at January 31, 2005 was paid in the three months ended April 30, 2005. In fiscal 2006, we began implementing the second phase of this enterprise resource planning system. In connection with the implementation, we have incurred approximately \$419,000 and \$700,000 in external consulting costs during the three and nine months ended October 31, 2005, respectively, and we expect to incur an additional \$250,000 during the remainder of fiscal 2006. Of the costs incurred to date, \$509,000 has been capitalized in the nine months ended October 31, 2005.

We believe that existing cash, cash equivalents and investments, together with any cash generated from operations will be sufficient to fund our operating activities, capital expenditures, and other obligations for the foreseeable future. However, if during that period or thereafter we are not successful in generating sufficient cash flow from operations or in raising additional financing when required in sufficient amounts on terms acceptable to us, our business could suffer.

We currently plan to reinvest our cash generated from operations in new short and long term investments, in high-quality financial, government, and corporate securities or other investments, consistent with past investment practices, and therefore net cash used in investing activities may increase. However, cash could also be used in the future for acquisitions or strategic investments. Cash may also be used to repurchase equity under our stock repurchase program or repurchase additional subordinated convertible notes.

Off-Balance Sheet Arrangements

As of October 31, 2005, we did not have any off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of Regulation S-K promulgated by the SEC.

Recent Accounting Pronouncements

Recent Accounting Pronouncements. In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment*, (SFAS No. 123R), that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for either equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using the intrinsic value method as prescribed by APB No. 25, *Accounting for Stock Issued to Employees*, and generally requires that such transactions be accounted for using a fair-value-based method and recognized as expenses. The statement requires companies to assess the most appropriate model to calculate the value of the options. We currently use the Black-Scholes option pricing model to value options and is currently assessing which model it may use in the future under the statement and may deem an alternative model to be the most appropriate. The use of a different model to value options may result in a different fair value than the use of the Black-Scholes option-pricing model. In addition, there are a number of other requirements under the new standard that will result in differing accounting treatment than currently required. These differences include, but are not limited to, the accounting for the tax benefit on employee stock options and for stock issued under our employee stock purchase plan. In addition to the appropriate fair value model to be used for valuing share-based payments, we will also be required to determine the transition method to be used at date of adoption. The allowed transition methods include prospective and retroactive adoption options. Under the retroactive options, prior periods may be restated either as of the beginning of the year of adoption or for all periods presented. The prospective method requires that compensation expense be recorded for all unvested stock options and restricted stock at the beginning of the first quarter of adoption of SFAS No. 123R, while the retroactive methods would record compensation expense for all unvested stock options and restricted stock beginning with the first period restated. The effective date of the new standard for our consolidated financial statements is our first quarter of fiscal 2007. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) relating to the adoption of SFAS No. 123R.

Upon adoption of SFAS No. 123R and SAB 107, these statements will have a significant impact on our consolidated financial statements, specifically our statement of operations and earnings per share on a quarterly and annual basis, as we will be required to expense the fair value of our stock option grants and stock purchases under our employee stock purchase plan rather than disclose the impact on our consolidated net income within our footnotes as is its current practice. The amounts disclosed herein are not necessarily indicative of the amounts that will be expensed upon the adoption of SFAS No. 123R and SAB 107. Compensation expense calculated under SFAS No. 123R and SAB 107 may differ materially from amounts currently disclosed based on changes in the fair value of our common stock, changes in the number of options granted or the terms of such options, the treatment of tax benefits and changes in interest rates or other factors. In addition, upon adoption of SFAS No. 123R and SAB 107, we may choose to use a different valuation model to value the compensation expense associated with our employee stock options.

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In June 2005, the Financial Accounting Standards Board (FASB) completed its review of Emerging Issues Task Force (EITF) Issue No. 03-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1). EITF 03-1 provides accounting guidance regarding the determination of when an impairment of debt and marketable equity securities and investments accounted for under the cost method should be considered other-than-temporary and recognized in income. EITF 03-1 also requires certain quantitative and qualitative disclosures for debt and marketable equity securities classified as available-for-sale or held-to-maturity under SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (SFAS No. 115), that are impaired at the balance sheet date but for which an other-than-temporary impairment has not been recognized. The FASB decided not to provide additional guidance on the meaning of other-than-temporary impairment but has issued FASB Staff Position (FSP) 115-1 and 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments* (FSP 115-1 and 124-1), which nullifies the accounting guidance on the determination of whether an investment is other-than-temporarily impaired as set forth in EITF 03-1. FSP 115-1 and 124-1 are effective on a prospective basis for other-than-temporary impairments on certain investments in reporting periods beginning after December 15, 2005. EITF 03-1 was effective December 31, 2003 and will remain in effect until the adoption of FSP 115-1 and 124-1. We have complied with its disclosure requirements, which were presented in our Annual Report on Form 10-K for the fiscal year ended January 31, 2005. We do not anticipate that the adoption of FSP 115-1 and 124-1 will have a material impact on our results of operations, cash flows, or financial position.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20, Accounting Changes, and Statement No. 3, Reporting Accounting Changes in Interim Financial Statements* (SFAS No. 154). This statement changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS No. 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the statement does not change the transition provisions of any existing accounting pronouncements. We do not believe adoption of SFAS No. 154 will have a material effect on our results of operations, cash flows, or financial position.

Factors That May Affect Our Future Results or the Market Price of Our Stock

Our business faces significant risks. The risks described below may not be the only risks we face. Additional risks that we do not yet know of or that we currently think are immaterial may also impair our business operations or have a negative impact on our stock price. If any of the events or circumstances described in the following risks actually occur, our business, financial condition or results of operations could suffer, and the trading price of our common stock could decline.

We may not be able to increase adoption of our enterprise license model.

An increasing proportion of our products are licensed under an enterprise license model that is based upon subscription licenses rather than our traditional perpetual licenses. There is a risk that we will not be able to increase our rate of adoption by new or transitioning customers to our subscription-based model, that customers may not accept the new products we offer under our enterprise license model or that they may reject the terms of the model itself. In addition, although enterprise licenses represent a potential source of renewable license revenue, there is also a risk that new and transitioned customers will not renew their licenses at the end of the term.

There is a further risk that we may remain dependent upon large end-of-quarter transactions, that the more complex and time consuming negotiations for enterprise licenses may affect our ability to close such transactions, that customers who purchase enterprise licenses may spend less in the aggregate over the term of the enterprise license than if they had been required to purchase perpetual licenses, and that because our enterprise license model includes limited services, customers may purchase fewer stand-alone services from us, which could negatively impact our services revenue. In any such event, our future revenue and earnings could be below our expectations. If we do successfully manage the

transition to our enterprise license model, our revenues may decrease significantly.

Our enterprise license model has impacted the timing of our reported revenues.

The adoption of a subscription-based license model in late fiscal 2004 has impacted the timing of our reported revenues. Under the enterprise license model revenues are recognized ratably over the subscription period. By contrast, our traditional perpetual license requires a majority of license revenues to be recognized in the quarter in which the products are delivered and a much smaller amount relating to the fair value of the maintenance being deferred and recognized subsequently over the maintenance period. Therefore, an order for a subscription-based license will result in lower current-quarter revenue than an equal-sized order for a perpetual license. As a result, our reported revenues have been affected by the adoption of the enterprise license model for our subscription-based products. The impact on near-term and deferred revenues

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will continue to depend on the rate at which customer s adoption or transition from our perpetual model to our enterprise license model. In addition, an increase in the number of subscription license renewals on multi-year terms may result in larger deferred revenues. To the extent that the adoption rate is higher than we expect, we may experience a greater decline in near-term revenues, as well as an increase in deferred revenues. If we do not successfully manage the shift in our revenues to our enterprise license model, we may not be able to manage our expenses, many of which are fixed in nature, which could have an adverse effect on our profitability.

Because a significant portion of our revenues continues to be derived from production licenses, we are dependent upon the ability of our customers to develop and penetrate new markets successfully.

Our production license revenues depend both upon our ability to successfully negotiate production license agreements with our customers and, in turn, upon our customers successful commercialization of their underlying products. In particular, we derive significant revenues from customers that develop products in highly competitive and technologically complex markets such as the Internet infrastructure, server and storage, digital consumer, aerospace and defense, industrial control and automotive markets. If these customers sell fewer products or otherwise face significant economic difficulties, our revenues will decline. For example, our production license revenues increased 19% in the nine months ended October 31, 2005 compared to the nine months ended October 31, 2004, which we believe is primarily due to our customers response to the current market conditions in the high-technology sector. We cannot control our customers product development or commercialization or predict their success. In addition, we depend on our customers to accurately report the use of their products in order for us to collect our revenues from production licenses. If our customers are not successful with their products or do not accurately report use of their products to us, our production license revenues may decline significantly.

We have adopted an open source strategy that may not be successful or may expose us to additional risks.

We have adopted a strategy to address the open source market, and accordingly we have released a development tool and platform products based on Linux, and have also announced our plans to release other platform products based on open source. We cannot be certain whether this strategy will be successful and it may create additional risks for us. Specifically, we cannot be certain that we will be able to develop the products necessary to satisfy customer demand, or that our customers will adopt our products based on open source. Additionally, even if our products are adopted by our customers, they may not be profitable. Very few open source companies have been profitable and we may not be able to generate profits on our Linux-based offerings. Moreover, it is possible that these efforts to coexist with the open source movement could result in a decline in sales of our proprietary software either as a result of a diversion of internal resources or customer preference. Additionally, customers may defer orders in anticipation of our new products. If any of these events were to occur, our revenues and earnings could be adversely affected.

As our products that include open source components are adopted, we face increased legal risks, which could affect our ability to develop or sell our open source products. Our open source strategy may make us increasingly vulnerable to claims that our products infringe third-party intellectual property rights, in particular because many of the open source components we may incorporate with our products are developed by numerous independent parties over whom we exercise no supervision or control. Third parties may, in particular, assert claims for infringement or claims based on trade secret theories. Our risk is further exacerbated by our lack of access to unpublished software patent applications. Defending claims of infringement, even claims without significant merit, can be expensive. An adverse legal decision affecting our intellectual property could materially harm our business. It is also possible that our own intellectual property rights in derivative works we develop under the GNU General Public License (GPL) that applies to Linux, or other open source license, may be infringed and that as a result we may need to bring our own claim against third parties.

In addition, the enforceability of the GPL and other open source licenses affect the success of our open source strategy. The GPL states that any program licensed under it may be liberally copied, modified and distributed. The GPL is a subject of litigation in the case of *The SCO Group*,

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Inc. v. International Business Machines Corp., pending in the United States District Court for the District of Utah. It is possible that this court would hold the GNU license to be unenforceable in that litigation, that the GNU license or other open source license could be found to be unenforceable in a separate legal challenge, or that someone could assert a claim for proprietary rights in a program developed and distributed under them. If an open source license that applies to the licensing of components of our open source products is found to be partially or completely unenforceable, or if there are claims of infringement, we could be required to obtain licenses from third parties in order to continue offering our products, reengineer our products, or discontinue the sale of our products in the event reengineering could not be accomplished on a timely basis. An adverse legal decision affecting our intellectual property could materially harm our business.

Uncertainty regarding the legal risks related to open source components could affect sales of our open source products generally. Finally, as we expand our open source product offerings, we face increased pressure by our customers to adopt additional indemnification or otherwise protect them from potential claims from third parties related to infringement based on use of open source code in our products. Indemnification of open source components involves increased legal risk since it requires us to indemnify for components developed by third parties over whom we exercise no supervision or control.

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The Financial Accounting Standards Board's adoption of SFAS No. 123R will cause, and changes to existing accounting pronouncements or taxation rules or practices may affect our reported results of operations or how we conduct our business.

In December 2004, the FASB adopted SFAS No. 123R, which will require us, starting in the first quarter of fiscal year 2007, to measure compensation costs for all stock-based compensation (including our stock options and employee stock purchase plan, as currently constructed) at fair value and record a compensation charge equal to that value. Also, a change in accounting pronouncements or taxation rules or practices can have a significant effect on our reported results and may even affect our reporting of transactions completed before the change is effective. Other new accounting pronouncements or taxation rules and varying interpretations of accounting pronouncements or taxation practice have occurred and may occur in the future. This change to existing rules, future changes, if any, or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. We expect the adoption of SFAS No. 123R to have a material adverse impact on our net income or loss and our net income or loss per share by decreasing our income or increasing our losses by the additional amount of such stock option charges. We are currently in the process of evaluating the extent of such impact and cannot quantify the amount of such impact at this time.

If we do not continue to address new and rapidly changing markets and increasingly complex technologies successfully and deliver our products on a timely basis, our revenues and operating results will decline.

The DSO market is characterized by ongoing technological developments, evolving industry standards and rapid changes in customer requirements and product offerings in the device market. Our success depends upon our ability to adapt and respond to these changes in a timely and cost-effective manner. If we fail to continually update our existing products to keep them current with customer needs or to develop new or enhanced products to take advantage of new technologies, emerging standards and expanding customer requirements, our existing products could become obsolete and our financial performance would suffer. We have from time to time experienced delays in the commercial release of new technologies, new products and enhancements of existing products. These delays are commonplace in the software industry due to the complexity and unpredictability of the development work required. If we fail to commercially release new products on schedule as announced, our financial performance could suffer. We must effectively market and sell new product offerings to key customers, because once a customer has designed a product with a particular operating system, that customer typically is reluctant to change its supplier due to the significant related costs. If we cannot adapt or respond in a cost-effective and timely manner to new technologies and new customer requirements, or if the new products we develop are not attractive to our customers, sales of our products could decline.

Numerous factors may cause our total revenues and operating results to fluctuate significantly from period to period. These fluctuations increase the difficulty of financial planning and forecasting and may result in decreases in our available cash and declines in the market price of our stock.

A number of factors, many of which are outside our control, may cause or contribute to significant fluctuations in our total revenues and operating results. These fluctuations make financial planning and forecasting more difficult. In addition, these fluctuations may result in unanticipated decreases in our available cash, which could negatively impact our operations. As discussed more fully below, these fluctuations also could increase the volatility of our stock price. Factors that may cause or contribute to fluctuations in our operating results and revenues include:

acceptance by our customers of our Wind River Platforms;

the number and timing of orders we receive, including disproportionately higher receipt and shipment of orders in the last month of the quarter;

changes in the length of our products' sales cycles, which increase as our customers' purchase decisions become more strategic and are made at higher management levels;

reductions in the number of engineering projects started by our customers due to their own difficult financial or economic conditions;

the impact of impairment charges arising from past acquisitions;

the success of our customers' products from which we derive our production license revenues;

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the mix of our revenues as between sales of products that have more upfront revenue, subscriptions that have more deferred revenues and services which have lower profit margins;

our ability to control our operating expenses, and fully realize the impact of the restructuring plans we have implemented;

our ability to continue to develop, introduce and ship competitive new products and product enhancements quickly;

possible deferrals of orders by customers in anticipation of new product introductions;

announcements, product introductions and price reductions by our competitors;

our ability to manage costs for fixed-price consulting agreements;

seasonal product purchases by our customers, which historically have been higher in our fourth fiscal quarter;

the impact of, and our ability to react to, natural disasters and/or events of terrorism;

the impact of, and our ability to react to business disruptions arising from or relating to internet or computer viruses service interruptions;

changes in business cycles that affect the markets in which we sell our products and services;

economic, political, legal, regulatory and other conditions in the United States and internationally;

foreign currency exchange rates; and

the impact of any stock-based compensation charges arising from the issuance of stock options, stock appreciation rights or any other stock-based awards.

One or more of the foregoing factors may cause our operating expenses to be disproportionately high or may cause our net revenues and operating results to fluctuate significantly. Results from prior periods are thus not necessarily indicative of the results of future periods.

We face intense competition in the device software industry, which could decrease demand for our products or cause us to reduce our prices.

The DSO industry is characterized by rapid change, new and complex technology and intense competition. Our ability to maintain our current market share depends upon our ability to satisfy customer requirements, enhance existing products and develop and introduce new products. Due

to the complexity of the markets in which we operate, where our customers often develop device systems in-house, it is difficult to assess the impact of competition on our business and our related share of the markets that we operate in. We have faced increasing competition in recent years as customers have decreased research and development budgets, sought to increase the value they receive from vendors, including us, attempted to leverage a more competitive bidding process when spending research and development budgets and/or deferred or canceled projects, in whole or in part. As a result, we believe that some customers have elected not to purchase our products and have chosen to undertake such development in-house, selected solutions they perceive to be less expensive or relied upon existing licenses from us rather than making new purchases. We expect the intensity of competition to increase in the future. Increased competitiveness may result in reductions in the prices of our products, run-time royalties and services, lower-than-expected gross margins or loss of market share, any of which would harm our business.

Our primary competition comes from internal research and development departments of companies that develop device systems in-house. In many cases, companies that develop device systems in-house have already made significant investments of time and effort in developing their own internal systems, making acceptance of our products as a replacement more difficult. Additionally, many of these in-house departments may increasingly choose to use open-source software, such as the Linux operating system. We also compete with independent software vendors and, to a limited extent, with open-source vendors. Some of the companies that develop device systems in-house and some of these independent software vendors, such as Microsoft Corporation, may have significantly greater financial, technical, marketing, sales and other resources and significantly greater name recognition than we do.

Demands for rapid change and the increasing complexity of the technology in our industry intensify the competition we face. In addition, our competitors may consolidate or establish strategic alliances to expand product offerings and resources

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or address new market segments. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements or to devote greater resources to the development, promotion, sale and support of their products. These factors favor larger competitors that have the resources to develop new technologies or to respond more quickly with new product offerings or product enhancements. We may be unable to meet the pace of rapid development set by our competitors or may incur additional costs attempting to do so, which may cause declines in our operating results. Our competitors may foresee the course of market developments more accurately than we do and could in the future develop new technologies that compete with our products or even render our products obsolete, any of which could adversely affect our competitive position.

If our strategic relationships are not successful, our product offerings, distribution and/or revenues may be adversely impacted.

We have many strategic relationships with semiconductor companies and customers. These strategic relationships are complex because some of the companies that are our strategic partners in certain business areas are also our competitors in other business areas. Our strategic partners may also have concurrent relationships with companies that provide open-source and in-house solutions, which may put pressure on our product development roadmaps, timelines and prices. If we are not successful in developing and maintaining these strategic relationships, our business may be harmed. If our collaborative marketing and distribution agreements terminate or expire, the scope of our product offerings may be restricted, and the distribution of our products and revenues may be adversely impacted.

The costs of software development can be high, and we may not realize revenues from our development efforts for a substantial period of time.

Introducing new products that rapidly address changing market demands requires a continued high level of investment in research and development. Our product development and engineering expenses, which are net of funded research and development and capitalized research and development were \$16.2 million, or 24% of total revenues, for the three months ended October 31, 2005, compared to \$15.0 million, or 25% of total revenues, for the three months ended October 31, 2004, and were \$49.9 million, or 25% of total revenues, for the nine months ended October 31, 2005, compared to \$44.3 million, or 26% of total revenues, for the nine months ended October 31, 2004. If we are required to undertake extensive capital outlays to address changes in the device software optimization market, we may be unable to realize revenue as soon as we may expect. The costs associated with software development are increasing, including the costs of acquiring or licensing new technologies. Our investment in new and existing market opportunities prior to our ability to generate revenue from these new opportunities may adversely affect our operating results.

Our significant international business activities subject us to increased costs and economic risks.

We develop and sell a substantial percentage of our products internationally. For the three and nine months ended October 31, 2005, revenues from international sales were \$30.4 million, or 45% of total revenues, and \$88.6 million, or 45% of total revenues, respectively, as compared to \$26.7 million, or 45% of total revenues, and \$78.4 million, or 46% of total revenues for the three and nine months ended October 31, 2004. Additionally, we have investments in, or have made acquisitions of, companies located outside the United States. Over the long-term, we expect to continue to make investments to further support and expand our international operations and increase our direct sales force and distribution network in EMEA, Japan and Asia Pacific. Risks inherent in international operations include:

the imposition of governmental controls and regulatory requirements;

the costs and risks of localizing products for foreign countries;

differences in business cultures and sales cycles;

differences in operation and sales support expenses;

unexpected changes in tariffs, import and export restrictions and other barriers and restrictions;

greater difficulty in accounts receivable collection;

restrictions on repatriation of earnings;

exposure to adverse movements in foreign currency exchange rates;

the burdens of complying with a variety of foreign laws;

difficulties in staffing and managing foreign subsidiaries and branch operations;

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the costs and risks of operating in countries experiencing geopolitical conflict and/or terrorism;

the effect of our adoption of global pricing models;

difficulties in integrating products and operations from foreign acquisitions;

the impact of local health and political crises that prohibit or severely limit travel or other interaction with a local economic market;

exposure to local economic slowdowns; and

the need to guarantee credit instruments extended to support foreign operations.

Any of these events, regionally and as a whole, could reduce our international sales and increase our costs of doing business internationally and have a material adverse effect on our gross margins and net operating results.

The rights we rely upon to protect the intellectual property underlying our products may not be adequate, which could enable third parties to use our technology and reduce our ability to compete.

Our success depends significantly upon the proprietary technology contained in our products. We currently rely on a combination of patents, copyrights, trademarks, trade secret laws, and contractual provisions to establish and protect our intellectual property rights in our technology and products. We cannot be certain that the steps we take to protect our intellectual property will adequately protect our rights, that others will not independently develop or otherwise acquire equivalent or superior technology, or that we can maintain our technology as trade secrets. In addition, discovery and investigation of unauthorized use of our intellectual property is difficult. We expect software piracy, which is difficult to detect, to be a persistent problem, particularly in those foreign countries where the laws may not protect our intellectual property as fully as in the United States. Employees, consultants, and others who participate in the development of our products may breach their agreements with us regarding our intellectual property. We might not have adequate remedies for infringement or breach of our proprietary rights by third parties, employees or consultants. Further, we have in the past initiated, and in the future may initiate, claims or litigation against third parties for infringement or breach of our proprietary rights or to establish the validity of our proprietary rights. Whether or not such litigation is determined in our favor, such actions could result in significant expense to us, divert the efforts of our technical and management personnel from productive tasks or cause product shipment delays.

Patent, trademark or copyright infringement or product liability claims against us may result in costly litigation, cause product shipment delays or require us to expend significant resources. In addition, patent or copyright claims may require us to enter into royalty or licensing arrangements.

We occasionally receive communications from third parties alleging patent, trademark or copyright infringement or other intellectual property claims, and there is always the chance that third parties may assert infringement claims against us or against our customers under circumstances that might require us to provide indemnification. Adoption of our open source strategy increases this risk. Additionally, because our products are increasingly used in applications, such as network infrastructure, transportation, medical and mission-critical business systems, in which the failure of the device system could cause property damage, personal injury or economic loss, we may face product liability claims.

Although our agreements with our customers typically contain provisions intended to limit our exposure to infringement and liability claims, these provisions may not be effective in doing so in all circumstances or in all jurisdictions. Any of these types of claims, with or without merit, could result in claims for indemnification by us or costly litigation, could require us to expend significant resources to develop non-infringing technology or remedy product defects, cause product shipment delays or require us to pay significant damages if the claims are successful. In the case of infringement of another party's intellectual property, we may be required to enter into royalty or licensing agreements; however, we cannot be certain that the necessary licenses will be available or that they can be obtained on commercially reasonable terms. If we are not successful in defending these claims or, with respect to infringement claims, were to fail to obtain royalty or licensing agreements in a timely manner and on reasonable terms, our business, financial condition and results of operations would be materially adversely affected.

Our restructuring plans may not enable us to achieve long-term profitability or achieve our business objectives.

In each of fiscal 2002, through 2005, we implemented restructuring plans that were designed to align our anticipated revenues more closely with our cost structure. Our restructuring plans were based on certain assumptions regarding the cost structure of our business and the nature and severity of the current industry adjustment and general economic trends. We

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cannot be certain that the assumptions underlying the restructuring plans will prove to be accurate. If they are not, our restructuring plans may not result in the correct alignment of our anticipated revenues and cost structure. Our restructuring plans involved the implementation of a number of initiatives, including headcount reductions, facilities closures, and other cost-control measures, that may adversely affect our ability to realize our current or future business objectives. As a result of the headcount reductions, we eliminated an aggregate of 1,205 employee positions since the beginning of fiscal 2002. We also recorded net restructuring charges of \$765,000 and \$313,000 in the three months ended October 31, 2005 and 2004 respectively, and \$1.2 million and \$2.4 million in the nine months ended October 31, 2005 and 2004, respectively. These measures may adversely affect our ability to realize our current or future business objectives. In addition, the costs actually incurred in connection with restructuring actions may exceed our estimated costs of these actions. Additional restructuring actions may result in further cash and/or non-cash charges, which could have a material adverse effect on our business and results of operations. As a result, we cannot be sure that we will return to long-term profitability as a result of our restructuring plans.

If we are not able to comply with the certification and attestation requirements under Section 404 of the Sarbanes-Oxley Act of 2002 for the year ended January 31, 2006, we may not be able to timely and accurately report our financial results and the price of our common stock may be adversely affected.

While we have evaluated our internal controls system as of January 31, 2005 and complied with the management certification and auditor attestation requirements of Section 404 of the Sarbanes-Oxley Act of 2002 in connection with our Annual Report on Form 10-K for the year ended January 31, 2005, we may not continue to meet such certification and attestation requirements annually. If we are not able to continue to meet the requirements of Section 404 in a timely manner or with adequate compliance, or if our independent registered public accounting firm does not timely attest to the evaluation, we might be subject to sanctions or investigation by regulatory authorities, such as the SEC or the NASDAQ National Market, which could adversely affect our financial results and the market price of our common stock.

Our management, including our CEO and CFO, does not, however, expect that our disclosure controls or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Our disclosure controls or procedures can be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the control. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Our common stock price is subject to volatility.

In recent years, the stock markets in general and the shares of technology companies in particular have experienced extreme price fluctuations. These recent price fluctuations have often been unrelated or disproportionate to the operating performance of the companies affected. Our stock price has similarly experienced significant volatility. As reported on The NASDAQ National Market, during the quarter ended October 31, 2005, our stock had a high sales price of \$17.60 and a low sales price of \$11.04. In some of our past fiscal quarters, we experienced shortfalls in revenue and earnings from levels expected by securities analysts and investors, which have had an immediate and significant adverse effect on the trading price of our common stock. These factors relating to the fluctuations in our revenues and operating results may continue to affect our stock price. Comments by or changes in estimates from securities analysts as well as significant developments involving our competitors or our industry could also affect our stock price.

In addition, the market price of our common stock is affected by the stock performance of other technology companies generally, as well as companies in our industry and our customers in particular. Other broad market and industry factors may negatively affect our operating results or cause our stock price to decline, as may general political or economic conditions in the United States and globally, such as recessions, or interest rate or currency fluctuations. In particular, the stock market may be adversely impacted, or experience unusual volatility, as a result of the outbreak of armed conflict or hostilities involving the United States or incidences of terrorism in, or directed at, the United States or its allies.

We have substantial financial commitments, which could make it difficult for us to obtain financing and deplete our cash reserves. Additionally, these commitments could be accelerated in certain circumstances, which could have a material adverse effect on our financial condition, results of operations and cash flows.

As of October 31, 2005, we had \$42.2 million in outstanding indebtedness under our 3.75% convertible subordinated notes. As of October 31, 2005, we had cash and cash equivalents of \$36.4 million, short-term investments of \$43.7 million and investments with maturities of greater than one year of \$117.9 million. The indenture under which our convertible subordinated notes were issued contains customary events of default, and also provides that an event of default occurs if we (or one of our significant subsidiaries) fail to pay, at final maturity or upon acceleration, any indebtedness for money borrowed in an outstanding principal amount in excess of \$35.0 million, and the indebtedness is not discharged, or the default is not cured, waived or rescinded within 60 days after written notice is provided in accordance with the terms of the

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indenture. Under the terms of our convertible subordinated notes, if an event of default were to occur for any of the aforementioned reasons or other reasons and we do not or cannot cure the event of default within specified periods, the lenders could in each case accelerate payment of the indebtedness.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**Interest Rate Sensitivity**

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and debt obligations.

We have an investment policy that has been approved by our Board. We place our investments with high quality credit issuers and, by policy, limit the amount of credit exposure to any one issuer. As stated in our investment policy, our first priority is to reduce the risk of principal loss. Consequently, we seek to preserve our invested funds by limiting default risk, market risk and reinvestment risk. We mitigate default risk by investing in only high quality credit securities that we believe to be low risk and by positioning our portfolio to respond appropriately to a significant reduction in a credit rating of any investment issuer or guarantor. The portfolio includes only marketable securities with active secondary or resale markets to ensure portfolio liquidity.

Our investment portfolio consists of various marketable debt securities. The longer the duration of these securities, the more susceptible these securities are to general changes in market interest rates. As general market interest rates increase, those securities purchased with a lower yield-at-cost will likely show a mark-to-market unrealized loss. All unrealized losses are due to changes in general market interest rates and bond yields. We expect to realize the full value of all these investments upon their maturity.

Foreign Currency Risk

We may enter into foreign currency forward exchange contracts to manage foreign currency exposures related to certain non-functional currency related inter-company and other non-functional accounts receivable and cash balances. Additionally, we may adjust our foreign currency hedging position by taking out additional contracts or by terminating or offsetting existing forward contracts. These adjustments may result from changes in the underlying non-functional currency exposures or from fundamental shifts in the economics of particular exchange rates. Realized gains and losses on terminated forward contracts, or on contracts that are offset, are recognized in income in the period of contract termination or offset. Our ultimate realized gain or loss with respect to currency fluctuations will depend on the currency exchange rates and other factors in effect as the contracts mature. As of October 31, 2005, we had outstanding contracts with the following terms:

Buy / Sell:	Sell	Buy	Sell	Buy	Buy
Currency:	GBP(£)	EURO()	JPY(¥)	CAD(CAD\$)	SEK(kr)
Amount:	1,800,000	11,400,000	130,000,000	600,000	18,000,000
Rate:	0.5603	0.8205	115.05	1.1767	7.7995
USD Equivalent:	\$ 3,212,640	\$ 13,893,180	\$ 1,129,944	\$ 509,914	\$ 2,307,840
Maturity Date:	11/30/2005	11/30/2005	11/30/2005	11/30/2005	11/30/2005

Contract amounts are representative of the expected amounts to be paid under the terms of these instruments. We do not enter into derivative financial instruments for trading or speculative purposes. As of October 31, 2005, the fair value of the above contracts was not significant.

Equity Price Risk

There have been no material changes to our equity price risk since the fiscal year ended January 31, 2005. See Item 7A, Quantitative and Qualitative Disclosures about Market Risk, in our 2005 Form 10-K for the fiscal year ended January 31, 2005.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Control and Procedures

Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act) as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file

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or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate, to allow timely decisions regarding required disclosure and that such information is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION**ITEM 1. LEGAL PROCEEDINGS**

On June 7, 2004, we filed a complaint against Green Hills, a direct competitor of ours, in the Superior Court of California, County of Alameda. The action was transferred to the Superior Court of California, County of Santa Barbara. The subsequently amended complaint requested \$25,000 in damages due to breach by Green Hills of a cooperative marketing and technology agreement entered into between the parties in October 1992. Green Hills subsequently filed an answer and cross-complaint in that action. On January 18, 2005, Green Hills filed a complaint against us in the United States District Court for the Central District of California alleging, among other things, that we violated antitrust and unfair competition laws by allegedly refusing to license our VxWorks product to Green Hills and refusing to market VxWorks separately from the integrated development environment for VxWorks. Green Hills requested an award for damages and injunctive relief on these matters. On June 10, 2005, we entered into a non-monetary settlement agreement with Green Hills regarding the above-described claims. Each party's request for dismissal without prejudice of its respective complaint or cross-complaint in the above-described state claims was dismissed on June 20, 2005. Green Hills' request for dismissal without prejudice of its complaint in the above-described federal claims was dismissed on July 7, 2005.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**Issuer Purchases of Equity Securities**

The following table provides information about purchases we made of shares of our common stock during the three months ended October 31, 2005.

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly</u>	<u>Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program</u>
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			Announced Program ⁽¹⁾	
August 1, 2005 through August 31, 2005				\$ 25,360,676
September 1, 2005 through September 30, 2005	170,100	\$ 12.61	170,100	23,215,715
October 1, 2005 through October 31, 2005	238,600	\$ 11.95	238,600	20,364,445
Total for quarter ended October 31, 2005	408,700	\$ 12.22	408,700	\$ 20,364,445

- (1) In June 2002, our Board of Directors authorized a stock repurchase program to acquire outstanding common stock in the open market or negotiated transactions. Under the program, we may, but are not required to, purchase up to \$30.0 million of our common stock over two years of which 958,500 shares of our common stock at an aggregate purchase price of approximately \$4.6 million were repurchased in fiscal 2003. In June 2004, our Board of Directors extended the term of the existing share repurchase program for an additional two years through June 2006. No purchases were made during fiscal 2004 or 2005. In addition, our Board approved the purchase of 300,000 shares each year for replenishment of the Employee Stock Purchase Plan. In the three months ended October 31, 2005, we repurchased 408,700 shares of our common stock for an aggregate total purchase price of approximately \$5.0 million. All repurchases were made on The NASDAQ National Market at prevailing open market prices and paid out of general corporate funds.

Table of Contents**ITEM 5. OTHER INFORMATION**

On December 1, 2005, Jerry L. Fiddler, a member of our Board of Directors, executed a pre-arranged stock trading plan in accordance with the guidelines specified by Rule 10b5-1 under the Securities and Exchange Act of 1934.

ITEM 6. EXHIBITS

<u>Exhibit No.</u>	<u>Description</u>
3.1 ⁽¹⁾	Amended and Restated Certificate of Incorporation of Wind River Systems, Inc., as amended.
3.2 ⁽²⁾	Amended and Restated Bylaws of Wind River Systems, Inc.
31.1	Certification of Chairman of the Board, President and Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Senior Vice President of Finance and Administration, Chief Financial Officer and Secretary pursuant to Rule 13a-14(a) and Rule 15d-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chairman of the Board, President and Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Senior Vice President of Finance and Administration, Chief Financial Officer and Secretary pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

⁽¹⁾ Incorporated by reference to the Form 10-Q filed on December 15, 2000.

⁽²⁾ Incorporated by reference to the Form 10-K filed on April 30, 2002.

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SIGNATURE

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.

WIND RIVER SYSTEMS, INC.

Dated: December 9, 2005

By: /s/ Michael W. Zellner

Michael W. Zellner
*Senior Vice President of Finance and Administration,
Chief Financial Officer and Secretary*

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