WIND RIVER SYSTEMS INC
Form 10-Q
December 12, 2003
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended October 31, 2003

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)

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

500 Wind River Way, Alameda, California 94501

(Address of principal executive offices, including zip code)

(510) 748-4100

(Registrant s telephone number, including area code)

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

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

As of December 10, 2003, there were 80,311,350 shares of the registrant s common stock outstanding.

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FORM 10-Q

FOR THE QUARTER ENDED OCTOBER 31, 2003

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PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

WIND RIVER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2003	2002	2003	2002
Revenues, net:				
Product	$ 27,957	$ 36,317	$ 83,516	$ 122,051
Subscription	5,995	1,002	12,640	1,294
Service	15,634	20,962	52,386	64,877
Total revenues, net	49,586	58,281	148,542	188,222
Cost of revenues:				
Product	2,323	3,948	8,043	14,109
Subscription	1,551	116	3,538	147
Service	8,705	12,483	27,822	39,453
Total cost of revenues	12,579	16,547	39,403	53,709
Gross profit	37,007	41,734	109,139	134,513
Operating expenses:				
Selling and marketing	20,937	27,431	65,055	93,993
Product development and engineering	13,790	18,049	42,222	56,463
General and administrative	6,181	8,749	20,091	26,430
Amortization of purchased intangibles	1,465	2,259	5,040	6,777
Restructuring and other charges	971		2,987	17,665
Impairment of purchased intangibles			1,400	
Total operating expenses	43,344	56,488	136,795	201,328
Loss from operations	(6,337)	(14,754)	(27,656)	(66,815)
Other income (expense):				
Interest income	2,104	2,943	7,071	9,482

Interest expense	(1,863)	(1,717)	(5,451)	(5,277)
Other income (expense), net	(170)	(815)	963	(5,950)
Total other income (expense)	71	411	2,583	(1,745)
Loss before provision for income taxes	(6,266)	(14,343)	(25,073)	(68,560)
Provision for income taxes	667		1,911	775
Net loss	$ (6,933)	$ (14,343)	$ (26,984)	$ (69,335)
Basic and diluted net loss per share	$ (0.09)	$ (0.18)	$ (0.34)	$ (0.88)
Shares used in basic and diluted per share calculation	80,496	79,089	79,924	78,965

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

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WIND RIVER SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

(Unaudited)

	October 31, 2003	January 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 24,912	$ 31,938
Short-term investments	21,308	31,110
Accounts receivable, net	37,419	42,129
Prepaid and other current assets	9,692	11,763
Total current assets	93,331	116,940
Investments	160,183	161,575
Property and equipment, net	94,684	45,618
Goodwill	84,428	84,253
Other intangibles, net	3,672	10,123
Other assets	9,861	11,645
Restricted cash	46,504	60,300
Total assets	$ 492,663	$ 490,454
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 1,568	$ 2,063
Accrued liabilities	17,508	19,230
Accrued restructuring costs	3,750	18,717
Accrued compensation	16,406	15,264
Income taxes payable	1,363	4,392
Deferred revenues	33,707	28,863
Total current liabilities	74,302	88,529
Convertible debt	150,000	150,000
Other long-term debt	40,000	
Total liabilities	264,302	238,529
Stockholders equity:		
Common stock, par value $0.001, 325,000 shares authorized; 82,237 and 81,775 shares issued as of October 31, 2003 and January 31, 2003, respectively; 80,274 and 79,539 shares outstanding as of October 31, 2003 and January 31, 2003, respectively	83	82
Additional paid-in-capital	750,154	747,642
Loan to stockholder, net	(747)	(2,006)
Treasury stock, 1,963 and 2,236 shares at cost at October 31, 2003 and January 31, 2003, respectively	(32,997)	(34,185)
Accumulated other comprehensive income (loss)	(638)	644

Accumulated deficit	(487,494)	(460,252)
Total stockholders equity	228,361	251,925
Total liabilities and stockholders equity	$ 492,663	$ 490,454

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

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WIND RIVER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended October 31,	
	2003	**2002**
Cash flows from operating activities:		
Net loss	$ (26,984)	$ (69,335)
Adjustments to reconcile net loss to net cash used in operations:		
Depreciation and amortization	15,101	22,401
Non-cash compensation, including 401(k) match and stock compensation	2,131	2,002
Provision for loan to stockholder, net	1,200	
Impairment of purchased intangibles	1,400	
Gains and losses on assets, investments and technology	(416)	4,820
Interest on loan to stockholder	59	(84)
Non-cash restructuring charge	1,787	1,545
Deferred income taxes		69
Changes in assets and liabilities:		
Accounts receivable, net	4,710	18,930
Prepaid and other current assets	2,071	162
Accounts payable	(495)	(1,995)
Accrued restructuring costs	(16,754)	(2,227)
Accrued liabilities	(1,722)	3,040
Accrued compensation	1,142	(2,599)
Income taxes payable	(3,029)	(3,785)
Deferred revenues	4,844	(5,227)
Other assets and liabilities	1,784	5,257
Net cash used in operating activities	(13,171)	(27,026)
Cash flows from investing activities:		
Acquisition of property and equipment	(59,116)	(4,921)
Capitalized software development costs		(969)
Purchase of investments	(147,787)	(204,528)
Sales of investments	85,154	116,081
Maturities of investments	72,026	48,060
Net reduction in restricted cash	14,164	
Acquisition, net of cash	(175)	(175)
Sale of technology	416	
Net cash used in investing activities	(35,318)	(46,452)
Cash flows from financing activities:		
Issuance of common stock	1,312	6,346
Repayment of line of credit		(14,988)

Acquisition of treasury stock		(4,697)
Borrowings from loan facility	40,000	
Net cash provided by (used in) financing activities	41,312	(13,339)
Effect of exchange rate changes on cash and cash equivalents	151	1,212
Net decrease in cash and cash equivalents	(7,026)	(85,605)
Cash and cash equivalents at beginning of period	31,938	131,067
Cash and cash equivalents at end of period	$ 24,912	$ 45,462

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

Note 1: Basis of Presentation

The accompanying condensed consolidated financial statements and related notes of Wind River Systems, Inc. are unaudited. However, in the opinion of management, all adjustments (consisting only of normal recurring adjustments) that are necessary for a fair presentation of the financial position as of October 31, 2003 and January 31, 2003, and the results of operations for the three and nine months ended October 31, 2003 and 2002, and the cash flows for the nine months ended October 31, 2003 and 2002 have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2003 filed with the Securities and Exchange Commission (2003 Form 10-K). The results of operations for the three and nine months ended October 31, 2003 are not necessarily indicative of results to be expected for the entire 2004 fiscal year, which ends on January 31, 2004, or for any future period.

In accordance with the rules and regulations of the Securities and Exchange Commission, unaudited condensed consolidated financial statements may omit or condense certain information and disclosures normally required for a complete set of financial statements prepared in accordance with United States generally accepted accounting principles (GAAP). Accordingly, certain information and disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. The consolidated balance sheet at January 31, 2003 was derived from audited financial statements, but does not include all disclosures required by GAAP. We believe that the notes to the condensed consolidated financial statements contain disclosures adequate to make the information presented not misleading.

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.

Certain amounts have been reclassified to conform to the presentation for the current period.

Note 2: Stock-Based Compensation

In December 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock Based Compensation Transition and Disclosure an Amendment of SFAS No. 123 (SFAS 148), which amended SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) to provide alternative methods of transition for a voluntary change to the fair-value-based method of accounting for stock-based employee compensation. In addition, SFAS 148 amended the disclosure requirements of SFAS 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results.

SFAS 123, as amended by SFAS 148, permits companies to measure the compensation cost of stock-based awards based on their estimated fair value at the date of grant and recognize the amount over the related service period. Therefore, as permitted by SFAS 123 and SFAS 148, we apply the existing accounting rules under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25),

and provide pro forma net loss and pro forma net loss per share disclosures for stock-based awards made during the three and nine months ended October 31, 2003 and 2002, as if the fair-value-based method defined in SFAS 123 had been applied.

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We account for equity instruments issued to non-employees in accordance with the provisions of SFAS 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. We use the Black-Scholes option-pricing model to value options granted to non-employees.

Pro Forma Disclosures. Under SFAS 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, 2003 and 2002:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2003	**2002**	**2003**	**2002**
Risk free interest rate	3.35%	2.84%	3.35%	2.84%
Expected volatility	84.3%	78.9%	84.3%	78.9%
Expected option life (in years)	4.89	4.93	4.89	4.93
Expected dividends				

The weighted average fair value per share of options granted during the three months ended October 31, 2003 and 2002 was $4.69 and $2.66, respectively, and the weighted average fair value per share of options granted during the nine months ended October 31, 2003 and 2002 was $4.62 and $3.62, respectively.

The fair value of employees stock purchase rights under Wind River s 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:

	Nine Months Ended October 31,	
	2003	**2002**
Risk free interest rate	1.22%	1.81%
Expected volatility	81.6%	89.2%
Expected option life (in years)	0.5	0.5
Expected dividends		

The weighted fair value of the common stock purchase rights granted under the Purchase Plan during the nine months ended October 31, 2003 was $1.52, as compared to a weighted average fair value of $6.96 per share during the nine months ended October 31, 2002.

Had compensation expense under these arrangements been determined pursuant to SFAS 123, our net loss and net loss per share for the three and nine months ended October 31, 2003 and 2002 would have been:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2003	2002	2003	2002
	(In thousands, except per share amounts)			
Net loss:				
As reported	$ (6,933)	$ (14,343)	$ (26,984)	$ (69,335)
Add: Stock-based compensation expense included in net income, net of tax	428		640	
Less: Stock-based compensation expense determined under fair-value-based method for all awards	11,901	11,728	22,745	35,971
Pro forma	$ (18,406)	$ (26,071)	$ (49,089)	$ (105,306)
Basic and diluted net loss per share:				
As reported	$ (0.09)	$ (0.18)	$ (0.34)	$ (0.88)
Pro forma	$ (0.23)	$ (0.33)	$ (0.61)	$ (1.33)

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The pro forma amounts include compensation expense related to stock option grants and purchases of common stock under the Purchase Plan. The effects of applying SFAS 123 on pro forma disclosures of net loss and net loss per share in the three and nine months ended October 31, 2003 and 2002 are not likely to be representative of the pro forma effects on net income (loss) and net income (loss) per share in future fiscal periods.

A summary of option activity for the nine months ended October 31, 2003 and 2002 is as follows:

	Nine Months Ended October 31,			
	2003		2002	
	Number of Shares Outstanding	Weighted Average Price per Share	Number of Shares Outstanding	Weighted Average Price per Share
	(In thousands, except for per share amounts)			
Beginning balance	19,433	$ 17.92	18,503	$ 21.62
Granted	3,365	6.66	4,931	5.66
Exercised	(124)	3.15	(553)	7.05
Canceled	(10,931)	23.30	(3,073)	22.39
Ending Balance	11,743	9.84	19,808	17.93

Options outstanding and exercisable as of October 31, 2003 from all option plans are as follows by exercise price ranges:

		Options Outstanding			Options Exercisable	
Range of Exercise Prices		Number Outstanding	Weighted Average Remaining Contractual Life (in Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
		(In thousands, except exercise price and contractual life data)				
$1.10	$4.27	504	3.54	$ 3.44	380	$ 3.47
4.32	5.00	3,049	3.69	4.99	34	4.71

5.28	6.33	508	6.05	5.67	193	5.72
6.36	6.92	2,931	5.03	6.92	2,196	6.92
7.15	10.25	796	5.47	9.43	591	9.33
10.27	10.40	1,394	7.89	10.40	754	10.40
11.14	16.00	1,613	6.25	15.40	1,427	15.46
16.19	44.50	944	5.83	30.07	857	29.94
47.94	47.94	3	6.92	47.94	2	47.93
48.63	48.63	1	6.36	48.63	1	48.63
1.10	48.63	11,743	5.27	9.84	6,435	12.28

As of October 31, 2002, options to purchase 9.7 million shares of common stock were exercisable at a weighted average exercise price of $22.23. As of October 31, 2003, an aggregate of 9.0 million shares were available for grant under all of our option plans.

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On March 21, 2003, we announced a voluntary stock option exchange program for employees. Under the program, eligible employees were offered the opportunity to exchange outstanding options to purchase 7.7 million shares of our common stock with exercise prices equal to or greater than $11.00 per share for new stock options to be granted at least six months and one day after the existing options were cancelled. The number of shares subject to the new options was dependant on the applicable exchange ratio determined by the exercise price of the exchanged stock options and the number of participating employees. Participating employees received new stock options in exchange for outstanding stock options at an exchange ratio of either 3 for 4, 1 for 2, or 1 for 3, depending on the exercise price of the exchanged stock option. In accordance with the program, on April 18, 2003, we canceled outstanding options to purchase approximately 7.4 million shares of our common stock, and on October 21, 2003, we granted new options to purchase a total of approximately 2.9 million shares of our common stock to the eligible employees. The exercise price per share of the new options was $6.92, which was equal to the fair market value of our common stock on the date of grant as determined in accordance with our applicable option plans. The new stock options represent approximately 4% of the total shares of our common stock outstanding as of December 10, 2003, and could have a dilutive impact on our future earnings per share if the market price of our common stock exceeds the exercise price of the new stock options granted.

During the three and nine months ended October 31, 2003, we recorded a charge of approximately $428,000 and $640,000, respectively, relating to options previously granted to our former chief executive officer who resigned in June 2003. See Note 7, Separation of Former Chief Executive Officer.

Note 3: Goodwill and Other Intangible Assets

We refer you to Note 3, Acquisitions and Dispositions, of Notes to Consolidated Financial Statements in our 2003 Form 10-K for further details of acquisitions completed during the fiscal years ended January 31, 2002, 2001 and 2000.

Information regarding our goodwill and other intangible assets is as follows:

	Goodwill	Purchased Technologies	Trademarks and Other Intangibles	Total
		(In thousands)		
Gross Carrying Amount:				
Balance as of January 31, 2003	$ 84,253	$ 32,096	$ 9,501	$ 125,850
Additions	175			175
Impairments		(1,400)		(1,400)
Balance as of October 31, 2003	84,428	30,696	9,501	124,625
Accumulated Amortization, Foreign Translation and Other Adjustments:				
Balance as of January 31, 2003		(24,316)	(7,158)	(31,474)
Additions to accumulated amortization		(4,180)	(860)	(5,040)
Foreign translation and other adjustments			(11)	(11)
Balance as of October 31, 2003		(28,496)	(8,029)	(36,525)

Net Book Value:	$ 84,428	$ 2,200	$ 1,472	$ 88,100

During the three months ended July 31, 2003 we performed our annual test for goodwill impairment as required by Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets (SFAS 142) as of June 30, 2003. Wind River currently operates in one reportable

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segment, which is also the only reporting unit for the purposes of SFAS 142. We completed our evaluation with the assistance of a third party consultant and concluded that goodwill was not impaired as the fair value of our Company exceeded its carrying value, including goodwill. The primary methods used to determine the fair values for SFAS 142 impairment purposes were the discounted cash flow and market methods. The assumptions supporting the discounted cash flow method, including the discount rate, which was assumed to be 17%, were determined using our best estimates as of the date of the impairment review.

During the three months ended July 31, 2003, we identified a possible impairment of certain purchased technologies relating to a previous acquisition. This impairment was based on a change in the long-term strategic plan for these purchased technologies. Accordingly, we compared the undiscounted cash flows associated with such acquired business and long-lived assets with the respective carrying amounts and determined that an impairment of certain of these assets existed. As a result, during the three months ended July 31, 2003, we recorded an aggregate charge of $1.4 million related to the impairment of purchased technologies. The impaired amount was measured as the amount by which the carrying amount exceeded the respective present value of the estimated future cash flows for these purchased technologies.

The estimated future amortization expense of purchased intangible assets is as follows:

Fiscal Year	Amount (In thousands)
2004*	$ 1,487
2005	2,185
2006	
Thereafter	
	$ 3,672

* For the remaining three months

Note 4: Restricted Cash

As of October 31, 2003, restricted cash consisted of investments held as collateral under our loan facility. See Note 8, Other Borrowings, below. As of January 31, 2003, restricted cash consisted of the investments held as collateral under the synthetic leases for our headquarters buildings in Alameda, California. See Note 11, Commitments and Contingencies.

Note 5: Derivative Financial Instruments

We enter into foreign currency forward exchange contracts to manage foreign currency exposures related to certain foreign currency denominated inter-company 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 foreign currency exposures or from fundamental shifts in the economics of particular exchange rates. 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. As of October 31, 2003, we had outstanding contracts with

the following terms:

Buy/Sell:	Sell	Sell	Sell
Currency:	GBP	EURO	JPY
Amount:	2,400,000	3,300,000	537,900,000
Rate:	1.6595	1.1792	109.6200
USD Equivalent:	$ 3,973,440	$ 3,887,730	$4,911,880
Maturity Date:	11/13/03	11/13/03	11/13/03

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, 2003, the fair value of our outstanding contracts was not significant.

Note 6: Restructuring and Other Charges

Restructuring and other charges consist of costs associated with restructuring programs implemented by Wind River, costs associated with the separation of our former chief executive officer and costs associated with the settlement of litigation and related remediation efforts.

Prior to January 1, 2003, we accounted for our restructuring and acquisition-related activity according to Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit and Activity (including Certain Costs Incurred in a Restructuring) (EITF 94-3).

Restructuring Charges. As a result of the decisions to restructure our business during fiscal 2003 and 2002, we recorded net restructuring charges of $32.7 million and $21.7 million, respectively, which in each case were classified as operating expenses. During the three months ended July 31, 2003, we undertook a further restructuring consisting of a limited headcount reduction of 10 employees, including four executive level positions in sales, legal and operations, and six positions in information technology. During the three months ended October 31, 2003, an additional restructuring, which consisted of a limited headcount reduction of 38 people, occurred at all levels and regions in the areas of general and administrative and sales operations. As a result of these decisions to restructure, we recorded net restructuring charges of $971,000 and $1.8 million in the three and nine months ended October 31, 2003, respectively, and $13.9 million in both the three and nine months ended October 31, 2002.

As of January 31, 2003, there were no remaining restructuring liabilities related to our restructuring plans for fiscal 2002. As of October 31, 2003, our total restructuring liabilities related to our restructuring plans for fiscal 2003 and 2004 were approximately $3.8 million. The following table summarizes our restructuring liabilities as of January 31, 2003 and our restructuring activity accounted for according to EITF 94-3 and SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), for the nine months ended October 31, 2003:

	Work Force Reduction	Consolidation of Excess Facilities	Other	Total
		(In thousands)		
Restructuring liabilities as of January 31, 2003	$ 15,155	$ 2,665	$ 897	$ 18,717
Cash payments	(14,797)	(1,329)	(628)	(16,754)
Cash charges	1,787			1,787
Restructuring liabilities as of October 31, 2003	$ 2,145	$ 1,336	$ 269	$ 3,750

The worldwide workforce reductions implemented as a result of the restructuring plan announced in the fourth quarter of fiscal 2003 were substantially completed during the first half of fiscal 2004. The workforce reductions implemented in the second and third quarters of fiscal 2004

were substantially completed by the end of the third quarter of fiscal 2004.

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Other Charges. In June 2003, our chief executive officer resigned. As a result, during the three months ended July 31, 2003, we recorded a charge of $1.2 million relating to a provision against the value of an outstanding loan to this officer. See Note 7, Separation of Former Chief Executive Officer.

During the three months ended July 31, 2002, we recorded a charge of $3.7 million relating to the settlement of litigation with a third party and related remediation efforts.

Note 7: Separation of Former Chief Executive Officer

Effective June 24, 2003, Thomas St. Dennis, our President and Chief Executive Officer, resigned his position. Under the terms of the employment agreement entered into by Mr. St. Dennis and us in September 1999, Mr. St. Dennis is required to provide certain consulting services to us, as and when requested by the Board of Directors, for a period of one year from the date his employment terminated.

In return for providing these services, Mr. St. Dennis will receive payments equivalent to his annual salary plus a pro-rata share of his target bonus for the current fiscal year. Options held by Mr. St. Dennis will also continue to vest for a period of 12 months. Based on the terms of the options held by Mr. St. Dennis at the date his employment terminated, approximately 314,000 options are expected to vest during the consulting period.

Due to Mr. St. Dennis change in status from employee to consultant we re-measured on the date his employment terminated, and will continue to re-measure, the fair value of these options until these options either become vested or the consulting period is completed. The fair value of these options was calculated using the Black-Scholes option-pricing model assuming a volatility of 101.2%, a term of 2 years and a risk free rate of 4.38%. The resulting fair value, together with the periodic adjustments arising from re-measurement, will be recorded as an expense over the consulting period using the accelerated method of accounting discussed in FASB Interpretation No. 28 Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans an Interpretation of APB Opinions No. 15 and 25 (FIN 28). During the three and nine months ended October 31, 2003, we recorded in general and administrative expenses of approximately $428,000 and $640,000, respectively, related to these options.

The total amount of compensation expense recorded for these options will vary based on any increases or decreases in our stock price. As a result, the amount recorded for the nine months ended October 31, 2003 may not be indicative of the total expense that will be recorded for these options.

At the time his employment terminated, Mr. St. Dennis was indebted to us in the amount of approximately $1.9 million, under the terms of a secured promissory note dated as of September 7, 1999. This note is secured by approximately 126,000 shares of our common stock, which Mr. St. Dennis purchased in the open market with the proceeds of the loan. Based on the terms of the note and Mr. St. Dennis employment agreement, the note does not become due until a date that is six months after the date of completion of the consulting services discussed above. Because the aggregate amount outstanding under the note exceeds the fair market value of the shares of common stock securing the loan, the fact Mr. St. Dennis is no longer an employee and the length of time of the repayment date after the completion of Mr. St. Dennis consulting services, we elected to record a provision of approximately $1.2 million, during the second quarter of fiscal 2004, against the aggregate amount outstanding under the note. Such provision is calculated as the difference between the carrying value of the note and the fair market value of the shares of common stock securing the loan as of Mr. St. Dennis separation date.

We will continue to assess the carrying value of the note in relation to the value of the security and may record additional provisions. However, we intend to seek the full collection of the note when it becomes due in accordance with its terms.

Note 8: Other Borrowings

In April 2003, 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, both of which mature in April 2005. During the nine months ended October 31, 2003, we borrowed $40.0 million against the loan facility. The unused commitment is subject to a fee equal to 0.10% per annum on the average daily-unused amount of the loan commitment.

Interest, which is payable monthly in arrears, is calculated at either a floating rate equivalent to the prime rate or a fixed rate equal to the London Interbank Offering Rate, or LIBOR, plus 0.40%. At our option, the rate may be fixed for periods of 1, 2, 3, 6, 9 or 12 months, or the Fixed Rate Term. We elected an initial Fixed Rate Term of 12 months. As of October 31, 2003, borrowings under the facility bear interest at the rate of 1.84% per annum.

If, during a Fixed Rate Term, we elect to prepay a portion or all of the outstanding principal due under the facility, then we must pay the bank a fee equivalent to the difference between the interest which would have been due on the principal repaid for the remaining portion of the Fixed Rate Term and the interest which would have been paid based on the LIBOR rate for a hypothetical loan of the same principal amount for the remaining period of the Fixed Rate Term.

Our restricted cash balance consists of $46.5 million in marketable securities held as collateral (the Securities Collateral) in order to ensure the performance of our obligations under the loan facility. In addition, we are required to maintain liquidity of at least $100.0 million. Under the facility agreement, liquidity is defined as the aggregate of our unencumbered and unrestricted cash, cash equivalents and readily marketable securities acceptable to the bank.

In the event that we meet certain financial performance and debt security ratios, as defined in the facility agreement, we may elect to release the Securities Collateral and replace it with a first priority mortgage on our headquarters property located in Alameda, California. In such event, we would be required to maintain liquidity of at least $150.0 million. Furthermore, we would be required to maintain tangible net worth of not less than $280.0 million through and including January 31, 2004, and tangible net worth of not less than $300.0 million as of and after February 1, 2004. Under the facility agreement, tangible net worth is defined as the aggregate of total stockholders equity plus subordinated debt less any intangible assets.

The facility agreement contains customary events of defaults, including payment defaults, breaches of representations and warranties, covenant defaults, certain events of bankruptcy, insolvency and change of control, material judgments, and a cross-default to other material agreements and debt where we have incurred any liability in excess of $3.0 million. If an event of default occurs, and we do not or cannot cure the default within the time periods specified in the facility agreement, the lender would be entitled to terminate the facility and declare the outstanding amounts under the loan facility to be immediately due and payable.

Note 9: Comprehensive Loss

Comprehensive 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

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owners and distributions to owners. The difference between net loss and comprehensive loss for Wind River results from foreign currency translation adjustments, mark-to-market adjustments on interest rate swaps and unrealized gains and losses on available-for-sale securities, net of taxes.

Comprehensive loss for the three and nine months ended October 31, 2003 and 2002 is as follows:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2003	2002	2003	2002
	(In thousands)			
Net loss	$ (6,933)	$ (14,343)	$ (26,984)	$ (69,335)
Other comprehensive loss:				
Foreign currency translation adjustments	(254)	(282)	151	1,212
Unrealized gain (loss) on investments	(97)	1,203	(1,433)	1,142
Fair value measurement of interest rate swaps		(893)		(2,399)
Other comprehensive gain (loss)	(351)	28	(1,282)	(45)
Total comprehensive loss	$ (7,284)	$ (14,315)	$ (28,266)	$ (69,380)

Note 10: Net Loss Per Share Computation

In accordance with SFAS No. 128, Earnings Per Share, the calculation of shares used in basic and diluted net loss per share computation for the three and nine months ended October 31, 2003 and 2002 is presented below:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2003	2002	2003	2002
	(In thousands)			
Shares used in basic net loss per share computation	80,496	79,089	79,924	78,965
Effect of dilutive potential common shares				
Shares used in diluted net loss per share computation	80,496	79,089	79,924	78,965

The effect of assumed conversion of the 3.75% convertible subordinated notes into 6.2 million shares of our common stock for both the three and nine months ended October 31, 2003 and 2002 is anti-dilutive, and is, therefore, excluded from the above computation. If we had recorded

net income for the three and nine months ended October 31, 2003 and 2002, we would have included in the computation dilutive potential common shares from outstanding stock options totaling approximately 739,000 and 89,000 for the three months ended October 31, 2003 and 2002, respectively, and 123,000 and 781,000 for the nine months ended October 31, 2003 and 2002, respectively. Because we recorded a net loss for the three and nine months ended October 31, 2003 and 2002, there is no difference between basic and diluted net loss per share.

Note 11: Commitments and Contingencies

From time to time, we are subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of patents and other intellectual property rights. We are not currently aware of any legal proceedings or claims that we believe will have, individually or in the aggregate, a material adverse affect on our financial position, results of operations or cash flows.

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In September 1997 and November 1999, we entered into operating leases for our headquarters facility constructed on land owned by us in Alameda, California. After considering various financing alternatives for the construction of our headquarters buildings, the related economic impact of each alternative and the ability to retain control of the property, we chose a form of financing that we believed offered beneficial economic terms, commonly referred to as a synthetic lease. These leases were treated as operating leases for accounting purposes and financing leases for tax purposes. A synthetic lease is a form of off-balance sheet financing under which an unrelated third party funds 100% of the costs for the acquisition and/or construction of the property and leases the asset back to the company, as lessee. None of our officers or employees had any financial interest in these synthetic lease arrangements.

In January 2003, we notified the lessor of our intent to exercise the purchase option under the leases and purchase the buildings. In April 2003, we completed the exercise of the purchase options and acquired the buildings for a purchase price of $57.4 million. As a result, we now reflect the buildings as an asset on our balance sheet. Additionally, the restricted cash of $60.3 million held to secure our obligations under the synthetic leases was released. Prior to the exercise of the purchase options, we reflected lease payments as a rental expense in our statement of operations. Having acquired the buildings, we no longer record lease expense for the buildings and, commencing in the first quarter of fiscal 2004, we began recording depreciation expense for the buildings over their estimated useful life of 30 years.

Note 12: Segment and Geographic Information

We report in one industry segment technology for embedded operating systems. We market our products and related services to customers in four geographic regions: North America (the United States and Canada), EMEA (Europe, the Middle East and Africa), Japan, and Asia Pacific. Internationally, we market our products and services primarily through our subsidiaries and various distributors. Revenues are attributed to geographic areas based on the country in which the customer is domiciled. The distribution of revenues and long-lived assets, net of depreciation and amortization, by geographic location is as follows:

	Revenues				Long-lived Assets	
	Three Months Ended October 31,		Nine Months Ended October 31,			
	2003	2002	2003	2002	As of Oct. 31, 2003	As of Jan. 31, 2003
	(In thousands)				(In thousands)	
North America	$ 27,382	$ 34,715	$ 84,047	$ 110,105	$183,795	$140,823
EMEA	11,709	12,219	34,241	42,509	5,728	6,523
Japan	6,811	7,288	19,530	20,157	2,902	3,906
Asia Pacific	3,684	4,059	10,724	15,451	220	387
Consolidated	$ 49,586	$ 58,281	$ 148,542	$ 188,222	$192,645	$151,639

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Revenue information on a product, subscription and services basis is as follows:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2003	2002	2003	2002
	(In thousands)			
Software licenses	$ 14,221	$ 22,355	$ 44,560	$ 73,768
Production license revenues	13,736	13,962	38,956	48,283
Subscription revenues	5,995	1,002	12,640	1,294
Maintenance revenues	10,698	12,633	34,807	38,202
Other service revenues	4,936	8,329	17,579	26,675
Total	$ 49,586	$ 58,281	$ 148,542	$ 188,222

No single customer accounted for more than 10% of our total revenues in the three or nine months ended October 31, 2003 or 2002.

Note 13: Recent Accounting Pronouncements

In November 2002, the EITF reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21), addressing how to account for arrangements that involve the delivery or performance of multiple products, services, and/or rights to use assets. Revenue arrangements with multiple deliverables are divided into separate units of accounting if the deliverables in the arrangement meet the following criteria: (1) the delivered item has value to the customer on a standalone basis; (2) there is objective and reliable evidence of the fair value of undelivered items; and (3) delivery of any undelivered item is probable. Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values, with the amount allocated to the delivered item being limited to the amount that is not contingent on the delivery of additional items or meeting other specified performance conditions. The final consensus is applicable to agreements entered into in fiscal periods beginning after June 15, 2003. The provisions of this consensus did not have a significant effect on the Company s results of operations or financial position.

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003. We are currently assessing the impact of the adoption of the pronouncement on our consolidated financial statements.

In April 2003, the FASB issued SFAS 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS 149), which amends SFAS 133 for certain decisions made by the FASB Derivatives Implementation Group. In particular, SFAS 149: (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FASB Interpretation No. 45, Guarantor s

Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, and (4) amends certain other existing pronouncements. SFAS 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, most provisions of SFAS 149 are to be applied prospectively. The adoption of SFAS 149 did not have a material impact on the Company s financial position, cash flows or results of operations.

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Note 14: Subsequent Events

On November 5, 2003, Wind River and Mr. Kenneth R. Klein entered into an employment agreement providing for the employment of Mr. Klein as Chairman of the Board of Directors, President and Chief Executive Officer effective as of January 5, 2004. Under the agreement, Mr. Klein will be entitled to receive an annualized base salary of $450,000 and an annualized bonus for on-plan performance, as determined by the Board of Directors. In addition, Mr. Klein will be granted certain stock options and/or stock appreciation rights as outlined in the following two paragraphs.

If the stockholders approve certain amendments to Wind River s 1998 Equity Incentive Plan, upon his commencement of employment, Mr. Klein will be granted three stock options to purchase an aggregate of 2,400,000 shares of common stock under the terms and conditions of the amended 1998 Equity Incentive Plan. The exercise price of the options will be the fair market value (as defined in the 1998 Equity Incentive Plan) of the covered shares on the date of grant. The three options will consist of a standard grant of 2,000,000 shares with time-based vesting and two grants of 200,000 shares each which shall have limitation on exercise tied to the Company s stock price performance.

If the stockholders do not approve the proposed amendments to Wind River s 1998 Equity Incentive Plan, then, in lieu of the option grants outlined in the preceding paragraph, the Company will grant Mr. Klein a combination of stock options and stock appreciation rights covering an aggregate of 2,400,000 shares of common stock under the terms of the existing 1998 Equity Incentive Plan. In such an event, the stock options and stock appreciation rights will be granted to Mr. Klein under the existing 1998 Equity Incentive Plan as follows:

On December 31, 2003, which shall be the date Mr. Klein s employment shall commence under the employment agreement if the proposed amendments to the 1998 Equity Incentive Plan are not approved by the Company s stockholders, the Company will grant Mr. Klein a stock option to purchase an aggregate of 750,000 shares of common stock and a stock appreciation right covering 750,000 shares of common stock, each in accordance with the terms of the 1998 Equity Incentive Plan;

On January 5, 2004, the Company will then grant Mr. Klein three additional stock options to purchase an aggregate of 750,000 shares of common stock. These three options will consist of a standard grant of 350,000 shares and two performance grants of 200,000 shares each which shall have a limitation on exercise tied to the Company s stock price performance; and

On January 5, 2004, the Company will grant Mr. Klein a stock appreciation right covering 150,000 shares of common stock.

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

Forward Looking Statements

The following Management s Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These statements include the sentence in the fourth paragraph under Results of Operations Revenues regarding expectations for subscription revenue; the sentence in the fifth paragraph under Results of Operations Revenues regarding expectations for maintenance revenue and service revenue; the sentence in the sixth paragraph under Results of Operations Revenues regarding expectations for international sales; the sentences in the second, third and fourth paragraphs under Results of Operations Cost of Revenues regarding factors that may affect product and subscription related costs of revenues in the future and our expectations regarding cost of subscription and service revenues as a percentage of subscription revenue and service revenue, respectively; the sentences in the first, second and third paragraphs under Results of Operations Operating Expenses regarding our expectations about sales and marketing expenses, product development and engineering expenses, and general and administrative expenses, respectively; the sentences in the last paragraph of Liquidity and Capital Resources regarding our beliefs about future liquidity and capital requirements; and the statements under Recent Accounting Pronouncements regarding the impact of the adoption of the pronouncements discussed thereunder.

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. The cautionary statements set forth below and in Factors that May Affect Future Results identify important factors that could cause actual results to differ materially from those in any such forward-looking statements. Additionally, see our Annual Report on Form 10-K for the fiscal year ended January 31, 2003 (2003 Form 10-K) for further discussion of these factors. 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 leading supplier of embedded software and services for embedded systems. An embedded system consists of a microprocessor, or a series of microprocessors, and related software and is used to control, monitor or assist the operation of electronic devices, equipment and machinery. Embedded systems are used in diverse products such as digital imaging products, auto braking systems, internet routers, jet fighter control panels and factory automation devices. Our products help customers to enhance product performance, standardize designs across projects, reduce research and development costs and shorten product development cycles. We sell our products to customers in a variety of markets, including the aerospace and defense, automotive, digital consumer, industrial measurement and networking markets.

During the fourth quarter of fiscal 2003, we introduced our Integrated Embedded Platforms, in which we bundle our software technology into market specific platforms and license these platforms

using an enterprise license model. These market specific platforms include a combination of development tools, an operating system and various protocols and interfaces. Under the enterprise license model, we license these market specific platforms under an annual subscription-based development license and aggregated production licenses, while eliminating our traditional project and site restrictions. See Factors That May Affect Future Results In late fiscal 2003, we introduced a new business model, including a new type of licensing arrangement, and cannot be sure that the new model will be successful. Additionally, we expect the transition to the new model will impact the timing of our reported revenues.

During the transition of our business model from project-based licensing to the enterprise license model, we expect the timing of our reported revenue to be impacted because revenue is recognized ratably over the subscription period under the enterprise license model. At the end of the subscription period, the customer s usage rights to our products expire unless renewed. By contrast, our traditional project-based license requires a majority of license revenue to be recognized in the quarter in which the products are delivered with a much smaller amount of revenue relating to the fair value of the maintenance to be deferred and recognized subsequently over the maintenance period. Therefore, an order for a subscription license will result in lower current-quarter revenue than an equal-sized order for a project-based license. As a result, the impact on near-term revenue and deferred revenue will depend on the rate at which customers transition from our project-based model to our enterprise license model. Since the introduction of the Integrated Embedded Platforms, the rate at which customers have transitioned to the enterprise license model has been in line with our expectations. However, we cannot be sure that the adoption rate will continue as we anticipate and, to the extent that the adoption rate is higher or lower than we expect, our revenue and deferred revenue will be impacted.

Management s discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with United States generally accepted accounting principles, or GAAP. We review the accounting policies we use in reporting our results on a regular basis. The preparation of our consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, as well as the disclosure of contingent assets and liabilities. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP and does not require our judgment in its applications. There are also areas in which our judgments in selecting among available accounting alternatives would not produce a materially different result. We have identified certain policies as critical to our business operation and to the understanding of our financial condition and results of operations, and our senior management has reviewed these critical accounting policies and related disclosures with the Audit Committee of our Board of Directors. Those 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 investments and long-lived assets, including goodwill and purchased intangibles
- Restructuring charges
- Accounting for income taxes

For a more comprehensive discussion of these critical accounting policies, please see Critical Accounting Policies, under Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations in our 2003 Form 10-K.

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Results of Operations

Beginning in the second quarter of fiscal 2002, we began to be significantly impacted by the continuing economic downturn in the high-technology sector. The downturn in the high-technology sector, as well as the adverse impact on us, has continued into the third quarter of fiscal 2004. Our revenues were $49.6 million and $58.3 million for the three months ended October 31, 2003 and 2002, respectively, and $148.5 million and $188.2 million for the nine months ended October 31, 2003 and 2002, respectively. Net loss was $6.9 million, or $0.09 per share, for the quarter ended October 31, 2003 compared to a net loss of $14.3 million, or $0.18 per share, for the quarter ended October 31, 2002. Net loss was $27.0 million, or $0.34 per share, for the nine months ended October 31, 2003 compared to a net loss of $69.3 million, or $0.88 per share, for the nine months ended October 31, 2002. See Revenues and Factors That May Affect Future Results The continuing economic downturn has adversely impacted, and may continue to adversely impact, our revenues and earnings, for a further discussion regarding the impact of the economic downturn on our financial condition and results of operations.

The following table sets forth certain consolidated statement of operations data as a percentage of revenues for the periods indicated:

	Three Months Ended October 31,		Nine Months Ended October 31,	
	2003	2002	2003	2002
Revenues, net:				
Product	56%	62%	56%	65%
Subscription	12	2	9	1
Service	32	36	35	34
Total revenues, net	100	100	100	100
Cost of revenues:				
Product	5	7	5	7
Subscription	3		2	
Service	17	21	19	21
Total cost of revenues	25	28	26	28
Gross profit	75	72	74	72
Operating expenses:				
Selling and marketing	42	47	44	50
Product development and engineering	28	31	28	30
General and administrative	13	15	14	14
Amortization of purchased intangibles	3	4	3	4
Impairment of purchased intangibles			1	
Restructuring and other charges	2		2	9
Total operating expenses	88	97	92	107
Loss from operations	(13)	(25)	(18)	(35)
Other income (expense):				

Interest income	4	5	5	5
Interest expense	(4)	(3)	(4)	(3)
Other income (expense), net		(1)		(3)
Total other income (expense)		1	1	(1)
Loss before provision for income taxes	(13)	(24)	(17)	(36)
Provision for income taxes	1		1	1
Net loss	(14)%	(24)%	(18)%	(37)%

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Revenues

Revenues consist of product, subscription and service revenues, net of sales returns and other allowances. Product revenues consist of revenues from production licenses (sometimes referred to as royalties) and fees for operating systems, hardware, licenses, and fees for the use of development tools. Subscription revenues consist of revenues from the licensing of our integrated embedded platforms which include a combination of development tools, an operating system, various protocols and interfaces and maintenance and support services such as installation and training, over a limited period of time, typically 12 months. In prior quarters, subscription revenues were reported as part of product revenues and service revenues due to their immateriality. Service revenues are derived from fees from professional services, which include design and development fees, software maintenance contracts, and customer training and consulting. We accrue for sales returns and other allowances based on historical experience. Total revenues were $49.6 million and $58.3 million for the three months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 15%. Total revenues were $148.5 million and $188.2 million for the nine months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 21%.

Product Revenues. Our product revenues, excluding revenue from production licenses, decreased 36% to $14.2 million in the three months ended October 31, 2003, compared to $22.4 million in the three months ended October 31, 2002 and decreased 40% to $44.6 million in the nine months ended October 31, 2003, compared to $73.8 million in the nine months ended October 31, 2002. Revenue from production licenses declined 2% to $13.7 million in the three months ended October 31, 2003, compared to $14.0 million in the three months ended October 31, 2002 and declined 19% to $39.0 million in the nine months ended October 31, 2003, compared to $48.3 million in the nine months ended October 31, 2002. Product revenues accounted for approximately 56% and 62% of total revenues in the three months ended October 31, 2003 and 2002, respectively, and 56% and 65% in the nine months ended October 31, 2003 and 2002, respectively. The general decline in product revenues is primarily due to lower customer demand for hardware and software products, including revenues from production licenses, which are generally tied to the number of products deployed. This lower customer demand is primarily a result of the continuing economic downturn in the high-technology sector. This downturn has affected us both directly, by decreasing our sales, and indirectly, because our products are incorporated into our customers products, and as our customers sales decline, our production license revenue declines as well. Our product revenues have also been affected as the result of the transition of some of our customers to our integrated embedded platforms. Fees from our transactions are recorded as subscription revenue ratably over the one year license term. See Factors That May Affect Future Results In late fiscal 2003, we introduced a new business model, including a new type of licensing arrangement, and cannot be sure that the new model will be successful. Additionally, we expect the transition to the new model will impact the timing of our reported revenues.

During the first nine months of fiscal 2004 and during fiscal 2003 and 2002, some of our customers have (i) decreased research and development budgets, (ii) sought to increase the value they receive from vendors, including us, (iii) attempted to leverage a more competitive bidding process when spending research and development budgets, and/or (iv) deferred or canceled projects, in whole or in part. As a result of these factors, we believe that some of our customers have undertaken development in-house, selected solutions they perceive to be less expensive or have relied on existing licenses rather than making new product purchases from us. Also, we cannot anticipate or calculate the potential adverse impact of open source or in-house software on our revenues or market share particularly where our customers budget constraints may make such software, which is royalty-free, more appealing than our products for their initial project development.

Subscription Revenues. Subscription revenues were $6.0 million in the three months ended October 31, 2003, compared to $1.0 million in the three months ended October 31, 2002, and $12.6 million in the nine months ended October 31, 2003, compared to $1.3 million in the nine months ended October 31, 2002. Subscription revenues accounted for approximately 12% and 2% of total revenues in the three months ended October 31, 2003 and 2002, respectively, and 9% and 1% in the nine months ended October 31, 2003 and 2002, respectively. The increase in subscription revenues resulted from the transition of a number of our customers from our traditional project-based licensing model to our integrated platforms. We expect that subscription revenues will increase both in absolute terms and as a percentage of revenue in the future. In the short term, the transition of customers to this business model will affect the level of our overall revenues as we recognize fees received under our enterprise licensing model ratably. Under our project-based perpetual model a significant percentage of the transaction fee is recognized in the quarter the transaction is completed. See Factors That May Affect Future Results In late fiscal 2003, we introduced a new business model, including a new type of licensing arrangement, and cannot be sure that the new model will be successful. Additionally, we expect the transition to the new model will impact the timing of our reported revenues.

Service Revenues. Service revenues decreased 25% to $15.6 million in the three months ended October 31, 2003, compared to $21.0 million in the three months ended October 31, 2002, and decreased 19% to $52.4 million in the nine months ended October 31, 2003, compared to $64.9 million in the nine months ended October 31, 2002. Service revenues accounted for approximately 32% and 36% of total revenues in the three months ended October 31, 2003 and 2002, respectively, and 35% and 34% in the nine months ended October 31, 2003 and 2002, respectively. Excluding maintenance revenues, service revenues declined 41% to $4.9 million in the three months ended October 31, 2003, compared to $8.3 million in the three months ended October 31, 2002, and declined 34% to $17.6 million in the nine months ended October 31, 2003, compared to $26.7 million in the nine months ended October 31, 2002. These declines were a result of the disruption to our services backlog that arose from the reorganization of our sales force as part of the restructuring plan announced in the fourth quarter of fiscal 2003 as well as the economic downturn in the high technology sector. Our services backlog reduced again in the third quarter of fiscal 2004, which could impact the volume of service revenues recognized in the fourth quarter. During the three and nine months ended October 31, 2003, we generated $1.1 million and $7.0 million, respectively, in revenue from fixed-price services contracts accounted for under the percentage-of-completion method of accounting. Maintenance revenues decreased 15% to $10.7 million in the three months ended October 31, 2003, compared to $12.6 million in the three months ended October 31, 2002 and declined 9% to $34.8 million in the nine months ended October 31, 2003, compared to $38.2 million in the nine months ended October 31, 2002. We expect maintenance revenues will continue to decline as our customers transition to our enterprise license model, which includes maintenance as a part of the subscription fee.

International Revenues. Revenues from international sales decreased by 6% to $22.2 million in the three months ended October 31, 2003, compared to $23.6 million in the three months ended October 31, 2002 and declined 17% to $64.5 million in the nine months ended October 31, 2003, compared to $78.1 million in the nine months ended October 31, 2002. The overall decrease in the three months ended October 31, 2003 compared to the three months ended October 31, 2002 was due to a 4% decline in revenues from Europe, the Middle East and Africa, or EMEA, a 7% decline in revenues from Japan, and a 9% decline in revenues from Asia Pacific. The overall decrease in the nine months ended October 31, 2003 compared to the nine months ended October 31, 2002 was due to a 19% decline in revenues from EMEA, a 3% decrease in revenues from Japan, and a 31% decline in revenues from Asia Pacific. Revenues in EMEA were $11.7 million in the three months ended October 31, 2003, compared to $12.2 million in the three months ended October 31, 2002 and were $34.2 million in the nine months ended October 31, 2003, compared to $42.5 million in the nine months ended October 31, 2002. Revenues in Japan were $6.8 million in the three months ended October 31, 2003, compared to

$7.3 million in the three months ended October 31, 2002 and were $19.5 million in the nine months ended October 31, 2003, compared to $20.2 million in the nine months ended October 31, 2002. Revenues from Asia Pacific were $3.7 million in the three months ended October 31, 2003, compared to $4.1 million in the three months ended October 31, 2002 and were $10.7 million in the nine months ended October 31, 2003, compared to $15.5 million in the nine months ended October 31, 2002. The decrease in international revenues resulted primarily from macroeconomic factors that have caused our customers to reduce their research and development spending and purchase fewer of our products and services. Additionally, many of our customers are large multinational corporations that have reduced capital spending across all geographic regions. Our international revenues have also been affected as the result of the transition of some of our customers to our integrated embedded platforms, in which revenue is recognized ratably as opposed to being recognized immediately under our existing project-based license model. International revenues accounted for 45% and 43%, respectively, of total revenues in the three and nine months ended October 31, 2003, compared to 40% and 42%, respectively, of total revenues the three and nine months ended October 31, 2002. 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 mostly denominated in local currencies.

The economic downturn experienced in the past two years, together with the uncertainties surrounding the timing and strength of any economic recovery, makes forecasting and financial and strategic planning are more difficult than usual. The adverse impact of the downturn on the capital markets and any uncertainty surrounding the timing and strength of any recovery could impair our ability to raise capital as needed and impede our ability to expand our business. For further discussion about factors affecting our revenues see Factors That May Affect Future Results.

Cost of Revenues

The overall cost of product, subscription and service as a percentage of total revenues was 25% and 28% in the three months ended October 31, 2003 and 2002, and was 26% and 28% in the nine months ended October 31, 2003 and 2002, respectively.

Cost of Product. Cost of product was $2.3 million and $4.0 million in the three months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 41%, and $8.0 million and $14.1 million in the nine months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 43%. Product-related cost of revenues as a percentage of product revenues was 8% in the three months ended October 31, 2003, compared to 11% in the three months ended October 31, 2002 and was 10% in the nine months ended October 31, 2003, compared to 12% in the nine months ended October 31, 2002. Product-related costs consist primarily of salaries and benefits for production employees, 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 decline in product-related costs in absolute dollars in the three and nine months ended October 31, 2003 was primarily due to lower direct production costs and manufacturing and distribution costs. Direct production costs were $929,000 and $1.0 million for three months ended October 31, 2003 and 2002, respectively, and $2.6 million and $4.0 million for the nine months ended October 31, 2003 and 2002, respectively. Manufacturing and distribution costs were $419,000 and $1.1 million for the three months ended October 31, 2003 and 2002, respectively, and $1.8 million and $3.9 million for the nine months ended October 31, 2003 and 2002, respectively. Amortization of capitalized software development costs for the three months ended October 31, 2003 and 2002 amounted to $69,000 and $252,000, respectively; and third-party royalty costs for the three months ended October 31, 2003 and 2002 were $740,000 and $1.2 million, respectively. Amortization of capitalized software development costs for the nine months ended October 31, 2003 and 2002 amounted to $321,000 and $667,000, respectively; and third party royalty costs for the nine months ended October 31, 2003 and 2002 amounted to $2.5 million and $4.4 million, respectively. The decline in cost of

product as a percentage of product revenue was as a result of a lower proportion of revenues of amortization of third-party royalties and internally developed software costs. Product-related cost of revenues may be affected in the future by the amortization of capitalized software development costs, costs of distribution related to the introduction of new products and by royalty costs for use of third-party software in our products.

Cost of Subscription. Cost of subscriptions was $1.6 million and $116,000 in the three months ended October 31, 2003 and 2002, respectively, and was $3.5 million and $147,000 in the nine months ended October 31, 2003 and 2002, respectively. Subscription-related cost of revenues as a percentage of subscription revenues was 26% and 12% in the three months ended October 31, 2003 and 2002, respectively, and 28% and 11% in the nine months ended October 31, 2003 and 2002, respectively. Subscription-related cost of revenues, which were reported in prior quarters as cost of product revenues and cost of service revenues, consists primarily of subscription-related costs, including salaries and benefits for production 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 in subscription costs in the three and nine months ended October 31, 2003, compared to the three and nine months ended October 31, 2002, was primarily due to the increase in sales due to the transition of some of our customers from project-based licensing to the subscription-based integrated platforms. Subscription-related production costs were $114,000 and $20,000 for the three months ended October 31, 2003 and 2002, respectively, and $254,000 and $23,000 for the nine months ended October 31, 2003 and 2002, respectively. Subscription-related manufacturing and distribution costs were $306,000 and $53,000 for the three months ended October 31, 2003 and 2002, respectively, and $692,000 and $69,000 for the nine months ended October 31, 2003 and 2002, respectively. Amortization of capitalized software development costs for the three months ended October 31, 2003 and 2002 amounted to $51,000 and $12,000, respectively; and third party royalty costs for the three months ended October 31, 2003 amounted to $70,000. Amortization of capitalized software development costs for the nine months ended October 31, 2003 and 2002 amounted to $118,000 and $14,000, respectively; and third party royalty costs for the nine months ended October 31, 2003 amounted to $298,000. We expect cost of subscriptions to continue to fluctuate as a percentage of subscription revenue based on our ability to attract customers to transition to the subscription-based integrated platform. 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. Cost of service was $8.7 million and $12.5 million in the three months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 30%, and was $27.8 million and $39.5 million in the nine months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 29%. Service-related cost of revenues as a percentage of service revenues was 56% and 60% in the three months ended October 31, 2003 and 2002, respectively, and 53% and 61% in the nine months ended October 31, 2003 and 2002, respectively. 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 decrease in absolute dollars of service costs in the three and nine months ended October 31, 2003, compared to the three and nine months ended October 31, 2002, was primarily due to reduced use of outside consultants and a reduction of full-time employees as part of the restructuring plans we implemented in fiscal 2003. We realized cost reductions of $2.7 million in professional services costs, $855,000 in training costs, and $145,000 in maintenance costs in the quarter ended October 31, 2003, compared to the quarter ended October 31, 2002. In the nine months ended October 31, 2003, we realized cost reductions of $7.6 million in professional services costs, $2.2 million in training costs, and $1.7 million in maintenance costs compared to the nine months ended October 31, 2002. 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.

Operating Expenses

Selling and Marketing. Selling and marketing expenses were $20.9 million and $27.4 million in the three months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 24%. Selling and marketing expenses were $65.0 million and $94.0 million in the nine months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 31%. As a percentage of total revenues, selling and marketing expenses were 42% and 47% in the three months ended October 31, 2003 and 2002, respectively, and 44% and 50% in the nine months ended October 31, 2003 and 2002, respectively. The decreases in absolute dollars and as a percentage of revenues, in selling and marketing expenses was attributable to lower sales commission expenses as a result of decreased sales volume and the impact of our restructuring plans implemented during fiscal 2003, including reduced expenditures for salaries and related fringe costs and travel costs. Due to our restructuring plans implemented in fiscal 2003 and the general decline in sales, we realized cost reductions of $892,000 in sales commissions, $1.8 million in the area of payroll-related costs, $480,000 in travel costs, and $673,000 in consulting costs together with smaller savings achieved in various other areas in the quarter ended October 31, 2003, compared to the quarter ended October 31, 2002. We also realized cost reductions of $4.4 million in sales commissions, $8.9 million in the area of payroll related costs, $2.8 million in travel costs, $2.2 million in consulting costs and $2.8 million in other costs in the nine months ended October 31, 2003, compared to the nine months ended October 31, 2002. In addition, in the three and nine months ended October 31, 2003 compared to the three and nine months ended October 31, 2002, depreciation expense decreased $1.0 million and $3.4 million, respectively, due to a lower depreciable base of our short-lived fixed assets. We believe selling and marketing expenses in absolute dollars will not increase significantly in the short term. However, we do expect an increase in absolute dollars in the 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. Product development and engineering expenses were $13.8 million and $18.0 million in the three months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 24%, and were $42.2 million and $56.5 million in the nine months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 25%. As a percentage of total revenues, product development and engineering expenses were 28% and 31% in the three months ended October 31, 2003 and 2002, and were 28% and 30% in the nine months ended October 31, 2003 and 2002, respectively. The decrease in product development and engineering expenses in absolute dollars in the three and nine months ended October 31, 2003, compared to the same periods ended October 31, 2002, was primarily due to our implementation of cost-control measures related to our restructuring plans implemented in fiscal 2003. Due to these restructuring plans, we realized cost reductions of $2.5 million in payroll-related costs, and $527,000 in depreciation costs, together with smaller savings achieved in various other areas in the quarter ended October 31, 2003, compared to the quarter ended October 31, 2002, and cost reductions of $8.7 million in payroll-related costs, $1.2 million in consulting costs, and $1.7 million in depreciation costs together with smaller savings achieved in various other areas in the nine months ended October 31, 2003, compared to the nine months ended October 31, 2002. In addition, we received $946,000 and $581,000 of funded research and development related to our Center of Excellence program and other similar initiatives in the three months ended October 31, 2003 and 2002, respectively, and $2.7 million and $3.8 million in the nine months ended October 31, 2003 and 2002, respectively, which offset a portion of our gross research and development expenses. We believe that product development and engineering expenses in absolute dollars will not increase significantly in the short term. However, we do expect an increase in absolute dollars in the long term, as we continue to focus on long-term growth in the areas of research and development.

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General and Administrative. General and administrative expenses were $6.2 million and $8.7 million in the three months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 29%, and were $20.1 million and $26.4 million in the nine months ended October 31, 2003 and 2002, respectively, reflecting a decrease of 24%. As a percentage of total revenues, general and administrative expenses were 13% and 15% in the three months ended October 31, 2003 and 2002, respectively, and were 14% in each of the nine months ended October 31, 2003 and 2002. The decline in general and administrative expenses in absolute dollars was the result of an overall decline in expenses due to our implementation of cost-control measures related to our restructuring plans implemented in fiscal 2003 and a reduction in legal costs. Due to our restructuring plans implemented in fiscal 2003, we realized $1.2 million in payroll-related cost reductions in the quarter ended October 31, 2003, compared to the quarter ended October 31, 2002, and cost reductions of $2.5 million in payroll-related costs in the nine months ended October 31, 2003 compared to the nine months ended October 31, 2002. Additionally, our legal costs in the three months ended October 31, 2003 were $1.3 million less than the three months ended October 31, 2002, and $3.3 million less in the nine months ended October 31, 2003, compared to the nine months ended October 31, 2002, primarily as a result of lower legal costs resulting from our restructuring plans, and from our having incurred $800,000 of legal costs in the quarter ended April 30, 2002 relating to an employee litigation matter. During the three and nine months ended October 31, 2003, these declines have been offset by approximately $646,000 and $932,000, respectively, of expenses associated with the consulting arrangement with our former chief executive officer. See Note 7, Separation of Former Chief Executive Officer , in the notes to the condensed consolidated financial statements. We believe that general and administrative expenses will not increase significantly in absolute dollars in the short term as a result of the restructuring plans discussed above and the restructuring currently being undertaken in the general and administrative areas as discussed in, Restructuring and Other Charges, below. However, we do 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.

We allocate the total costs for information technology, facilities and fixed asset depreciation to each of the functional areas based on certain headcount data. Information technology allocated costs include salaries, information technology, project costs, communication costs and depreciation expense for fixed assets. Facilities allocated costs include depreciation for the corporate offices and facility rent for our other 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.

Amortization of Purchased Intangibles. Amortization of purchased intangibles totaled $1.5 million and $2.3 million in the three months ended October 31, 2003 and 2002, respectively, and $5.0 million and $6.8 million in the nine months ended October 31, 2003 and 2002, respectively.

Goodwill. During the three months ended July 31, 2003 we performed the annual test for goodwill impairment as required by Statement of Financial Accounting Standards (SFAS) No. 142, Goodwill and Other Intangible Assets (SFAS 142) as of June 30, 2003. Wind River currently operates in one reportable segment, which is also the only reporting unit for the purposes of SFAS 142. We completed our evaluation with the assistance of a third party consultant and concluded that goodwill was not impaired as the fair value of our Company exceeded its carrying value, including goodwill. The primary methods used to determine the fair values for SFAS 142 impairment purposes were the discounted cash flow and market methods. The assumptions supporting the discounted cash flow method, including the discount rate, which was assumed to be 17%, were determined using our best estimates as of the date of the impairment review.

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Restructuring and Other Charges. Restructuring and other charges consists of costs associated with restructuring programs we have implemented, costs associated with the separation of the former chief executive officer and costs associated with the settlement of litigation and related remediation efforts.

Prior to January 1, 2003, we accounted for our restructuring and acquisition-related activity according to Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit and Activity (including Certain Costs Incurred in a Restructuring) (EITF 94-3).

Restructuring Charges. As a result of the decisions to restructure our business during fiscal 2003 and 2002, we recorded net restructuring charges of $32.7 million and $21.7 million, respectively, which in each case were classified as operating expenses. During the three months ended July 31, 2003, we undertook a further restructuring consisting of a limited headcount reduction of 10 employees, including four executive level positions in sales, legal and operations, and six positions in information technology. During the three months ended October 31, 2003, an additional restructuring, which consisted of a limited headcount reduction of 38 people, occurred at all levels and regions in the areas of general and administrative and sales operations. As a result of these decisions to restructure, we recorded net restructuring charges of $971,000 and $1.8 million in the three and nine months ended October 31, 2003 and $13.9 million in both the three and nine months ended October 31, 2002, respectively.

As of January 31, 2003, there were no remaining restructuring liabilities related to our restructuring plans for fiscal 2002. As of October 31, 2003, our total restructuring liabilities related to our restructuring plans for fiscal 2003 and 2004 were approximately $3.8 million. The following table summarizes our restructuring liabilities as of January 31, 2003 and our restructuring activity accounted for according to EITF 94-3 and SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS 146), for the nine months ended October 31, 2003:

	Work Force Reduction	Consolidation of Excess Facilities	Other	Total
		(In thousands)		
Restructuring liabilities as of January 31, 2003	$ 15,155	$ 2,665	$ 897	$ 18,717
Cash payments	(14,797)	(1,329)	(628)	(16,754)
Cash charges	1,787			1,787
Restructuring liabilities as of October 31, 2003	$ 2,145	$ 1,336	$ 269	$ 3,750

The worldwide workforce reductions implemented as a result of the restructuring plan announced in the fourth quarter of fiscal 2003 were substantially completed during the first half of fiscal 2004. The workforce reductions implemented in the second and third quarters of fiscal 2004 were substantially completed by the end of the third quarter of fiscal 2004.

Other Charges. In June 2003, our former chief executive officer resigned. As a result of this separation during the three months ended July 31, 2003, we recorded a charge of $1.2 million relating to a provision against the value of an outstanding loan to this officer. See Note 7, Separation of Former Chief Executive Officer, in the notes to condensed consolidated financial statements.

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During the three months ended July 31, 2002, Wind River recorded a charge of $3.7 million relating to the settlement of litigation with a third party and related remediation efforts.

Impairment of Purchased Intangibles. During the three months ended July 31, 2003, we identified a possible impairment of certain purchased technologies relating to a previous acquisition. This impairment was based on a change in the long-term strategic plan for these purchased technologies. Accordingly, we compared the undiscounted cash flows associated with such acquired business and long-lived assets with the respective carrying amounts and determined that an impairment of certain of these assets existed. As a result, during the three months ended July 31, 2003, we recorded an aggregate charge of $1.4 million related to the impairment of purchased technologies. The impaired amount was measured as the amount by which the carrying amount exceeded the respective present value of the estimated future cash flows for these purchased technologies.

Other Income (Expense)

Interest Income. Interest income was $2.1 million and $2.9 million for the three months ended October 31, 2003 and 2002, respectively, and $7.1 million and $9.5 million for the nine months ended October 31, 2003 and 2002, respectively. The decrease in interest income was primarily due to lower invested balances, lower interest earned on our investments as a result of lower interest rates, and higher amortization expense related to our fixed-income securities. Total cash and cash equivalents, investments and restricted cash totaled $252.9 million and $296.3 million as of October 31, 2003 and 2002, respectively.

Interest Expense. Interest expense was $1.9 million and $1.7 million for the three months ended October 31, 2003 and 2002, respectively, and $5.5 million and $5.3 million in the nine months ended October 31, 2003 and 2002. 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. Additionally, we incur interest of approximately $184,000 each quarter on our loan facility.

Other Income (Expense), Net. Other income (expense), net, was expense of $170,000 and $815,000 for the three months ended October 31, 2003 and 2002, respectively, and income of $963,000 and expense of $6.0 million for the nine months ended October 31, 2003 and 2002, respectively. During the three and nine months ended October 31, 2003, other income consisted mainly of gains on the disposal of assets of acquired businesses of $616,000, respectively. During the three and nine months ended October 31, 2002, other expense reflected our write-down of certain public and private investments of approximately $4.5 million.

Provision For Income Taxes

Despite consolidated net losses, we had a tax provision of $667,000 in the three months ended October 31, 2003 and no provision in the three months ended October 31, 2002. We had a tax provision of $1.9 million and $775,000 in the nine months ended October 31, 2003 and 2002, respectively. These provisions represented effective tax rates of 10.6% for the three months ended October 31, 2003 and 7.6% and 1.1% for the nine months ended October 31, 2003 and 2002, respectively. Our tax provision is based on estimates for foreign and withholding taxes that we expect to incur during the year. As of January 31, 2003, our deferred tax assets were fully valued based on our determination it is more likely than not that these assets will not be realized. In the event that our estimates change, our effective tax rate will fluctuate from period to period.

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Liquidity and Capital Resources

Cash Flows

As of October 31, 2003, we had working capital of approximately $19.0 million, and cash, cash equivalents and investments of approximately $206.4 million, which included $21.3 million of short-term investments and $160.2 million of investments with maturities of greater than one year, but excluded restricted cash of $46.5 million associated with our loan facility discussed below under Commitments. We invest primarily in highly liquid, investment-grade instruments. We have substantial debt service and principal repayment obligations, which could affect our liquidity, cash reserves and ability to obtain additional financing if we need to do so.

Operating activities primarily include the net loss for the quarter, non-cash charges such as depreciation and amortization expense and changes in assets and liabilities. In the nine months ended October 31, 2003, our operating activities used net cash of $13.2 million compared to $27.0 million in the nine months ended October 31, 2002. Net cash used in operating activities for the nine months ended October 31, 2003 consisted of cash used by operations of $5.7 million and a decrease in cash of $7.5 million arising from changes in assets and liabilities, primarily as a result of payments of accrued restructuring costs and income taxes payable offset by a decrease in accounts receivable and an increase in deferred revenues. Accounts receivable decreased by $4.7 million due primarily to the lower sales volume in the nine months ended October 31, 2003 and deferred revenue increased by $4.8 million primarily as a result of the introduction of our enterprise license model. During the nine months ended October 31, 2003, we also made net payments of $16.8 million associated with our restructuring plans and net payments of $3.0 million associated with income taxes. Net cash used in operating activities for the nine months ended October 31, 2002 consisted of a decrease in cash used by operations of $38.6 million offset by an increase in cash of $11.6 million arising from changes in assets and liabilities, primarily accounts receivable, which decreased by $18.9 million. Cash from operations includes net loss of $27.0 million and $69.3 million offset primarily by depreciation and amortization of $15.1 million and $22.4 million in the nine months ended October 31, 2003 and 2002, 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, other competitive factors and our ability to control expenses successfully.

Our investing activities used net cash of $35.3 million compared to $46.5 million in the nine months ended October 31, 2003 and 2002, respectively. Investing activities generally relate to the purchase of investments, business acquisitions and property and equipment purchases, partially offset by cash provided from the sale and maturity of investments. Acquisitions of property and equipment totaled $59.1 million in the nine months ended October 31, 2003, of which $57.4 million represented the purchase price of our headquarters buildings, which we acquired upon exercise of the purchase options associated with the synthetic leases covering our headquarters buildings. See Commitments below for further information on the exercise of the purchase options. In the nine months ended October 31, 2002, purchases of property and equipment totaled $4.9 million. During the nine months ended October 31, 2003, the net decrease in our restricted cash was $14.2 million as a result of the release of restricted cash associated with our synthetic leases offset by the restricted cash being held to secure the loan facility that we entered into in the same quarter.

In the nine months ended October 31, 2003, our financing activities provided net cash of $41.3 million compared to net cash used of $13.3 in the nine months ended October 31, 2002. During the nine months ended October 31, 2003, the primary source of cash was the $40.0 million that we borrowed under our loan facility, which we entered into in the quarter ended April 30, 2003. In the nine months ended October 31, 2002, the primary source of cash was $6.3 million received from the issuance of

common stock from employee stock option exercises and employee stock purchase plan exercises, offset by $15.0 million in repayment of a line of credit at our Japanese subsidiary and $4.7 million for the acquisition of treasury stock.

Convertible Subordinated Notes

In December 2001, we issued $150.0 million of 3.75% convertible subordinated notes due December 2006. The notes are unsecured, subordinated to all existing and future senior debt and convertible into shares of our common stock at an initial conversion price of $24.115 per share. The notes mature on December 15, 2006, unless earlier redeemed or converted. Interest is payable in cash semi-annually in arrears on June 15 and December 15 of each year, commencing June 15, 2002. At the option of the holder, the notes may be converted into our common stock at any time at the then-current conversion price. We may redeem all or a portion of the notes for cash at a redemption price of 100.75% of the principal amount between December 15, 2004 and December 14, 2005, and 100.0% of the principal amount beginning December 15, 2005 and thereafter. Additionally, under specified circumstances we may redeem the notes prior to 2004.

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.

Commitments

In September 1997 and November 1999, we entered into two operating leases for our headquarters facility constructed on land owned by us in Alameda, California. After consideration of various financing alternatives for the construction of our headquarters buildings on land owned by us, the related economic impact of each alternative and the ability to retain control of the property, we chose a form of financing that we believed offered beneficial economic terms, commonly referred to as a synthetic lease. These leases were treated as operating leases for accounting purposes and financing leases for tax purposes. A synthetic lease is a form of off-balance sheet financing under which an unrelated third party funds 100% of the costs for the acquisition and/or construction of the property and leases the asset back to the company, as lessee. None of our officers or employees had any financial interest in these synthetic lease arrangements.

In January 2003, we notified the lessor of our intent to exercise the purchase options under the synthetic leases. In April 2003, we completed the transactions, terminated the synthetic leases and purchased the buildings for a purchase price of $57.4 million. As a result of our completion of the purchase options, we reflect the buildings as an asset on our balance sheet. Additionally, restricted cash of $60.3 million held under the leases was released. Prior to the exercise of the purchase options, we reflected lease payments as a rental expense in our statement of operations. Having acquired the buildings, we no longer record a lease expense for the buildings and we record depreciation expense for the buildings over their estimated useful lives of 30 years.

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In connection with the termination of the synthetic leases, in April 2003, we entered into a loan facility for an aggregate principal amount of $57.4 million, consisting of a $37.4 million non-revolving loan commitment and $20.0 million term loan, both of which mature in April 2005. During the quarter ended April 30, 2003, we borrowed $40.0 million of the facility at an interest rate currently equal to 1.84%. Under the terms of the facility, we are holding $46.5 million in marketable securities as restricted cash to secure the performance of our obligations under the facility. See Note 8, Other Borrowings in notes to condensed consolidated financial statements for further information regarding the loan facility. The facility agreement contains customary events of defaults, including payment defaults, breaches of representations and warranties, covenant defaults, certain events of bankruptcy, insolvency and change of control, material judgments, and a cross-default to other material agreements and debt where we have incurred any liability in excess of $3.0 million. If an event of default occurs, and we do not or cannot cure the default within the time periods specified in the facility agreement, the lender would be entitled to terminate the facility and declare the outstanding amounts under the loan facility to be immediately due and payable.

As of October 31, 2003, our future financial commitments, including interest payments, are as set forth in the table below:

	Three Months Ending January 31,	Year Ended January 31,					
	2004	2005	2006	2007	2008	Thereafter	Total
				(In thousands)			
3.75% subordinated convertible debt[1]	$ 2,813	$ 5,625	$ 5,625	$ 155,625	$	$	$ 169,688
Loan facility[2]	188	753	40,155				41,096
Other operating leases[3]	2,236	9,458	4,280	2,082	1,669	8,493	28,218
Total	$ 5,237	$ 15,836	$ 50,060	$ 157,707	$ 1,669	$ 8,493	$ 239,002

(1) The $150.0 million 3.75% convertible subordinated notes mature in December 2006, but may be redeemed by us starting in 2004 or earlier if certain conditions are met. See Convertible Subordinated Notes above.

(2) We may prepay the loan facility at any time.

(3) Minimum future sublease income to be received under noncancelable subleases is approximately $2.1 million. As part of our restructuring reserve, we have accrued approximately $1.4 million relating to future payments associated with leases for excess facilities.

We had no material planned capital commitments as of October 31, 2003. Our capital requirements depend on numerous factors including our research and development expenditures, expenses related to selling, general and administrative operations and working capital to support business growth. We anticipate that our operating and capital expenditures will constitute a material use of our cash resources. As a result, our net cash flows will depend heavily on (i) the level of our future sales (which depend, to a large extent, on general economic conditions affecting us and our customers, as well as the timing of new product introductions, the rate at which our customers transition to our enterprise license model and other competitive factors) and (ii) our ability to control expenses and realize the objectives of the various restructuring plans we implemented in fiscal 2003 and 2004. Although it is difficult for us to predict future liquidity requirements with certainty, we believe that our current cash and cash equivalents will satisfy our cash requirements for planned expansion, product development and capital expenditures

for at least the next twelve months and on a longer term basis. During or after this period, if cash generated by operations is insufficient to satisfy our liquidity requirements, we may need to sell additional equity or debt securities or obtain an additional credit facility. Our ability to obtain additional financing may be limited by the amount of indebtedness we have outstanding and/or our recent performance and financial condition, particularly if our bond rating is lowered or withdrawn, as well as general market conditions if the continuing economic downturn were to continue or become more serious. During the first quarter of fiscal 2004, our corporate credit rating was downgraded by Standard & Poor s from B+ to B. Accordingly, there can be no assurance that additional financing will be available to us or, if available, that such financing will be available on favorable terms. If we were unable to obtain financing, we might be required to reduce our expenses, including product development and engineering expenses, which could have a material adverse effect on our business and results of operations.

Recent Accounting Pronouncements

In November 2002, the EITF reached a consensus on Issue No. 00-21, Revenue Arrangements with Multiple Deliverables (EITF 00-21), addressing how to account for arrangements that involve the delivery or performance of multiple products, services, and/or rights to use assets. Revenue arrangements with multiple deliverables are divided into separate units of accounting if the deliverables in the arrangement meet the following criteria: (1) the delivered item has value to the customer on a standalone basis; (2) there is objective and reliable evidence of the fair value of undelivered items; and (3) delivery of any undelivered item is probable. Arrangement consideration should be allocated among the separate units of accounting based on their relative fair values, with the amount allocated to the delivered item being limited to the amount that is not contingent on the delivery of additional items or meeting other specified performance conditions. The final consensus is applicable to agreements entered into in fiscal periods beginning after June 15, 2003. The provisions of this consensus did not have a significant effect on the Company s results of operations or financial position.

In January 2003, the FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 (FIN 46). FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity to finance its activities without additional subordinated financial support from other parties. FIN 46 is effective immediately for all new variable interest entities created or acquired after January 31, 2003. For variable interest entities created or acquired prior to February 1, 2003, the provisions of FIN 46 must be applied for the first interim or annual period beginning after December 15, 2003. We are currently assessing the impact of the adoption of the pronouncement on our consolidated financial statements.

In April 2003, the FASB issued SFAS 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities (SFAS 149), which amends SFAS 133 for certain decisions made by the FASB Derivatives Implementation Group. In particular, SFAS 149: (1) clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative, (2) clarifies when a derivative contains a financing component, (3) amends the definition of an underlying to conform it to language used in FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, and (4) amends certain other existing pronouncements. SFAS 149 is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, most provisions of SFAS 149 are to be applied prospectively. The adoption of SFAS 149 did not have a material impact on the Company s financial position, cash flows or results of operations.

Factors That May Affect Future Results

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. 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.

The economic downturn has adversely impacted and may continue to adversely impact our revenues and earnings. In addition, uncertainties associated with the downturn increase the difficulty of financial planning and forecasting.

We are currently in the midst of a general economic downturn that commenced in 2001 in the United States and expanded to many other regions of the world during 2002. The economic downturn has been especially pronounced in the high technology sector generally and the telecommunications sector in particular. Beginning in fiscal year 2002 and continuing through fiscal year 2003 and into the first nine months of fiscal 2004, we have experienced a decline in revenues and a loss of profitability, which we believe is attributable primarily to these downturns. Our total revenues decreased 29% in fiscal 2003, compared to fiscal 2002, and decreased 20% in fiscal 2002 compared to fiscal 2001.

Our decline in revenues during fiscal years 2002 and 2003, and for the three and nine months ended October 31, 2003, as well as the continuing adverse economic conditions, led us to implement restructuring plans in fiscal 2002 and 2003, and in the second and third quarters of fiscal 2004 that included headcount reductions and other cost-control measures. The restructuring plan announced in the fourth quarter of fiscal 2003 was substantially completed during the first half of fiscal 2004. Due to the restructuring plans, we recorded charges for restructuring and impairment of acquired goodwill and other intangible assets during fiscal years 2002 and 2003, and in the three and nine months ended October 31, 2003.

The economic downturn experienced in the past two years, together with the uncertainties surrounding the timing and strength of any economic recovery, makes forecasting and financial and strategic planning more difficult than usual. The adverse impact of the downturn on the capital markets and any uncertainty surrounding the timing and strength of any recovery could impair our ability to raise capital as needed and impede our ability to expand our business.

In late fiscal 2003, we introduced a new business model, including a new type of licensing arrangement, and cannot be sure that the new model will be successful. Additionally, we expect the transition to the new model will impact the timing of our reported revenues.

In November 2002, we introduced our enterprise license model, which includes technology integrated into market specific platforms and subscription-based licenses. While we believe that the introduction of the enterprise license model will have significant benefits for our customers, it is possible these benefits may not materialize. There is a risk that customers may not accept the new products we offered under our enterprise license model, or that they may reject the terms of the model itself. There is a risk that customers may delay or defer product ordering decisions, and that we may not be able to engage our customers at appropriate levels of management to make enterprise-wide subscription orders feasible. There is a further risk that we may remain dependent upon large end-of-quarter transactions, that our selling efforts in coming quarters could be disrupted, and that the transition to the enterprise license model could cause us to incur unanticipated administrative and other costs. In any such event, our revenue and earnings for a quarter could be below our expectations.

Although enterprise licenses represent a potential source of renewable license revenue, there is also a risk that customers will not renew their licenses at the end of the term. In addition, there is a risk 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 under our traditional project-based model. Also, because the enterprise license includes limited services, customers may purchase fewer stand-alone services from us, which could negatively impact our service revenues. Additionally, we expect maintenance revenues will decline as our customers transition to our enterprise license model, which includes maintenance as a part of the subscription fee. We expect many of our strategic and major customers to adopt our enterprise license model for their current needs, and that they may also transition existing perpetual development seats to enterprise license model terms.

During the transition of our business model from project-based licensing to the enterprise license model, we expect the timing of our reported revenue to be impacted because under the enterprise license model revenue is recognized ratably over the subscription period. By contrast, our traditional project-based license requires a majority of license revenue to be recognized in the quarter in which the products are delivered with a much smaller amount of revenue relating to the fair value of the maintenance being deferred and recognized subsequently over the maintenance period. Therefore, an order for a subscription license will result in lower current-quarter revenue than an equal-sized order for a project-based license. As a result, the impact on near-term and deferred revenue will depend on the rate at which customers transition from our project-based model to our enterprise license model. To the extent that the adoption rate is higher than we expect, we may experience a greater decline in near-term revenue, as well as an increase in deferred revenue.

Our restructuring plans may not enable us to achieve profitability in a difficult economic environment or achieve our business objectives.

In response to market conditions and the decline in our revenues, in both fiscal years 2002 and 2003, and in the second and third quarters of fiscal 2004 we implemented restructuring plans that were designed to align our anticipated revenues more closely with our cost structure. Our restructuring plans have been 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 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 significant headcount reductions, facilities closures, and other cost-control measures, that may adversely affect our ability to realize our current or future business objectives. For example, the reorganization of our sales force disrupted our services backlog and adversely impacted our services revenues for the quarter ended October 31, 2003. 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 profitability as a result of our restructuring plans.

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:

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implementation of our enterprise license model and use of subscription-based licenses, as discussed above;

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 revenue;

the mix of our revenues as between sales of products and lower-margin sales of services;

our ability to control our operating expenses, and fully realize the objectives 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 or service interruptions;

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

economic, political 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 revenue and operating results to fluctuate significantly. Results from prior periods are thus not necessarily indicative of the results of future periods.

We have substantial 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, 2003, we had $150.0 million in outstanding indebtedness under our 3.75% convertible subordinated notes and $40.0 million in other long-term debt. As of October 31, 2003, we had cash and cash equivalents of $24.9 million, short-term investments of $21.3 million, investments with maturities of greater than one year of $160.2 million and restricted cash of $46.5 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 indenture. Similarly, our loan facility agreement contains customary events of default, including a cross-default to other material agreements and debt where we have incurred any liability in excess of $3.0 million. Under the terms of our convertible subordinated notes and our loan facility, if an event of default were to occur for 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.

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

The embedded software 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 embedded 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, decreased revenue from our production licenses 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 embedded systems in-house. In many cases, companies that develop embedded 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 with open-source vendors. Some of the companies that develop embedded 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.

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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 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 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 market for embedded software is characterized by ongoing technological developments, evolving industry standards and rapid changes in customer requirements and product offerings in the embedded 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. 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, sales of our products could decline.

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 were $13.8 million, or 28% of total revenues, for the three months ended October 31, 2003 compared to $18.0 million, or 31% of total revenues, for the three months ended October 31, 2002. Our product development and engineering expenses were $42.2 million, or 28% of total revenues, for the nine months ended October 31, 2003 compared to $56.5 million, or 30% of total revenues, for the nine months ended October 31, 2002. If we are required to undertake extensive capital outlays to address changes in the embedded software 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.

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

Our operating systems and middleware products are embedded in end-user products developed and marketed by our customers, and we receive production license fees for each copy of our operating system and middleware products embedded in those products. Therefore, our production license revenues depend both upon our ability to successfully negotiate the production license agreements with our customers and, in turn, upon our customers successful commercialization of their underlying products. In particular, we derive significant revenue from customers that develop products in highly competitive and technologically complex markets such as the Internet infrastructure, servers and data 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, during fiscal 2003, our revenues from production licenses declined 13% as compared to fiscal 2002, 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. Additionally, because Linux is royalty-free, we may be forced to reduce the prices of our production licenses, which may cause our revenues and profit margins to decline.

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 months ended October 31, 2003, revenues from international sales were $22.2 million, or 45% of total revenue, as compared to $23.6 million, or 40% of total revenue, for the three months ended October 31, 2002. For the nine months ended October 31, 2003, revenues from international sales were $64.5 million, or 43% of total revenue, as compared to $78.1 million, or 42% of total revenue, for nine months ended October 31, 2002. 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;
- 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 or 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.

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 fiscal 2003, our stock had a high sales price of $18.35 and a low sales price of $2.03, and during the nine months ended October 31, 2003, our stock had a high sales price of $8.07 and a low sales price of $2.71. The last sale price of our common stock as reported on The Nasdaq National Market on December 10, 2003 was $6.24. In recent fiscal quarters, we have 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.

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

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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. 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 embedded 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.

Legislative actions may cause our operating expenses to increase.

The Sarbanes-Oxley Act of 2002, the California Disclosure Act and newly proposed or enacted rules and regulations of the Securities and Exchange Commission or the National Association of Securities Dealers impose new duties on us and our executives, directors, attorneys and independent accountants. In order to comply with the Sarbanes-Oxley Act and such new rules and regulations, we may be required to hire additional personnel and use additional outside legal, accounting and advisory services. Any of these developments could materially increase our operating expenses and accordingly reduce our net income or increase our net losses.

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Potential new accounting pronouncements may cause our net income to decrease or our net losses to increase.

In December 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 148, Accounting for Stock Based Compensation Transition and Disclosure an Amendment of SFAS No. 123 (SFAS 148), which amends SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123) to provide alternative methods of transition for a voluntary change to the fair-value-based method of accounting for stock based employee compensation. SFAS 123, as amended by SFAS 148, permits us to measure the compensation cost of stock-based awards based on their estimated fair value at the date of grant and recognize the amount over the related service period. Therefore, as permitted by SFAS 123 and SFAS 148, we apply the existing accounting rules under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25), and provide pro forma net income (loss) and pro forma net income (loss) per share disclosures for stock-based awards made during the three and nine months ended October 31, 2003 and 2002, as if the fair-value-based method defined in SFAS 123 had been applied. If we change our method of accounting for employee stock-based awards, whether voluntarily or as a result of changes in accounting rules, our net income could materially decrease or our net losses could materially increase. For example, had we recorded compensation expenses based on the estimated grant date fair value for awards under our stock option and stock purchase plans (as defined in SFAS 123) our pro forma net loss for the three months ended October 31, 2003 would have been $18.4 million, or $0.23 per share, instead of reported net loss of $6.9 million, or $0.09 per share, and our pro forma net loss for the nine months ended October 31, 2003 would have been $49.1 million, or $0.61 per share, instead of reported net loss of $27.0 million, or $0.34 per share.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Sensitivity

Our exposure to market risk for changes in interest rates relate primarily to our investment portfolio and debt obligations. 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 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. During the nine months ended October 31, 2003, we entered into a loan facility for an aggregate principal amount of $57.4 million, of which we have borrowed $40.0 million. As of October 31, 2003, borrowings under the facility bear interest at the rate of 1.84% per annum.

Foreign Currency Risk

We enter into foreign currency forward exchange contracts to manage foreign currency exposures related to certain foreign currency denominated inter-company 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 foreign currency exposures or from fundamental shifts in the economics of particular exchange rates. Gains and losses on terminated forward contracts, or on contracts that are offset, are recognized in other income (expense) 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, 2003, we had outstanding contracts with the following terms:

Buy/Sell:	Sell	Sell	Sell
Currency:	GBP	EURO	JPY
Amount:	2,400,000	3,300,000	537,900,000
Rate:	1.6595	1.1792	109.6200
USD Equivalent:	$ 3,973,440	$ 3,887,730	$4,911,880
Maturity Date:	11/13/03	11/13/03	11/13/03

Contract amounts are representative of the expected amounts to be paid under the terms of these instruments. As of October 31, 2003, the fair value of our outstanding 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, 2003. See item 7A, Quantitative And Qualitative Disclosures About Market Risk, in our Annual Report on Form 10-K for the fiscal year ended January 31, 2003.

ITEM 4. CONTROLS AND PROCEDURES

Our management evaluated, with the participation of our Interim 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 October 31, 2003. Based on this evaluation, our Interim Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures were effective as of October 31, 2003 to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in Securities and Exchange Commission rules and forms.

There has been 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.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Not applicable.

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Not applicable.

ITEM 5. OTHER INFORMATION

On September 19, 2003, James W. Bagley resigned from the Board of Directors of Wind River Systems, Inc.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

Exhibit No.	Description

31.1	Certification of Interim President and Chief Executive Officer pursuant to Rule 13a-14(a)/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 Chief Financial Officer and Senior Vice President of Finance and Administration, pursuant to Rule 13a-14(a)/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 Interim President and Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer and Senior Vice President of Finance and Administration, pursuant to 18 U.S.C. 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K

(i) On August 14, 2003 Wind River filed a report on Form 8-K relating to its announcement of its operating results for the quarter ended July 31, 2003.

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SIGNATURE

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: December 12, 2003	**WIND RIVER SYSTEMS, INC.**	
	By:	/s/ MICHAEL W. ZELLNER
		Michael W. Zellner *Chief Financial Officer and Senior Vice President of Finance and Administration* *(Principal Financial and Accounting Officer)*

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