WIND RIVER SYSTEMS INC
Form 10-Q
September 13, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended July 31, 2002 or

o **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. ý Yes o No

As of September 10, 2002, there were 79,144,950 shares of the registrant's common stock outstanding.

WIND RIVER SYSTEMS, INC.
FORM 10-Q
FOR THE QUARTER ENDED JULY 31, 2002

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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 July 31,		Six months ended July 31,	
	2002	2001	2002	2001

	Three months ended July 31,		Six months ended July 31,	
Revenues, net:				
Products	$ 42,301	$ 54,550	$ 86,026	$ 128,220
Services	21,281	25,680	43,915	62,202
Total revenues	63,582	80,230	129,941	190,422
Cost of revenues:				
Products	4,709	6,809	10,182	13,766
Services	12,992	15,138	26,980	33,318
Total cost of revenues	17,701	21,947	37,162	47,084
Gross profit	45,881	58,283	92,779	143,338
Operating expenses:				
Selling and marketing	32,747	38,773	66,562	83,195
Product development and engineering	17,792	21,720	38,414	47,027
General and administrative	8,397	9,796	17,681	19,840
Amortization of goodwill and purchased intangibles	2,395	24,321	4,518	55,807
Impairment of goodwill and purchased intangibles		225,418		225,418
Restructuring and other nonrecurring costs	17,665	28,615	17,665	28,615
Total operating expenses	78,996	348,643	144,840	459,902
Loss from operations	(33,115)	(290,360)	(52,061)	(316,564)
Other income (expense):				
Interest income	3,147	4,336	6,539	9,288
Interest expense	(1,773)	(2,053)	(3,560)	(4,206)
Other expense, net	(4,928)	(682)	(5,135)	(916)
Total other income (expense)	(3,554)	1,601	(2,156)	4,166
Loss before provision for (benefit from) income taxes	(36,669)	(288,759)	(54,217)	(312,398)
Provision for (benefit from) income taxes	275	(7,200)	775	(5,998)
Net loss	$ (36,944)	$ (281,559)	$ (54,992)	$ (306,400)
Net loss per share:				
Basic	$ (0.47)	$ (3.64)	$ (0.70)	$ (3.98)
Diluted	$ (0.47)	$ (3.64)	$ (0.70)	$ (3.98)
Shares used in per share calculation:				
Basic	79,035	77,354	78,901	77,070

	Three months ended July 31,		Six months ended July 31,	
Diluted	79,035	77,354	78,901	77,070

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)

	July 31, 2002	January 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 47,805	$ 131,067
Short-term investments	29,154	22,364
Accounts receivable, net	45,505	61,109
Prepaid and other current assets	13,038	18,404
Total current assets	135,502	232,944
Investments	173,078	123,136
Property and equipment, net	52,379	59,804
Intangibles, net	104,576	108,409
Other assets	15,454	19,644
Restricted cash	63,683	63,683
Total assets	$ 544,672	$ 607,620
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 4,331	$ 7,191
Line of credit	12,119	14,988
Accrued liabilities	22,563	19,346
Accrued restructuring costs	5,266	5,243
Accrued compensation	13,575	17,575
Income taxes payable	4,879	7,485
Deferred revenue	31,067	34,656
Total current liabilities	93,800	106,484
Convertible subordinated debt	150,000	150,000
Other long-term liabilities	4,066	2,995

	July 31, 2002	January 31, 2002
Total liabilities	247,866	259,479
Stockholders' equity:		
Common stock, par value $0.001; 325,000 shares authorized; 81,130 and 79,863 shares issued at July 31, 2002 and January 31, 2002, respectively; 79,090 and 78,586 shares outstanding at July 31, 2002 and January 31, 2002, respectively.	81	80
Additional paid-in-capital	745,318	737,595
Loan to stockholder	(1,949)	(1,893)
Treasury stock, 2,040 shares at cost	(33,426)	(29,488)
Accumulated other comprehensive loss	(4,838)	(4,765)
Accumulated deficit	(408,380)	(353,388)
Total stockholders' equity	296,806	348,141
Total liabilities and stockholders' equity	$ 544,672	$ 607,620

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

WIND RIVER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended July 31,	
	2002	2001
Cash flows from operating activities:		
Net loss	$ (54,992)	$ (306,400)
Adjustments to reconcile net loss to net cash provided by (used in) operations:		
Depreciation and amortization	15,306	64,938
Non-cash charge for other-than-temporary decline in investment	4,259	3,275
Non-cash restructuring charge	1,545	1,411
Non-cash compensation, including 401(k) match	1,453	1,563
Interest on loan to stockholder	(56)	(52)
Impairment of goodwill and purchased intangibles		225,418
Loss on asset dispositions	153	
Realized gain on repurchase of convertible subordinated notes		(293)
Deferred income taxes	69	(2,509)
Changes in assets and liabilities, net of acquired businesses:		
Accounts receivable, net	15,604	39,138
Prepaid and other current assets	4,760	5,718

	Six Months Ended July 31,	
Accounts payable	(2,860)	(9,177)
Accrued restructuring costs	(126)	20,644
Accrued liabilities	3,217	(4,842)
Accrued compensation	(4,000)	(3,931)
Income taxes payable	(2,633)	(1,982)
Deferred revenue	(3,589)	(14,110)
Other assets and liabilities	(61)	(2,049)
Net cash provided by (used in) operating activities	(21,951)	16,760
Cash flows from investing activities:		
Acquisition of property and equipment	(4,161)	(12,052)
Capitalized software development costs	(969)	(801)
Purchase of investments	(163,436)	(194,637)
Sales of investments	83,600	115,003
Maturities of investments	22,670	61,500
Acquisitions, net of cash acquired		(37,771)
Restricted cash		(1,055)
Net cash used in investing activities	(62,296)	(69,813)
Cash flows from financing activities:		
Issuance of common stock	6,298	10,898
Repurchase of convertible subordinated notes		(11,151)
Acquisition of treasury stock	(3,938)	
Borrowings (repayment) of line of credit	(2,869)	1,170
Net cash provided by (used in) financing activities	(509)	917
Effect of exchange rate changes on cash and cash equivalents	1,494	(1,787)
Net decrease in cash and cash equivalents	(83,262)	(53,923)
Cash and cash equivalents at beginning of period	131,067	92,431
Cash and cash equivalents at end of period	$ 47,805	$ 38,508

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. ("Wind River") 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 July 31, 2002 and January 31, 2002, the results of operations for the three and six months ended

July 31, 2002 and 2001, and cash flows for the six months ended July 31, 2002 and 2001 have been included. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in Wind River's Annual Report on Form 10-K for the fiscal year ended January 31, 2002 filed with the Securities and Exchange Commission on April 30, 2002 ("2002 Form 10-K"). The results of operations for the three and six months ended July 31, 2002 are not necessarily indicative of results to be expected for the entire fiscal year, which ends on January 31, 2003, 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 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 condensed consolidated balance sheet at January 31, 2002 was derived from audited financial statements, but does not include all disclosures required by GAAP. Management of Wind River believes 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. Wind River has a reporting year ending January 31 while, through December 31, 2001, its international subsidiaries (outside of North America) had reporting years ending December 31; thus, the condensed consolidated financial statements for the three and six months ended July 31, 2001 include such subsidiaries' results for the three and six months ended June 30, 2001. Effective January 31, 2002, each of Wind River's international subsidiaries (outside of North America) changed its reporting year to end on January 31 rather than December 31; thus, the condensed consolidated financial statements for the three and six months ended July 31, 2002 include such subsidiaries' results for the three and six months ended July 31, 2002.

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

Note 2: Acquisitions

Wind River has completed a number of acquisitions accounted for as purchase transactions. The condensed consolidated financial statements include the operating results of each business from the date of acquisition. The purchase price for each acquisition is allocated to the tangible and identifiable intangible assets acquired and liabilities assumed on the basis of the estimated fair values on the effective date of the acquisition.

On April 18, 2001, Wind River purchased certain identified software products, including an operating system for digital signal processors from Eonic Systems, Inc. ("Eonic"). The total purchase price of $15.6 million consisted of $15.0 million in cash and approximately $642,000 in acquisition related costs.

On May 4, 2001, we purchased from Berkeley Software Design, Inc. ("BSDI") certain identified software assets, including the BSDI operating system, a UNIX-based code suitable for various Internet applications, for a total purchase price of $23.4 million, consisting of approximately $22.9 million in cash and $507,000 in acquisition-related costs. Prior to the closing of the transaction, we loaned $7.5 million to BSDI to repay BSDI creditors.

Pro forma results of the Eonic and BSDI purchases have not been presented because the effects were not material to the condensed consolidated financial statements of Wind River.

Refer to Note 3 of Notes to Consolidated Financial Statements in Wind River's 2002 Form 10-K for further details of acquisitions completed during the fiscal years ended January 31, 2002, 2001 and 2000.

The table below sets forth the amortization expense, foreign translation and other adjustments for the six months ended July 31, 2002 and the net book value of goodwill and purchased intangibles as of July 31, 2002 for certain acquisitions completed during fiscal years ended January 31, 2002, 2001 and 2000:

	Acquisitions									
	Tele-networks	**BSDI**	**Eonic**	**Rapid Logic**	**ICESoft**	**AudeSi**	**Embedded Support Tools**	**Software Development Systems**	**Other**	**Total**

Acquisitions

(In thousands)

Total at acquisition										
Goodwill	$ 2,354	$ 20,073	$ 11,664	$ 49,028	$ 23,961	$ 50,180	$ 317,393	$ 23,018	$ 8,964	$ 506,635
Purchased intangibles	2,875	3,410	3,870	7,000	750	1,100	15,800	12,100	655	47,560
	5,229	23,483	15,534	56,028	24,711	51,280	333,193	35,118	9,619	554,195
Disposition as of January 31, 2002										
Goodwill		215			3,062					3,277
Purchased Technology					468					468
		215			3,530					3,745
Impairment as of January 31, 2002										
Goodwill				24,024	15,255	35,397	167,481	13,811		255,968
Purchased intangibles						440		977		1,417
				24,024	15,255	35,837	167,481	14,788		257,385
Accumulated amortization as of January 31, 2002										
Goodwill		3,764	2,187	14,841	5,644	14,632	107,474	7,385	6,151	162,078
Purchased intangibles	220	639	726	2,220	282	466	7,242	10,128	655	22,578
	220	4,403	2,913	17,061	5,926	15,098	114,716	17,513	6,806	184,656
Amortization expense, foreign translation and other adjustments for the six months ended July 31, 2002										
Goodwill										
Purchased intangibles	360	426	484	876		44	1,975	355	(687)	3,833
	360	426	484	876		44	1,975	355	(687)	3,833
Net book value at July 31, 2002										
Goodwill	2,354	16,094	9,477	10,163		151	42,438	1,822	2,813	85,312
Purchased intangibles	2,295	2,345	2,660	3,904		150	6,583	640	687	19,264
	$ 4,649	$ 18,439	$ 12,137	$ 14,067	$	$ 301	$ 49,021	$ 2,462	$ 3,500	$ 104,576
Fiscal year acquired	2002	2002	2002	2001	2001	2001	2001	2000		

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Impairment of Goodwill and Purchased Intangibles

During the quarter ended July 31, 2001, Wind River identified indicators of possible impairment of goodwill and other acquired intangible assets relating to previous acquisitions. These indicators included the deterioration in the business climate, changes in sales and cash flow forecasts, strategic plans for certain of the acquired businesses and significant declines in the market values of companies in the embedded software industry. Accordingly, Wind River compared the undiscounted cash flows associated with the acquired businesses 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 and six months ended July 31, 2001, Wind River recorded an aggregate charge of $225.4 million, of which, $223.6 million related to the impairment of goodwill, including both impaired goodwill and workforce balances, and $1.8 million related to the impairment of purchased intangible assets. 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 goodwill and purchased intangible assets presented in the table above. During the quarter ended January 31, 2002, Wind River recorded a further impairment of goodwill and purchased intangibles of $32.0 million.

The impairment charge for those assets held for use was determined based upon the estimated discounted cash flows over the remaining useful life of the goodwill using discount rates ranging from 17% to 23%. The assumptions supporting the cash flows, including the discount rates, were determined using Wind River's best estimates as of the date of the impairment review. The impairment charge for those assets held for disposal was determined based on the expected proceeds of disposition. As of July 31, 2002 and January 31, 2002, Wind River had net book values in goodwill and purchased intangible assets of approximately $104.6 million and $108.4 million, respectively. Accumulated amortization for goodwill and purchased intangibles as of July 31, 2002 and January 31, 2002 was $188.5 million and $184.7 million, respectively. Amortization expense relating to completed technology for the three months ended July 31, 2002 and 2001 was $1.7 million and $2.2 million, respectively, and was $3.4 million and $4.4 million for the six months ended July 31, 2002 and 2001, respectively. Other than goodwill, all identifiable intangible assets of approximately $19.3 million in net book value as of July 31, 2002 will continue to be amortized in accordance with Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" ("SFAS 142").

Wind River adopted SFAS 142 on February 1, 2002, and accordingly, ceased amortizing goodwill with net book value totaling $85.3 million, including $8.5 million of acquired workforce previously

classified as purchased intangibles. The following table presents the impact of SFAS 142 on net loss and net loss per share had SFAS 142 been applicable for the three and six months ended July 31, 2001:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2002	2001	2002	2001
	(In thousands, except per share amounts)			
Reported loss	$ (36,944)	$ (281,559)	$ (54,992)	$ (306,400)
Adjustments:				
Amortization of goodwill		21,107		49,517
Amortization of acquired workforce previously classified as purchased intangible assets		695		1,370
Net adjustments		21,802		50,887
Adjusted net income (loss)	$ (36,944)	$ (259,757)	$ (54,992)	$ (255,513)
Reported net loss per share basic and diluted	$ (0.47)	$ (3.64)	$ (0.70)	$ (3.98)
Adjusted net income (loss) per share basic and diluted	$ (0.47)	$ (3.36)	$ (0.70)	$ (3.32)

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

Year Ended January 31,	Amount
	(In thousands)
2003*	$ 4,518
2004	8,609
2005	4,498
2006	953

* Remaining six months

Wind River is required to perform an assessment of whether there was an indication that goodwill is impaired as of the date of Wind River's adoption of SFAS 142. To accomplish this, Wind River was required to identify its reporting units and determine the carrying value of each reporting unit by assigning the assets and liabilities, including the existing goodwill and intangible assets, to those reporting units as of February 1, 2002. Wind River currently operates in one reportable segment, which is also the only reporting unit for purposes of SFAS 142. Since Wind River currently only has one reporting unit, all of the goodwill has been assigned to the enterprise as a whole. In July 2002, Wind River completed the transitional goodwill impairment tests required by SFAS 142 with the assistance of a third-party valuation consultant, and determined that the goodwill was not impaired at February 1, 2002. The primary method used to determine the fair values for SFAS 142 impairment purposes was the discounted cash flow method.

SFAS 142 also requires that Wind River test goodwill for impairment on an annual basis as well as when circumstances indicate a possible impairment. Wind River has determined that it will conduct its annual impairment tests during its second fiscal quarter. The deterioration of the telecommunications industry as well as the decline in Wind River's current product sales in the second quarter of fiscal 2003 were factors that also required Wind River to evaluate the fair value of the goodwill. During the quarter ended July 31, 2002, Wind River therefore completed its annual impairment test and its second

quarter trigger test with the assistance of a third-party valuation consultant, and concluded that there was no impairment of goodwill. The primary method used to determine the fair values for SFAS 142 impairment purposes was the discounted cash flow method. The assumptions supporting the cash flows, including the discount rate, which was assumed to be 17%, were determined using Wind River's best estimates as of the date of the impairment review.

Note 3: Revenue Recognition

Wind River derives revenue from two sources: (i) product revenue and (ii) service revenue. Product revenues consist of royalties and fees for operating systems and fees for the use of development tools. Wind River licenses its software products under perpetual as well as time-based arrangements. Service revenues are derived from fees from professional services, which include design and development fees, software maintenance contracts, and customer training and consulting. Maintenance contract renewals are generally sold separately from Wind River's products. Wind River's customers consist of end users, distributors, original equipment manufacturers, system integrators and value-added resellers. Agreements generally do not allow the right of return or sales price adjustments.

Wind River recognizes revenue in accordance with Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended, SOP 81-1, "Accounting for Performance of Construction-Type and Certain Production-Type Contracts" and Staff Accounting Bulletin ("SAB") 101, "Revenue Recognition."

Wind River recognizes revenue when (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred, (iii) the vendor's fee is fixed or determinable and (iv) vendor-specific objective evidence ("VSOE") exists to allocate the total fee to all undelivered elements of the arrangement and collection is determined to be probable. These four criteria are further described below:

Persuasive evidence of an arrangement exists. Wind River's customary practice is to have written non-cancelable contracts and a customer purchase order prior to recognizing revenue on an arrangement.

Delivery has occurred. Product revenues for software and hardware are recognized at the time of shipment or upon the delivery of a product master, with standard transfer terms of FOB shipping point. If undelivered products or services exist that are essential to the functionality of the delivered product in an arrangement, delivery is not considered to have occurred. If evidence of fair value of all undelivered elements exists, then revenue is recognized using the residual method. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue.

Wind River recognizes revenues from one-year, time-based licenses ratably over the term of the agreement. For multi-year time-based licenses, Wind River defers recognition of the fees associated with the VSOE of the maintenance and support over the term of the license and recognizes the residual contract amount in the period in which the agreement is signed, so long as it has VSOE for undelivered elements, which typically consist of maintenance and support. Where VSOE does not exist for undelivered elements, Wind River recognizes the fees ratably over the term of the multi-year license.

Sales to distributors, original equipment manufacturers, system integrators and value-added resellers are recognized either at the time the risks of ownership have transferred or upon receipt of royalty reports related to the sale of product to an end-user, depending on Wind River's historical experience with these customers.

Service revenues from professional services contracts are recognized as the services are performed for time-and-materials contracts and using the percentage-of-completion basis for fixed-price contracts. Service revenues from software maintenance, support and update fees are recognized ratably over the contract period, which in most instances is one year. Service revenues from training and consulting are recognized when the services are provided.

The vendor's fee is fixed or determinable. At the time of each transaction, Wind River assesses whether the fee associated with a revenue transaction is fixed or determinable based on the payment terms associated with the transaction. If any portion of a fee is due after Wind River's standard payment terms, which are generally no greater than 90 days from invoice date, Wind River accounts for the fee as not being fixed or determinable. In these cases, revenue is recognized as the fees become due.

Collection is probable. Wind River assesses probability of collection based on a number of factors, including its past transaction history with the customer and the credit-worthiness of the customer. New customers and certain existing customers are subject to a credit review process that evaluates the customers' financial position and ultimately their ability to pay according to the original terms of the arrangement. Based on Wind River's review process, if it is determined from the outset of an arrangement that collection of the resulting receivable is not probable, then revenue is recognized on a cash-collected basis.

Significant management judgments and estimates are made in connection with the revenues recognized in any accounting period. Wind River must assess whether the fee associated with a revenue transaction is fixed or determinable and whether or not collection is probable. Material differences could result in the amount and timing of revenues for any period if management were to make different judgments or utilize different estimates.

Note 4: Cash and Cash Equivalents, Investments and Restricted Cash

Cash equivalents consist of highly liquid investments with remaining maturity at the date of purchase of three months or less. These fixed income securities are readily convertible to cash and are stated at cost, which approximates fair value. Fair value is determined based upon the quoted market prices of the securities as of the balance sheet date.

Investments with original maturities greater than three months and less than or equal to one year are classified as short-term investments. Investments with original maturities greater than one year are classified as long-term investments. Wind River accounts for its investments, including marketable equity securities, money market funds, municipal bonds, U.S. government and agency obligations, corporate bonds and other debt securities, in accordance with Statement of Financial Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities." Wind River determines the appropriate classification of its investments at the time of purchase and re-evaluates such classification at each balance sheet date. Wind River has classified all of its investments as available-for-sale and carries such investments at fair value, with unrealized gains and losses reported in

the accumulated other comprehensive income (loss) component of stockholders' equity until disposition. The cost of securities sold is based on the specific identification method. Realized gains or losses and declines in value, which are judged to be other-than-temporary, are reported in other income or expense.

Wind River values its publicly held investments using the closing price of the stock at the end of each month. As a result, Wind River reflects these investments on its balance sheet as of July 31, 2002, as long-term investments, at their aggregate market value of approximately $463,000. During the three months ended July 31, 2002, Wind River recorded an impairment charge on these publicly held investments of $259,000, which represented the amount of other-than-temporary decline as of the date of impairment.

Wind River has certain other minority investments in non-publicly traded companies. These investments were included as a component of other long-term assets on Wind River's balance sheet and were carried at cost, subject to adjustment for impairment. Due to the economic downturn and specifically the decline in the telecommunications sector, Wind River recorded further impairment losses on its investments in private companies of $4.0 million during the three months ended July 31, 2002, and $2.3 million and $3.3 million during the three and six month periods ended July 31, 2001, respectively. As a result of this write-down recorded during the quarter ended July 31, 2002, Wind River has no remaining investment book value on its balance sheet relating to private companies.

Restricted cash consists of the investments held as collateral under the operating leases for Wind River's headquarters and interest rate swap agreements.

Note 5: Derivative Financial Instruments

Wind River enters into foreign currency forward exchange contracts to manage foreign currency exposures related to certain foreign currency denominated inter-company balances. Additionally, Wind River may adjust its foreign currency hedging position by taking out additional contracts or by terminating or offsetting existing forward contracts. These adjustments may result from changes in the underlying 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 July 31, 2002, Wind River had outstanding forward contracts with notional amounts of $7.6 million. At January 31, 2002, Wind River had no outstanding forward contracts.

In March 1998, Wind River entered into an interest rate swap agreement to reduce the impact of changes in interest rates on its first floating rate operating lease for its corporate headquarters. The interest rate swap effectively changes Wind River's interest rate exposure on its operating lease, which is at the one-month London interbank offering rate ("LIBOR"), to a fixed rate of 5.9%. As of both July 31, 2002 and January 31, 2002, the notional amount of this interest rate swap was $28.5 million.

In January 2001, Wind River entered into another interest rate swap agreement to mitigate the impact of changes in interest rates on its second floating rate operating lease for additional construction at its headquarters facility. This second interest rate swap changes Wind River's interest rate exposure on its second operating lease, which is at one-month LIBOR, to a fixed rate of 5.6%. As of both July 31, 2002 and January 31, 2002, the notional amount of this interest rate swap was $27.9 million. Wind River's potential credit exposure under the interest rate swaps (arising from the

inability of the counter parties to meet the terms of their contracts) is limited to the amounts, if any, by which the counter parties' obligations exceed the obligations of Wind River.

The fair value of these interest rate swap liabilities was approximately $4.1 million and $2.6 million at July 31, 2002 and January 31, 2002, respectively, and was recorded as a long-term liability and as a component of comprehensive loss. The interest rate swap agreements mature at the same time that the respective operating lease expires.

Note 6: Restructuring and Other Nonrecurring Costs

Restructuring and other nonrecurring costs consists of costs associated with restructuring programs implemented by Wind River and costs associated with the settlement of litigation and related remediation efforts.

Restructuring Costs

In May 2001, Wind River announced initial cost control measures that included a reduction of its worldwide work force, organizational restructuring and certain measures aimed at controlling operational expenses. In May 2002, Wind River announced additional cost control measures that included further reduction of its worldwide work force and measures focused on further reducing operational expenses. In both the May 2001 and May 2002 restructuring programs, Wind River made permanent and temporary adjustments to the business operations in order to optimize operating efficiency.

As a result of the decisions to restructure its business, Wind River recorded restructuring costs of $13.9 million and $28.6 million in the quarters ended July 31, 2002 and 2001, respectively, in each case classified as operating expenses. In the fourth quarter of fiscal 2002, Wind River recorded a reversal of $6.9 million such that the net restructuring charge for fiscal year 2002 was $21.7 million.

As of January 31, 2002, the remaining restructuring liabilities related to the May 2001 restructuring program totaled $5.2 million. The following table provides detailed restructuring liabilities at the end of the fiscal year 2002, total charges recorded in the three months ended July 31, 2002, cash payments made during the six months ended July 31, 2002, non-cash write-offs for the six months ended July 31, 2002, and the aggregate remaining restructuring liabilities for both the May 2001 and the May 2002 restructuring programs as of July 31, 2002:

	Restructuring Liabilities as of January 31, 2002	Cash Charges for the Three Months Ended July 31, 2002	Non-Cash Charges for the Three Months Ended July 31, 2002	Total Charges for the Three Months Ended July 31, 2002	Cash Payments for the Six Months Ended July 31, 2002	Non-Cash Write-offs for the Six Months Ended July 31, 2002	Restructuring Liabilities at July 31, 2002
				(In thousands)			
Work force reduction	$ 4,294	$ 10,429	$	$ 10,429	$ (11,843)	$	$ 2,880
Consolidation of excess facilities	949	1,607	355	1,962	(445)	(347)	2,119
Other		356	1,190	1,546	(81)	(1,198)	267
Total	$ 5,243	$ 12,392	$ 1,545	$ 13,937	$ (12,369)	$ (1,545)	$ 5,266

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The following paragraphs provide detailed information relating to the restructuring costs that were recorded during the quarters ended July 31, 2002 and 2001.

Worldwide Work Force Reduction. The May 2002 and 2001 restructuring programs resulted in the reduction of 219 and 425 employees, respectively, across all business functions, operating units and geographic regions. The worldwide work force reductions implemented as part of the May 2001 restructuring were substantially completed as of July 31, 2002. The May 2002 worldwide work force reduction started in the quarter ended July 31, 2002, and will be substantially completed during the third quarter of fiscal 2003. In addition, the number of contractors and temporary workers employed by Wind River was reduced as a result of both restructuring programs.

Wind River recorded work force reduction charges of approximately $10.4 million and $20.1 million during the quarters ended July 31, 2002 and 2001, respectively, relating primarily to severance payments and the continuation of benefits. During the quarter ended July 31, 2001, equipment disposed of or removed from operations as a result of the work force reduction resulted in a charge of $765,000 and consisted primarily of computer equipment.

Consolidation of Excess Facilities. Wind River recorded restructuring charges of $2.0 million and $8.4 million during the quarters ended July 31, 2002 and 2001, respectively, relating to the consolidation of certain excess facilities primarily in the United States, Japan and the United Kingdom. In the fourth quarter of fiscal 2002, Wind River recorded a reversal of $6.9 million against the $8.4 million charge after Wind River determined that certain of such facilities could continue to be used by Wind River personnel. The consolidation of excess facilities includes the closure of certain leased corporate facilities and sales offices that related to business activities that were restructured. The estimated excess facility costs represent the remaining lease payments and estimated costs less estimated proceeds from sub-leasing certain facilities. The estimated proceeds from sub-leasing these facilities are based on current comparable rates for leases in the respective markets. If the facilities operating lease rental rates continue to decrease in these markets or it takes longer than expected to find a suitable tenant to sublease these facilities, the actual loss could exceed this estimate. Cash and non-cash charges relate primarily to lease terminations, non-cancelable lease costs and impairment of leasehold improvements related to the excess facilities. Amounts accrued related to the net lease expense due to the consolidation of excess facilities consolidated as a result of the May 2002 and May 2001 restructuring programs will be paid through fiscal 2006 and 2005, respectively, unless Wind River successfully negotiates to exit the leases at an earlier date.

Other Items. During the quarter ended July 31, 2002, Wind River recorded a restructuring charge of $1.5 million relating to other items, primarily consisting of the write-offs of capitalized software, leasehold improvements associated with office closures and inventory relating to products that management decided to discontinue during the quarter.

Litigation-related costs

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. For further information on the underlying claims, refer to Item 2 "Legal Proceedings."

Note 7: Other Borrowings

As of July 31, 2002, Wind River had United States dollar equivalent net borrowings of $12.1 million from a line of credit obtained through its Japanese subsidiary for up to 2.1 billion Japanese yen or approximately $17.6 million. Wind River extended the line of credit until August 30, 2002, at an average annual interest rate of 2.9% on any borrowed amount. Refer to Note 13, "Subsequent Events" for information regarding the repayment of this line of credit.

Note 8: Stockholder's Equity

Stock Repurchase Program

In June 2002, the Board of Directors authorized a stock repurchase program to enable Wind River to acquire outstanding common stock in the open market or negotiated transactions. Under the program, Wind River may, but is not required to, purchase up to $30.0 million of Wind River common stock over two years. During the quarter ended July 31, 2002, Wind River repurchased approximately 762,500 shares of Wind River common stock for an aggregate purchase price of approximately $3.9 million. Purchases were made on the Nasdaq Stock Market at prevailing open market prices and paid out of general corporate funds. Shares repurchased through the program are held as treasury stock.

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 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 swap and unrealized gains and losses on available-for-sale securities, net of taxes.

Comprehensive loss for the three and six months ended July 31, 2002 and 2001 is as follows:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2002	**2001**	**2002**	**2001**
	(In thousands)			
Net loss	$ (36,944)	$ (281,559)	$ (54,992)	$ (306,400)
Other comprehensive loss:				
Foreign currency translation adjustments	872	(359)	1,494	(2,172)
Unrealized gain (loss) on available-for-sale securities	60	12	(61)	(1,084)
Fair value measurement of interest rate swap	(1,426)		(1,506)	
Total other comprehensive loss	(494)	(347)	(73)	(3,256)
Total comprehensive loss	$ (37,438)	$ (281,906)	$ (55,065)	$ (309,656)

Note 9: Net Loss Per Share Computation

In accordance with Statement of Financial Accounting Standards No. 128, "Earnings Per Share," the calculation of shares used in basic and diluted net loss per share computation is presented below:

	Three Months Ended July 31,		Six Months Ended July 31,	
	2002	**2001**	**2002**	**2001**
	(In thousands)			
Shares used in basic net loss per share computation	79,035	77,354	78,901	77,070
Effect of dilutive potential common shares				
Shares used in diluted net loss per share computation	79,035	77,354	78,901	77,070

	Three Months Ended July 31,		Six Months Ended July 31,	

The effect of assumed conversion of the convertible subordinated notes of 6.2 million shares for both the three and six months ended July 31, 2002, and 4.0 million shares for both the three and six months ended July 31, 2001, respectively, is anti-dilutive, and is therefore excluded from both of the above computations. In addition, dilutive potential common shares totaling approximately 408,000 and

678,000 for the three and six months ended July 31, 2002, respectively, and 1.9 million and 2.3 million for the three and six months ended July 31, 2001, respectively, were excluded from the computation of the number of shares used in the diluted net loss per share calculations as their inclusion would be anti-dilutive. Since Wind River has a net loss for all periods presented, net loss per share on a diluted basis is equivalent to basic net loss per share.

Note 10: Commitments and Contingencies

In fiscal 1998, Wind River entered into an operating lease for its headquarters facility constructed on the land Wind River purchased in Alameda, California under terms and conditions commonly known as a "synthetic lease." In fiscal 2000, Wind River entered into a second operating lease agreement for the construction of two additional buildings at its headquarters facility. None of Wind River's officers or employees has any financial interest in these synthetic lease arrangements.

The lessor has funded a total of $32.4 million of construction costs related to the first operating lease and $25.0 million of construction costs related to the second operating lease. The operating lease payments under both leases vary based upon the total construction costs of the property, including capitalized interest at LIBOR. In connection with the lease of Wind River's headquarters, Wind River leased the land to the lessor of the building at a nominal rate and for a term of 55 years. If Wind River were to terminate the ground lease prior to maturity, it would be obligated to purchase the buildings for 100% of the amount financed. The operating leases provide Wind River with the option, at the end of their terms, to either acquire the buildings at the lessor's original cost or arrange for the buildings to be acquired. Both leases have initial terms of seven years but may be renewed under certain circumstances. Unless renewed, the first lease will terminate in September 2004 and the second lease will terminate in November 2006. As of July 31, 2002, Wind River had not made a decision with respect to the option it will pursue at the end of the lease terms, and it may seek to amend or terminate these lease arrangements prior to the end of the lease term. However, it is likely that Wind River will decide to continue to occupy the buildings, and may therefore purchase the buildings or arrange for their purchase and lease back.

Under the terms of the leases, Wind River must maintain compliance with certain financial covenants, relating to minimum consolidated fixed charge ratio, minimum EBITDA, minimum tangible net worth and minimum net unencumbered cash. As of July 31, 2002, Wind River was in compliance with each of the applicable covenants. There can be no assurance that Wind River will continue to be in compliance with these covenants, particularly if its revenues continue to be negatively impacted by the economy or other factors or if Wind River is not able to control its costs adequately. Further, in the event Wind River was not in compliance with the covenants, there can be no assurance that it would be able to obtain a waiver or amendment of the covenants, and, if it could not, Wind River may become obligated to purchase the buildings, as discussed below, and could incur additional costs associated with replacing the synthetic leases. In the event of a default, Wind River's obligation to purchase the leased properties for 100% of the amount financed by the lessor could be accelerated.

If the leases were terminated as a result of either an event of default or Wind River's exercise of its purchase option, and Wind River became obligated to pay the purchase price of the buildings, Wind River would reflect the purchase price as an asset on its balance sheet, and its restricted cash and investment position would be reduced by the amount of the purchase price. Currently, Wind River reflects rent payments as an expense on its statement of operations. In the event Wind River purchased the buildings (as a result of an event of default or its election to do so), its rent expense for the buildings would cease and Wind River would subsequently record depreciation expense for the buildings over their estimated useful lives. Although no assurance can be given, management believes

that Wind River's purchase of the buildings would not have a material adverse effect on Wind River's financial condition, results of operations or cash flows, provided the fair value of the buildings was greater than the purchase price. However, if at the time the leases were terminated the fair value of the buildings was less than the purchase price, Wind River would be required to record a one-time charge for the difference between the purchase price and the fair value of the buildings which, depending on the magnitude of the charge, could have a material adverse effect on Wind River's financial position, results of operations and cash flows. Additionally, if during the life of the leases, Wind River were to make a determination that the fair value of the buildings was less than the purchase price, Wind River would be required to amortize the difference between the fair value and the purchase price on a straight line basis over the remaining lives of the leases. Depending on the magnitude of these differences, these additional charges could have a material adverse effect on Wind River's financial position, results of operations, and cash flows.

Wind River has guaranteed the residual value associated with the buildings under the first operating lease and the second operating lease to the lessor of a fixed amount of approximately 82% and 85%, respectively, of the lessor's actual funding of the two leases. If Wind River does not purchase the buildings upon maturity of the operating leases, it may be obligated to pay the amount of the residual value guarantee to the lessor. Wind River has deposited fixed income securities with a custodian to ensure the performance of its obligations under the leases; as of July 31, 2002 and January 31, 2002, Wind River held $60.3 million in cash and cash equivalents as restricted cash in satisfaction of this requirement. In addition, Wind River holds $3.4 million of restricted cash associated with related interest rate swaps. The amounts held as restricted cash as of July 31, 2002 are sufficient to satisfy performance of Wind River's obligations under the operating leases. The majority of restricted cash represents the costs incurred for construction of the buildings.

From time to time, Wind River is subject to legal proceedings and claims in the ordinary course of business, including claims of alleged infringement of patents and other intellectual property rights. Wind River is not currently aware of any legal proceedings or claims that Wind River believes will have, individually or in the aggregate, a material adverse effect on Wind River's financial position, results of operations or cash flows.

Note 11: Segment and Geographic Information

Wind River reports in one industry segment technology for embedded systems. Wind River markets its products and related services to customers in North America, Europe, Japan and Asia Pacific. Internationally, Wind River markets its products and services primarily through its 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 by geographic location is as follows:

	Revenues				Long-Lived Assets	
	Three Months Ended July 31,		Six Months Ended July 31,			
	2002	2001	2002	2001	As of July 31, 2002	As of January 31, 2002
	(In thousands)					
North America	$ 35,095	$ 48,384	$ 75,390	$ 118,326	$ 158,238	$ 173,903
Japan	6,960	7,508	12,869	18,361	6,598	7,385
Other international	21,527	24,338	41,682	53,735	7,573	6,569
Consolidated	$ 63,582	$ 80,230	$ 129,941	$ 190,422	$ 172,409	$ 187,857

Other international consists of the revenues and long-lived assets of operations in Europe and Asia Pacific.

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

Three Months Ended July 31,		Six Months Ended July 31,	
2002	2001	2002	2001

	Three Months Ended July 31,		Six Months Ended July 31,	
	(In thousands)			
Software license revenues	$ 25,418	$ 38,366	$ 51,667	$ 87,956
Run-time license revenues	16,883	16,184	34,359	40,264
Maintenance revenues	12,958	14,060	25,570	34,808
Other service revenues	8,323	11,620	18,345	27,394
Total	$ 63,582	$ 80,230	$ 129,941	$ 190,422

No single customer accounted for more than 10% of Wind River's total revenues in the three or six months ended July 31, 2002 and 2001.

Note 12: Recent Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 146, "Accounting for Exit or Disposal Activities" ("SFAS 146"). SFAS 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for under Emerging Issues Task Force ("EITF") No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)" ("EITF No. 94-3"). The scope of SFAS 146 also includes costs related to terminating a contract that is not a capital lease and termination benefits that employees who are involuntarily terminated receive under the terms of a one-time benefit arrangement that is not an ongoing benefit arrangement or an individual deferred-compensation contract. SFAS 146 will be effective for exit or disposal activities that are initiated after December 31, 2002 and early application is encouraged. The provisions of EITF No. 94-3 shall continue to apply for an exit activity initiated under an exit plan that met the criteria of EITF No. 94-3 prior to the adoption of SFAS 146. The effect on adoption of SFAS 146 will change on a prospective basis the timing of when restructuring charges are recorded from a commitment date approach to when the liability is incurred. Wind River is currently assessing the impact of SFAS 146 on its financial statements.

Note 13: Subsequent Events

On August 30, 2002, Wind River repaid the entire line of credit obtained through its Japanese subsidiary, which line of credit is described in Note 7 above.

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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 sentences in the sentence in the fifth paragraph under " Revenues" regarding expectations for international sales; the sentences in the second and third paragraphs under "Cost of Revenues" regarding factors that may affect product related costs of revenues in the future and our expectations regarding cost of service revenues in absolute dollars and as a percentage of revenue; the sentences in the first, second and third paragraphs under " Operating Expenses" regarding our expectations about selling and marketing expenses, product development and engineering expenses, and general and administrative expenses, respectively; the statements under " Restructuring and Other Nonrecurring Costs" regarding our expectations as to when the impact of the restructuring efforts will be realized; the statements under "Liquidity and Capital Resources Commitments" about our expectations regarding amendment or termination of our synthetic leases, our ability to obtain a waiver or amendment of the lease agreement and the impact that an event of default or termination of the leases would have on our financial condition, results of operations and cash flows; 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 on Wind River of the adoption of the pronouncement discussed thereunder.

These forward-looking statements are based on current expectations and involve known and unknown risks and uncertainties that may cause our results, levels of activity, performance or achievements or those of our industry to be materially different from those expressed or implied by the forward-looking statements. The cautionary statements set forth below and in "Additional Risk Factors that May Affect Future Results of Operations" 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, 2002 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 software solutions and development tools 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 cellular phones, digital imaging products, auto braking systems, internet routers, jet fighter control panels and factory automation devices. Our products, including our flagship products, the Tornado® development platform and the VxWorks® real-time operating system, 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 aerospace and defense, automotive, digital consumer, industrial measurement and networking.

We market our products and services in North America, Europe, Japan and the Asia Pacific region primarily through our own direct sales organization, which consists of sales persons and field engineers. We also license international distributors, primarily in the Asia Pacific region, to serve customers in

regions not serviced by our direct sales force. Wind River was incorporated in California in February 1983 and reincorporated in Delaware in April 1993.

For a discussion of our critical accounting policies, please refer to "Critical Accounting Policies," in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for the fiscal year ended January 31, 2002, which was filed with the Securities and Exchange Commission on April 30, 2002.

Results of Operations

Beginning in fiscal 2002, we were significantly impacted by the economic downturn, which has been especially pronounced in the high-technology sector generally and the telecommunications sector in particular. The downturn, as well as its adverse impact on our revenues, has continued into the first and second quarters of fiscal 2003. Our revenues were $63.6 million and $80.2 million for the three months ended July 31, 2002 and 2001, respectively, and $129.9 million and $190.4 million for the six months ended July 31, 2002 and 2001, respectively. Net loss was $36.9 million, or $0.47 per share, for the quarter ended July 31, 2002 compared to a net loss of $281.6 million, or $3.64 per share, for the quarter ended July 31, 2001. Net loss was $55.0 million, or $0.70 per share, for the six months ended July 31, 2002 compared to a net loss of $306.4 million, or $3.98 per share, for the six months ended July 31, 2001. On February 1, 2002, we adopted Statement of Financial Accounting Standards No. 142 ("SFAS 142") and, accordingly, we did not amortize any goodwill in the three and six months ended July 31, 2002. If we had not amortized goodwill in the three and six month periods ended July 31, 2001, net loss would have been $259.8 million, or $3.36 per share, for the three months ended July 31, 2001, and $255.5 million, or $3.32 per share for the six months ended July 31, 2001. Refer to Note 2 "Acquisitions" to Notes to Condensed Consolidated Financial Statements for further information about the impact on net loss and net loss per share had the Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" been applicable for the three and six months ended July 31, 2001 and 2000.

In May 2002, we implemented a restructuring plan, which included a headcount reduction and the implementation of other cost saving measures, and recorded a restructuring charge of $13.9 million during the quarter ended July 31, 2002. See "Results of Operations" 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 July 31,		Six Months Ended July 31,	
	2002	2001	2002	2001
Revenues, net:				
Products	67%	68%	66%	67%
Services	33	32	34	33
Total revenues	100	100	100	100
Cost of revenues:				
Products	7	8	8	7
Services	20	19	21	17
Total cost of revenues	27	27	29	24
Gross profit	73	73	71	76
Operating expenses:				
Selling and marketing	52	49	51	44
Product development and engineering	28	27	30	25
General and administrative	13	12	14	11
Amortization of goodwill and purchased intangibles	4	30	3	29
Impairment of goodwill and purchased intangibles		281		118
Restructuring and other nonrecurring costs	28	36	14	15
Total operating expenses	125	435	112	242
Loss from operations	(52)	(362)	(41)	(166)
Other income (expense):				
Interest income	5			