SALESFORCE COM INC
Form 10-Q
May 18, 2007
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the quarterly period ended April 30, 2007

OR

¨ **Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
Commission File Number: 001-32224

salesforce.com, inc.

(Exact name of registrant as specified in its charter)

Delaware	**94-3320693**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

The Landmark @ One Market, Suite 300

San Francisco, California 94105

(Address of principal executive offices)

Telephone Number (415) 901-7000

(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 (the Exchange Act) 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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

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

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

As of April 30, 2007, there were approximately 115.5 million shares of the Registrant s Common Stock outstanding.

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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Condensed Consolidated Balance Sheets

(in thousands)

	April 30, 2007 (unaudited)	January 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 87,492	$ 86,608
Short-term marketable securities	162,881	165,816
Accounts receivable, net	105,013	128,693
Deferred commissions	22,970	22,072
Deferred income taxes	240	228
Prepaid expenses and other current assets	21,537	15,679
Total current assets	400,133	419,096
Marketable securities, noncurrent	197,698	160,088
Fixed assets, net	33,849	30,155
Deferred commissions, noncurrent	8,723	9,478
Deferred income taxes, noncurrent	19,499	20,625
Capitalized software	22,225	10,983
Goodwill	6,705	6,705
Other assets	9,137	7,702
Total assets	$ 697,969	$ 664,832
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 11,606	$ 8,870
Accrued expenses and other current liabilities	68,718	77,327
Income taxes payable	1,321	6,739
Deferred revenue	295,672	284,063
Total current liabilities	377,317	376,999
Income taxes payable, noncurrent	4,635	
Long-term lease abandonment liability and other	1,358	1,408
Minority interest	5,377	4,634
Total liabilities	388,687	383,041
Commitments and contingencies		
Stockholders equity:		
Common stock	115	115
Additional paid-in capital	346,466	319,496
Accumulated other comprehensive loss	(2,087)	(2,187)
Accumulated deficit	(35,212)	(35,633)
Total stockholders equity	309,282	281,791

Total liabilities and stockholders equity	$ 697,969	$ 664,832

See accompanying Notes to Condensed Consolidated Financial Statements.

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Condensed Consolidated Statements of Operations

(in thousands, except per share data)

(unaudited)

	Three months ended April 30, 2007	Three months ended April 30, 2006
Revenues:		
Subscription and support	$ 147,690	$ 94,493
Professional services and other	14,722	10,193
Total revenues	162,412	104,686
Cost of revenues (1):		
Subscription and support	20,184	12,775
Professional services and other	18,983	11,785
Total cost of revenues	39,167	24,560
Gross profit	123,245	80,126
Operating expenses (1):		
Research and development	14,121	8,825
Marketing and sales	83,925	52,016
General and administrative	25,085	19,405
Total operating expenses	123,131	80,246
Income (loss) from operations	114	(120)
Interest income	5,048	2,990
Interest expense	(41)	(11)
Other income (expense)	169	(599)
Income before provision for income taxes and minority interest	5,290	2,260
Provision for income taxes	(3,842)	(2,005)
Income before minority interest	1,448	255
Minority interest in consolidated joint venture	(718)	(484)
Net income (loss)	$ 730	$ (229)
Basic net income (loss) per share	$ 0.01	$ 0.00
Diluted net income (loss) per share	0.01	0.00
Weighted-average number of shares used in per share amounts:		
Basic	114,987	110,957
Diluted	120,635	110,957

(1) Amounts include stock-based expenses, as follows:

	Three months ended April 30, 2007	2006
Cost of revenues	$ 1,774	$ 1,154
Research and development	1,277	720
Marketing and sales	5,619	3,482
General and administrative	3,342	2,250
	$ 12,012	$ 7,606

See accompanying Notes to Condensed Consolidated Financial Statements.

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Condensed Consolidated Statements of Cash Flows

(in thousands)

(unaudited)

	Three months ended April 30, 2007	2006
Operating activities		
Net income (loss)	$ 730	$ (229)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Minority interest in consolidated joint venture	718	484
Depreciation and amortization	4,848	2,325
Amortization of deferred commissions	9,039	5,127
Expense related to stock-based awards	12,012	7,606
Excess tax benefits from employee stock plans	(6,286)	(2,600)
Changes in assets and liabilities	15,769	(297)
Net cash provided by operating activities	36,830	12,416
Investing activities		
Business combination		(15,502)
Changes in marketable securities	(34,212)	27,208
Capital expenditures	(15,957)	(2,595)
Net cash provided by (used in) investing activities	(50,169)	9,111
Financing activities		
Proceeds from the exercise of stock options and warrants	8,300	5,503
Excess tax benefits from employee stock plans	6,286	2,600
Principal payments on capital lease obligations	(157)	(151)
Net cash provided by financing activities	14,429	7,952
Effect of exchange rate changes	(206)	(748)
Net increase in cash and cash equivalents	884	28,731
Cash and cash equivalents at beginning of period	86,608	99,842
Cash and cash equivalents at end of period	$ 87,492	$ 128,573
Supplemental cash flow disclosure:		
Cash paid during the period for:		
Interest	$ 41	$ 11
Income taxes, net of tax refunds	$ 182	$ 9

See accompanying Notes to Condensed Consolidated Financial Statements.

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Notes to Condensed Consolidated Financial Statements

1. Summary of Business and Significant Accounting Policies

Description of Business

Salesforce.com, inc. (the Company) is the leading provider, based on market share, of application services that allow organizations to easily share customer information on demand, according to a December 2006 report by International Data Corporation. It provides a comprehensive customer relationship management (CRM) service to businesses of all sizes and industries worldwide. The Company began to offer its on-demand application service on a subscription basis in February 2000. The Company conducts its business worldwide.

Fiscal Year

The Company s fiscal year ends on January 31. References to fiscal 2008, for example, refer to the fiscal year ending January 31, 2008.

Basis of Presentation

The accompanying condensed consolidated balance sheet as of April 30, 2007 and the condensed consolidated statements of operations and the condensed consolidated statements of cash flows for the three months ended April 30, 2007 and 2006, respectively, are unaudited. The condensed consolidated balance sheet data as of January 31, 2007 was derived from the audited consolidated financial statements which are included in the Company s Form 10-K for the fiscal year ended January 31, 2007, which was filed with the Securities and Exchange Commission (the SEC) on March 9, 2007. The accompanying statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company s fiscal 2007 Form 10-K.

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles, or GAAP, for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the financial information and footnotes required by GAAP for complete financial statements. In the opinion of the Company s management, the unaudited condensed consolidated financial statements have been prepared on the same basis as the audited consolidated financial statements in the Form 10-K, and include all adjustments necessary for the fair presentation of the Company s statement of financial position as of April 30, 2007, and its results of operations and its cash flows for the three months ended April 30, 2007 and 2006. All adjustments are of a normal recurring nature. The results for the three months ended April 30, 2007 are not necessarily indicative of the results to be expected for any subsequent quarter or for the fiscal year ending January 31, 2008.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions in the Company s consolidated financial statements and notes thereto.

Significant estimates and assumptions made by management include the determination of the provision for income taxes and the fair value of stock awards issued. Actual results could differ from those estimates.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated in consolidation.

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Notes to Condensed Consolidated Financial Statements (Continued)

Additionally, the Company holds a majority interest in Kabushiki Kaisha salesforce.com (Salesforce Japan), a Japanese joint venture. As of April 30, 2007, the Company owned a 65 percent interest in the joint venture. Given the Company s majority ownership interest in the joint venture, the accounts of the joint venture have been consolidated with the accounts of the Company, and a minority interest has been recorded for the minority investors interests in the net assets and operations of the joint venture to the extent of the minority investors individual investments. Additionally, the Company records gains and losses resulting from the change of interest in Salesforce Japan directly to stockholders equity as additional paid-in capital.

Segments

The Company operates in one segment.

Foreign Currency Translation

The functional currency of the Company s major foreign subsidiaries is generally the local currency. Adjustments resulting from translating foreign functional currency financial statements into U.S. dollars are recorded as part of a separate component of stockholders equity. Foreign currency transaction gains and losses are included in net income for the period. All assets and liabilities denominated in a foreign currency are translated into U.S. dollars at the exchange rate on the balance sheet date as quoted on the Federal Reserve Bank of New York. Revenues and expenses are translated at the average exchange rate during the period. Equity transactions are translated using historical exchange rates.

Concentrations of Credit Risk and Significant Customers and Suppliers

The Company s financial instruments that are exposed to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities and trade accounts receivable. Although the Company deposits its cash with multiple financial institutions, its deposits, at times, may exceed federally insured limits. Collateral is not required for accounts receivable. The Company maintains an allowance for doubtful accounts receivable balances. The allowance is based upon historical loss patterns, the number of days that billings are past due and an evaluation of the potential risk of loss associated with problem accounts.

The Company s accounts receivable and net revenues are derived from a large number of direct customers. No customer accounted for more than 5 percent of accounts receivable at April 30, 2007 and January 31, 2007. No single customer accounted for 5 percent or more of total revenue during the three month periods ended April 30, 2007 and 2006.

As of April 30, 2007 and January 31, 2007, assets located outside the Americas were 14 percent and 12 percent of total assets, respectively. Revenues by geographical region are as follows (in thousands):

	Three months ended April 30,	
	2007	2006
Revenues by geography:		
Americas	$ 124,452	$ 83,025
Europe	25,574	14,950
Asia Pacific	12,386	6,711
	$ 162,412	$ 104,686

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Notes to Condensed Consolidated Financial Statements (Continued)

Cash and Cash Equivalents

The Company considers all highly liquid investments purchased with an original maturity of three months or less to be cash equivalents. Cash and cash equivalents, which primarily consist of cash on deposit with banks and money market funds, are stated at cost, which approximates fair value.

Marketable Securities

Management determines the appropriate classification of investments in marketable securities at the time of purchase in accordance with Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* and reevaluates such determination at each balance sheet date. Securities, which are classified as available for sale at April 30, 2007 and January 31, 2007, are carried at fair value, with the unrealized gains and losses, net of tax, reported as a separate component of stockholders equity. Fair value is determined based on quoted market rates. Realized gains and losses and declines in value judged to be other-than-temporary on securities available for sale are included as a component of interest income. The cost of securities sold is based on the specific-identification method. Interest on securities classified as available for sale is also included as a component of interest income.

Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income and other comprehensive income (loss), which includes certain changes in equity that is excluded from net income. Specifically, cumulative foreign currency translation and unrealized gains and losses on marketable securities adjustments, net of tax, are included in accumulated other comprehensive loss. Comprehensive income (loss) has been reflected in stockholders equity.

Comprehensive income (loss) consisted of the following (in thousands):

	Three months ended April 30,	
	2007	**2006**
Net income (loss)	$ 730	$ (229)
Translation adjustment	(363)	(151)
Unrealized gain (loss) on marketable securities	463	(2)
Total comprehensive income (loss)	$ 830	$ (382)

The components of accumulated other comprehensive loss were as follows (in thousands):

	April 30, 2007 (unaudited)	**January 31, 2007**
Foreign currency translation adjustments	$ (1,742)	$ (1,379)
Net unrealized losses on marketable securities	(345)	(808)
	$ (2,087)	$ (2,187)

Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing net income (loss) by the weighted-average number of common shares outstanding for the fiscal period. Diluted net income (loss) per share is computed giving effect to all potential dilutive common stock, including options and warrants.

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Notes to Condensed Consolidated Financial Statements (Continued)

A reconciliation of the denominator used in the calculation of basic and diluted net income (loss) per share is as follows (in thousands):

	Three months ended April 30, 2007	Three months ended April 30, 2006
Numerator:		
Net income (loss)	$ 730	$ (229)
Denominator:		
Weighted-average shares outstanding for basic earnings (loss) per share, net of weighted-average shares of common stock subject to repurchase	114,987	110,957
Effect of dilutive securities:		
Employee stock awards and warrants	5,648	
Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings (loss) per share	120,635	110,957

Outstanding unvested common stock purchased by employees is subject to repurchase by the Company and therefore is not included in the calculation of the weighted-average shares outstanding for basic earnings (loss) per share.

The following were excluded from the computation of diluted shares outstanding as they would have had an anti-dilutive impact (in thousands):

	Three months ended April 30, 2007	Three months ended April 30, 2006
Stock awards	3,488	10,822

Income Taxes

The Company uses the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on temporary differences between the financial statement and tax basis of assets and liabilities and net operating loss and credit carryforwards using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce deferred tax assets to the amounts more likely than not expected to be realized.

The Company recorded a provision for income taxes of $3.8 million during the first quarter of fiscal 2008, compared to a provision for income taxes of $2.0 million during the same period a year ago.

The fiscal 2008 provision as a percentage of income before provision for income taxes and minority interest was lower than the prior year primarily due to a reduced proportion of foreign losses for which no tax benefit can be realized.

The total income tax benefit recognized in the accompanying consolidated statements of operations related to SFAS 123R was $4.1 million during the three months ended April 30, 2007 and $2.4 million during the same period a year ago.

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Notes to Condensed Consolidated Financial Statements (Continued)

A reconciliation of income taxes at the statutory federal income tax rate to the provision for income taxes included in the accompanying consolidated statements of operations is as follows (in thousands):

	Three months ended April 30,	
	2007	2006
U.S. federal taxes at statutory rate	$ 1,852	$ 791
State, net of the federal benefit	362	207
Foreign losses providing no benefit	1,633	1,121
Foreign taxes in excess of the U.S. statutory rate	348	342
Tax credits	(708)	(323)
Other	355	(133)
	$ 3,842	$ 2,005

The Company adopted the provisions of Financial Accounting Standards Board Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, or Interpretation 48, on February 1, 2007. As a result of the implementation of Interpretation 48, the Company recorded a cumulative effect adjustment of $0.3 million as an increase in the liability for unrecognized tax benefits, with a corresponding increase to the accumulated deficit balance. If recognized, $5.7 million of the unrecognized tax benefits would reduce the Company s income tax expense and effective tax rate. Management does not believe that it is reasonably possible that the estimates of unrecognized tax benefits will change significantly in the next 12 months. The Company also reclassified $4.1 million of current income taxes payable to noncurrent income taxes payable since the Company cannot reasonably estimate the period of cash settlement, if any, with various taxing authorities.

The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in tax provision. The Company has an insignificant amount of interest accrued as of April 30, 2007.

Tax positions for the Company and its subsidiaries are subject to income tax audits by many tax jurisdictions throughout the world. Tax returns for all tax years since February 1999, which was the inception of the Company, remain open to examination in all major jurisdictions where the Company operates, including the U.S., Europe and Asia Pacific.

Revenue Recognition

The Company derives its revenues from two sources: (1) subscription revenues, which are comprised of subscription fees from customers accessing its on-demand application service, and from customers purchasing additional support beyond the standard support that is included in the basic subscription fee; and (2) related professional services and other revenue. Other revenues consist primarily of training fees. Because the Company provides its application as a service, the Company follows the provisions of SEC Staff Accounting Bulletin No. 104, *Revenue Recognition* and Emerging Issues Task Force Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables*. The Company recognizes revenue when all of the following conditions are met:

There is persuasive evidence of an arrangement;

The service has been provided to the customer;

The collection of the fees is reasonably assured; and

The amount of fees to be paid by the customer is fixed or determinable.

The Company s arrangements do not contain general rights of return.

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Notes to Condensed Consolidated Financial Statements (Continued)

Subscription and support revenues are recognized ratably over the contract terms beginning on the commencement date of each contract. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue or revenue, depending on whether the revenue recognition criteria have been met.

Professional services and other revenues, when sold with subscription and support offerings, are accounted for separately when these services have value to the customer on a standalone basis and there is objective and reliable evidence of fair value of each deliverable. When accounted for separately, revenues are recognized as the services are rendered for time and material contracts, and when the milestones are achieved and accepted by the customer for fixed price contracts. The majority of the Company s consulting contracts are on a time and material basis. Training revenues are recognized after the services are performed. For revenue arrangements with multiple deliverables, the Company allocates the total customer arrangement to the separate units of accounting based on their relative fair values, as determined by the price of the undelivered items when sold separately. For revenue arrangements with multiple deliverables, such as an arrangement that includes subscription, premium support, consulting or training services, the Company allocates the total amount the customer will pay to the separate units of accounting based on their relative fair values, as determined by the price of the undelivered items when sold separately.

In determining whether the consulting services can be accounted for separately from subscription and support revenues, the Company considers the following factors for each consulting agreement: availability of the consulting services from other vendors, whether objective and reliable evidence for fair value exists for the undelivered elements, the nature of the consulting services, the timing of when the consulting contract was signed in comparison to the subscription service start date, and the contractual dependence of the subscription service on the customer s satisfaction with the consulting work. If a consulting arrangement does not qualify for separate accounting, the Company recognizes the consulting revenue ratably over the remaining term of the subscription contract. Additionally, in these situations, the Company defers only the direct costs of the consulting arrangement and amortizes those costs over the same time period as the consulting revenue is recognized. As of April 30, 2007 and January 31, 2007, the deferred cost on the accompanying consolidated balance sheet totaled $7,908,000 and $5,232,000, respectively. These deferred costs are included in prepaid and other current assets and other assets.

Deferred Revenue

Deferred revenue primarily consists of billings or payments received in advance of revenue recognition from the Company s subscription service described above and is recognized as the revenue recognition criteria are met. The Company generally invoices its customers in annual or quarterly installments. Accordingly, the deferred revenue balance does not represent the total contract value of annual or multi-year, noncancelable subscription agreements.

Deferred Commissions

Deferred commissions are the incremental costs that are directly associated with noncancelable subscription contracts with customers and consist of sales commissions paid to the Company s direct sales force. The commissions are deferred and amortized over the noncancelable terms of the related customer contracts, which are typically 12 to 24 months. The commission payments are paid in full the month after the customer s service commences. The deferred commission amounts are recoverable through the future revenue streams under the noncancelable customer contracts. The Company believes this is the preferable method of accounting as the commission charges are so closely related to the revenue from the noncancelable customer contracts that they should be recorded as an asset and charged to expense over the same period that the subscription revenue is recognized. Amortization of deferred commissions is included in marketing and sales expense in the accompanying consolidated statements of operations.

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Notes to Condensed Consolidated Financial Statements (Continued)

Accounting for Stock-Based Compensation

The Company accounts for stock-based expenses pursuant to the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, which requires that all share-based payments, including grants of employee stock options, be recognized as an expense in the statement of operations based on their fair values and vesting periods, which is 4 years.

The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model with the following assumptions and fair value per share:

	Three months ended April 30,	
	2007	**2006**
Volatility	46%	48 50%
Weighted-average estimated life	4 Years	4 Years
Weighted-average risk-free interest rate	4.41 4.46%	4.63 4.81%
Dividend yield		
Weighted-average fair value per share of grants	$ 17.55	$ 15.33

The expected life of options granted is based on the simplified calculation of expected life, described in the U.S. Securities and Exchange Commission s Staff Accounting Bulletin 107. Accordingly, the weighted-average estimated life assumption of 4 years is based on the average of the vesting term and the 5 year contractual lives of all options awarded after February 1, 2006. The weighted-average risk free interest rate is based on the rate for a 4 year U.S. government security at the time of the option grant.

The Company estimated its future stock price volatility considering both observed option-implied volatilities and historical volatility calculations for both the Company and a group of peer comparable companies. Management believes this is the best estimate of the expected volatility over the 4 year weighted-average expected life of its option grants.

During the three months ended April 30, 2007 and 2006, the Company capitalized $561,000 and $68,000, respectively, of stock-based expenses related to internal-use software development and deferred professional services costs.

During the three months ended April 30, 2007, the Company recognized stock-based expense of $12.0 million. As of April 30, 2007, the aggregate stock compensation remaining to be amortized to costs and expenses was $158.7 million. The Company expects this stock compensation balance to be amortized as follows: $44.2 million during the remaining nine months of fiscal 2008; $52.5 million during fiscal 2009; $41.6 million during fiscal 2010; $20.0 million during fiscal 2011; and $0.4 million during fiscal 2012. The expected amortization reflects only outstanding stock awards as of April 30, 2007 and assumes no forfeiture activity. We expect to continue to issue share-based awards to our employees in future periods.

The Company grants stock options and restricted stock units to employees throughout the world. In certain foreign jurisdictions, the Company incurs a payroll or social tax cost when its employees exercise their vested awards. Pursuant to SFAS 123R, the payroll and social tax costs are recognized as an operating expense at the time of the exercise. As of April 30, 2007, the Company would incur as an operating expense in excess of $4.5 million if all vested awards held by employees in these foreign jurisdictions were exercised. This amount is based on the number of vested awards held and the market price of the Company s common stock. The timing of when employees in these foreign jurisdictions exercise their vested awards could materially affect the Company s future results of operations in a particular period.

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Notes to Condensed Consolidated Financial Statements (Continued)

Warranties and Indemnification

The Company s on-demand application service is typically warranted to perform in a manner consistent with general industry standards that are reasonably applicable and materially in accordance with the Company s online help documentation under normal use and circumstances.

The Company s arrangements generally include certain provisions for indemnifying customers against liabilities if its products or services infringe a third-party s intellectual property rights. To date, the Company has not incurred any material costs as a result of such indemnifications and has not accrued any liabilities related to such obligations in the accompanying consolidated financial statements.

The Company has entered into service level agreements with a small number of its customers warranting certain levels of uptime reliability and performance and permitting those customers to receive credits or terminate their agreements in the event that the Company fails to meet those levels. During the three months ended April 30, 2007, the Company reduced its reserve by $0.2 million. As of April 30, 2007 and January 31, 2007, the reserve balance was approximately $0.2 million and $0.4 million, respectively.

The Company has also agreed to indemnify its directors and executive officers for costs associated with any fees, expenses, judgments, fines and settlement amounts incurred by any of these persons in any action or proceeding to which any of those persons is, or is threatened to be, made a party by reason of the person s service as a director or officer, including any action by the Company, arising out of that person s services as the Company s director or officer or that person s services provided to any other company or enterprise at the Company s request. The Company maintains director and officer insurance coverage that would generally enable the Company to recover a portion of any future amounts paid.

Recent Accounting Pronouncement

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS No. 157). The purpose of SFAS No. 157 is to define fair value, establish a framework for measuring fair value and enhance disclosures about fair value measurements. The measurement and disclosure requirements are effective beginning in the first quarter of fiscal 2009. The Company is currently assessing whether adoption of SFAS No. 157 will have an impact on its financial statements.

Reclassifications

Certain reclassifications to the January 31, 2007 assets and liabilities balances were made to conform to the current period presentation.

2. Balance Sheet Accounts

Marketable Securities

At April 30, 2007, marketable securities consisted of the following (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate notes and obligations	$ 195,232	$ 85	$ (257)	$ 195,060
Municipal bonds	1,990		(6)	1,984
U.S. treasury securities	22,002		(114)	21,888
U.S. agency obligations	141,700	16	(69)	141,647
	$ 360,924	$ 101	$ (446)	$ 360,579

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Notes to Condensed Consolidated Financial Statements (Continued)

At January 31, 2007, marketable securities consisted of the following (in thousands):

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Corporate notes and obligations	$ 156,826	$ 9	$ (402)	$ 156,433
Municipal bonds	1,974		(17)	1,957
U.S. treasury securities	30,805		(215)	30,590
U.S. agency obligations	137,107	5	(188)	136,924
	$ 326,712	$ 14	$ (822)	$ 325,904

	April 30, 2007 (unaudited)	January 31, 2007
Recorded as follows (in thousands):		
Short-term (due in one year or less)	$ 162,881	$ 165,816
Long-term (due between one and 3 years)	197,698	160,088
	$ 360,579	$ 325,904

The unrealized losses are attributable to changes in interest rates. As of April 30, 2007, the following investments were in an unrealized loss position (in thousands):

	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Corporate notes and obligations	$ 103,257	$ (96)	$ 31,651	$ (161)	$ 134,908	$ (257)
Municipal bonds			1,984	(6)	1,984	(6)
U.S. treasury securities			21,888	(114)	21,888	(114)
U.S. agency obligations	94,070	(28)	9,798	(41)	103,868	(69)
	$ 197,327	$ (124)	$ 65,321	$ (322)	$ 262,648	$ (446)

The unrealized loss for each of these fixed rate investments ranged from less than $1,000 to $28,000. Of the $65.3 million in investments that were in an unrealized loss position 12 months or greater, $51.3 million will reach maturity within the next 12 months. The Company has the ability and intent to hold these investments to maturity and does not believe any of the unrealized losses represent an other-than-temporary impairment based on its evaluation of available evidence as of April 30, 2007. The Company expects to receive the full principal and interest on all of these investment securities.

Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consisted of the following (in thousands):

	April 30, 2007 (unaudited)	January 31, 2007
Deferred professional services costs	$ 5,195	$ 3,898
Prepaid expenses and other current assets	16,342	11,781
	$ 21,537	$ 15,679

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Notes to Condensed Consolidated Financial Statements (Continued)

Fixed Assets

Fixed assets consisted of the following (in thousands):

	April 30, 2007 (unaudited)	January 31, 2007
Computers, equipment and software	$ 30,147	$ 29,440
Furniture and fixtures	5,245	3,866
Leasehold improvements	25,513	20,757
	60,905	54,063
Less accumulated depreciation and amortization	(27,056)	(23,908)
	$ 33,849	$ 30,155

Depreciation and amortization expense totaled $3,584,000 and $2,070,000 for the three months ended April 30, 2007 and 2006, respectively.

Fixed assets at April 30, 2007 and January 31, 2007 included a total of $3,616,000 acquired under capital lease agreements. Accumulated amortization relating to equipment and software under capital leases totaled $3,515,000 and $3,364,000, respectively, at April 30, 2007 and January 31, 2007. Amortization of assets under capital leases is included in depreciation and amortization expense.

Capitalized Software

Capitalized software consisted of the following (in thousands):

	April 30, 2007 (unaudited)	January 31, 2007
Capitalized internal-use software development costs, net of accumulated amortization of $2,568 and $2,150, respectively	$ 9,157	$ 5,626
Acquired developed technology, net of accumulated amortization of $2,604 and $1,653, respectively	13,068	5,357
	$ 22,225	$ 10,983

In March 2007, the Company acquired 100 percent of the outstanding stock of a corporation, whose principal asset was developed technology, for $5.3 million in cash. The Company accounted for this acquisition as a capital expenditure as the acquired entity did not meet the accounting definition of a business. As part of the acquisition accounting, the Company recorded a $3.4 million deferred income tax liability to reflect the tax effect of the difference between the $5.3 million in cash paid and the tax basis of the technology acquired. Correspondingly, the Company increased the cost of the acquired technology by the amount of the deferred income tax liability. The total acquisition cost of $8.7 million is being amortized on a straight-line basis to cost of revenues over 3 years.

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Notes to Condensed Consolidated Financial Statements (Continued)

Other Assets

Other assets consisted of the following (in thousands):

	April 30, 2007 (unaudited)	January 31, 2007
Deferred professional services costs, noncurrent portion	$ 2,713	$ 1,334
Long-term deposits	2,083	1,958
Purchase of subsidiary shares in Salesforce Japan	2,777	2,777
Purchased intangible assets, net of accumulated amortization of $243 and $184, respectively	447	506
Other	1,117	1,127
	$ 9,137	$ 7,702

Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consisted of the following (in thousands):

	April 30, 2007 (unaudited)	January 31, 2007
Accrued compensation	$ 28,099	$ 40,951
Accrued other liabilities	18,339	15,109
Current portion of lease abandonment liability	185	186
Liability for early exercise of unvested employee stock options	283	400
Accrued other taxes payable	10,942	11,276
Accrued professional costs	2,896	2,749
Accrued rent	7,949	6,480
Current portion of capital lease obligations	25	176
	$ 68,718	$ 77,327

3. Stockholders Equity

Stock Options Issued to Employees

The 1999 Stock Option Plan (the 1999 Plan) provides for the issuance of incentive and nonstatutory options to employees and nonemployees of the Company. The 1999 Plan provides for grants of immediately exercisable options; however, the Company has the right to repurchase any unvested common stock upon the termination of employment at the original exercise price.

In addition to the 1999 Plan, the Company maintains the 2004 Equity Incentive Plan, 2004 Employee Stock Purchase Plan and the 2004 Outside Directors Stock Plan. These plans, other than the 2004 Outside Directors Plan, provide for annual automatic increases on February 1 to the shares reserved for issuance based on the lesser of (i) a specific percentage of the total number of shares outstanding at year end; (ii) a fixed number of shares; or (iii) a lesser number of shares set by the Company s Board of Directors, all as specified in the respective plans.

On February 1, 2007, 4.0 million additional shares were reserved under the 2004 Equity Incentive Plan pursuant to the automatic increase. The 2004 Employee Stock Purchase Plan will not be implemented unless and until the Company s Board of Directors authorizes the commencement of one or more offerings under the plan. No offering periods have been authorized to date.

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Notes to Condensed Consolidated Financial Statements (Continued)

In April 2006, the Company s Board of Directors approved the 2006 Inducement Equity Incentive Plan (the Inducement Plan) that allows for stock option and other equity incentive grants to employees in connection with merger or acquisition activity. The total number of shares reserved for issuance under the Inducement Plan is 400,000 shares. As of April 30, 2007, there were 149,350 shares of common stock available for grant under the Inducement Plan.

Prior to February 1, 2006, options issued under the Company s stock option plans were generally for periods not to exceed 10 years and were issued at fair value of the shares of common stock on the date of grant as determined by the trading price of such stock on the New York Stock Exchange. After February 1, 2006, options issued to employees are for periods not to exceed 5 years. Grants made pursuant to the 2004 Equity Incentive Plan and the Inducement Plan do not provide for the immediate exercise of options.

Stock option activity for the three months ended April 30, 2007 is as follows:

	Shares Available for Grant	Options Outstanding		
		Outstanding Stock Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value
Balance as of January 31, 2007	5,001,926	15,955,334	$ 19.67	
Increase in options authorized:				
2004 Equity Incentive Plan	4,000,000			
Options granted under all plans	(428,594)	428,594	42.66	
Restricted stock unit activity	(276,785)			
Stock grants to board members for board services and advisory board members	(8,250)			
Exercised		(791,626)	10.28	
Cancelled	206,996	(206,996)	26.03	
Balance as of April 30, 2007	8,495,293	15,385,306	$ 20.71	$ 327,992,000
Vested or expected to vest		14,592,076	$ 20.13	$ 319,411,000
Exercisable at April 30, 2007		6,199,706	$ 10.00	$ 198,364,000

The total intrinsic value of the options exercised during the three months ended April 30, 2007 and 2006 were $27.3 million and $30.8 million, respectively.

The weighted-average remaining contractual life of vested and expected to vest options is 6 years.

As of April 30, 2007, options to purchase 6,199,706 shares were vested at a weighted average exercise price of $10.00 per share and a remaining weighted-average remaining contractual life of 6 years. The total intrinsic value of these vested options as of April 30, 2007 was $198.4 million.

As of April 30, 2007, 37,453 shares issued pursuant to exercises of options issued under the 1999 Plan remained subject to repurchase.

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Notes to Condensed Consolidated Financial Statements (Continued)

The following table summarizes information about stock options outstanding as of April 30, 2007:

	Options Outstanding			Options Vested	
Range of Exercise Prices	**Number Outstanding**	**Weighted-Average Remaining Contractual Life (Years)**	**Weighted-Average Exercise Price**	**Number of Shares**	**Weighted-Average Exercise Price**
$0.06 to $2.50	2,871,395	5.71	$ 1.94	2,675,636	$ 1.90
$4.00 to $13.73	2,886,424	7.04	9.06	1,739,490	8.21
$13.89 to $22.64	2,453,661	7.85	17.36	978,014	16.85
$23.05 to $29.35	2,387,658	5.47	27.60	223,129	24.83
$30.40 to $36.90	2,347,357	5.52	34.46	447,705	33.97
$38.39 to $42.79	2,240,271	5.36	39.66	135,732	39.97
$43.24	198,540	4.83	43.24		
	15,385,306		$ 20.71	6,199,706	$ 10.00

Restricted stock unit activity for the three months ended April 30, 2007 is as follows:

	Restricted Stock Units Outstanding		
	Outstanding	**Weighted-Average Exercise Price**	**Aggregate Intrinsic Value**
Balance as of January 31, 2007	841,678	$ 0.001	
Granted	303,852	0.001	
Cancelled	(27,067)	0.001	
Balance as of April 30, 2007	1,118,463	$ 0.001	$ 46,974,000
Expected to vest	991,827		$ 41,656,000

As of April 30, 2007, none of the restricted stock units had vested.

Common Stock

The following shares of common stock are available for future issuance at April 30, 2007:

Options outstanding	15,385,306
Restricted stock units outstanding	1,118,463
Warrants outstanding	18,000
Stock available for future grant:	
1999 Stock Option Plan	857,653

2004 Equity Incentive Plan	6,693,290
2006 Inducement Equity Incentive Plan	149,350
2004 Employee Stock Purchase Plan	1,000,000
2004 Outside Directors Stock Plan	795,000
	26,017,062

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Notes to Condensed Consolidated Financial Statements (Continued)

4. Commitments and Contingencies

Letters of Credit

As of April 30, 2007, the Company had a total of $5.9 million in letters of credit outstanding substantially in favor of its landlords for office space in San Francisco and San Mateo, California, New York, Singapore and Australia. These letters of credit renew annually and mature at various dates through December 2015.

Leases

The Company leases office space and equipment under noncancelable operating and capital leases with various expiration dates.

As of April 30, 2007, the future minimum lease payments under noncancelable operating and capital leases are as follows (in thousands):

	Capital Leases	Operating Leases
Fiscal Period:		
Remaining nine months in fiscal 2008	$ 22	$ 47,927
Fiscal 2009	7	54,570
Fiscal 2010		26,513
Fiscal 2011		18,939
Fiscal 2012		13,984
Thereafter		34,830
Total minimum lease payments	29	$ 196,763
Less: amount representing interest	(2)	
Present value of capital lease obligations	$ 27	

Our agreements for the facilities and certain services provide us with the option to renew. Our future contractual obligations would change if we exercised these options.

In December 2001, the Company abandoned certain office space in San Francisco, California. The following table sets forth the lease abandonment activity since January 31, 2007 (in thousands):

Liability balance at January 31, 2007	$ 762
Charges utilized	(46)
Liability balance at April 30, 2007	$ 716

5. Legal Proceedings

On August 6, 2004, a shareholder derivative action was filed in the Superior Court of the State of California, San Francisco County, entitled Borrelli v. Benioff, et al., against the Company s Chief Executive Officer, its Chief Financial Officer and members of its Board of Directors alleging breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets and unjust enrichment under state common law. Subsequently, a substantially similar complaint was filed in the same court based on the same facts and allegations, entitled Johnson v. Benioff, et al. The two actions were consolidated under the caption Borrelli v.

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Notes to Condensed Consolidated Financial Statements (Continued)

Benioff, Case No. CGC-04-433615 (Cal. Super. Ct., S.F. Cty.). On October 5, 2004, plaintiffs filed a consolidated complaint, and assert that the defendants breached their fiduciary duties by making, or failing to prevent salesforce.com, inc. and its management from making, statements or omissions that potentially subject the Company to liability and injury to its reputation. The action seeks damages on behalf of salesforce.com in an unspecified amount, among other forms of legal and equitable relief. Salesforce.com is named solely as a nominal defendant against which no recovery is sought. On December 22, 2006, the trial Court ordered that the lawsuit be bifurcated into two phases. The first phase is a bench trial to decide the legal issues of (a) whether a duty to disclose internal forecasts in an IPO registration statement exists in law, (b) if so, under what circumstances this duty exists, and (c) which party bears the burden of proof with respect to the foregoing two issues. The second phase will address the remaining issues, if any. Accordingly, pursuant to the Court s order, on January 19, 2007 the parties simultaneously filed briefs on the three legal issues listed above. The parties filed simultaneous reply briefs on February 23, 2007. On March 27, 2007, the Court ruled in favor of defendants and found that there is no duty to disclose internal forecasts in an IPO registration statement. The Court found the remaining two issues inapplicable to its analysis. On May 8, 2007, plaintiffs filed a Request for Dismissal asking the Court to dismiss the case with prejudice in its entirety. The Court has not yet entered an order of dismissal.

Additionally, the Company is involved in various legal proceedings arising from the normal course of business activities. In management s opinion, resolution of these matters is not expected to have a material adverse impact on the Company s consolidated results of operations, cash flows or its financial position. However, depending on the nature and timing of any such dispute, an unfavorable resolution of a matter could materially affect the Company s future results of operations, cash flows or financial position in a particular period.

6. Related-Party Transactions

In January 1999, the salesforce.com/foundation, commonly referred to as the Foundation, a non-profit public charity, was chartered to build philanthropic programs that are particularly focused on youth and technology. The Company s chairman is the chairman of the Foundation. He, one of the Company s officers and one of the Company s board members hold three of the Foundation s eight board seats. The Company is not the primary beneficiary of the Foundation s activities, and accordingly, the Company does not consolidate the Foundation s statement of activities with its financial results.

Since the Foundation s inception, the Company has provided at no charge certain resources to Foundation employees such as office space. The value of these items totals approximately $35,000 per quarter.

In addition to the resource sharing with the Foundation, the Company issued the Foundation warrants in August 2002 to purchase 500,000 shares of common stock. Through April 30, 2007, the Foundation exercised all of these warrants. As of April 30, 2007, the Foundation held 300,000 shares of salesforce.com common stock. Additionally, the Company has donated subscriptions to the Company s service to other qualified non-profit organizations. The fair value of these donated subscriptions is in excess of $2.0 million per month. The Company plans to continue providing free subscriptions to qualified non-profit organizations.

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

The following discussion in Management s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. Forward-looking statements consist of, among other things, trend analyses, statements regarding future events, future financial performance, our business strategy and our plan to build our business, the expenses associated with our data center capacity, our anticipated growth, trends in our business, new application service features, our strategy of acquiring or making investments in complementary companies, services and technologies, the effect of foreign currency exchange rate and interest rate fluctuations on our financial results, the potential impact of current or any future litigation, the potential availability of additional tax assets in the future and related matters, the impact of expensing stock options, the sufficiency of our capital resources, and our strategy to become a platform player for on-demand applications, all of which are based on current expectations, estimates, and forecasts, and the beliefs and assumptions of our management. Words such as expects, anticipates, projects, intends, plans, believes, estimates, variations of such words, and similar expressions are also intended to identify such forward-looking statements. These forward-looking statements are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Readers are directed to risks and uncertainties identified below, under Risk Factors and elsewhere in this report, for factors that may cause actual results to be different than those expressed in these forward-looking statements. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

We are the leading provider, based on market share, of application services that allow organizations to easily share customer information on demand, according to a December 2006 report by IDC. We provide a comprehensive CRM service to businesses of all sizes and industries worldwide.

We were founded in February 1999 and began offering our on-demand CRM application service in February 2000.

In order to increase our revenues and take advantage of our market opportunity, we will need to, among other things, continue to add substantial numbers of paying subscriptions and upgrade our customers to more fully featured versions such as our Unlimited Edition. We plan to re-invest our revenues for the foreseeable future by expanding our data center capacity; upgrading our development and test data center; hiring additional personnel, particularly in customer-related areas; expanding our domestic and international selling and marketing activities; increasing our research and development activities to upgrade and extend our service offerings and to develop new services and technologies; expanding the number of locations around the world where we conduct business; adding to our infrastructure to support our growth; and expanding our operational systems to manage a growing business. Additionally, in our effort to further strengthen and extend our service offering, we may in the future acquire or make investments in complementary companies, services and technologies.

We expect marketing and sales costs, which were 52 percent of our total revenues for the three months ended April 30, 2007 and 50 percent of our total revenues for the same period a year ago, to continue to represent a substantial portion of total revenues in the future as we seek to add and manage more paying subscribers, build brand awareness and increase the number of marketing events that we sponsor.

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Fiscal Year

Our fiscal year ends on January 31. References to fiscal 2008, for example, refer to the fiscal year ended January 31, 2008.

Sources of Revenues

We derive our revenues from two sources: (1) subscription revenues, which are comprised of subscription fees from customers accessing our on-demand application service, and from customers purchasing additional support beyond the standard support that is included in the basic subscription fee; and (2) related professional services and other revenues. Other revenues consist primarily of training fees. Subscription and support revenues accounted for approximately 90 percent of our total revenues. Subscription revenues are driven primarily by the number of paying subscribers of our service and the subscription price of our service. None of our customers accounted for more than 5 percent of our revenues during the three months ended April 30, 2007 and 2006.

Subscription and support revenues are recognized ratably over the contract terms beginning on the commencement dates of each contract. The typical subscription and support term is 12 to 24 months, although terms range from one to 60 months. Our subscription and support contracts are noncancelable, though customers typically have the right to terminate their contracts for cause if we materially fail to perform. We generally invoice our customers in advance, in annual or quarterly installments, and typical payment terms provide that our customers pay us within 30 days of invoice. Amounts that have been invoiced are recorded in accounts receivable and in deferred revenue, or in revenue depending on whether the revenue recognition criteria have been met. In general, we collect our billings in advance of the subscription service period.

Professional services and other revenues consist of fees associated with consulting and implementation services and training. Our consulting and implementation engagements are typically billed on a time and materials basis. We also offer a number of classes on implementing, using and administering our service that are billed on a per person, per class basis. Our typical payment terms provide that our customers pay us within 30 days of invoice.

Cost of Revenues and Operating Expenses

Cost of Revenues. Cost of subscription and support revenues primarily consists of expenses related to hosting our service and providing support, the costs of additional data center capacity, depreciation or operating lease expense associated with computer equipment, costs associated with website development activities, allocated overhead and amortization expense associated with capitalized software. We allocate overhead such as rent and occupancy charges based on headcount. Employee benefit costs and taxes are allocated based upon a percentage of total compensation expense. As such, general overhead expenses are reflected in each cost of revenue and operating expense category. Cost of professional services and other revenues consists primarily of employee-related costs associated with these services, including stock-based expenses, the cost of subcontractors and allocated overhead. The cost associated with providing professional services is significantly higher as a percentage of revenue than for our on-demand subscription service due to the labor costs associated with providing professional services.

We intend to continue to invest additional resources in our on-demand application service and in our consulting services. The timing of these additional expenses will affect our cost of revenues, both in terms of absolute dollars and as a percentage of revenues, in a particular quarterly period. For example, we plan to increase the number of employees who are fully dedicated to consulting services. We have also obtained additional data center capacity on the west and east coasts of the United States. We expect the annual cost of these resources to be significant.

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Research and Development. Research and development expenses consist primarily of salaries and related expenses, including stock-based expenses, the costs of our development and test data center and allocated overhead. We have historically focused our research and development efforts on increasing the functionality and enhancing the ease of use of our on-demand application service. Our proprietary, scalable and secure multi-tenant architecture enables us to provide all of our customers with a service based on a single version of our application. As a result, we do not have to maintain multiple versions, which enables us to have relatively low research and development expenses as compared to traditional enterprise software companies. We expect that in the future, research and development expenses will increase in absolute dollars as we upgrade and extend our service offerings and develop new technologies.

Marketing and Sales. Marketing and sales expenses are our largest cost and consist primarily of salaries and related expenses, including stock-based expenses, for our sales and marketing staff, including commissions, payments to partners, marketing programs and allocated overhead. Marketing programs consist of advertising, events, corporate communications and brand building and product marketing activities.

We plan to continue to invest heavily in marketing and sales by increasing the number of direct sales personnel in order to add new customers and increase penetration within our existing customer base, expanding our domestic and international selling and marketing activities, building brand awareness and sponsoring additional marketing events. We expect that in the future, marketing and sales expenses will increase in absolute dollars and continue to be our largest cost.

General and Administrative. General and administrative expenses consist of salaries and related expenses, including stock-based expenses, for finance and accounting, human resources and management information systems personnel, legal costs, professional fees, other corporate expenses and allocated overhead. We expect that in the future, general and administrative expenses will increase in absolute dollars as we add personnel and incur additional professional fees and insurance costs related to the growth of our business, international expansion and operations as a public company, including the continuing cost of our compliance with Section 404 of the Sarbanes-Oxley Act.

Stock-Based Expenses. Our cost of revenues and operating expenses include stock-based expenses related to option and stock awards to employees and non-employee directors. We account for stock-based expenses pursuant to the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, which requires that share-based payments, including grants of employee stock options, be recognized as an expense in the statement of operations based on their fair values and vesting periods. These charges are significant.

Joint Venture

In December 2000, we established a Japanese joint venture, Kabushiki Kaisha salesforce.com, with SunBridge, Inc., a Japanese corporation, to assist us with our sales efforts in Japan. As of April 30, 2007, we owned a 65 percent interest in the joint venture. Because of this majority interest, we consolidate the venture s financial results, which are reflected in each revenue, cost of revenues and expense category in our consolidated statement of operations. We then record minority interest, which reflects the minority investors interest in the venture s results, exclusive of intercompany charges. Through April 30, 2007, the operating performance and liquidity requirements of the Japanese joint venture had not been significant. While we plan to expand our selling and marketing activities in Japan in order to add new customers, we believe the future operating performance and liquidity requirements of the Japanese joint venture will not be significant.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make

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estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses, and related disclosures. On an ongoing basis, we evaluate our estimates and assumptions. Our actual results may differ from these estimates under different assumptions or conditions.

We believe that of our significant accounting policies, which are described in note 1 to our consolidated financial statements, the following accounting policies involve a greater degree of judgment and complexity. Accordingly, these are the policies we believe are the most critical to aid in fully understanding and evaluating our consolidated financial condition and results of operations.

Revenue Recognition. We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 104, Revenue Recognition and Emerging Issues Task Force, or EITF, Issue No. 00-21, Revenue Arrangements with Multiple Deliverables.

We recognize revenue when all of the following conditions are satisfied: (1) there is persuasive evidence of an arrangement; (2) the service has been provided to the customer; (3) the collection of our fees is reasonably assured; and (4) the amount of fees to be paid by the customer is fixed or determinable. Our arrangements do not contain general rights of return.

We recognize subscription revenues ratably over the contract terms beginning on the commencement dates of each contract. Support revenues from customers who purchase our premium support offerings are recognized similarly over the term of the support contract. As part of their subscription agreements, customers generally benefit from new features and functionality with each release at no additional cost. In situations where we have contractually committed to an individual customer specific technology, we defer all of the revenue for that customer until the technology is delivered and accepted. Once delivery occurs, we then recognize the revenue over the remaining contract term.

Consulting services and training revenues are accounted for separately from subscription and support revenues when these services have value to the customer on a standalone basis and there is objective and reliable evidence of fair value of each deliverable. When accounted for separately, revenues are recognized as the services are rendered for time and material contracts, and when the milestones are achieved and accepted by the customer for fixed price contracts. The majority of our consulting service contracts are on a time and material basis. Training revenues are recognized after the services are performed. For revenue arrangements with multiple deliverables, such as an arrangement that includes subscription, premium support, consulting or training services, we allocate the total amount the customer will pay to the separate units of accounting based on their relative fair values, as determined by the price of the undelivered items when sold separately.

In determining whether the consulting services can be accounted for separately from subscription and support revenues, we consider the following factors for each consulting agreement: availability of the consulting services from other vendors, whether objective and reliable evidence for fair value exists for the undelivered elements, the nature of the consulting services, the timing of when the consulting contract was signed in comparison to the subscription service start date, and the contractual dependence of the subscription service on the customer s satisfaction with the consulting work. If a consulting arrangement does not qualify for separate accounting, we recognize the consulting revenue ratably over the remaining term of the subscription contract. Additionally, in these situations we defer the direct costs of the consulting arrangement and amortize those costs over the same time period as the consulting revenue is recognized. The deferred cost on our consolidated balance sheet totaled $7,908,000 at April 30, 2007 and $5,232,000 at January 31, 2007. Such amounts are included in prepaid expenses and other current assets and other assets.

Accounting for Deferred Commissions. We defer commission payments to our direct sales force. The commissions are deferred and amortized to sales expense over the noncancelable terms of the related subscription contracts with our customers, which are typically 12 to 24 months. The commission payments, which are paid in full the month after the customer s service commences, are a direct and incremental cost of the revenue arrangements. The deferred commission amounts are recoverable through the future revenue streams under the noncancelable customer contracts. We believe this is the preferable method of accounting as the commission charges are so closely related to the revenue from the noncancelable customer contracts that they should be recorded as an asset and charged to expense over the same period that the subscription revenue is recognized.

During the three months ended April 30, 2007, we deferred $9.2 million of commission expenditures and we amortized $9.1 million to sales expense. During the same period a year ago, we deferred $4.5 million of commission expenditures and we amortized $5.1 million to sales expense. Deferred commissions on our consolidated balance sheet totaled $31.7 million at April 30, 2007 and $31.6 million at January 31, 2007.

Accounting for Stock-Based Awards. We account for share-based compensation under SFAS 123R. We recognize the fair value of our stock awards on a straight-line basis over the requisite service period of the award, which is the vesting term of four years.

We recognized stock-based expense of $12.0 million, or 7 percent of revenue, during the three months ended April 30, 2007. The requirement to expense stock-based awards will continue to materially reduce our reported results of operations. As of April 30, 2007, we had an aggregate of $158.7 million of stock compensation remaining to be amortized to expense over the remaining requisite service period of the underlying awards. We currently expect this stock compensation balance to be amortized as follows: $44.2 million during the remaining nine months of fiscal 2008; $52.5 million during fiscal 2009; $41.6 million during fiscal 2010; $20.0 million during fiscal 2011; and $0.4 million during fiscal 2012. The expected amortization reflects only outstanding stock awards as of April 30, 2007 and assumes no forfeiture activity. We expect to continue to issue share-based awards to our employees in future periods.

We grant stock options and restricted stock units to employees throughout the world. In certain foreign jurisdictions, we are obligated for the payroll or social tax costs when employees exercise their vested awards. Pursuant to SFAS 123R, we recognize as an operating expense the payroll and social tax costs at the time of the exercise. As of April 30, 2007, we would incur as an operating expense in excess of $4.5 million if all vested awards held by employees in these foreign jurisdictions were exercised. This amount is based on the number of vested awards held and the market price of our common stock. The timing of when employees in these foreign jurisdictions exercise their vested awards could materially affect our future results of operations in a particular period.

The impact of SFAS 123R in the future is dependent upon, among other things, the timing of when we hire additional employees, the effect of long-term incentive strategies involving stock awards in order to continue to attract and retain employees, the total number of stock awards granted, the fair value of the stock awards at the time of grant, changes in estimated forfeiture assumption rates and the tax benefit that we may or may not receive from stock-based expenses. Additionally, the application of SFAS 123R requires the use of an option-pricing model to determine the fair value of stock option awards. This determination of fair value is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards.

As of April 30, 2007, there were 1,118,463 restricted stock units outstanding. We plan to continue awarding restricted stock units to our employees in the future. The restricted stock units, which upon vesting entitles the holder to one share of common stock for each restricted stock unit, have an exercise price of $0.001 per share, which is equal to the par value of our common stock, and vest over 4 years. The fair value of the restricted units is based on our closing stock price on the date of grant, and compensation expense, net of estimated forfeitures, is recognized on a straight-line basis over the vesting period.

Accounting for Income Taxes. We account for income taxes using the liability method, which requires the recognition of deferred tax assets or liabilities for the tax-effected temporary differences between the financial reporting and tax bases of our assets and liabilities and for net operating loss and tax credit carryforwards. The

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tax expense or benefit for unusual items, prior year tax exposure items or certain adjustments to the valuation allowance are treated as discrete items in the interim period in which the events occur.

Our effective tax rate could be adversely affected by changes in the mix of earnings and losses in countries with differing statutory tax rates, certain non-deductible expenses arising from SFAS 123R and the valuation of deferred tax assets and liabilities.

Results of Operations

The following tables set forth selected data for each of the periods indicated and are in thousands. All data is unaudited.

	Three months ended April 30, 2007	Three months ended April 30, 2006
Revenues:		
Subscription and support	$ 147,690	$ 94,493
Professional services and other	14,722	10,193
Total revenues	162,412	104,686
Cost of revenues:		
Subscription and support	20,184	12,775
Professional services and other	18,983	11,785
Total cost of revenues	39,167	24,560
Gross profit	123,245	80,126
Operating expenses:		
Research and development	14,121	8,825
Marketing and sales	83,925	52,016
General and administrative	25,085	19,405
Total operating expenses	123,131	80,246
Income (loss) from operations	114	(120)
Interest income	5,048	2,990
Interest expense	(41)	(11)
Other income (expense)	169	(599)
Income before provision for income taxes and minority interest	5,290	2,260
Provision for income taxes	(3,842)	(2,005)
Income before minority interest	1,448	255
Minority interest in consolidated joint venture	(718)	(484)
Net income (loss)	$ 730	$ (229)
Basic net income (loss) per share	$ 0.01	$ 0.00
Diluted net income (loss) per share	0.01	0.00
Weighted-average number of shares used in per share amounts:		
Basic	114,987	110,957
Diluted	120,635	110,957
In addition to the statement of operations data above:		
Cash flow provided by operating activities	$ 36,830	$ 12,416

	April 30, 2007	As of January 31, 2007	April 30, 2006
Balance sheet data:			
Cash, cash equivalents and marketable securities	$ 448,071	$ 412,512	$ 298,313
Deferred revenue	295,672	284,063	182,036

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	Three months ended April 30, 2007	2006
Revenues by geography:		
Americas	$ 124,452	$ 83,025
Europe	25,574	14,950
Asia Pacific	12,386	6,711
	$ 162,412	$ 104,686

Cost of revenues and operating expenses include the following amounts related to stock-based awards.

	Three months ended April 30, 2007	2006
Cost of revenues	$ 1,774	$ 1,154
Research and development	1,277	720
Marketing and sales	5,619	3,482
General and administrative	3,342	2,250
	$ 12,012	$ 7,606

The following tables set forth selected consolidated statements of operations data for each of the periods indicated as a percentage of total revenues.

	Three months ended April 30, 2007