SALESFORCE COM INC
Form 10-Q
August 18, 2006
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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 July 31, 2006**

**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 July 31, 2006, there were approximately 112.3 million shares of the Registrant s Common Stock outstanding.

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**salesforce.com, inc.**

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**PART I. FINANCIAL INFORMATION**

**ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**salesforce.com, inc.**

**Condensed Consolidated Balance Sheets**

(in thousands)

| | July 31, 2006 (unaudited) | January 31, 2006 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 149,992 | $ 99,842 |
| Short-term marketable securities | 116,697 | 107,723 |
| Accounts receivable, net | 75,704 | 76,128 |
| Deferred commissions | 13,870 | 13,186 |
| Prepaid expenses and other current assets | 13,401 | 6,338 |
| Total current assets | 369,664 | 303,217 |
| Marketable securities, noncurrent | 67,418 | 89,227 |
| Fixed assets, net | 24,842 | 24,216 |
| Deferred commissions, noncurrent | 4,627 | 3,889 |
| Deferred income taxes, noncurrent | 17,512 | 10,416 |
| Goodwill | 7,239 | |
| Other assets | 10,049 | 3,784 |
| Total assets | $ 501,351 | $ 434,749 |
| **Liabilities and stockholders equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 6,026 | $ 10,212 |
| Accrued expenses and other current liabilities | 49,250 | 48,782 |
| Income taxes payable | 3,736 | 2,650 |
| Deferred income taxes | 4,393 | 3,191 |
| Deferred revenue | 202,836 | 169,175 |
| Current portion of capital lease obligations | 475 | 615 |
| Total current liabilities | 266,716 | 234,625 |
| Capital lease obligations, net of current portion | 20 | 184 |
| Long-term lease abandonment liability and other | 1,138 | 1,155 |
| Minority interest | 3,358 | 2,414 |
| Total liabilities | 271,232 | 238,378 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Common stock | 112 | 111 |
| Additional paid-in capital | 268,855 | 237,010 |
| Deferred stock-based compensation | | (2,531) |
| Accumulated other comprehensive loss | (2,360) | (2,105) |
| Accumulated deficit | (36,488) | (36,114) |

| | | |
|---|---|---|
| Total stockholders equity | 230,119 | 196,371 |
| Total liabilities and stockholders equity | $ 501,351 | $ 434,749 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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**salesforce.com, inc.**

**Condensed Consolidated Statements of Operations**

(in thousands, except per share data)

(unaudited)

| | Three months ended July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Subscription and support | $ 106,663 | $ 65,638 | $ 201,156 | $ 123,828 |
| Professional services and other | 11,474 | 6,305 | 21,667 | 12,292 |
| Total revenues | 118,137 | 71,943 | 222,823 | 136,120 |
| Cost of revenues (1): | | | | |
| Subscription and support | 15,775 | 8,013 | 28,550 | 13,349 |
| Professional services and other | 13,356 | 8,224 | 25,141 | 14,853 |
| Total cost of revenues | 29,131 | 16,237 | 53,691 | 28,202 |
| Gross profit | 89,006 | 55,706 | 169,132 | 107,918 |
| Operating expenses (1): | | | | |
| Research and development | 11,008 | 5,470 | 19,833 | 9,772 |
| Marketing and sales | 59,811 | 34,688 | 111,827 | 69,190 |
| General and administrative | 19,466 | 11,355 | 38,871 | 20,778 |
| Lease recovery | | | | (285) |
| Total operating expenses | 90,285 | 51,513 | 170,531 | 99,455 |
| Income (loss) from operations | (1,279) | 4,193 | (1,399) | 8,463 |
| Interest income | 3,321 | 1,724 | 6,311 | 3,178 |
| Interest expense | (151) | (31) | (162) | (44) |
| Other income (expense) | 137 | 666 | (462) | 710 |
| Income before provision for income taxes and minority interest | 2,028 | 6,552 | 4,288 | 12,307 |
| Provision for income taxes | (1,713) | (1,310) | (3,718) | (2,461) |
| Income before minority interest | 315 | 5,242 | 570 | 9,846 |
| Minority interest in consolidated joint venture | (460) | (202) | (944) | (426) |
| Net income (loss) | $ (145) | $ 5,040 | $ (374) | $ 9,420 |
| Basic net income (loss) per share | $ 0.00 | $ 0.05 | $ 0.00 | $ 0.09 |
| Diluted net income (loss) per share | 0.00 | 0.04 | 0.00 | 0.08 |
| Weighted-average number of shares used in per share amounts: | | | | |
| Basic | 111,838 | 106,614 | 111,397 | 105,918 |
| Diluted | 111,838 | 117,974 | 111,397 | 117,181 |

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

| | Three months ended July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Cost of revenues | $ 1,442 | $ 160 | $ 2,596 | $ 310 |
| Research and development | 1,286 | 91 | 2,006 | 179 |
| Marketing and sales | 4,718 | 365 | 8,200 | 727 |
| General and administrative | 2,747 | 322 | 4,997 | 578 |
| | $ 10,193 | $ 938 | $ 17,799 | $ 1,794 |

See accompanying Notes to Condensed Consolidated Financial Statements.

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**salesforce.com, inc.**

**Condensed Consolidated Statements of Cash Flows**

(in thousands)

(unaudited)

| | Three months ended July 31, 2006 | Three months ended July 31, 2005 | Six months ended July 31, 2006 | Six months ended July 31, 2005 |
|---|---|---|---|---|
| **Operating activities** | | | | |
| Net income (loss) | $ (145) | $ 5,040 | $ (374) | $ 9,420 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | | |
| Minority interest in consolidated joint venture | 460 | 202 | 944 | 426 |
| Depreciation and amortization | 2,562 | 1,468 | 4,798 | 2,589 |
| Amortization of deferred commissions | 5,651 | 3,326 | 10,778 | 6,728 |
| Amortization of purchased intangibles | 541 | | 630 | |
| Lease recovery | | | | (285) |
| Expense related to stock-based awards | 10,193 | 938 | 17,799 | 1,794 |
| Tax benefits from employee stock plans | (3,328) | 1,918 | (5,928) | 1,918 |
| Changes in assets and liabilities | 14,088 | 1,180 | 13,791 | 9,392 |
| Net cash provided by operating activities | 30,022 | 14,072 | 42,438 | 31,982 |
| **Investing activities** | | | | |
| Business combination | | | (15,502) | |
| Restricted cash | | (22) | | (116) |
| Changes in marketable securities | (14,151) | (31,518) | 13,057 | (38,033) |
| Capital expenditures | (2,818) | (3,372) | (5,413) | (12,529) |
| Net cash used in investing activities | (16,969) | (34,912) | (7,858) | (50,678) |
| **Financing activities** | | | | |
| Proceeds from the exercise of stock options and warrants | 5,388 | 5,290 | 10,891 | 7,442 |
| Tax benefits from employee stock plans | 3,328 | | 5,928 | |
| Principal payments on capital lease obligations | (153) | (171) | (304) | (311) |
| Repurchase of unvested shares | (10) | (24) | (10) | (28) |
| Collection of notes receivable from stockholders | | | | 727 |
| Net cash provided by financing activities | 8,553 | 5,095 | 16,505 | 7,830 |
| Effect of exchange rate changes | (187) | 281 | (935) | 275 |
| Net increase (decrease) in cash and cash equivalents | 21,419 | (15,464) | 50,150 | (10,591) |
| Cash and cash equivalents at beginning of period | 128,573 | 40,604 | 99,842 | 35,731 |
| Cash and cash equivalents at end of period | $ 149,992 | $ 25,140 | $ 149,992 | $ 25,140 |
| **Supplemental cash flow disclosure:** | | | | |
| Cash paid during the period for: | | | | |
| Interest | $ 151 | $ 31 | $ 162 | $ 44 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Income taxes, net of tax refunds | $ | 111 | $ | | $ | 120 | $ | (116) |
| **Noncash financing and investing activities** | | | | | | | | |
| Fixed assets acquired under capital lease | $ | | $ | 122 | $ | | $ | 122 |
| Net exercise of warrants | $ | | $ | 2 | $ | | $ | 48 |

See accompanying Notes to Condensed Consolidated Financial Statements.

**salesforce.com, inc.**

**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. 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 2007, for example, refer to the fiscal year ending January 31, 2007.

***Basis of Presentation***

The accompanying condensed consolidated balance sheet as of July 31, 2006 and the condensed consolidated statements of operations and the condensed consolidated statements of cash flows for the three and six months ended July 31, 2006 and 2005, respectively, are unaudited. The condensed consolidated balance sheet data as of January 31, 2006 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, 2006, which was filed with the Securities and Exchange Commission (the SEC ) on March 15, 2006. The accompanying statements should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company s fiscal 2006 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 July 31, 2006, and its results of operations and its cash flows for the three and six months ended July 31, 2006 and 2005. Other than for the lease recovery which is described in Note 5 below, all adjustments are of a normal recurring nature. The results for the three and six months ended July 31, 2006 are not necessarily indicative of the results to be expected for any subsequent quarter or for the fiscal year ending January 31, 2007.

***Accounting for Stock-Based Compensation***

Effective February 1, 2006, the Company adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, using the modified prospective transition method and therefore has not restated results for prior periods. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized as expenses in the statement of operations based on their fair values and vesting periods.

As a result of implementing SFAS 123R, the Company s income before provision for income taxes and minority interest for the six months ended July 31, 2006 was $17.0 million, or approximately $11.0 million after tax, lower than if it had continued to account for share-based compensation under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ). Basic and diluted earnings per share for the six months ended July 31, 2006 were $0.10 and $0.09, respectively, lower than if the Company continued to account for share-based compensation under APB 25.

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**Notes to Condensed Consolidated Financial Statements (Continued)**

Under the modified prospective transition method, stock-based expense includes compensation expense for all options granted prior to, but not yet vested as of February 1, 2006, based on the grant date fair value estimated in accordance with the original provision of Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation ( SFAS 123 ). Stock-based compensation expense for all stock-based compensation awards granted after February 1, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123R.

The Company recognizes these stock-based expenses on a straight-line basis over the requisite service period of the award, which is the option vesting term of four years. Stock-based expenses are recognized net of an estimated forfeiture rate of 3 percent which is applied to grants because they are not expected to vest. The Company evaluates its forfeiture rate assumption quarterly. Should a change in estimate occur, the effect of the adjustment will be recognized in the period the forfeiture rate changes.

Prior to the adoption of SFAS 123R, the Company recognized stock-based compensation expense in accordance with APB 25. Under APB 25, compensation expense of fixed stock options was based on the difference on the date of the grant between the deemed fair value of the Company s stock and the exercise price of the option. The differences occurred prior to the Company s initial public offering in June 2004 when there was no established public market for the Company s common stock. Compensation expense was recognized on a single award straight-line basis over the option-vesting period of four years.

Additionally, SFAS 123R requires the tax benefits from employee stock plans to be classified as a financing activity in the consolidated statement of cash flows. The Company historically classified these tax benefits as a source of cash provided by operating activities. These benefits totaled $3.3 million and $5.9 million during the three and six months ended July 31, 2006, respectively, and $1.9 million for both the three and six months ended July 31, 2005.

In May 2006, the Company awarded 346,073 restricted stock units to its employees from one of its stockholder approved stock incentive plans. 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 the Company s common stock, and vest over 4 years. The fair value of the restricted stock units is based on the Company s stock price on the date of grant, which was $29.35 per share, and compensation expense, net of estimated forfeitures, is recognized on a straight-line basis over the vesting period.

As of July 31, 2006, the aggregate stock compensation remaining to be amortized to costs and expenses was $110.4 million. The Company expects this stock compensation balance to be amortized as follows: $18.7 million during the remainder of fiscal 2007; $39.3 million during fiscal 2008; $29.5 million during fiscal 2009; $19.7 million during fiscal 2010; and $3.2 million during fiscal 2011. The expected amortization reflects only outstanding stock awards as of July 31, 2006.

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 July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Volatility | 48% | 50% | 48-50% | 50-75% |
| Weighted-average estimated life | 4 years | 4 years | 4 years | 4 years |
| Weighted-average risk-free interest rate | 4.84-5.03% | 3.79% | 4.63-5.03% | 3.79-3.95% |
| Dividend yield | | | | |
| Weighted-average fair value per share of grants | $ 12.48 | $ 9.03 | $ 13.64 | $ 8.84 |

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**salesforce.com, inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

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. This is an acceptable method prescribed by the U.S. Securities and Exchange Commission. 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.

During the three months ended July 31, 2005, the Company reevaluated the assumptions used to estimate the future volatility of its stock price. 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. As a result of its reevaluation and the general market decline in share price volatilities, the Company reduced its volatility assumption from 75 percent to 50 percent. In March 2006, the Company revised the estimated volatility of its stock price to be 48 percent.

Had compensation cost for the Company s stock-based compensation plans been determined using the fair-value method at the grant date for awards under those plans calculated using the Black-Scholes pricing model and recognized on a straight-line basis over the option vesting periods, the Company s net income for the three and six months ended July 31, 2005 would have been decreased to the pro forma amounts indicated below (in thousands, except per share data):

| | Three months ended July 31, 2005 | Six months ended July 31, 2005 |
|---|---|---|
| Net income, as reported | $ 5,040 | $ 9,420 |
| Add: Total stock-based compensation expense included in the determination of net income | 754 | 1,514 |
| Deduct: Total stock-based compensation expense determined under the fair-value-based method for all awards. Such expense amounts are not net of tax benefits | (5,248) | (10,006) |
| Net income, pro forma | $ 546 | $ 928 |
| Net income, per share: | | |
| Basic: | | |
| As reported | $ 0.05 | $ 0.09 |
| Pro forma | 0.01 | 0.01 |
| Diluted: | | |
| As reported | $ 0.04 | $ 0.08 |
| Pro forma | 0.00 | 0.01 |

***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 July 31, 2006, the Company owned a 63 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, restricted cash, 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 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 July 31, 2006 and January 31, 2006. No single customer accounted for 5 percent or more of total revenue during the three and six month periods ended July 31, 2006 and 2005.

As of July 31, 2006 and January 31, 2006, assets located outside the Americas were 10 percent and 6 percent of total assets, respectively. Revenues by geographical region are as follows (in thousands):

| | Three months ended July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | **2006** | **2005** | **2006** | **2005** |
| Revenues by geography: | | | | |
| Americas | $ 92,553 | $ 57,689 | $ 175,578 | $ 108,601 |
| Europe | 17,624 | 10,038 | 32,574 | 19,421 |
| Asia Pacific | 7,960 | 4,216 | 14,671 | 8,098 |
| | $ 118,137 | $ 71,943 | $ 222,823 | $ 136,120 |

As of July 31, 2006, the Company serves all of its customers and users from a single, third-party Web hosting facility located on the west coast of the United States, operated by Equinix, Inc. As part of the

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**salesforce.com, inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

Company s current disaster recovery arrangements, the existing production environment and all of the customers data is replicated in near real-time in a separate back-up facility located on the east coast. The Company does not control the operation of any of these facilities, and they are vulnerable to damage or interruption. Even with the disaster recovery arrangements, the Company s service could be interrupted.

***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 July 31, 2006 and January 31, 2006, 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 (loss) and other comprehensive income (loss), which includes certain changes in equity that is excluded from net income (loss). Specifically, cumulative foreign currency translation and unrealized gains and losses on marketable securities adjustments, net of tax, are included in accumulated other comprehensive income (loss). Comprehensive income (loss) has been reflected in stockholders equity.

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

| | Three months ended July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net income (loss) | $ (145) | $ 5,040 | $ (374) | $ 9,420 |
| Translation adjustment | (326) | (485) | (477) | (491) |
| Unrealized gain (loss) on marketable securities | 224 | (348) | 222 | (670) |
| Total comprehensive income (loss) | $ (247) | $ 4,207 | $ (629) | $ 8,259 |

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

| | July 31, 2006 (unaudited) | January 31, 2006 |
|---|---|---|
| Foreign currency translation adjustments | $ (1,014) | $ (537) |

| | | |
|---|---|---|
| Net unrealized losses on marketable securities | (1,346) | (1,568) |
| | $ (2,360) | $ (2,105) |

**salesforce.com, inc.**

**Notes to Condensed Consolidated Financial Statements (Continued)**

***Net Income (Loss) Per Share***

Basic net income (loss) per share is computed by dividing net income 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.

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 July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| **Numerator:** | | | | |
| Net income (loss) | $ (145) | $ 5,040 | $ (374) | $ 9,420 |
| **Denominator:** | | | | |
| Weighted-average shares outstanding for basic earnings (loss) per share, net of weighted-average shares of common stock subject to repurchase | 111,838 | 106,614 | 111,397 | 105,918 |
| Effect of dilutive securities: | | | | |
| Employee stock awards and warrants | | 11,360 | | 11,263 |
| Adjusted weighted-average shares outstanding and assumed conversions for diluted earnings (loss) per share | 111,838 | 117,974 | 111,397 | 117,181 |

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 periods where the Company has a net loss, all dilutive securities are excluded. In periods where the Company has net income, the dilutive securities are excluded when their exercise prices are greater than the average fair values of the Company s common stock (in thousands):

| | Three months ended July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Options | | 580 | | 845 |

***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 expected to be realized.

The Company recorded a provision for income taxes of $3.7 million during the six months ended July 31, 2006, compared to a provision for income taxes of $2.5 million during the same period a year ago. The fiscal 2007 provision as a percentage of income before provision for income taxes was significantly higher than the previous year primarily due to foreign losses for which no tax benefit can be realized, certain nondeductible

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**Notes to Condensed Consolidated Financial Statements (Continued)**

stock-based expenses resulting from the adoption of SFAS 123R and the expiration of U.S. federal research and development tax credit on December 31, 2005. The total income tax benefit recognized in the accompanying condensed consolidated statements of operations related to SFAS 123R was $5.5 million for the six months ended July 31, 2006.

***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.

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

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**Notes to Condensed Consolidated Financial Statements (Continued)**

July 31, 2006 and January 31, 2006, the deferred cost on the accompanying consolidated balance sheet totaled $2,574,000 and $1,686,000, respectively. These deferred costs are included in prepaid and other current assets and other assets.

On occasion, the Company has purchased from its suppliers goods or services for the Company s use in its operations at or around the same time these same businesses entered into subscription and/or consulting agreements. The Company generally defines at or around the same time as within six months. Revenues recognized from customers who were also suppliers were not significant during the three and six months ended July 31, 2006 and 2005. Both the procurement and revenue agreements are separately negotiated, settled ultimately in cash, and recorded at what the Company considers to be fair value. When any of these factors is not present, the Company does not recognize the revenue from the underlying sale agreements; rather, the revenue is netted with expenses.

***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 condensed consolidated statements of operations.

***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 six months ended July 31, 2006, the Company recorded a provision of approximately $0.8 million for potential credits and paid out approximately $0.8 million. As of July 31, 2006 and January 31, 2006, the reserve balance was approximately $1.4 million.

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**Notes to Condensed Consolidated Financial Statements (Continued)**

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 June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* ( FIN 48 ). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. Measurement of the tax uncertainty occurs if the recognition threshold has been met. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 will be effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating what impact, if any, the adoption of FIN 48 will have on its financial position and results of operations.

**2. Acquisition**

On April 10, 2006, the Company acquired 100 percent of the outstanding stock of Sendia Corporation, a privately-held company based in Santa Monica, California, for $15.2 million in cash and $304,000 in acquisition costs. Approximately $1.8 million of the purchase price is attributed to assumed debt that was repaid immediately following the close of the transaction. The Company acquired Sendia because it had an established wireless solution technology.

The Company accounted for this acquisition using Statement of Financial Accounting Standards No. 141, Business Combinations. Accordingly, the results of operations for the acquired business are included in the accompanying condensed consolidated statements of operations since the acquisition date, and the related assets and liabilities were recorded based upon their relative fair values as of the acquisition date. Pro forma results of operations have not been presented because the effects of the acquisition were not significant.

Management s preliminary allocation of the purchase price consideration, based on a valuation of the acquired assets and liabilities performed in part by an unrelated third-party appraiser, is as follows (in thousands):

| | |
|---|---|
| Net tangible liabilities | $ (49) |
| Developed technology | 5,710 |
| Customer relationships | 690 |
| Goodwill | 7,239 |
| Deferred taxes | 2,612 |
| Deferred revenue | (700) |
| Total purchase price consideration | $ 15,502 |

The above purchase price allocation is preliminary. The portion of the purchase price allocation that is not yet finalized is the valuation of acquired net operating losses. When this valuation is completed, adjustments to deferred taxes may be required.

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**Notes to Condensed Consolidated Financial Statements (Continued)**

The goodwill balance of $7.2 million is not deductible for tax purposes. This asset is attributed to the premium paid for an established wireless solution.

The deferred revenue balance of $0.7 million reflects the estimated fair value of the fulfillment of the existing service arrangements assumed from Sendia in connection with the acquisition plus a reasonable profit margin. The Company estimates that the arrangements assumed from Sendia will be substantially fulfilled by the end of fiscal 2007.

In performing the preliminary purchase price allocation, the Company considered, among other factors, its intention for future use of the acquired assets, analyses of historical financial performance and estimates of future performance of Sendia s products. The fair value of intangible assets was primarily based on the income approach. The cost approach was also utilized when appropriate. The rate of return utilized to discount the net cash flows to their present values was 25 percent. At July 31, 2006, identifiable intangible assets purchased in the Sendia acquisition consisted of the following (in thousands, except for useful life):

| | Gross Fair Value | Accumulated Amortization | Net Book Value | Useful Life |
|---|---|---|---|---|
| Developed technology | $ 5,710 | $ (562) | $ 5,148 | 3 years |
| Customer relationships | 690 | (68) | 622 | 3 years |
| | $ 6,400 | $ (630) | $ 5,770 | |

**3. Balance Sheet Accounts**

***Marketable Securities***

At July 31, 2006, marketable securities consisted of the following (in thousands):

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Corporate notes and obligations | $ 97,083 | $ 4 | $ (647) | $ 96,440 |
| Municipal bonds | 1,944 | | (39) | 1,905 |
| US government and agency obligations | 86,434 | 5 | (669) | 85,770 |
| | $ 185,461 | $ 9 | $ (1,355) | $ 184,115 |

At January 31, 2006, marketable securities consisted of the following (in thousands):

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Corporate notes and obligations | $ 98,686 | $ | $ (749) | $ 97,937 |
| Municipal bonds | 1,915 | | (52) | 1,863 |
| US government and agency obligations | 97,917 | 4 | (771) | 97,150 |

| | | | |
|---|---|---|---|
| $ 198,518 | $ 4 | $ (1,572) | $ 196,950 |

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**Notes to Condensed Consolidated Financial Statements (Continued)**

| | July 31, 2006 (unaudited) | January 31, 2006 |
|---|---|---|
| Recorded as follows (in thousands): | | |
| Short-term (due in one year or less) | $ 116,697 | $ 107,723 |
| Long-term (due between one and three years) | 67,418 | 89,227 |
| | $ 184,115 | $ 196,950 |

As of July 31, 2006, 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 | $ 58,750 | $ (311) | $ 28,364 | $ (336) | $ 87,114 | $ (647) |
| Municipal bonds | | | 1,905 | (39) | 1,905 | (39) |
| US government and agency obligations | 24,142 | (170) | 39,648 | (499) | 63,790 | (669) |
| | $ 82,892 | $ (481) | $ 69,917 | $ (874) | $ 152,809 | $ (1,355) |

The unrealized loss for each of these fixed rate investments ranged from less than $1,000 to $65,000. Of the $69.9 million in investments that were in an unrealized loss position 12 months or greater, $52.4 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 July 31, 2006. 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):

| | July 31, 2006 (unaudited) | January 31, 2006 |
|---|---|---|
| Deferred professional services costs | $ 2,191 | $ 1,200 |
| Prepaid expenses and other current assets | 11,210 | 5,138 |
| | $ 13,401 | $ 6,338 |

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**Notes to Condensed Consolidated Financial Statements (Continued)**

***Fixed Assets***

Fixed assets consisted of the following (in thousands):

| | July 31, 2006 (unaudited) | January 31, 2006 |
|---|---|---|
| Computers, equipment and software | $ 25,904 | $ 24,029 |
| Furniture and fixtures | 2,865 | 2,831 |
| Leasehold improvements | 15,084 | 12,355 |
| | 43,853 | 39,215 |
| Less accumulated depreciation and amortization | (19,011) | (14,999) |
| | $ 24,842 | $ 24,216 |

Depreciation and amortization expense totaled $2,390,000 and $1,358,000 for the three months ended July 31, 2006 and 2005, respectively, and $4,460,000 and $2,381,000 for the six months ended July 31, 2006 and 2005, respectively.

Fixed assets at July 31, 2006 and January 31, 2006 included a total of $3,616,000 acquired under capital lease agreements. Accumulated amortization relating to equipment and software under capital leases totaled $3,068,000 and $2,765,000, respectively, at July 31, 2006 and January 31, 2006. Amortization of assets under capital leases is included in depreciation and amortization expense.

***Other Assets***

Other assets consisted of the following (in thousands):

| | July 31, 2006 (unaudited) | January 31, 2006 |
|---|---|---|
| Capitalized internal-use software development costs, net of accumulated amortization of $1,738 and $1,400, respectively | $ 1,864 | $ 1,550 |
| Acquired developed technology, net of accumulated amortization of $562 and zero, respectively | 5,148 | |
| Acquired other intangible assets, net of accumulated amortization of $68 and zero, respectively | 622 | |
| Deferred professional services costs, noncurrent portion | 383 | 486 |
| Long-term deposits | 1,792 | 1,542 |
| Other | 240 | 206 |
| | $ 10,049 | $ 3,784 |

During the three and six months ended July 31, 2006, the Company capitalized $88,000 and $155,000, respectively, of stock-based expenses related to internal-use software development and deferred professional services costs.

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**Notes to Condensed Consolidated Financial Statements (Continued)**

***Accrued Expenses and Other Current Liabilities***

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

| | July 31, 2006 (unaudited) | January 31, 2006 |
|---|---|---|
| Accrued compensation | $ 24,770 | $ 24,465 |
| Accrued other liabilities | 11,198 | 10,844 |
| Current portion of lease abandonment liability | 186 | 186 |
| Liability for early exercise of unvested employee stock options | 584 | 229 |
| Accrued non-income taxes payable | 6,016 | 7,463 |
| Accrued professional costs | 2,054 | 1,911 |
| Accrued rent | 4,442 | 3,684 |
| | $ 49,250 | $ 48,782 |

**4. Stockholders Equity**

***Stock Options Issued to Employees***

The Company has in place the 1999 Stock Option Plan (the 1999 Plan ) which 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, 2006, 5,000,000 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.

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. In April 2006, the Company granted 268,150 options to Sendia employees who joined the Company.

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.

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**Notes to Condensed Consolidated Financial Statements (Continued)**

Stock option activity for the six months ended July 31, 2006 is as follows:

| | Shares Available for Grant | Outstanding Stock Options | Options Outstanding Weighted-Average Exercise Price | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Balance as of January 31, 2006 | 4,292,015 | 16,005,907 | $ 12.24 | |
| Increase in options authorized: | | | | |
| 2004 Equity Incentive Plan | 5,000,000 | | | |
| 2006 Inducement Equity Incentive Plan | 400,000 | | | |
| Options granted under all plans | (3,104,189) | 3,104,189 | 31.56 | |
| Stock grants to a board member for board services and advisory board members | (6,000) | | | |
| Exercised | | (1,679,204) | 6.40 | |
| Repurchased | 7,314 | | 1.10 | |
| Cancelled | 962,023 | (962,023) | 25.24 | |
| Balance as of July 31, 2006 | 7,551,163 | 16,468,869 | $ 15.72 | $ 192,984,779 |
| Vested or expected to vest | | 16,046,370 | $ 15.49 | $ 191,000,450 |
| Exercisable at July 31, 2006 | | 5,865,760 | $ 6.13 | $ 114,776,471 |

The total intrinsic value of the options exercised during the six months ended July 31, 2006 was $45.4 million.

The weighted-average remaining contractual life of vested and expected to vest options is 7 years.

As of July 31, 2006, options to purchase 5,865,760 shares were vested at a weighted average exercise price of $6.13 per share and a remaining weighted-average remaining contractual life of 7 years. The total intrinsic value of these vested options as of July 31, 2006 was $114.8 million.

As of July 31, 2006, 114,782 shares issued pursuant to exercises of options issued under the 1999 Plan remained subject to repurchase.

The following table summarizes information about stock options outstanding as of July 31, 2006:

| | 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 $2.00 | 1,747,027 | 5.75 | $ 1.04 | 1,614,973 | $ 1.04 |
| $2.50 | 2,599,899 | 6.88 | 2.50 | 1,676,099 | 2.50 |
| $4.00 to $8.00 | 2,537,751 | 7.53 | 7.00 | 1,259,761 | 6.84 |
| $12.77 to $15.00 | 2,391,716 | 8.40 | 13.91 | 747,110 | 13.87 |
| $15.10 to $23.57 | 2,363,025 | 8.79 | 20.01 | 567,817 | 19.60 |
| $24.53 to $29.35 | 2,431,120 | 6.05 | 27.90 | | |
| $30.44 to $39.97 | 2,398,331 | 7.14 | 35.22 | | |

| | | | | |
|---|---|---|---|---|
| 16,468,869 | $ | 15.72 | 5,865,760 | $ 6.13 |

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**Notes to Condensed Consolidated Financial Statements (Continued)**

In May 2006, the Company awarded 346,073 restricted stock units to its employees from the 2004 Equity Incentive Plan. The restricted stock units have an exercise price of $0.001 per share, which is equal to the par value of the Company s common stock, and vest over 4 years. The fair value of the restricted units is based on the Company s stock price on the date of grant, and compensation expense is recognized on a straight-line basis over the vesting period.

Restricted stock unit activity for the six months ended July 31, 2006 is as follows:

| | Restricted Stock Units Outstanding | | |
|---|---|---|---|
| | Outstanding | Weighted-Average Exercise Price | Aggregate Intrinsic Value |
| Balance as of January 31, 2006 | | $ | |
| Granted in May 2006 | 346,073 | 0.001 | |
| Cancelled | (14,171) | 0.001 | |
| Balance as of July 31, 2006 | 331,902 | $ 0.001 | $ 8,526,562 |
| Expected to vest | | | $ 8,018,702 |

As of July 31, 2006, none of the restricted stock units have vested.

***Common Stock***

The following shares of common stock are available for future issuance at July 31, 2006:

| | |
|---|---|
| Options outstanding | 16,468,869 |
| Restricted stock units outstanding | 331,902 |
| Warrants outstanding | 143,000 |
| Stock available for future grant: | |
| 1999 Stock Option Plan | 1,181,574 |
| 2004 Equity Incentive Plan | 5,038,837 |
| 2006 Inducement Equity Incentive Plan | 136,350 |
| 2004 Employee Stock Purchase Plan | 1,000,000 |
| 2004 Outside Directors Stock Plan | 862,500 |
| | 25,163,032 |

During the six months ended July 31, 2006, a board member received stock grants for a total of 5,000 shares of common stock for board services pursuant to the terms described in the 2004 Outside Directors Stock Plan.

**5. Commitments and Contingencies**

***Letters of Credit***

As of July 31, 2006, the Company had a total of $4.4 million in letters of credit outstanding substantially in favor of its landlords for office space in San Francisco, California, New York, Singapore and Switzerland. None of these letters of credit are collateralized by certificates of deposit maintained at a granting financial institution.

These letters of credit renew annually and mature at various dates through December 2015.

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**Notes to Condensed Consolidated Financial Statements (Continued)**

***Leases***

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

As of July 31, 2006, the future minimum lease payments under noncancelable operating and capital leases are as follows (in thousands):

| | Capital Leases | Operating Leases |
|---|---|---|
| Fiscal Period: | | |
| Remaining six months in fiscal 2007 | $ 319 | $ 26,693 |
| Fiscal 2008 | 181 | 50,406 |
| Fiscal 2009 | 7 | 38,379 |
| Fiscal 2010 | | 14,908 |
| Fiscal 2011 | | 11,971 |
| Thereafter | | 31,356 |
| Total minimum lease payments | 507 | $ 173,713 |
| Less: amount representing interest | (12) | |
| Present value of capital lease obligations | $ 495 | |

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 March 2005, the Company entered into an agreement with its primary landlord that released it from a portion of the future obligations associated with the remaining 4,000 square feet of San Francisco office space that was abandoned in December 2001 in exchange for an agreement to lease additional space elsewhere in the building at fair value. Accordingly, the Company recorded a $285,000 credit to reflect the reversal of a portion of the accrual that was directly related to the previously abandoned space.

The following table sets forth the lease abandonment activity since January 31, 2006:

| | |
|---|---|
| Liability balance at January 31, 2006 | $ 948,000 |
| Charges utilized | (93,000) |
| Liability balance at July 31, 2006 | $ 855,000 |

**6. Legal Proceedings**

On July 26, 2004, a purported class action complaint was filed in the United States District Court for the Northern District of California, entitled *Morrison v. salesforce.com, inc. et al.*, against the Company, its Chief Executive Officer and its Chief Financial Officer. The complaint alleged violations of Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934, as amended (the 1934 Act ), purportedly on behalf of all persons who purchased salesforce.com common stock between June 21, 2004 and July 21, 2004, inclusive. The claims were based upon allegations that defendants failed to disclose an allegedly declining trend in its revenues and earnings. Subsequently, four other substantially similar class action complaints were filed in the same district based upon the same facts and allegations, asserting claims under Section 10(b) and Section 20(a) of the 1934 Act and Section 11 and Section 15 of the Securities Act of 1933, as amended. The actions were consolidated

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**Notes to Condensed Consolidated Financial Statements (Continued)**

under the caption *In re salesforce.com, inc. Securities Litigation*, Case No. C-04-3009 JSW (N.D. Cal.). On December 22, 2004, the Court appointed Chuo Zhu as lead plaintiff. On February 22, 2005, lead plaintiff filed a Consolidated and Amended Class Action Complaint (the CAC ). The CAC alleged violations of Section 10(b) and Section 20(a) of the 1934 Act, purportedly on behalf of all persons who purchased salesforce.com common stock between June 23, 2004 and July 21, 2004, inclusive. As in the original complaints, the claims in the CAC were based upon allegations that defendants failed to disclose an allegedly declining trend in its revenues and earnings. On April 14, 2005, defendants filed a motion to dismiss the CAC. On April 15, 2005, the Court granted lead plaintiff leave to file an amended/superseding complaint. On April 22, 2005, lead plaintiff filed a Corrected and Superceding [sic] First Amended Class Action Complaint ( FAC ). As in the CAC, the FAC alleged violations of Section 10(b) and Section 20(a) of the 1934 Act, purportedly on behalf of all persons who purchased salesforce.com common stock between June 23, 2004 and July 21, 2004, inclusive. The claims in the FAC were based upon allegations that defendants failed to disclose an internal forecast that earnings for fiscal year 2005 would decline from the prior fiscal year. On April 29, 2005, defendants filed a motion to dismiss the FAC. On December 22, 2005, the court entered an order granting defendants motion to dismiss, with prejudice, and directing the clerk to close the file. On January 23, 2006, lead plaintiff filed a motion for leave to file a motion for reconsideration, as well as a notice of appeal to the United States Court of Appeals for the Ninth Circuit. On January 26, 2006, the Ninth Circuit entered a time schedule order for the appeal, requiring, *inter alia*, lead plaintiff to file his opening brief on May 11, 2006, and defendants to file their responsive brief on June 12, 2006. On January 27, 2006, defendants filed a motion to strike as untimely lead plaintiff s motion for leave to file a motion for reconsideration. On February 2, 2006, lead plaintiff filed a motion with the Ninth Circuit requesting a stay of the appellate proceedings pending the district court s determination of lead plaintiff s motion for leave and defendants motion to strike. Defendants opposed that motion. On February 9, 2006, the Ninth Circuit denied the lead plaintiff s motion for a stay of the appellate proceedings, without prejudice to making a motion for limited remand. On March 1, 2006, the district court denied the lead plaintiff s motion for leave to file a motion for reconsideration and defendants motion to strike on grounds of lack of jurisdiction. Also on March 1, 2006, the lead plaintiff filed a motion with the district court seeking certification for limited remand from the Ninth Circuit. Defendants opposed this motion, which was denied by the district court on April 3, 2006. The lead plaintiff filed his opening brief with the Ninth Circuit on May 25, 2006 and the Company filed its answering brief on July 17, 2006. The lead plaintiff s reply brief is due on August 17, 2006. The Company does not believe that the lawsuit has any merit and intends to continue to defend the action and appeal vigorously.

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. Benioff*, Case No. CGC-04-433615 (Cal. Super. Ct., S.F. Cty.). On October 5, 2004, plaintiffs filed a consolidated complaint, which is based upon the same facts and circumstances as alleged in the shareholder class action discussed above, and asserts 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. The plaintiff shareholders made no demand upon the Board of Directors prior to filing these actions. On June 15, 2006, defendants filed a demurrer to the consolidated complaint on the grounds that plaintiffs lack standing to pursue the action because of their failure to make demand upon the Board of Directors. The hearing on defendants demurrer is scheduled for August 31, 2006. To this point, no discovery has occurred in this case. The derivative action is still in the preliminary stages, and it is

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**Notes to Condensed Consolidated Financial Statements (Continued)**

not possible for the Company to quantify the extent of potential liability to the individual defendants, if any. Management does not believe that the lawsuits have any merit and intends to defend the actions vigorously.

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.

**7. 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 executive officers and one of the Company s board members hold three of the Foundation s nine 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 $30,000 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 July 31, 2006, the Foundation has exercised 375,000 of these warrants. 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 currently approximately $1.2 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, our future 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 the recent accounting pronouncement to expense stock options, the sufficiency of our capital resources, and our belief that Sendia Corporation s wireless solution will provide value to our customers, 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 Which May Impact Future Operating Results 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 an August 2005 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 continue to add substantial numbers of paying subscriptions. 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.

As our revenues increase, we expect marketing and sales costs, which were 50 percent of our total revenues for the six months ended July 31, 2006 and 51 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.

**Fiscal Year**

Our fiscal year ends on January 31. References to fiscal 2007, for example, refer to the fiscal year ended January 31, 2007.

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**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 90 percent of our total revenues during the six months ended July 31, 2006 and 91 percent during the same period a year ago. 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 and six months ended July 31, 2006 and 2005.

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. To date, the amortization expense associated with capitalized software has not been material to our cost of revenues. 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.

To the extent that our customer base grows, 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.

*Research and Development*. Research and development expenses consist primarily of salaries and related expenses, including stock-based expenses, the costs of upgrading 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

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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.

We recently upgraded our development and test data center. We expect the annual cost of this data center to be significant.

*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.

As our revenues increase, 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. As described below, on February 1, 2006 we adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, which requires companies to expense their stock option awards. We adopted SFAS 123R using the modified prospective transition method and therefore we have not restated results for prior periods. These charges are significant and are reflected in our financial results.

Prior to February 1, 2006, we recognized stock-based expenses related to options and warrants issued to non-employees and option grants to employees in situations prior to our June 2004 initial public offering where the exercise price was less than the deemed fair value of our common stock at the date of grant and stock awards to board members for board services.

**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 July 31, 2006, we owned a 63 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 July 31, 2006, 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 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 of the notes to our condensed 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 $2,574,000 at July 31, 2006 and $1,686,000 at January 31, 2006.

*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,

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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 six months ended July 31, 2006, we deferred $12.2 million of commission expenditures and we amortized $10.8 million to sales expense. During the same period a year ago, we deferred $7.6 million of commission expenditures and we amortized $6.7 million to sales expense. Deferred commissions on our consolidated balance sheet totaled $18.5 million at July 31, 2006 and $17.1 million at January 31, 2006.

*Accounting for Stock-Based Awards.* Effective February 1, 2006, we adopted the fair value recognition provisions of SFAS 123R, using the modified prospective transition method and therefore we have not restated results for prior periods. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized as expense in the statement of operations based on their fair values and vesting periods. 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 $17.8 million during the six months ended July 31, 2006. The requirement to expense stock-based awards will continue to materially reduce our reported results of operations. As of July 31, 2006, we had an aggregate of $110.4 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: $18.7 million during the remainder of fiscal 2007; $39.3 million during fiscal 2008; $29.5 million during fiscal 2009; $19.7 million during fiscal 2010; and $3.2 million during fiscal 2011. The expected amortization reflects only outstanding stock awards as of July 31, 2006. We expect to continue to issue share-based awards to our employees in future periods.

The full impact of SFAS 123R in the future is dependent upon, among other things, the timing of when we hire additional employees, the effect of new 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.

In May 2006, we awarded 346,073 restricted stock units to our employees. We plan to continue awarding restricted stock units in the future. The restricted stock units 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 stock price on the date of grant, which was $29.35 per share, and compensation expense 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 tax expense or benefit for unusual items, tax exposure items or adjustments to the valuation allowance are treated as discrete items in the interim period in which the events occur.

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**Results of Operations**

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

| | Three months ended July 31, | | Six months ended July 31, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Revenues: | | | | |
| Subscription and support | $ 106,663 | $ 65,638 | $ 201,156 | $ 123,828 |
| Professional services and other | 11,474 | 6,305 | 21,667 | 12,292 |
| Total revenues | 118,137 | 71,943 | 222,823 | 136,120 |
| Cost of revenues: | | | | |
| Subscription and support | 15,775 | 8,013 | 28,550 | 13,349 |
| Professional services and other | 13,356 | 8,224 | 25,141 | 14,853 |
| Total cost of revenues | 29,131 | 16,237 | 53,691 | 28,202 |
| Gross profit | 89,006 | 55,706 | 169,132 | 107,918 |
| Operating expenses: | | | | |
| Research and development | 11,008 | 5,470 | 19,833 | 9,772 |
| Marketing and sales | 59,811 | 34,688 | 111,827 | 69,190 |
| General and administrative | 19,466 | 11,355 | 38,871 | 20,778 |
| Lease recovery | | | | (285) |
| Total operating expenses | 90,285 | 51,513 | 170,531 | 99,455 |
| Income (loss) from operations | (1,279) | 4,193 | (1,399) | 8,463 |
| Interest income | 3,321 | 1,724 | 6,311 | 3,178 |
| Interest expense | (151) | (31) | (162) | (44) |
| Other income (expense) | 137 | 666 | (462) | 710 |
| Income before provision for income taxes and minority interest | 2,028 | 6,552 | 4,288 | 12,307 |
| Provision for income taxes | (1,713) | (1,310) | (3,718) | (2,461) |
| Income before minority interest | 315 | 5,242 | 570 | 9,846 |
| Minority interest in consolidated joint venture | (460) | (202) | (944) | (426) |
| Net income (loss) | $ (145) | $ 5,040 | $ (374) | $ 9,420 |
| Basic net income (loss) per share | $ 0.00 | $ 0.05 | $ 0.00 | $ 0.09 |
| Diluted net income (loss) per share | 0.00 | 0.04 | 0.00 | 0.08 |
| Weighted-average number of shares used in per share amounts: | | | | |
| Basic | 111,838 | 106,614 | 111,397 | 105,918 |
| Diluted | 111,838 | 117,974 | 111,397 | 117,181 |

In addition to the statement of operations data above:

| | | | | |
|---|---|---|---|---|
| Cash flow provided by operating activities | $ 30,022 | $ 14,072 | $ 42,438 | $ 31,982 |

**As of**

| | July 31, 2006 | January 31, 2006 | July 31, 2005 |
|---|---|---|---|
| Balance sheet data: | | | |
| Cash, cash equivalents and marketable securities | $ 334,107 | $ 296,792 | $ 232,710 |
| Deferred revenue | 202,836 | 169,175 | 117,311 |
| Customer and subscriber data: | | | |
| Approximate number of customers | 24,800 | 20,500 | 16,900 |
| Approximate number of paying subscriptions (1) | 501,000 | 399,000 | 308,000 |

(1) Paying subscriptions are defined as unique user accounts, purchased by customers for use by their employees and other customer-authorized users that have not been suspended for non-payment and for which we are recognizing subscription revenue.

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| | Three months ended July 31, 2006 | 2005 | Six months ended July 31, 2006 | 2005 |
|---|---|---|---|---|
| Revenues by geography: | | | | |
| Americas | $ 92,553 | $ 57,689 | $ 175,578 | $ 108,601 |
| Europe | 17,624 | 10,038 | 32,574 | 19,421 |
| Asia Pacific | 7,960 | 4,216 | 14,671 | 8,098 |
| | $ 118,137 | $ 71,943 | $ 222,823 | $ 136,120 |

Cost of revenues and operating expenses include the following amounts related to stock-based awards (see Note 1 in the Notes to Condensed Consolidated Financial Statements).

| | Three months ended July 31, 2006 | 2005 | Six months ended July 31, 2006 | 2005 |
|---|---|---|---|---|
| Cost of revenues | $ 1,442 | $ 160 | $ 2,596 | $ 310 |
| Research and development | 1,286 | 91 | 2,006 | 179 |
| Marketing and sales | 4,718 | 365 | 8,200 | 727 |
| General and administrative | 2,747 | 322 | 4,997 | 578 |
| | $ 10,193 | $ 938 | $ 17,799 | $ 1,794 |

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 July 31, 2006 | 2005 | Six months ended July 31, 2006 | 2005 |
|---|---|---|---|---|
| Revenues: | | | | |
| Subscription and support | 90% | 91% | 90% | 91% |
| Professional services and other | 10 | 9 | 10 | 9 |
| Total revenues | 100 | 100 | 100 | 100 |
| Cost of revenues: | | | | |
| Subscription and support | 13 | 11 | 13 | 10 |
| Professional services and other | 12 | 12 | 11 | 11 |
| Total cost of revenues | 25 | 23 | 24 | 21 |
| Gross profit | 75 | 77 | 76 | 79 |
| Operating expenses: | | | | |
| Research and development | 9 | 7 | 9 | 7 |
| Marketing and sales | 51 | 48 | 50 | 51 |
| General and administrative | 16 | 16 | 18 | 15 |
| Lease abandonment recovery | | | | |
| Total operating expenses | 76 | 71 | 77 | 73 |
| Income (loss) from operations | (1) | 6 | (1) | 6 |
| Interest income | 3 | 2 | 3 | 2 |
| Interest expense | | | | |

| | | | | |
|---|---|---|---|---|
| Other income (expense) | | 1 | | 1 |
| Income before provision for income taxes and minority interest | 2 | 9 | 2 | 9 |
| Provision for income taxes | (2) | (2) | (2) | (2) |
| Income before minority interest | | 7 | | 7 |
| Minority interest in consolidated joint venture | | | | |
| Net income (loss) | % | 7% | % | 7% |

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| | Three months ended July 31, 2006 | Three months ended July 31, 2005 | Six months ended July 31, 2006 | Six months ended July 31, 2005 |
|---|---|---|---|---|
| Revenues by geography: | | | | |
| Americas | 78% | 80% | 79% | 80% |
| Europe | 15 | 14 | 15 | 14 |
| Asia Pacific | 7 | 6 | 6 | 6 |
| | 100% | 100% | 100% | 100% |

| | Three months ended July 31, 2006 | Three months ended July 31, 2005 | Six months ended July 31, 2006 | Six months ended July 31, 2005 |
|---|---|---|---|---|
| Stock-based expenses: | | | | |
| Cost of revenues | 1% | % | 1% | % |
| Research and development | 1 | | 1 | |
| Marketing and sales | 4 | 1 | 4 | 1 |
| General and administrative | 3 | | 2 | |
| | 9% | 1% | 8% | 1% |

**Overview of the Three Months Ended July 31, 2006**

During the three months ended July 31, 2006, the net loss was $145,000 or nil per share. Included in net loss was $10.2 million of stock-based expenses. Net income during the same period a year ago was $5.0 million, or $0.04 per diluted share. Net income during the three months ended July 31, 2005 included $0.9 million of stock-based expenses.

Revenues during the three months ended July 31, 2006 were $118.1 million, an increase of 64 percent over the same period a year ago. The total number of paying subscriptions increased to approximately 501,000 as of July 31, 2006 from approximately 399,000 as of January 31, 2006.

Our gross profit during the three months ended July 31, 2006 was $89.0 million, or 75 percent of revenues, and included pre-tax stock-based expenses of $1.4 million. Our operating loss was $1.3 million and included stock-based expenses of $10.2 million. During the same period a year ago, we generated a gross profit of $55.7 million, or 77 percent of revenues, and had operating income of $4.2 million. Operating income during the three months ended July 31, 2005 also included $0.9 million of stock-based expense.

Additionally, during the three months ended July 31, 2006, we incurred substantial costs and operating expenses related to the expansion of our business. We incurred costs related to our data center capacity and upgrading our development and test data center. Additionally, we added sales personnel to focus on adding new customers and increasing the penetration within our existing customer base, professional services personnel to support our consulting services, and developers to broaden and enhance our on-demand service.

During the three months ended July 31, 2006, we generated $30.0 million of cash from operating activities, as compared to $14.1 million during the same period a year ago. At July 31, 2006, we had cash, cash equivalents and marketable securities of $334.1 million, as compared to $232.7 million at July 31, 2005, accounts receivable of $75.7 million at July 31, 2006, as compared to $50.2 million at July 31, 2005, and deferred revenue of $202.8 million at July 31, 2006, as compared to $117.3 million at July 31, 2005.

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***Three Months Ended July 31, 2006 and 2005***

*Revenues.* Total revenues were $118.1 million for the three months ended July 31, 2006, compared to $71.9 million during the same period a year ago, an increase of $46.2 million, or 64 percent. Subscription and support revenues were $106.7 million, or 90 percent of total revenues, for the three months ended July 31, 2006, compared to $65.6 million, or 91 percent of total revenues, during the same period a year ago. The increase in subscription and support revenues was due primarily to the increase in the number of paying subscriptions to approximately 501,000 as of July 31, 2006 from approximately 308,000 as of July 31, 2005. Professional services and other revenues were $11.4 million, or 10 percent of total revenues, for the three months ended July 31, 2006, compared to $6.3 million, or 9 percent of total revenues, for the same period a year ago. The increase in professional services and other revenues was due primarily to the higher demand for services from an increased number of paying subscriptions and customers.

Revenues in Europe and Asia Pacific accounted for $25.6 million, or 22 percent of total revenues, during the three months ended July 31, 2006, compared to $14.3 million, or 20 percent of total revenues, during the same period a year ago, an increase of $11.3 million, or 79 percent. The increase in revenues outside of the Americas was the result of our efforts to expand the number of locations around the world where we conduct business and our international selling and marketing activities.

*Cost of Revenues*. Cost of revenues was $29.1 million, or 25 percent of total revenues, during the three months ended July 31, 2006, compared to $16.2 million, or 23 percent of total revenues, during the same period a year ago, an increase of $12.9 million. The increase in absolute dollars was primarily due to an increase of $4.2 million in employee-related costs, primarily all of which was due to the 31 percent increase in the headcount of our professional services organization since July 31, 2005, an increase of $1.3 million in stock-based expenses, an increase of $5.1 million in service delivery costs, primarily due to our efforts in adding data center capacity, an increase of $1.0 million in depreciation and amortization expenses and an increase of $1.4 million in outside subcontractor and other service costs. The cost of the additional professional services headcount resulted in the cost of professional services and other revenues to be in excess of the related revenue during the three months ended July 31, 2006 by $1.9 million. We increased the professional services headcount in order to meet the anticipated demand for our consulting and training services as our subscriber base has expanded.

As described above, we intend to continue to invest additional resources in our on-demand application service and in our capacity to deliver professional services. The timing of these additional expenses, together with the new requirement to expense stock options, will affect our cost of revenues, both in terms of absolute dollars and as a percentage of revenues. We believe that our cost of revenues as a percentage of revenues will approximate recent percentages, exclusive of the new requirement to expense stock options.

*Research and Development*. Research and development expenses were $11.0 million, or 9 percent of total revenues, during the three months ended July 31, 2006, compared to $5.5 million, or 7 percent of total revenues, during the same period a year ago, an increase of $5.5 million. The increase in absolute dollars was due to an increase of $3.5 million in employee-related costs, $1.2 million in stock-based expenses and $0.7 million in allocated overhead charges. We increased our research and development headcount by 89 percent since July 31, 2005 in order to upgrade and extend our service offerings and develop new technologies. During the three months ended July 31, 2006, we capitalized $0.4 million in development costs associated with planned releases of our application service.

*Marketing and Sales*. Marketing and sales expenses were $59.8 million, or 51 percent of total revenues, during the three months ended July 31, 2006, compared to $34.7 million, or 48 percent of total revenues, during the same period a year ago, an increase of $25.1 million. The increase in absolute dollars was primarily due to an increase of $17.2 million in employee-related costs, $4.4 million in stock-based expenses, $0.9 million in marketing, advertising and event costs and a $2.1 million increase in allocated overhead. Our marketing and sales headcount increased by 54 percent since July 31, 2005 as we hired additional sales personnel to focus on adding new customers and increasing penetration within our existing customer base.

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*General and Administrative*. General and administrative expenses were $19.5 million, or 16 percent of total revenues, during the three months ended July 31, 2006, compared to $11.4 million, or 16 percent of total revenues, during the same period a year ago, an increase of $8.1 million. The increase was primarily due to an increase of $6.5 million in employee-related costs, $2.4 million in stock-based expenses, $1.6 million in infrastructure-related costs and $0.6 million in professional and outside service costs, which were primarily offset by $3.0 million in increased allocated charges to non-general and administrative departments. Our general and administrative headcount increased by 54 percent since July 31, 2005 as we added personnel to support our growth.

*Operating Income (Loss).* Operating loss during the three months ended July 31, 2006 was $1.3 million and included $10.2 million of stock-based expenses related to SFAS 123R. During the same period a year ago, operating income was $4.2 million. The increase in our revenues were re-invested in an effort to expand our business.

*Interest Income*. Interest income consists of investment income on cash and marketable securities balances. Interest income was $3.3 million during the three months ended July 31, 2006 and was $1.7 million during the same period a year ago. The increase was primarily due to increased marketable securities balances resulting from the cash generated by operating activities and increased market interest rates.

*Provision for Income Taxes.* We recorded a provision for income taxes of $1.7 million during the three months ended July 31, 2006, compared to a provision for income taxes of $1.3 million during the same period a year ago. The fiscal 2007 provision as a percentage of income before provision for income taxes was significantly higher than the previous year primarily due to foreign losses for which no tax benefit can be realized, certain nondeductible stock-based expenses resulting from the adoption of SFAS 123R and the expiration of the U.S. federal research and development tax credit on December 31, 2005.

Without the effect of SFAS 123R and the business combination accounting adjustments for the acquisition of Sendia Corporation, the effective tax rate for fiscal 2007 would have been approximately 45 percent. This effective tax rate differs from the statutory rate primarily due to foreign losses for which no tax benefit can be realized and other nondeductible items. Future actual results could vary from those projected if significant unusual items occur.

***Six Months Ended July 31, 2006 and 2005***

*Revenues.* Total revenues were $222.8 million for the six months ended July 31, 2006, compared to $136.1 million during the same period a year ago, an increase of $86.7 million, or 64 percent. Subscription and support revenues were $201.2 million, or 90 percent of total revenues, for the six months ended July 31, 2006, compared to $123.8 million, or 91 percent of total revenues, during the same period a year ago. The increase in subscription and support revenues was due primarily to the increase in the number of paying subscriptions. Professional services and other revenues were $21.6 million, or 10 percent of total revenues, for the six months ended July 31, 2006, compared to $12.3 million, or 9 percent of total revenues, for the same period a year ago. The increase in professional services and other revenues was due primarily to the higher demand for services from an increased number of paying subscriptions and customers.

Revenues in Europe and Asia Pacific accounted for $47.2 million, or 21 percent of total revenues, during the six months ended July 31, 2006, compared to $27.5 million, or 20 percent of total revenues, during the same period a year ago, an increase of $19.7 million, or 72 percent. The increase in revenues outside of the Americas was the result of our efforts to expand the number of locations around the world where we conduct business and our international selling and marketing activities.

*Cost of Revenues*. Cost of revenues was $53.7 million, or 24 percent of total revenues, during the six months ended July 31, 2006, compared to $28.2 million, or 21 percent of total revenues, during the same period a year ago, an increase of $25.5 million. The increase in absolute dollars was primarily due to an increase of $9.0 million in employee-related costs, primarily due to the 17 percent increase in the headcount of our professional

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services organization since January 31, 2006, an increase of $2.3 million in stock-based expenses, an increase of $9.4 million in service delivery costs, primarily due to our efforts in adding data center capacity, an increase of $1.7 million in depreciation and amortization expenses, an increase of $2.3 million in outside subcontractor and other service costs and an increase of $0.6 million in allocated overhead charges. The cost of the additional professional services headcount resulted in the cost of professional services and other revenues to be in excess of the related revenue during the six months ended July 31, 2006 by $3.5 million. We increased the professional services headcount in order to meet the anticipated demand for our consulting and training services as our subscriber base has expanded.

As described above, we intend to continue to invest additional resources in our on-demand application service and in our capacity to deliver professional services. The timing of these additional expenses, together with the new requirement to expense stock options, will affect our cost of revenues, both in terms of absolute dollars and as a percentage of revenues. Excluding the impact of stock-based compensation expense, we believe that our cost of revenues as a percentage of revenues will approximate recent percentages.

*Research and Development*. Research and development expenses were $19.8 million, or 9 percent of total revenues, during the six months ended July 31, 2006, compared to $9.8 million, or 7 percent of total revenues, during the same period a year ago, an increase of $10.0 million. The increase in absolute dollars was due to an increase of $5.8 million in employee-related costs, $1.8 million in stock-based expenses, $1.2 million in equipment and service costs and $1.3 million in allocated overhead charges. We increased our research and development headcount by 57 percent since January 31, 2006 in order to upgrade and extend our service offerings and develop new technologies.

*Marketing and Sales*. Marketing and sales expenses were $111.8 million, or 50 percent of total revenues, during the six months ended July 31, 2006, compared to $69.2 million, or 51 percent of total revenues, during the same period a year ago, an increase of $42.6 million. The increase in absolute dollars was primarily due to an increase of $32.2 million in employee-related costs, $7.5 million in stock-based expenses, $3.8 million increase in allocated overhead, which were primarily offset by $2.3 million in decreased marketing, advertising and event expenses. Our marketing and sales headcount increased by 21 percent since January 31, 2006 as we hired additional sales personnel to focus on adding new customers and increasing penetration within our existing customer base.

*General and Administrative*. General and administrative expenses were $38.9 million, or 18 percent of total revenues, during the six months ended July 31, 2006, compared to $20.8 million, or 15 percent of total revenues, during the same period a year ago, an increase of $18.1 million. The increase was primarily due to an increase of $14.2 million in employee-related costs, $4.4 million in stock-based expenses, $1.7 million in infrastructure-related costs and $2.0 million in professional and outside service costs, which were primarily offset by $5.7 million in increased allocated charges to non-general and administrative departments. Our general and administrative headcount increased by 25 percent since January 31, 2006 as we added personnel to support our growth.

*Lease Recovery.* The lease recovery of $285,000, which occurred during the first quarter of last year, was due to the reduction in accruals associated with the San Francisco, California office space that we abandoned in December 2001. In March 2005, we entered into an agreement with our primary landlord that released us from a portion of the future obligations associated with the remaining space abandoned in exchange for an agreement to lease additional space elsewhere in the building at fair value. Accordingly, we recorded a $285,000 credit to reflect the reversal of a portion of the accrual that was directly related to this space.

*Operating Income (Loss).* Operating loss during the six months ended July 31, 2006 was $1.4 million and included $17.8 million of pre-tax stock-based expenses related to SFAS 123R. During the same period a year ago, operating income was $8.5 million. The increase in our revenues were re-invested in an effort to expand our business.

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*Interest Income*. Interest income consists of investment income on cash and marketable securities balances. Interest income was $6.3 million during the six months ended July 31, 2006 and was $3.2 million during the same period a year ago. The increase was primarily due to increased marketable securities balances resulting from the cash generated by operating activities and increased market interest rates.

*Other Income (Expense).* Other expense was $0.5 million during the six months ended July 31, 2006. Other income was $0.7 million during the same period a year ago. The increase in other expense was primarily due to losses on foreign currency transactions.

*Provision for Income Taxes.* We recorded a provision for income taxes of $3.7 million during the six months ended July 31, 2006, compared to a provision for income taxes of $2.5 million during the same period a year ago. The fiscal 2007 provision as a percentage of income before provision for income taxes was significantly higher than the previous year primarily due to foreign losses for which no tax benefit can be realized, certain nondeductible stock-based expenses resulting from the adoption of SFAS 123R and the expiration of the U.S. federal research and development tax credit on December 31, 2005.

***Recent Accounting Pronouncement***

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes,* ( FIN 48 ). This Interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements and prescribes a recognition threshold of more-likely-than-not to be sustained upon examination. Measurement of the tax uncertainty occurs if the recognition threshold has been met. This Interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 will be effective for fiscal years beginning after December 15, 2006. We are currently evaluating what impact, if any, the adoption of FIN 48 will have on our financial position and results of operations.

**Liquidity and Capital Resources**

At July 31, 2006, our principal sources of liquidity were cash, cash equivalents and marketable securities totaling $334.1 million and accounts receivable of $75.7 million.

Net cash provided by operating activities was $42.4 million during the six months ended July 31, 2006 and $32.0 million during the same period a year ago. The improvement in cash flow was primarily due to the increased number of paying subscriptions to our service. Cash provided by operating activities has historically been affected by sales of subscriptions and support and professional services, changes in working capital accounts, particularly increases in accounts receivable and deferred revenue and the timing of commission and bonus payments, and add-backs of non-cash expense items such as depreciation and the expense related to stock-based awards.

Net cash used in by investing activities was $7.9 million during the six months ended July 31, 2006 and $50.7 million during the same period a year ago. The net reduction was primarily due to changes in marketable securities and lower capital expenditures. In April 2006, we acquired Sendia Corporation for $15.5 million including acquisition costs.

Net cash provided by financing activities was $16.5 million during the six months ended July 31, 2006 and $7.8 million during the same period a year ago. During the six months ended July 31, 2006, the $10.9 million of proceeds from the exercise of employee stock options and warrants and the $5.9 million of tax benefits from our employee stock plans were offset by principal payments on capital lease obligations.

As of July 31, 2006, we have a total of $4.4 million in letters of credit outstanding substantially in favor of our landlords for office space in San Francisco, California, New York, Singapore and Switzerland. None of these

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letters of credit are collateralized. To date, no amounts have been drawn against the letters of credit, which renew annually and mature at various dates through December 2015.

We lease office space and equipment under noncancelable operating and capital leases with various expiration dates.

As of July 31, 2006, our future minimum lease payments under noncancelable operating and capital leases are as follows (in thousands):

| | Capital Leases | Operating Leases |
|---|---|---|
| Fiscal Period: | | |
| Remaining six months in fiscal 2007 | $ 319 | $ 26,693 |
| Fiscal 2008 | 181 | 50,406 |
| Fiscal 2009 | 7 | 38,379 |
| Fiscal 2010 | | 14,908 |
| Fiscal 2011 | | 11,971 |
| Thereafter | | 31,356 |
| Total minimum lease payments | 507 | $ 173,713 |
| Less: amount representing interest | (12) | |
| Present value of capital lease obligations | $ 495 | |

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.

We do not have any special purpose entities, and other than operating leases for office space and computer equipment, we do not engage in off-balance sheet financing arrangements. Additionally, we currently do not have a bank line of credit.

We believe our existing cash, cash equivalents and short-term marketable securities and cash provided by operating activities will be sufficient to meet our working capital and capital expenditure needs over the next 12 months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our marketing and sales activities, the timing and extent of spending to support product development efforts and expansion into new territories, the timing of introductions of new services and enhancements to existing services, the timing of capital expenditures and expenses associated with Web hosting, the continuing market acceptance of our services, and our future acquisition of or investment in other businesses, services and technologies. To the extent that available funds are insufficient to fund our future activities, we may need to raise additional funds through public or private equity or debt financing.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

***Foreign currency exchange risk***

Our results of operations and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the Euro, British Pound Sterling, Canadian dollar, Japanese Yen and Australian dollar. We seek to minimize the impact of certain foreign currency fluctuations by hedging certain balance sheet exposures with foreign currency forward and option contracts. Any gain or loss from settling these contracts is offset by the loss or gain derived from the underlying balance sheet exposures. The hedging contracts by policy have maturities of less than three months and settle before the end of each quarterly period. Additionally, by policy, we do not enter into any hedging contracts for trading or speculative purposes.

***Interest rate sensitivity***

We had cash, cash equivalents and marketable securities totaling $334.1 million at July 31, 2006. These amounts were invested primarily in money market funds and instruments, corporate notes and bonds, government securities and other debt securities with strong credit ratings. The cash, cash equivalents and short-term marketable securities are held for working capital purposes. We do not enter into investments for trading or speculative purposes.

Our fixed-income portfolio is subject to interest rate risk. An immediate increase or decrease in interest rates of 100-basis points could result in a $1.5 million market value reduction or increase of the same amount. This estimate is based on a sensitivity model that measures market value changes when changes in interest rates occur. Fluctuations in the value of our investment securities caused by a change in interest rates (gains or losses on the carrying value) are recorded in other comprehensive income, and are realized only if we sell the underlying securities.

At January 31, 2006, we had cash, cash equivalents and marketable securities totaling $296.8 million. The fixed-income portfolio was also subject to interest rate risk. Changes in interest rates of 100-basis points would have resulted in market value changes of $1.6 million.

## ITEM 4. CONTROLS AND PROCEDURES

**(a) Evaluation of disclosure controls and procedures**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act ), as of the end of the period covered by this report (the Evaluation Date ).

In designing and evaluating our disclosure controls and procedures, management recognizes that any disclosure controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on our evaluation, our principal executive officer and principal financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective to provide reasonable assurance that the information required to be disclosed in our Securities and Exchange Commission ( SEC ) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

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**(b) Changes in internal control over financial reporting**

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recently completed fiscal quarter. Based on that evaluation, our principal executive officer and principal financial officer concluded that there has not been any material change in our internal control over financial reporting during that quarter that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

On July 26, 2004, a purported class action complaint was filed in the United States District Court for the Northern District of California, entitled *Morrison v. salesforce.com, inc. et al.*, against the Company, its Chief Executive Officer and its Chief Financial Officer. The complaint alleged violations of Section 10(b) and Section 20(a) of the Securities Exchange Act of 1934, as amended (the 1934 Act ), purportedly on behalf of all persons who purchased salesforce.com common stock between June 21, 2004 and July 21, 2004, inclusive. The claims were based upon allegations that defendants failed to disclose an allegedly declining trend in its revenues and earnings. Subsequently, four other substantially similar class action complaints were filed in the same district based upon the same facts and allegations, asserting claims under Section 10(b) and Section 20(a) of the 1934 Act and Section 11 and Section 15 of the Securities Act of 1933, as amended. The actions were consolidated under the caption *In re salesforce.com, inc. Securities Litigation*, Case No. C-04-3009 JSW (N.D. Cal.). On December 22, 2004, the Court appointed Chuo Zhu as lead plaintiff. On February 22, 2005, lead plaintiff filed a Consolidated and Amended Class Action Complaint (the CAC ). The CAC alleged violations of Section 10(b) and Section 20(a) of the 1934 Act, purportedly on behalf of all persons who purchased salesforce.com common stock between June 23, 2004 and July 21, 2004, inclusive. As in the original complaints, the claims in the CAC were based upon allegations that defendants failed to disclose an allegedly declining trend in its revenues and earnings. On April 14, 2005, defendants filed a motion to dismiss the CAC. On April 15, 2005, the Court granted lead plaintiff leave to file an amended/superseding complaint. On April 22, 2005, lead plaintiff filed a Corrected and Superceding [sic] First Amended Class Action Complaint ( FAC ). As in the CAC, the FAC alleged violations of Section 10(b) and Section 20(a) of the 1934 Act, purportedly on behalf of all persons who purchased salesforce.com common stock between June 23, 2004 and July 21, 2004, inclusive. The claims in the FAC were based upon allegations that defendants failed to disclose an internal forecast that earnings for fiscal year 2005 would decline from the prior fiscal year. On April 29, 2005, defendants filed a motion to dismiss the FAC. On December 22, 2005, the court entered an order granting defendants motion to dismiss, with prejudice, and directing the clerk to close the file. On January 23, 2006, lead plaintiff filed a motion for leave to file a motion for reconsideration, as well as a notice of appeal to the United States Court of Appeals for the Ninth Circuit. On January 26, 2006, the Ninth Circuit entered a time schedule order for the appeal, requiring, *inter alia*, lead plaintiff to file his opening brief on May 11, 2006, and defendants to file their responsive brief on June 12, 2006. On January 27, 2006, defendants filed a motion to strike as untimely lead plaintiff s motion for leave to file a motion for reconsideration. On February 2, 2006, lead plaintiff filed a motion with the Ninth Circuit requesting a stay of the appellate proceedings pending the district court s determination of lead plaintiff s motion for leave and defendants motion to strike. Defendants opposed that motion. On February 9, 2006, the Ninth Circuit denied the lead plaintiff s motion for a stay of the appellate proceedings, without prejudice to making a motion for limited remand. On March 1, 2006, the district court denied the lead plaintiff s motion for leave to file a motion for reconsideration and defendants motion to strike on grounds of lack of jurisdiction. Also on March 1, 2006, the lead plaintiff filed a motion with the district court seeking certification for limited remand from the Ninth Circuit. Defendants opposed this motion, which was denied by the district court on April 3, 2006. The lead plaintiff filed his opening brief with the Ninth Circuit on May 25, 2006 and the Company filed its answering brief on July 17, 2006. The lead plaintiff s reply brief is due on August 17, 2006. The Company does not believe that the lawsuit has any merit and intends to continue to defend the action and appeal vigorously.

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. Benioff*, Case No. CGC-04-433615 (Cal. Super. Ct., S.F. Cty.). On October 5, 2004, plaintiffs filed a consolidated complaint, which is based upon the same facts and circumstances as alleged in the shareholder class action discussed above, and asserts that the defendants breached their fiduciary duties by making, or failing to prevent

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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. The plaintiff shareholders made no demand upon the Board of Directors prior to filing these actions. On June 15, 2006, defendants filed a demurrer to the consolidated complaint on the grounds that plaintiffs lack standing to pursue the action because of their failure to make demand upon the Board of Directors. The hearing on defendants demurrer is scheduled for August 31, 2006. To this point, no discovery has occurred in this case. The derivative action is still in the preliminary stages, and it is not possible for the Company to quantify the extent of potential liability to the individual defendants, if any. Management does not believe that the lawsuits have any merit and intends to defend the actions vigorously.

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

**ITEM 1A. RISK FACTORS**

*A restated description of the risk factors associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risk factors included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2006 and our Quarterly Report on Form 10-Q for the quarterly period ended April 30, 2006.*

**Risks Related to Our Business and Industry**

***If our on-demand application service is not widely accepted, our operating results will be harmed.***

We derive substantially all of our revenue from subscriptions to our on-demand application service, and we expect this will continue for the foreseeable future. As a result, widespread acceptance of our service is critical to our future growth and success. Factors that may affect market acceptance of our service include:

- reluctance by enterprises to migrate to an on-demand application service;
- a limited number of service offerings and risks associated with developing new service offerings;
- the price and performance of our service;
- the level of customization we can offer;
- the availability, performance and price of competing products and services;
- reluctance by enterprises to trust third parties to store and manage their internal data; and
- adverse publicity about us, our service or the viability, reliability or security of on-demand application services generally from third party reviews, industry analyst reports and adverse statements made by competitors.

Many of these factors are beyond our control. The inability of our on-demand application service to achieve widespread market acceptance would harm our business.

***Defects or disruptions in our service could diminish demand for our service and subject us to substantial liability.***

Because our service is complex and we have incorporated a variety of new computer hardware and software, both developed in-house and acquired from third party vendors, our service may have errors or defects that users identify after they begin using it that could result in unanticipated downtime for our subscribers and harm our reputation and our business. Internet-based services frequently contain undetected errors when first introduced or when new versions or enhancements are released. We have from time to time found defects in our service and new errors in our existing service may be detected in the future. In addition, our customers may use our service in unanticipated ways that may cause a disruption in service for other customers attempting to access their data. Since our customers use our service for important aspects of their business, any errors, defects, disruptions in service or other performance problems with our service could hurt our reputation and may damage our customers businesses. If that occurs, customers could elect not to renew, or delay or withhold payment to us, we could lose future sales or customers may make warranty claims against us, which could result in an increase in our provision for doubtful accounts, an increase in collection cycles for accounts receivable or the expense and risk of litigation.

***Interruptions or delays in service from our third-party Web hosting facilities could impair the delivery of our service and harm our business.***

As of July 31, 2006, we serve all of our customers from a single, third-party Web hosting facility located on the west coast of the United States, operated by Equinix, Inc. As part of our current disaster recovery arrangements, our production environment and all of our customers data is currently replicated in near real-time in a separate standby facility located on the east coast. We do not control the operation of any of these facilities, and they are vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunications failures and similar events. They are also subject to break-ins, sabotage, intentional acts of vandalism and similar misconduct. Despite precautions taken at these facilities, the occurrence of a natural disaster or an act of terrorism, a decision to close the facilities without adequate notice or other unanticipated problems at both facilities could result in lengthy interruptions in our service. Even with the disaster recovery arrangements, our service could be interrupted.

As we continue to add data center capacity, we may move or transfer data. Despite precautions taken during this process, any unsuccessful data transfers may impair the delivery of our service. Further, any damage to, or failure of, our systems generally could result in interruptions in our service. Interruptions in our service may reduce our revenue, cause us to issue credits or pay penalties, cause customers to terminate their subscriptions and adversely affect our renewal rates. Our business will also be harmed if our customers and potential customers believe our service is unreliable.

***We rely on third-party computer hardware and software that may be difficult to replace or which could cause errors or failures of our service.***

We rely on computer hardware purchased or leased and software licensed from third parties in order to offer our service, including database software from Oracle Corporation. This hardware and software may not continue to be available on commercially reasonable terms, or at all. Any loss of the right to use any of this hardware or software could result in delays in the provisioning of our service until equivalent technology is either developed by us, or, if available, is identified, obtained and integrated, which could harm our business. Any errors or defects in third-party hardware or software could result in errors or a failure of our service which could harm our business.

***If our security measures are breached and unauthorized access is obtained to a customer s data, our service may be perceived as not being secure, customers may curtail or stop using our service and we may incur significant liabilities.***

Our service involves the storage and transmission of customers proprietary information, and security breaches could expose us to a risk of loss of this information, litigation and possible liability. If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise, during transfer of data to additional data centers or at any time, and, as a result, someone obtains unauthorized access to one of our customers data, our reputation will be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and

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generally are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. If an actual or perceived breach of our security occurs, the market perception of the effectiveness of our security measures could be harmed and we could lose sales and customers. In addition, our customers may authorize third party technology providers, whose applications are available through our AppExchange directory, access to their customer data. Because we do not control the transmissions between our customers and third-party AppExchange participants or the processing of such data by third-party AppExchange participants, we cannot ensure the complete integrity or security of such transmissions or processings.

***The market in which we participate is intensely competitive, and if we do not compete effectively, our operating results could be harmed.***

The market for CRM applications is intensely competitive and rapidly changing, barriers to entry are relatively low, several of our competitors are larger and have more resources than we do, and with the introduction of new technologies and market entrants, we expect competition to intensify in the future. If we fail to compete effectively, our operating results will be harmed. Some of our principal competitors offer their products at a lower price, which has resulted in pricing pressures. If we are unable to maintain our current pricing, our operating results could be negatively impacted. In addition, pricing pressures and increased competition generally could result in reduced sales, reduced margins or the failure of our service to achieve or maintain more widespread market acceptance, any of which could harm our business.

Our current principal competitors include:

- enterprise software application vendors including Amdocs Limited, Infor Global Solutions, which recently acquired SSA Global Technologies, Inc., Epicor, IBM Corporation, Microsoft Corporation, SAP AG, and Oracle Corporation;

- packaged CRM software vendors, some of whom offer hosted services, such as FrontRange Solutions, Inc., Made2Manage Systems Inc., which recently acquired Onyx Software Corp., Pivotal Corporation, which is owned by CDC Software Corporation, a subsidiary of chinadotcom corporation, Sage Group plc, and SugarCRM;

- on-demand CRM application service providers such as Oracle, SAP, NetSuite, Inc., RightNow Technologies, Inc.; and

- enterprise application service providers including British Telecom and IBM.

In addition, we face competition from businesses that develop their own CRM applications internally, as well as from enterprise software vendors and online service providers who may develop and/or bundle CRM products with their products in the future. For small business customers, we also face competition from companies whose offering is based on Microsoft Outlook and Excel for limited contact management functionality.

We also face competition from some of our larger and more established competitors who historically have been packaged CRM software vendors, but who also have directly competitive on-demand CRM application services offerings. Our professional services organization competes with a broad range of large systems integrators, including Accenture Ltd., BearingPoint, Inc. and IBM, as well as smaller independent consulting firms specializing in CRM implementations. We have relationships with many of these consulting companies and frequently work cooperatively on projects with them, even as we compete for business in other customer engagements.

Many of our potential competitors enjoy substantial competitive advantages, such as greater name recognition, longer operating histories and larger marketing budgets, as well as substantially greater financial, technical and other resources. In addition, many of our potential competitors have established marketing relationships and access to larger customer bases, and have major distribution agreements with consultants, system integrators and resellers.

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As a result, our competitors may be able to respond more quickly and effectively than we can to new or changing opportunities, technologies, standards or customer requirements. Furthermore, because of these advantages, even if our service is more effective than the products that our competitors offer, potential customers might accept competitive products and services in lieu of purchasing our service. For all of these reasons, we may not be able to compete successfully against our current and future competitors.

***If we experience significant fluctuations in our operating results and rate of growth and fail to balance our expenses with our revenue and earnings expectations, our results would be harmed and our stock price may fall rapidly and without advance notice.***

Due to our limited operating history, our evolving business model and the unpredictability of our emerging industry, we may not be able to accurately forecast our rate of growth. We base our current and future expense levels and our investment plans on estimates of future revenue and future rate of growth. We may not be able to adjust our spending quickly enough if our revenue falls short of our expectations.

As a result, we expect that our operating results may fluctuate significantly on a quarterly basis. Revenue growth may not be sustainable and may decrease in the future. We believe that period-to-period comparisons of our operating results may not be meaningful, and you should not rely upon them as an indication of future performance.

***Our quarterly results can fluctuate and if we fail to meet the expectations of analysts or investors, our stock price and the value of your investment could decline substantially.***

Our quarterly operating results are likely to fluctuate, and if we fail to meet or exceed the expectations of securities analysts or investors, the trading price of our common stock could decline. Some of the important factors that could cause our revenues and operating results to fluctuate from quarter to quarter include:

- the adverse financial statement impact of having to expense stock options, which is now required of us effective February 1, 2006;
- our ability to retain and increase sales to existing customers, attract new customers and satisfy our customers requirements;
- the renewal rates for our service;
- changes in our pricing policies;
- the introduction of new features to our service;
- the rate of expansion and effectiveness of our sales force;
- the length of the sales cycle for our service;
- new product and service introductions by our competitors;
- our success in selling our service to large enterprises;

variations in the revenue mix of editions of our service;

technical difficulties or interruptions in our service;

expenses related to our new data centers;

changes in foreign currency exchange rates;

changes in tax rates and adjustments to the valuation allowance for our deferred tax assets;

general economic conditions in our geographic markets;

the timing of additional investments in our on-demand application service and in our consulting service;

regulatory compliance costs;

payment defaults by customers;

costs associated with acquisitions of companies and technologies;

the timing of non-income tax expense which is triggered when employees in foreign jurisdictions exercise their vested stock options; and

extraordinary expenses such as litigation or other dispute-related settlement payments.

Some of these factors are not within our control, and the occurrence of one or more of them might cause our operating results to vary widely. As such, we believe that quarter-to-quarter comparisons of our revenues and operating results may not be meaningful and should not be relied upon as an indication of future performance.

***We have incurred significant operating losses in the past and may incur significant operating losses in the future.***

We have incurred significant operating losses in each fiscal quarter from our inception in February 1999 through fiscal 2003 and we have begun generating profits only since fiscal 2003. As we are a relatively young company in an emerging market and with the new requirement to begin expensing stock options in fiscal 2007, we may not be able to maintain profitability and we may again incur significant operating losses in the future, exclusive of the requirement to expense stock options. In addition, we expect our costs and operating expenses to increase in the future as we expand our operations. If our revenue does not grow to offset these expected increased costs and operating expenses, we will not continue to be profitable. You should not consider recent quarterly revenue growth as indicative of our future performance. In fact, in future quarters we may not have any revenue growth and our revenue could decline. Furthermore, if our costs and operating expenses exceed our expectations, our financial performance will be adversely affected.

***Because we recognize revenue from subscriptions for our service over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our operating results.***

We generally recognize revenue from customers ratably over the terms of their subscription agreements, which are typically 12 to 24 months, although terms can range from one to 60 months. As a result, much of the revenue we report in each quarter is deferred revenue from subscription agreements entered into during previous quarters. Consequently, a decline in new or renewed subscriptions in any one quarter will not necessarily be fully reflected in the revenue in that quarter and will negatively affect our revenue in future quarters. In addition, we may be unable to adjust our cost structure to reflect these reduced revenues. Accordingly, the effect of significant downturns in sales and market acceptance of our service may not be fully reflected in our results of operations until future periods. Our subscription model also makes it difficult for us to rapidly increase our revenue through additional sales in any period, as revenue from new customers must be recognized over the applicable subscription term.

***The market for our technology delivery model and on-demand application services is immature and volatile, and if it does not develop or develops more slowly than we expect, our business will be harmed.***

The market for on-demand application services is relatively new and unproven, and it is uncertain whether these services will achieve and sustain high levels of demand and market acceptance. Our success will depend to a substantial extent on the willingness of enterprises, large and small, to increase their use of on-demand application services in general, and for CRM in particular. Many enterprises have invested substantial personnel and financial resources to integrate traditional enterprise software into their businesses, and therefore may be reluctant or unwilling to migrate to an on-demand application service. Furthermore, some enterprises may be reluctant or unwilling to use on-demand application services because they have concerns regarding the risks associated with security capabilities, among other things, of the technology delivery model associated with these services. If enterprises do not perceive the benefits of on-demand application services, then the market for these services may not develop at all, or it may develop more slowly than we expect, either of which would significantly adversely affect our operating results. In addition, as a new company in this unproven market, we have limited insight into trends that may develop and affect our business. We may make errors in predicting and reacting to relevant business trends, which could harm our business.

Our success also depends on the willingness of third-party developers to build applications that are complementary to our service. Without the development of these applications, both current and potential customers may not find our service sufficiently attractive. In fiscal 2006, we introduced the AppExchange directory, a central online marketplace for on-demand applications that we host for our customers, developers and partners to exchange custom on-demand applications that are built on, or can integrate with, our service. These custom applications, some of which are not CRM-related, include applications ranging from expense management to purchasing to recruiting. Although we do not presently charge for use of the AppExchange directory, it is uncertain whether this service will be accepted and adopted by our customers, developers and partners or will increase the demand for subscriptions to our service.

***We have limited history with our subscription model to accurately predict the rate of customer subscription renewals and the impact these renewal rates will have on our future revenue or operating results.***

Our customers have no obligation to renew their subscriptions for our service after the expiration of their initial subscription period and in fact, some customers have elected not to do so. In addition, our customers may renew for a lower priced edition of our service or for fewer subscriptions. We have limited historical data with respect to rates of customer subscription renewals, so we cannot accurately predict customer renewal rates. Our customers renewal rates may decline or fluctuate as a result of a number of factors, including their dissatisfaction with our service and their ability to continue their operations and spending levels. If our customers do not renew their subscriptions for our service, our revenue will decline and our business will suffer.

Our future success also depends in part on our ability to sell additional features and services, more subscriptions or enhanced editions of our service to our current customers. This may require increasingly sophisticated and costly sales efforts that are targeted at senior management. If these efforts are not successful, our business may suffer.

***Our growth could strain our personnel resources and infrastructure, and if we are unable to implement appropriate controls and procedures to manage our growth, we may not be able to successfully implement our business plan.***

We are currently experiencing a period of increasing headcount and rapid growth in our operations, which has placed, and will continue to place, to the extent that we are able to sustain such growth, a significant strain on our management, administrative, operational and financial infrastructure. We anticipate that further growth will be required to address increases in our customer base, as well as our expansion into new geographic areas.

Our success will depend in part upon the ability of our senior management to manage this growth effectively. To do so, we must continue to hire, train and manage new employees as needed. If our new hires perform poorly, or if we are unsuccessful in hiring, training, managing and integrating these new employees, or if we are not successful in retaining our existing employees, our business may be harmed. To manage the expected growth of our operations and personnel, we will need to continue to improve our operational, financial and management controls and our reporting systems and procedures. The additional headcount and capital investments we are adding will increase our cost base, which will make it more difficult for us to offset any future revenue shortfalls by offsetting expense reductions in the short term. If we fail to successfully manage our growth, we will be unable to execute our business plan.

***We derive a significant portion of our revenue from small businesses, which have a greater rate of attrition and non-renewal than medium-sized and large enterprise customers.***

Our small business customers, which we consider to be companies with fewer than 200 employees, typically have shorter initial subscription periods and, based on our limited experience to date, have had a higher rate of attrition and non-renewal as compared to our medium-sized and large enterprise customers. If we cannot replace our small business customers that do not renew their subscriptions for our service with new customers quickly enough, our revenue could decline.

***Our limited operating history may impede acceptance of our service by medium-sized and large customers.***

Our ability to increase revenue and maintain profitability depends, in large part, on widespread acceptance of our service by medium-sized and large businesses. Our efforts to sell to these customers may not continue to be successful. In particular, because we are a relatively new company with a limited operating history, these target customers may have concerns regarding our viability and may prefer to purchase critical CRM applications from one of our larger, more established competitors. Even if we are able to sell our service to these types of customers, they may insist on additional assurances from us that we will be able to provide adequate levels of service, which could harm our business.

***As more of our sales efforts are targeted at larger enterprise customers, our sales cycle may become more time-consuming and expensive, we may encounter pricing pressure and implementation challenges, and we may have to delay revenue recognition on these customers, all of which could harm our business.***

As we target more of our sales efforts at larger enterprise customers, we will face greater costs, longer sales cycles and less predictability in completing some of our sales. In this market segment, the customer s decision to use our service may be an enterprise-wide decision and, if so, these types of sales would require us to provide greater levels of education to prospective customers regarding the use and benefits of our service. In addition, larger customers may demand more customization, integration services and features. As a result of these factors, these sales opportunities may require us to devote greater sales support and professional services resources to individual customers, driving up costs and time required to complete sales and diverting sales and professional services resources to a smaller number of larger transactions, while at the same time requiring us to delay revenue recognition on some of these transactions until the technical or implementation requirements have been met. In addition, larger enterprise customers may seek volume discounts and price concessions that could make these transactions less profitable.

***If we are not able to develop enhancements and new features to our existing service or acceptable new services that keep pace with technological developments, our business will be harmed.***

If we are unable to develop enhancements to and new features for our existing service or acceptable new services that keep pace with rapid technological developments, our business will be harmed. The success of enhancements, new features and services depends on several factors, including the timely completion, introduction and market acceptance of the feature or edition. Failure in this regard may significantly impair our revenue growth. In addition, because our service is designed to operate on a variety of network hardware and software platforms using a standard browser, we will need to continuously modify and enhance our service to keep pace with changes in Internet-related hardware, software, communication, browser and database technologies. We may not be successful in either developing these modifications and enhancements or in timely bringing them to market. Furthermore, uncertainties about the timing and nature of new network platforms or technologies, or modifications to existing platforms or technologies, could increase our research and development expenses. Any failure of our service to operate effectively with future network platforms and technologies could reduce the demand for our service, result in customer dissatisfaction and harm our business.

***Any efforts we may make in the future to expand our service beyond the CRM market may not succeed.***

To date, we have focused our business on providing on-demand application services for the CRM market, but we may in the future seek to expand into other markets. In addition, we recently launched the AppExchange directory, an on-line marketplace for on-demand applications running on our on-demand application service

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platform. However, any efforts to expand beyond the CRM market may never result in significant revenue growth for us. In addition, efforts to expand our on-demand application service beyond the CRM market may divert management resources from existing operations and require us to commit significant financial resources to an unproven business, which may harm our business.

***As we acquire companies or technologies in the future, they could prove difficult to integrate, disrupt our business, dilute stockholder value and adversely affect our operating results and the value of our common stock.***

As part of our business strategy, we may acquire, enter into joint ventures with or make investments in complementary companies, services and technologies in the future. In April 2006, we acquired 100 percent of the stock of Sendia Corporation, a privately-held on-demand wireless application company based in Santa Monica, California, for $15.5 million in cash, including acquisition costs. This was our first acquisition. Acquisitions and investments involve numerous risks, including:

- difficulties in integrating operations, technologies, services and personnel;
- diversion of financial and managerial resources from existing operations;
- risk of entering new markets in which we have little to no experience;
- potential write-offs of acquired assets or investments;
- potential loss of key employees;
- inability to generate sufficient revenue to offset acquisition or investment costs;
- negative impact to our results of operations because of the depreciation and amortization of amounts related to acquired intangible assets, fixed assets and deferred compensation, and the loss of acquired deferred revenue;
- delays in customer purchases due to uncertainty and the inability to maintain relationships with customers of the acquired businesses; and
- the need to implement controls, procedures and policies appropriate for a public company at companies that prior to the acquisition lacked such controls, procedures and policies.

In addition, if we finance acquisitions by issuing debt or equity securities, our existing stockholders may be diluted which could affect the market price of our stock. Further, if we fail to properly evaluate and execute acquisitions or investments, our business and prospects may be seriously harmed and the value of our common stock may decline.

***If we fail to develop our brand cost-effectively, our business may suffer.***

We believe that developing and maintaining awareness of the salesforce.com brand in a cost-effective manner is critical to achieving widespread acceptance of our existing and future services and is an important element in attracting new customers. Furthermore, we believe that the importance of brand recognition will increase as competition in our market develops. Successful promotion of our brand will depend largely on the effectiveness of our marketing efforts and on our ability to provide reliable and useful services at competitive prices. In the past, our efforts to build our brand have involved significant expense. Brand promotion activities may not yield increased revenue, and even if they do, any increased revenue may not offset the expenses we incurred in building our brand. If we fail to successfully promote and maintain our brand, or incur substantial expenses in an unsuccessful attempt to promote and maintain our brand, we may fail to attract enough new customers or retain our existing customers to the extent necessary to realize a sufficient return on our brand-building efforts, and our business could suffer.

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***Failure to adequately expand our direct sales force and develop and expand our indirect sales channel will impede our growth.***

We continue to be substantially dependent on our direct sales force to obtain new customers, particularly large enterprise customers, and to manage our customer base. We believe that there is significant competition for direct sales personnel with the advanced sales skills and technical knowledge we need. Our ability to achieve significant growth in revenue in the future will depend, in large part, on our success in recruiting, training and retaining sufficient numbers of direct sales personnel. New hires require significant training and may, in some cases, take more than a year before they achieve full productivity. Our recent hires and planned hires may not become as productive as we would like, and we may be unable to hire sufficient numbers of qualified individuals in the future in the markets where we do business. If we are unable to hire and develop sufficient numbers of productive direct sales personnel, sales of our service will suffer and our growth will be impeded. In addition, we plan to develop and expand our indirect sales channel by engaging third-party resellers. Because of our on-demand service model, the structuring of such relationships is complex and requires the investment of significant business, financial and other resources. If we are unable to structure successful third-party channel relationships that enable us to enter markets we otherwise would have greater difficulty entering, our growth will be inhibited.

***Sales to customers outside the United States expose us to risks inherent in international sales.***

Because we sell our service throughout the world, we are subject to risks and challenges that we would otherwise not face if we conducted our business only in the United States. For example, sales in Europe and Asia Pacific together have historically represented approximately 20 percent of our total revenues, and we intend to continue to expand our international sales efforts. The risks and challenges associated with sales to customers outside the United States include:

- localization of our service, including translation into foreign languages and associated expenses;
- laws and business practices favoring local competitors;
- compliance with multiple, conflicting and changing governmental laws and regulations, including employment, tax, privacy and data protection laws and regulations;
- foreign currency fluctuations, whose effects we may not be able to mitigate through our hedging program;
- different pricing environments;
- difficulties in staffing and managing foreign operations;
- different or lesser protection of our intellectual property;
- longer accounts receivable payment cycles and other collection difficulties; and
- regional economic and political conditions.

Any of these factors could negatively impact our business and results of operations.

Additionally, some of our international subscription fees are currently denominated in U.S. dollars and paid in local currency. As a result, fluctuations in the value of the U.S. dollar and foreign currencies may make the service more expensive for international customers, which could harm our business.

***Any failure to protect our intellectual property rights could impair our ability to protect our proprietary technology and our brand.***

If we fail to protect our intellectual property rights adequately, our competitors might gain access to our technology, and our business might be harmed. In addition, defending our intellectual property rights might entail significant expense. Any of our trademarks or other intellectual property rights may be challenged by others or

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invalidated through administrative process or litigation. While we have U.S. and international patent applications pending, we currently have no issued patents and may be unable to obtain patent protection for our technology. In addition, if any patents are issued in the future, they may not provide us with any competitive advantages, or may be successfully challenged by third parties. Furthermore, legal standards relating to the validity, enforceability and scope of protection of intellectual property rights are uncertain. Effective patent, trademark, copyright and trade secret protection may not be available to us in every country in which our service is available. The laws of some foreign countries may not be as protective of intellectual property rights as those in the U.S., and mechanisms for enforcement of intellectual property rights may be inadequate. Accordingly, despite our efforts, we may be unable to prevent third parties from infringing upon or misappropriating our intellectual property.

We might be required to spend significant resources to monitor and protect our intellectual property rights. We may initiate claims or litigation against third parties for infringement of our proprietary rights or to establish the validity of our proprietary rights. Any litigation, whether or not it is resolved in our favor, could result in significant expense to us and divert the efforts of our technical and management personnel.

***We may be sued by third parties for alleged infringement of their proprietary rights.***

The software and Internet industries are characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. We have received in the past, and may receive in the future, communications from third parties claiming that we have infringed on the intellectual property rights of others. Our technologies may not be able to withstand any third-party claims or rights against their use. Any intellectual property claims, with or without merit, could be time-consuming and expensive to resolve, could divert management attention from executing our business plan and could require us to pay monetary damages or enter into royalty or licensing agreements. In addition, many of our subscription agreements require us to indemnify our customers for third-party intellectual property infringement claims, which would increase the cost to us of an adverse ruling on such a claim. An adverse determination could also prevent us from offering our service to others.

***We may be required to purchase the interest in our Japanese joint venture held by our joint venture partner, under certain circumstances, on terms that may not be favorable to us.***

In some circumstances, we may be required to purchase the interest of our Japanese joint venture partner. If we default under the terms of our joint venture agreement with our joint venture partner, or if we and our partner disagree over a course of action proposed for the joint venture entity and the disagreement continues, then our partner may require that we purchase its interest in the joint venture. In the event we are required to purchase our partner s interest in the joint venture, we could be forced to make an unanticipated outlay of a significant amount of capital, which could harm our financial condition. Although the timing and circumstances of any such purchase, were it to be required, are not predictable, if the joint venture were valued based on its most recent financing, which occurred in September 2003, the buyout price could be as much as approximately $13.0 million.

***Evolving regulation of the Internet may affect us adversely.***

As Internet commerce continues to evolve, increasing regulation by federal, state or foreign agencies becomes more likely. For example, we believe increased regulation is likely in the area of data privacy, and laws and regulations applying to the solicitation, collection, processing or use of personal or consumer information could affect our customers ability to use and share data, potentially reducing demand for CRM solutions and restricting our ability to store, process and share data with our customers. In addition, taxation of services provided over the Internet or other charges imposed by government agencies or by private organizations for accessing the Internet may also be imposed. Any regulation imposing greater fees for Internet use or restricting information exchange over the Internet could result in a decline in the use of the Internet and the viability of Internet-based services, which could harm our business.

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***Privacy concerns and laws or other domestic or foreign regulations may reduce the effectiveness of our solution and adversely affect our business.***

Our customers can use our service to store contact and other personal or identifying information regarding their customers and contacts. Federal, state and foreign government bodies and agencies, however, have adopted or are considering adopting laws and regulations regarding the collection, use and disclosure of personal information obtained from consumers and individuals. The costs of compliance with, and other burdens imposed by, such laws and regulations that are applicable to the businesses of our customers may limit the use and adoption of our service and reduce overall demand for it. Furthermore, privacy concerns may cause our customers customers to resist providing the personal data necessary to allow our customers to use our service effectively. Even the perception of privacy concerns, whether or not valid, may inhibit market adoption of our service in certain industries. For example, regulations such as the Gramm-Leach-Bliley Act, which protects and restricts the use of consumer credit and financial information, and the Health Insurance Portability and Accountability Act of 1996, which regulates the use and disclosure of personal health information, impose significant requirements and obligations on businesses that may affect the use and adoption of our service.

The European Union has also adopted a data privacy directive that requires member states to impose restrictions on the collection and use of personal data that, in some respects, are far more stringent, and impose more significant burdens on subject businesses, than current privacy standards in the United States. All of these domestic and international legislative and regulatory initiatives may adversely affect our customers ability to collect and/or use demographic and personal information from their customers, which could reduce demand for our service.

In addition to government activity, privacy advocacy groups and the technology and other industries are considering various new, additional or different self-regulatory standards that may place additional burdens on us. If the gathering of personal information were to be curtailed in this manner, CRM solutions would be less effective, which may reduce demand for our service and harm our business.

***Our business is subject to changing regulations regarding corporate governance and public disclosure that have increased both our costs and the risk of noncompliance.***

We are subject to rules and regulations by various governing bodies, including the Securities and Exchange Commission, New York Stock Exchange and Public Company Accounting Oversight Board, that are charged with the protection of investors and the oversight of companies whose securities are publicly traded. Our efforts to comply with these new regulations have resulted in, and are likely to continue to result in, increased general and administrative expenses and a diversion of management time and attention from revenue-generating activities to compliance activities.

We are required to comply on an on-going basis with the Sarbanes-Oxley Act, or SOX, requirements involving the assessment of our internal controls over financial reporting and our independent public accountants audit of that assessment. These requirements first became applicable to us on January 31, 2006. Our efforts to comply with the SOX requirements have required, and will continue to require the commitment of significant financial and personnel resources.

Moreover, because these laws, regulations and standards are subject to varying interpretations, their application in practice may evolve over time as new guidance becomes available. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices. If we fail to address and comply with these regulations and any subsequent changes, our business may be harmed.

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***We are dependent on our management team and development and operations personnel, and the loss of one or more key employees or groups could harm our business and prevent us from implementing our business plan in a timely manner.***

Our success depends largely upon the continued services of our executive officers and other key members of management. From time to time, there may be changes in our executive management team resulting from the hiring or departure of executives. Such changes in our executive management team may be disruptive to our business.

We are also substantially dependent on the continued service of our existing development and operations personnel because of the complexity of our service and technologies.

We do not have employment agreements with any of our executive officers, key management, development or operations personnel and, therefore, they could terminate their employment with us at any time. We do not maintain key person life insurance policies on any of our employees. The loss of one or more of our key employees or groups could seriously harm our business.

***Because competition for our target employees is intense, we may not be able to attract and retain the highly skilled employees we need to support our planned growth.***

To continue to execute on our growth plan, we must attract and retain highly qualified personnel. Competition for these personnel is intense, especially for engineers with high levels of experience in designing and developing software and Internet-related services and senior sales executives. We may not be successful in attracting and retaining qualified personnel. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Many of the companies with which we compete for experienced personnel have greater resources than we have. In addition, in making employment decisions, particularly in the Internet and high-technology industries, job candidates often consider the value of the stock options they are to receive in connection with their employment. Volatility in the price of our stock may, therefore, adversely affect our ability to attract or retain key employees. Furthermore, the new requirement to expense stock options may discourage us from granting the size or type of stock option awards that job candidates require to join our company. If we fail to attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could be severely harmed.

***We might require additional capital to support business growth, and this capital might not be available.***

We intend to continue to make investments to support our business growth and may require additional funds to respond to business challenges or opportunities, including the need to develop new services or enhance our existing service, enhance our operating infrastructure or acquire complementary businesses and technologies. Accordingly, we may need to engage in equity or debt financings to secure additional funds. If we raise additional funds through further issuances of equity or convertible debt securities, our existing stockholders could suffer significant dilution, and any new equity securities we issue could have rights, preferences and privileges superior to those of holders of our common stock. Any debt financing secured by us in the future could involve restrictive covenants relating to our capital raising activities and other financial and operational matters, which may make it more difficult for us to obtain additional capital and to pursue business opportunities, including potential acquisitions. In addition, we may not be able to obtain additional financing on terms favorable to us, if at all. If we are unable to obtain adequate financing or financing on terms satisfactory to us, when we require it, our ability to continue to support our business growth and to respond to business challenges could be significantly limited.

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***Changes in the accounting treatment of stock options will continue to adversely affect our reported results of operations.***

Effective February 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R. SFAS 123R requires all share-based payments to employees, including grants of employee stock options, to be recognized as expenses in the statement of operations based on their fair values and vesting periods. As a result of implementing SFAS 123R, we recognized pre-tax stock-based expense of $17.8 million during the six months ended July 31, 2006. We believe this change in accounting will continue to materially reduce our future reported results of operations.

***Unanticipated changes in our effective tax rate could adversely affect our future results.***

We are subject to income taxes in the United States and various foreign jurisdictions, and our domestic and international tax liabilities are subject to the allocation of expenses in differing jurisdictions.

Our tax rate in fiscal 2007 is significantly higher than in previous years. The tax rate is affected by changes in the mix of earnings and losses in countries with differing statutory tax rates, the tax accounting for option activities pursuant to the new requirement to expense stock options and the valuation of deferred tax assets and liabilities. Increases in our effective tax rate could materially affect our net results.

**Risks Related to Ownership of Our Common Stock**

***The trading price of our common stock is likely to be volatile and could subject us to litigation.***

The trading prices of the securities of technology companies have been highly volatile. Accordingly, the trading price of our common stock has been and is likely to continue to be subject to wide fluctuations. Further, our common stock has a limited trading history. Factors affecting the trading price of our common stock include:

- variations in our operating results and cash flows;
- the quarterly net increases in the number of customers and paying subscriptions;
- announcements of technological innovations, new services or service enhancements, strategic alliances or significant agreements by us or by our competitors;
- customer cancellations or delays in customer purchases;
- recruitment or departure of key personnel;
- changes in the estimates of our operating results or changes in recommendations by any securities analysts that elect to follow our common stock;
- market conditions in our industry, the industries of our customers and the economy as a whole; and
- disruptions in our service due to computer hardware, software or network problems or due to a natural disaster, act of terrorism or other catastrophic event.

In addition, if the market for technology stocks or the stock market in general experiences uneven investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. The trading price of our common stock might also decline in reaction to events that affect other companies within, or outside, our industry even if these events do not directly affect us. Any volatility in our stock price may result in litigation, such as the lawsuits filed following the approximately 25% decline in our stock price on July 21, 2004, which may harm our business and results of operations.

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***If securities analysts stop publishing research or reports about us or our business or if they downgrade our stock, the price of our stock could decline.***

The trading market for our common stock relies in part on the research and reports that industry or financial analysts publish about us or our business. We do not control these analysts. If one or more of the analysts who do cover us downgrade our stock, our stock price would likely decline rapidly. Furthermore, if one or more of these analysts cease coverage of our company, we could lose visibility in the market, which in turn could cause our stock price to decline.

***The concentration of our capital stock ownership with insiders will likely limit your ability to influence corporate matters.***

Our executive officers, directors, current 5 percent or greater stockholders and affiliated entities together beneficially own a majority of our outstanding common stock. As a result, these stockholders, acting together, will have control over most matters that require approval by our stockholders, including the election of directors and approval of significant corporate transactions, even if other stockholders oppose them. This concentration of ownership might also have the effect of delaying or preventing a change of control of our company that other stockholders may view as beneficial.

***Provisions in our amended and restated certificate of incorporation and bylaws and Delaware law might discourage, delay or prevent a change of control of our company or changes in our management and, therefore, depress the trading price of our common stock.***

Our amended and restated certificate of incorporation and bylaws contain provisions that could depress the trading price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions among other things:

- establish a classified board of directors so that not all members of our board are elected at one time;
- permit the board of directors to establish the number of directors;
- provide that directors may only be removed for cause and only with the approval of 66 2/3 percent of our stockholders;
- require super-majority voting to amend some provisions in our amended and restated certificate of incorporation and bylaws;
- authorize the issuance of blank check preferred stock that our board could issue to increase the number of outstanding shares and to discourage a takeover attempt;
- eliminate the ability of our stockholders to call special meetings of stockholders;
- prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;
- provide that the board of directors is expressly authorized to make, alter or repeal our bylaws; and
- establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company. Section 203 imposes certain restrictions on merger, business combinations and other transactions between us and holders of 15 percent or more of our common stock.

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### ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

a. Securities Sold

Since May 1, 2006 we issued 125,000 shares of common stock upon the exercise of warrants held by the salesforce.com/foundation, commonly referred to as the Foundation, at an exercise price of $1.10 per share.

### ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

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

Our 2006 Annual Meeting of Stockholders was held on July 6, 2006. The following proposals were adopted as follows.

1. To elect two Class II directors, Craig Ramsey and Sanford R. Robertson, to serve for a term of three years and until their successors are duly elected and qualified:

| | For | Withheld |
|---|---|---|
| Craig Ramsey | 97,454,202 | 2,253,778 |
| Sanford R. Robertson | 99,608,273 | 99,707 |

2. To ratify the appointment of Ernst & Young LLP as our independent registered public accounting firm for the fiscal year ending January 31, 2007:

| For | Against | Withheld |
|---|---|---|
| 99,626,134 | 73,481 | 8,365 |

Other directors whose term continued after the 2006 Annual Meeting of Stockholders include Marc Benioff, Craig Conway, Alan Hassenfeld, Stratton Sclavos, Larry Tomlinson and Shirley Young.

### ITEM 5. OTHER INFORMATION

None

**ITEM 6. EXHIBITS**

***Exhibits***

The Exhibits listed below are filed as part of this Form 10-Q.

| | |
|---|---|
| Exhibit 3.1(1) | Restated Certificate of Incorporation of salesforce.com, inc. |
| Exhibit 3.2(1) | Amended and Restated Bylaws of salesforce.com, inc. |
| Exhibit 10.1* | 2004 Equity Incentive Plan, as amended |
| Exhibit 31.1 | Certification of Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a) and 15(d)-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 31.2 | Certification of Chief Financial Officer pursuant to Exchange Act Rule 13a-14(a) and 15(d)-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* Denotes a compensatory plan or arrangement.

(1) Incorporated by reference from the Company s registration statement on Form S-1 (No. 333-111289) as filed with the Securities and Exchange Commission on April 20, 2004.

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## SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Dated: August 18, 2006

**salesforce.com, inc.**

/s/ Steve Cakebread
**Steve Cakebread**
**Chief Financial Officer**

**(Principal Financial Officer and Duly Authorized Officer)**

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