DELL INC
Form 10-Q
October 30, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended August 4, 2006

or

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

For the transition period from to .

Commission File Number: 0-17017

Dell Inc.
(Exact name of registrant as specified in its charter)

Delaware	**74-2487834**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

One Dell Way
Round Rock, Texas 78682
(Address of Principal Executive Offices) (Zip Code)

(512) 338-4400
(Registrant s telephone number, including area code)

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

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. (Check One)
Large accelerated filer þ Accelerated filer o Non-accelerated filer o

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

As of the close of business on October 19, 2007, 2,235,866,516 shares of common stock, par value $.01 per share, were outstanding.

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Special Note

The Audit Committee of our Board of Directors recently completed an independent investigation into certain accounting and financial reporting matters. As a result of issues identified in that investigation, as well as issues identified in additional reviews and procedures conducted by management, the Audit Committee, in consultation with management and PricewaterhouseCoopers LLP, our independent registered public accounting firm, concluded on August 13, 2007 that our previously issued financial statements for Fiscal 2003, 2004, 2005, and 2006 (including the interim periods within those years), and the first quarter of Fiscal 2007, should no longer be relied upon because of certain accounting errors and irregularities in those financial statements. Accordingly, we have restated our previously issued financial statements for those periods. Restated financial information is presented in this report, as well as in our Annual Report on Form 10-K for Fiscal 2007. For a discussion of the investigation, the accounting errors and irregularities identified, and the adjustments made as a result of the restatement, see Note 2 of Notes to Condensed Consolidated Financial Statements included in Part I Item 1 Financial Statements.

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

DELL INC.

CONDENSED CONSOLIDATED STATEMENTS OF FINANCIAL POSITION
(in millions)

	August 4, 2006 (unaudited)	February 3, 2006 As Restated
ASSETS		
Current assets:		
Cash and cash equivalents	$ 6,795	$ 7,054
Short-term investments	1,331	2,016
Accounts receivable, net	4,723	4,082
Financing receivables, net	1,459	1,366
Inventories	669	588
Other	2,606	2,688
Total current assets	17,583	17,794
Property, plant, and equipment, net	2,150	1,993
Investments	2,631	2,686
Long-term financing receivables, net	271	325
Other non-current assets	667	454
Total assets	$ 23,302	$ 23,252
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Short-term borrowings	$ 55	$ 65
Accounts payable	10,330	9,868
Accrued and other	6,658	6,240
Total current liabilities	17,043	16,173
Long-term debt	600	625
Other non-current liabilities	2,619	2,407
Total liabilities	20,262	19,205
Commitments and contingencies (Note 9)		

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Redeemable common stock and capital in excess of $.01 par value; 3 shares issued and outstanding (Note 12)		
Stockholders equity:		
Preferred stock and capital in excess of $.01 par value; shares issued and outstanding: none		
Common stock and capital in excess of $.01 par value; shares authorized: 7,000; shares issued: 2,828 and 2,818, respectively; shares outstanding: 2,238 and 2,330, respectively	9,857	9,503
Treasury stock at cost: 590 and 488 shares, respectively	(20,698)	(18,007)
Retained earnings	13,955	12,699
Accumulated other comprehensive loss	(144)	(101)
Other		(47)
Total stockholders equity	2,970	4,047
Total liabilities and equity	$ 23,302	$ 23,252

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

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DELL INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in millions, except per share amounts; unaudited)

	Three Months Ended		Six Months Ended	
	August 4, 2006	July 29, 2005 As Restated	August 4, 2006	July 29, 2005 As Restated
Net revenue	$ 14,211	$ 13,382	$ 28,531	$ 26,682
Cost of net revenue[1]	12,073	10,951	23,885	21,799
Gross margin	2,138	2,431	4,646	4,883
Operating expenses:				
Selling, general, and administrative[1]	1,469	1,196	2,883	2,402
Research, development, and engineering[1]	125	122	254	231
Total operating expenses	1,594	1,318	3,137	2,633
Operating income	544	1,113	1,509	2,250
Investment and other income, net	50	74	104	125
Income before income taxes	594	1,187	1,613	2,375
Income tax provision	114	205	357	485
Net income	$ 480	$ 982	$ 1,256	$ 1,890
Earnings per common share:				
Basic	$ 0.21	$ 0.41	$ 0.55	$ 0.78
Diluted	$ 0.21	$ 0.40	$ 0.55	$ 0.76
Weighted-average shares outstanding:				
Basic	2,264	2,418	2,280	2,437
Diluted	2,278	2,478	2,298	2,497

(1) Cost of revenue and operating expenses for the three and six-month periods ended August 4, 2006 include stock-based compensation expense pursuant to Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment.* See Note 6 of Notes to Condensed Consolidated Financial Statements for additional information.

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

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DELL INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in millions, unaudited)

	Six Months Ended	
	August 4, 2006	**July 29, 2005 As Restated**
Cash flows from operating activities:		
Net income	$ 1,256	$ 1,890
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	225	186
Stock-based compensation	217	9
Excess tax benefits from stock-based compensation	(53)	
Tax benefits from employee stock plans		123
Effects of exchange rate changes on monetary assets and liabilities denominated in foreign currencies	19	(24)
Other	58	65
Changes in:		
Operating working capital	3	(338)
Non-current assets and liabilities	87	224
Net cash provided by operating activities	1,812	2,135
Cash flows from investing activities:		
Investments:		
Purchases	(5,917)	(2,280)
Maturities and sales	6,745	5,593
Capital expenditures	(386)	(347)
Acquisition of business, net of cash received	(97)	
Net cash provided by investing activities	345	2,966
Cash flows from financing activities:		
Repurchase of common stock	(2,691)	(3,800)
Issuance of common stock under benefit plans	188	643
Excess tax benefits from stock-based compensation	53	
Other	(20)	(30)
Net cash used in financing activities	(2,470)	(3,187)
Effect of exchange rate changes on cash and cash equivalents	54	(49)
Net (decrease) increase in cash and cash equivalents	(259)	1,865
Cash and cash equivalents at beginning of period	7,054	4,479

Cash and cash equivalents at end of period	$	6,795	$	6,344

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

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

NOTE 1 Basis of Presentation

Basis of Presentation The accompanying condensed consolidated financial statements of Dell Inc. (Dell) should be read in conjunction with the consolidated financial statements and accompanying notes filed with the U.S. Securities and Exchange Commission (SEC) in Dell s Annual Report on Form 10-K for the fiscal year ended February 3, 2006. The accompanying condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments of a normal recurring nature, as well as all adjustments discussed in Note 2, Audit Committee Independent Investigation and Restatement, considered necessary to fairly state the financial position of Dell and its consolidated subsidiaries at August 4, 2006 and February 3, 2006; the results of its operations for the three and six month periods ended August 4, 2006 and July 29, 2005; and its cash flows for the six month periods ended August 4, 2006 and July 29, 2005.

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the amounts reported in Dell s condensed consolidated financial statements and the accompanying notes. Actual results could differ materially from those estimates.

Dell is currently a partner in Dell Financial Services L.P. (DFS), a joint venture with CIT Group, Inc. (CIT). The joint venture allows Dell to provide its customers with various financing alternatives. Dell consolidates DFS financial results in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46R (FIN 46R) as Dell is the primary beneficiary. See Note 7 of Notes to Condensed Consolidated Financial Statements.

Acquisitions On May 8, 2006, Dell acquired Alienware Corporation (Alienware). Consequently, Alienware s financial position, results of operations, and cash flows subsequent to acquisition are included in the accompanying condensed consolidated financial statements. Pro forma effects of the acquisition are not material.

Stock-Based Compensation Effective February 4, 2006, Dell adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123(R)) using the modified prospective transition method which does not require revising the presentation in prior periods for stock-based compensation. Under this transition method, stock-based compensation expense for the second quarter and first six-month period of Fiscal 2007 includes compensation expense for all stock-based compensation awards granted prior to, but not yet vested at, February 4, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, *Accounting for Stock-Based Compensation* (SFAS 123). Stock-based compensation expense for all stock-based compensation awards granted after February 3, 2006 is based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Dell recognizes this compensation expense net of an estimated forfeiture rate over the requisite service period of the award, which is generally the vesting term of five years for stock options and five-to-seven years for restricted stock awards. In March 2005, the SEC issued Staff Accounting Bulletin No. 107 (SAB 107) regarding the SEC s interpretation of SFAS 123(R) and the valuation of share-based payments for public companies. Dell has applied the provisions of SAB 107 in its adoption of SFAS 123(R). See Note 6 of Notes to Condensed Consolidated Financial Statements for further discussion on stock-based compensation.

Prior to the adoption of SFAS 123(R), Dell measured compensation expense for its employee stock-based compensation plans using the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25). Dell applied the disclosure provisions of SFAS 123 such that the fair value of employee stock-based compensation was disclosed in the notes to its

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financial statements. Under APB 25, when the exercise price of Dell s employee stock options equaled the market price of the underlying stock at the date of the grant, no compensation expense was recognized.

Recently Issued Accounting Pronouncements In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Instruments* (SFAS 155), which is an amendment of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* (SFAS 133), and SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities a replacement of FASB Statement No. 125* (SFAS 140). SFAS 155 allows Dell to elect to account for financial instruments with embedded derivatives as a whole on a fair value basis, instead of bifurcating the derivative from the host financial instrument. This statement also requires Dell to evaluate its interest in securitized financial assets to identify any freestanding derivatives and embedded derivatives, and clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives. SFAS 155 is effective for all financial instruments acquired, issued, or subject to a remeasurement event after the beginning of Dell s Fiscal 2008. Dell determined that its retained interest in securitized assets contains embedded derivatives and elected to account for the entire asset on a fair value basis. The fair value basis did not have a material effect on Dell s results of operations, financial position, or cash flows.

In March 2006, the FASB issued SFAS No. 156, *Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140* (SFAS 156). SFAS 156 requires an entity to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset by entering into a servicing contract in specific situations. Additionally, the servicing asset or servicing liability is initially measured at fair value; however, an entity may elect the amortization method or fair value method for subsequent reporting periods. SFAS 156 is effective beginning Dell s Fiscal 2008. Adoption of SFAS 156 did not have a material effect on Dell s results of operations, financial position, or cash flows.

In June 2006, the Emerging Issues Task Force reached a consensus on Issue No. 06-3, *Disclosure Requirements for Taxes Assessed by a Governmental Authority on Revenue-Producing Transactions* (EITF 06-3). The consensus allows an entity to choose between two acceptable alternatives based on their accounting policies for transactions in which the entity collects taxes on behalf of a governmental authority, such as sales taxes. Under the gross method, taxes collected are accounted for as a component of revenue with an offsetting expense. Conversely, the net method excludes such taxes from revenue. Companies are required to disclose the method selected pursuant to APB Opinion No. 22, *Disclosure of Accounting Policies*. If such taxes are reported gross and are significant, companies are required to disclose the amount of those taxes. The guidance should be applied to financial reports through retrospective application for all periods presented, if amounts are significant, for interim and annual reporting periods beginning after December 15, 2006, which is Dell s Fiscal 2008. Dell records revenue net of such taxes.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No 109* (FIN 48). FIN 48 clarifies the accounting and reporting for uncertainties in income tax law. This Interpretation prescribes a comprehensive model for the financial statement recognition, measurement, presentation, and disclosure of uncertain tax positions taken or expected to be taken in income tax returns. Dell adopted this Interpretation in the first quarter of Fiscal 2008, and this adoption resulted in a decrease to stockholders equity of approximately $62 million. In addition, consistent with the provisions of FIN 48, Dell changed the classification of $1.1 billion of income tax liabilities from current to non-current liabilities because payment of cash is not anticipated within one year of the balance sheet date.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (SAB 108). SAB 108 addresses the process of quantifying financial statement misstatements; however, it does not

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
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address how to assess materiality in interim financial statements. SAB 108 establishes the dual approach for the evaluation of the impact of financial statement misstatements. SAB 108 was effective for Dell s Fiscal 2007. There was no impact on Dell s results of operations, financial position, or cash flows due to the adoption of SAB 108. However, this guidance was considered in the determination by Dell to restate its previously issued financial statements as discussed in Note 2 of Notes to Condensed Consolidated Financial Statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (SFAS 157), which defines fair value, provides a framework for measuring fair value, and expands the disclosures required for assets and liabilities measured at fair value. SFAS 157 applies to existing accounting pronouncements that require fair value measurements; it does not require any new fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by Dell beginning in the first quarter of Fiscal 2009. Management is currently evaluating the impact that SFAS 157 may have on Dell s results of operations, financial position, and cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159), which provides companies with an option to report selected financial assets and liabilities at fair value with the changes in fair value recognized in earnings at each subsequent reporting date. SFAS 159 provides an opportunity to mitigate potential volatility in earnings caused by measuring related assets and liabilities differently, and it may reduce the need for applying complex hedge accounting provisions. If elected, SFAS 159 is effective for fiscal years beginning after November 15, 2007, which is Dell s Fiscal 2009. Management is currently evaluating the impact that this statement may have on Dell s results of operations and financial position, and has yet to make a decision on the elective adoption of SFAS 159.

Reclassifications To maintain comparability among the periods presented, Dell has revised the presentation of certain prior period amounts reported within the Notes to Condensed Consolidated Financial Statements. For further discussion regarding the presentation of service obligations honored, see Note 8 of Notes to Condensed Consolidated Financial Statements.

NOTE 2 Audit Committee Independent Investigation and Restatement

Background and Scope of the Investigation

In August 2005, the Division of Enforcement of the SEC initiated an inquiry into certain of Dell s accounting and financial reporting matters and requested that Dell provide certain documents. Over the course of several months, Dell produced documents and provided information in response to the SEC s initial request and subsequent requests.

In June 2006, the SEC sent Dell an additional request for documents and information that appeared to expand the scope of the inquiry, with respect to both issues and periods. As documents and information were collected in response to this additional request, Dell s management was made aware of information that raised significant accounting and financial reporting concerns, including whether accruals, reserves, and other balance sheet items had been recorded and reported properly. After evaluating this information and in consultation with PricewaterhouseCoopers LLP, Dell s independent registered public accounting firm, management determined that the identified issues warranted an independent investigation and recommended such to the Audit Committee of Dell s Board of Directors.

On August 16, 2006, the Audit Committee, acting on management s recommendation, approved the initiation of an independent investigation. The Audit Committee engaged Willkie Farr & Gallagher LLP (Willkie Farr) to lead the investigation as the independent legal counsel to the Audit Committee. Willkie Farr in turn engaged KPMG LLP (KPMG) to serve as its independent forensic accountants.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
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The scope of the investigation was determined by Willkie Farr, in consultation with the Audit Committee and KPMG. The investigation involved a program of forensic analysis and inquiry directed to aspects of Dell s accounting and financial reporting practices throughout the world, and evaluated aspects of its historical accounting and financial reporting practices since Fiscal 2002 and, with respect to certain issues, prior fiscal years.

Summary of Investigation Findings

The investigation raised questions relating to numerous accounting issues, most of which involved adjustments to various reserve and accrued liability accounts, and identified evidence that certain adjustments appear to have been motivated by the objective of attaining financial targets. According to the investigation, these activities typically occurred in the days immediately following the end of a quarter, when the accounting books were being closed and the results of the quarter were being compiled. The investigation found evidence that, in that timeframe, account balances were reviewed, sometimes at the request or with the knowledge of senior executives, with the goal of seeking adjustments so that quarterly performance objectives could be met. The investigation concluded that a number of these adjustments were improper, including the creation and release of accruals and reserves that appear to have been made for the purpose of enhancing internal performance measures or reported results, as well as the transfer of excess accruals from one liability account to another and the use of the excess balances to offset unrelated expenses in later periods. The investigation found that sometimes business unit personnel did not provide complete information to corporate headquarters and, in a number of instances, purposefully incorrect or incomplete information about these activities was provided to internal or external auditors.

The investigation identified evidence that accounting adjustments were viewed at times as an acceptable device to compensate for earnings shortfalls that could not be closed through operational means. Often, these adjustments ranged from several hundred thousand to several million dollars, in the context of a company with annual revenues ranging from $35.3 billion to $55.8 billion and annual net income ranging from $2.0 billion to $3.6 billion for the periods in question. The errors and irregularities identified in the course of the investigation revealed deficiencies in Dell s accounting and financial control environment, some of which were determined to be material weaknesses, that require corrective and remedial actions. For a description of the control deficiencies identified by management as a result of the investigation and Dell s internal reviews described below, as well as management s plan to remediate those deficiencies, see Part I Item 4 Controls and Procedures.

Other Company Identified Adjustments

Concurrently with the investigation, Dell also conducted extensive internal reviews for the purpose of the preparation and certification of Dell s Fiscal 2007 financial statements and its assessment of internal controls over financial reporting. Dell s procedures included expanded account reviews and expanded balance sheet reconciliations to ensure all accounts were fully reconciled, supported, and appropriately documented. Dell also implemented improvements to its quarterly and annual accounting close process to provide for more complete review of the various business unit financial results.

Restatement Adjustments

As a result of the issues identified in the Audit Committee independent investigation, as well as issues identified in additional reviews and procedures conducted by management, the Audit Committee, in consultation with management and PricewaterhouseCoopers LLP, concluded on August 13, 2007 that Dell s previously issued financial statements for Fiscal 2003, 2004, 2005, and 2006 (including the interim periods within those years), and the first quarter of Fiscal 2007, should no longer be relied upon because of

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certain accounting errors and irregularities in those financial statements. Accordingly, Dell has restated its previously issued financial statements for those periods. Restated financial information is presented in this report, as well as in Dell s Annual Report on Form 10-K for Fiscal 2007.

The nature of the restatement adjustments and the impact of the adjustments for the three-month period ended July 29, 2005 are shown in the following table:

	Three Month Period Ended July 29, 2005						
		Adjustments					
		Revenue recognition					
	As Reported	Software sales	Other	Warranty liabilities	Other reserves and accruals	Provision for income tax[(a)]	As Restated
	(in millions, except per share data)						
Net revenue	$ 13,428	$ (67)	$ 21	$	$	$	$ 13,382
Cost of net revenue	10,929	(64)	32	51	3		10,951
Gross margin	2,499	(3)	(11)	(51)	(3)		2,431
Operating expenses:							
Selling, general, and administrative	1,204				(8)		1,196
Research, development, and engineering	122						122
Total operating expenses	1,326				(8)		1,318
Operating income	1,173	(3)	(11)	(51)	5		1,113
Investment and other income, net	61		8	(1)	6		74
Income before income taxes	1,234	(3)	(3)	(52)	11		1,187
Income tax provision	214					(9)	205
Net income	$ 1,020						$ 982
Earnings per common share:							
Basic	$ 0.42						$ 0.41
Diluted	$ 0.41						$ 0.40

Weighted-average shares outstanding:		
Basic	2,418	2,418
Diluted	2,478	2,478

(a) Primarily represents the aggregate tax impact of the adjustments.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
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The nature of the restatement adjustments and the impact of the adjustments for the six-month period ended July 29, 2005 are shown in the following table:

	Six Month Period Ended July 29, 2005						
		Adjustments					
		Revenue recognition					
	As Reported	Software sales	Other	Warranty liabilities	Other reserves and accruals	Provision for income tax[(a)]	As Restated
	(in millions, except per share data)						
Net revenue	$ 26,814	$ (121)	$ (11)	$	$	$	$ 26,682
Cost of net revenue	21,824	(115)	18	65	7		21,799
Gross margin	4,990	(6)	(29)	(65)	(7)		4,883
Operating expenses:							
Selling, general, and administrative	2,411		2		(11)		2,402
Research, development, and engineering	232			(1)			231
Total operating expenses	2,643		2	(1)	(11)		2,633
Operating income	2,347	(6)	(31)	(64)	4		2,250
Investment and other income, net	120		8	(2)	(1)		125
Income before income taxes	2,467	(6)	(23)	(66)	3		2,375
Income tax provision	513					(28)	485
Net income	$ 1,954						$ 1,890
Earnings per common share:							
Basic	$ 0.80						$ 0.78
Diluted	$ 0.78						$ 0.76
Weighted-average shares outstanding:							
Basic	2,437						2,437
Diluted	2,497						2,497

(a) Primarily represents the aggregate tax impact of the adjustments.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
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Revenue Recognition Adjustments

Software Sales The largest revenue recognition adjustment relates to correcting the timing and amount of revenue recognized on the sale of certain software products. Dell is a reseller of a broad array of third-party developed software. Individually significant categories of software are analyzed for application of the appropriate accounting under American Institute of Certified Public Accountants (AICPA) Statement of Position No. 97-2, *Software Revenue Recognition* (SOP 97-2). However, the allocation of software sales revenue between the software license (recognized at point of sale) and post-contract support (deferred and recognized over time) for other high volume, lower dollar value software products has historically been assessed as a group and the post-contract support revenue was deferred based on an estimate of average Vendor Specific Objective Evidence (VSOE). During the course of its internal reviews, Dell determined that its application of SOP 97-2 for these high volume software products was not correct. Dell has determined that the most appropriate application of SOP 97-2 is to defer all of the revenue from these other software offerings and amortize the revenue over the post-contract support period as VSOE has not been appropriately established. Additionally, during the course of its reviews, Dell identified certain software offerings where it had previously recognized the gross amount of revenue from the sale but where it functions more as a selling agent as opposed to the principal in the sale to the customer. In those cases Dell should have recognized the revenue net of the related cost pursuant to EITF Issue No. 99-19, *Reporting Revenue Gross as a Principal vs. Net as an Agent.*

Other The other revenue recognition adjustments include cases where Dell recognized revenue in the incorrect periods or recognized the incorrect amount of revenue on certain transactions, and cases where the allocation of revenue among the individual elements of the sale was not correct. The primary categories of other revenue recognition adjustments include the following:

SAB 104 Deferrals Instances were identified where Dell prematurely recognized revenue prior to finalization of the terms of sale with the customer, or prior to title and/or risk of loss having been passed to the customer. Sometimes these situations involved warehousing arrangements. Additionally, there were situations where revenue was incorrectly deferred to later periods despite title and/or risk of loss having passed to the end customer. Under SAB 104, there were also cases where the in-transit deferral calculation for the period end was not appropriately calculated or was based on incorrect assumptions.

Deferred Warranty Revenue Pursuant to FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts,* Dell defers and amortizes the revenue from the sale of extended warranties and enhanced service level agreements over the service period of the associated agreement. In some instances Dell s accounting estimates of the agreement durations were not correct, resulting in revenue being recognized over a shorter time period than the actual contract durations. Additionally, an error was identified in the amount of deferred revenue recognized and amortized during the restatement period.

Customer Rebate Accruals Dell s U.S. Consumer segment and small business group historically offered various forms of rebates to stimulate sales, including mail-in rebates. The rebate redemption liability is estimated at the time of sale based on historical redemption rates for the various types of promotions. Dell has determined that this liability was overstated due to a number of factors, including failure to update redemption rates when appropriate, additional amounts accrued for expected customer satisfaction costs, and unsupported incremental accruals recorded in addition to the calculated redemption liability estimate.

Japan Services Transactions In late January 2007, a Japanese systems integrator with whom Dell s Japanese services division did business, filed for bankruptcy. The bankruptcy trustee publicly indicated that the systems integrator had engaged in fictitious transactions. Dell promptly commenced an internal

DELL INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

investigation led by Dell s Ethics Office to determine whether its Japanese business unit had engaged in any fictitious transactions with the systems integrator. Dell hired independent outside counsel who retained independent accountants to lead the investigation. The investigation determined that almost all of the transactions of the Japan services business involving the systems integrator likely were fabricated, as were certain additional smaller transactions involving two other Japanese systems integrators. The impact of the adjustments reduced net revenue and cost of revenue to eliminate the effect of the fictitious transactions.

Sales Reflected in Cost of Sales There were transactions identified involving the sale of certain computer component commodities and parts where the net proceeds were presented as a reduction of cost of sales rather than as revenue.

Warranty Liabilities

The issues related to Dell s warranty liabilities include situations where certain vendor reimbursement agreements were incorrectly accounted for as a reduction in the estimate of the outstanding warranty liabilities. There were also instances where warranty reserves in excess of the estimated warranty liability as calculated by the warranty liability estimation process were retained and not released to the income statement as appropriate. Additionally, certain adjustments in the warranty liability estimation process were identified where expected future costs or estimated failure rates were not accurate.

Other Reserves and Accruals

Many of the restatement adjustments relate to the estimates and reconciliation of various reserves and accrued liabilities, including employee benefits, accounts payable, litigation, sales commissions, payroll, employee bonuses, and supplier rebates. Dell extensively reviewed its accruals and underlying estimates, giving consideration to subsequent developments after the date of the financial statements, to assess whether any of the previously recorded amounts required adjustment. Dell conducted expanded account reviews and expanded balance sheet reconciliations to ensure that all accounts were fully reconciled, supported, and appropriately documented. As a result of this review, Dell determined that a number of its accruals required adjustment across various accounting periods. The largest of these adjustments are described in more detail below:

Employee Bonuses Certain employee bonuses were not accrued correctly, including the timing of the recording of the accrual for the employee bonuses. Additionally, in certain cases when excess accruals resulted from differences in the actual bonus payments, the excess accruals were not adjusted as appropriate.

Vendor Funding Arrangements In some instances vendor funding arrangements were not accounted for appropriately under EITF Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor.* Certain amounts received from vendors were recorded as a reduction in operating expenses instead of being correctly recorded as a reduction of cost of goods sold. Additionally, certain amounts received were retained on the balance sheet and released in future periods despite the earnings process having been complete in the earlier period. Finally, there were instances where the benefit of certain vendor funding was recorded prior to the completion of the earnings process.

Unsubstantiated Accruals and Inadequately Reconciled Accounts In some instances accrual and reserve accounts lacked justification or supporting documentation. In certain cases these accounts were used to accumulate excess amounts from other reserve and accrual accounts. However, these excess reserves were not released to the income statement in the appropriate reporting period or were released

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for other purposes. In some instances accounts had incorrect balances because they had not been properly reconciled or because reconciling items had not been adjusted timely.

The table below summarizes the effects of the restatement adjustments on the Consolidated Statement of Financial Position at February 3, 2006.

	February 3, 2006		
	As Reported	Adjustments (in millions)	As Restated
ASSETS			
Current assets:			
Cash and cash equivalents	$ 7,042	$ 12	$ 7,054
Short-term investments	2,016		2,016
Accounts receivable, net	4,089	(7)	4,082
Financing receivables, net	1,363	3	1,366
Inventories	576	12	588
Other	2,620	68	2,688
Total current assets	17,706	88	17,794
Property, plant, and equipment, net	2,005	(12)	1,993
Investments	2,691	(5)	2,686
Long-term financing receivables, net	325		325
Other non-current assets	382	72	454
Total assets	$ 23,109	$ 143	$ 23,252
LIABILITIES AND STOCKHOLDERS EQUITY			
Current liabilities:			
Short-term borrowings	$	$ 65	$ 65
Accounts payable	9,840	28	9,868
Accrued and other	6,087	153	6,240
Total current liabilities	15,927	246	16,173
Long-term debt	504	121	625
Other non-current liabilities	2,549	(142)	2,407
Total liabilities	18,980	225	19,205
Redeemable common stock and capital in excess of par value			

Stockholders equity:			
Common stock and capital in excess of par	9,540	(37)	9,503
Treasury stock	(18,007)		(18,007)
Retained earnings	12,746	(47)	12,699
Accumulated other comprehensive loss	(103)	2	(101)
Other	(47)		(47)
Total stockholders equity	4,129	(82)	4,047
Total liabilities and equity	$ 23,109	$ 143	$ 23,252

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Statement of Financial Position Adjustments

In addition to the income statement adjustments described above, certain Statement of Financial Position classification adjustments were also identified. These include (i) correcting the classification of advances under credit facilities by DFS from other current and non-current liabilities to short-term borrowings and long-term debt as appropriate; (ii) correcting the presentation of liabilities for estimated litigation settlements by presenting estimated insurance recoveries as a receivable from the insurance carriers rather than as a reduction of the estimated settlement liability; (iii) correcting an error in the calculation and recording of the tax benefit of employee stock options which had an offsetting impact on accrued and other liabilities and stockholders equity; (iv) adjusting the fair value of long-term debt, where the interest rate is hedged with interest rate swap agreements; and (v) adjusting deferred revenue to record professional and deployment services impacting accounts receivable and accrued and other liabilities. These balance sheet corrections in classification are included in the adjustments column above.

Statement of Cash Flows

The following table presents the major subtotals for Dell s Statement of Cash Flows and the related impact of the restatement adjustments discussed above for the six-month period ended July 29, 2005:

	Six Months Ended July 29, 2005	
	As Reported	As Restated
	(in millions)	
Net cash provided by (used in):		
Net income	$ 1,954	$ 1,890
Non-cash adjustments	386	359
Changes in working capital	(447)	(338)
Changes in noncurrent assets and liabilities	216	224
Operating activities	2,109	2,135
Investing activities	2,710	2,966
Financing activities	(3,173)	(3,187)
Effect of exchange rate changes on cash and cash equivalents[a]	(56)	(49)
Net increase in cash and cash equivalents	1,590	1,865
Cash and cash equivalents at beginning of period	4,747	4,479
Cash and cash equivalents at end of period	$ 6,337	$ 6,344

(a)

The cash flows have been revised to reflect a closer approximation of the weighted-average exchange rates during the reporting periods. For most periods, this revision reduced the previously reported effect of exchange rate changes on cash and cash equivalents and with an offsetting change in effects of exchange rate changes on monetary assets and liabilities denominated in foreign currencies and changes in operating working capital included in cash flows from operating activities.

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NOTE 3 Inventories

	August 4, 2006	February 3, 2006 As Restated
	(in millions)	
Inventories:		
Production materials	$ 374	$ 325
Work-in-process	61	43
Finished goods	234	220
Inventories	$ 669	$ 588

NOTE 4 Earnings Per Common Share

Basic earnings per share is based on the weighted-average effect of all common shares issued and outstanding, and is calculated by dividing net income by the weighted-average shares outstanding during the period. Diluted earnings per share is calculated by dividing net income by the weighted-average number of common shares used in the basic earnings per share calculation plus the number of common shares that would be issued assuming exercise or conversion of all potentially dilutive common shares outstanding. Dell excludes equity instruments from the calculation of diluted earnings per share if the effect of including such instruments is antidilutive. Accordingly, certain employee stock options have been excluded from the calculation of diluted earnings per share totaling 305 million and 74 million shares during the second quarter of Fiscal 2007 and Fiscal 2006, respectively, and 257 million and 73 million during the six month periods ended August 4, 2006 and July 29, 2005, respectively.

The following table sets forth the computation of basic and diluted earnings per share for the three and six month periods ended August 4, 2006 and July 29, 2005:

	Three Months Ended		Six Months Ended	
	August 4, 2006	July 29, 2005 As Restated	August 4, 2006	July 29, 2005 As Restated
	(in millions, except per share amounts)			
Numerator:				
Net income	$ 480	$ 982	$ 1,256	$ 1,890
Denominator:				

Weighted-average shares outstanding:				
Basic	2,264	2,418	2,280	2,437
Effect of dilutive options, restricted stock units, restricted stock, and other	14	60	18	60
Diluted	2,278	2,478	2,298	2,497
Earnings per common share:				
Basic	$ 0.21	$ 0.41	$ 0.55	$ 0.78
Diluted	$ 0.21	$ 0.40	$ 0.55	$ 0.76

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NOTE 5 Comprehensive Income

Dell s comprehensive income is comprised of net income, unrealized gains and losses on derivative financial instruments related to foreign currency hedging, unrealized gains and losses on marketable securities classified as available-for-sale, unrealized gains and losses related to the change in valuation of retained interests in securitized assets, and foreign currency translation adjustments.

The following table summarizes comprehensive income for the three and six month periods ended August 4, 2006 and July 29, 2005:

	Three Months Ended		Six Months Ended	
	August 4, 2006	July 29, 2005 As Restated	August 4, 2006	July 29, 2005 As Restated
	(in millions)			
Comprehensive income:				
Net income	$ 480	$ 982	$ 1,256	$ 1,890
Unrealized gains (losses) on foreign currency hedging instruments, net	64	92	(44)	99
Unrealized gains (losses) on marketable securities, net	16	(8)	1	(20)
Valuation of retained interests in securitized assets	4		6	
Foreign currency translation adjustments	(2)	(4)	(6)	(2)
Comprehensive income	$ 562	$ 1,062	$ 1,213	$ 1,967

NOTE 6 Benefit Plans

Description of the Plans

Employee Stock Purchase Plan Dell has a shareholder approved employee stock purchase plan (ESPP) that permits substantially all employees to purchase shares of Dell s common stock. Effective July 1, 2005, participating employees were permitted to purchase common stock through payroll deductions at the end of each three-month participation period at a purchase price equal to 85% of the fair market value of the common stock at the end of the participation period. Upon adoption of SFAS 123(R) in Fiscal 2007, Dell began recognizing compensation expense for the 15% discount received by the participating employees. Common stock reserved for future employee purchases under the plan aggregated 13 million shares at August 4, 2006 and 16 million shares at February 3, 2006. The weighted-average fair value of the purchase rights under the ESPP during the three and six month periods ended August 4, 2006 was $3.68 and $4.12, respectively.

Employee Stock Plans Dell has the following four employee stock plans (collectively referred to as the Stock Plans) under which options, restricted stock, and restricted stock units were outstanding at August 4, 2006:

The Dell Computer Corporation 1989 Stock Option Plan (the 1989 Option Plan)

The Dell Computer Corporation Incentive Plan (the 1994 Incentive Plan)

The Dell Computer Corporation 1998 Broad-Based Stock Option Plan (the 1998 Broad-Based Plan)

The Dell Computer Corporation 2002 Long-Term Incentive Plan (the 2002 Incentive Plan)

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The Stock Plans are administered by the Leadership Development and Compensation Committee of Dell s Board of Directors. The 1989 Option Plan, the 1994 Incentive Plan, and the 1998 Broad-Based Plan have been terminated (except for options previously granted under those plans that are still outstanding). Consequently, awards are currently only being granted under the 2002 Incentive Plan.

The 2002 Incentive Plan provides for the granting of stock-based incentive awards to Dell s employees, non-employee directors, and certain consultants and advisors to Dell. Awards may be incentive stock options within the meaning of Section 422 of the Internal Revenue Code, nonqualified stock options, restricted stock, or restricted stock units. There were approximately 262 million and 272 million shares of Dell s common stock available for future grants under the Stock Plans at August 4, 2006 and February 3, 2006, respectively. To satisfy stock option exercises, Dell has a policy of issuing new shares as opposed to repurchasing shares on the open market.

Stock Option Agreements The right to purchase shares pursuant to existing stock option agreements typically vests pro-rata at each option anniversary date over a five-year period. The options, which are granted with option exercise prices equal to the fair market value of Dell s common stock on the date of grant, generally expire within ten to twelve years from the date of grant. Dell has not issued any options to consultants or advisors to Dell since Fiscal 1999. In conjunction with the adoption of SFAS 123(R) in the first quarter of Fiscal 2007, Dell changed its method of attributing the value of stock-based compensation expense from an accelerated approach to a straight-line method. Compensation expense for all stock option awards granted on or prior to February 3, 2006 is recognized using an accelerated approach with the exception of stock options granted in Fiscal 2002 and Fiscal 2003, for which compensation expense is recognized using a straight-line method.

Restricted Stock Awards Awards of restricted stock may be either grants of restricted stock, restricted stock units, or performance-based stock units that are issued at no cost to the recipient. For restricted stock grants, at the date of grant, the recipient has all rights of a stockholder, subject to certain restrictions on transferability and a risk of forfeiture. Restricted stock grants typically vest over a five-to-seven-year period beginning on the date of grant. For restricted stock units, legal ownership of the shares is not transferred to the employee until the unit vests, which is generally over a five-year period. Dell also grants performance-based restricted stock units as a long-term incentive in which an award recipient receives shares contingent upon Dell achieving performance objectives and the employees continuing employment through the vesting period, which is generally over a five-year period. Compensation expense recorded in connection with these performance-based restricted stock units is based on Dell s best estimate of the number of shares that will eventually be issued upon achievement of the specified performance criteria and when it becomes probable that certain performance goals will be achieved. The cost of these awards is determined using the fair market value of Dell s common stock on the date of the grant. Compensation expense for restricted stock awards with a service condition is recognized on a straight-line basis over the vesting term. Compensation expense for performance-based restricted stock awards is recognized on an accelerated multiple-award approach based on the most probable outcome of the performance condition. In accordance with SFAS 123(R), deferred compensation related to restricted stock awards issued prior to Fiscal 2007, which was previously classified as other in stockholders equity, was classified as capital in excess of par value upon adoption.

Temporary Suspension of Option Exercises, Vesting of Restricted Stock Units, and ESPP Purchases As a result of Dell s inability to timely file its Annual Report on Form 10-K for Fiscal 2007, Dell suspended the exercise of employee stock options, the vesting of restricted stock units, and the purchase of shares under the ESPP. Dell expects to resume the exercise of employee stock options by employees, the vesting of restricted stock units, and the purchase of shares under the ESPP when it is again current in its reporting obligations under the Securities Exchange Act of 1934.

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Dell agreed to pay cash to certain current and former employees who held in-the-money stock options (options that have an exercise price less than the current stock market price) that expired during the period of unexercisability. Within 45 days after Dell files its Annual Report on Form 10-K for Fiscal 2007, Dell will make payments relating to in-the-money stock options that expired in the second and third quarters of Fiscal 2008, which are expected to total approximately $113 million. Dell will not continue to pay cash for expired in-the-money stock options once the options again become exercisable.

General Information

Stock Option Activity The following table summarizes stock option activity for the Stock Plans during the six-month period ended August 4, 2006:

	Number of Options (in millions)	Weighted-Average Exercise Price (per share)	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in millions)
Options outstanding February 3, 2006	343	$ 31.86		
Granted	5	28.00		
Exercised	(9)	12.62		
Forfeited	(2)	25.83		
Cancelled/expired	(9)	37.18		
Options outstanding August 4, 2006	328	$ 32.22		
Vested and expected to vest (net of estimated forfeitures) August 4, 2006[(a)]	326	$ 31.52	5.6	$ 191
Exercisable August 4, 2006[(a)]	290	$ 33.00	5.5	$ 121

(a) For options vested and expected to vest and options exercisable, the aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between Dell s closing stock price on August 4, 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had the holders exercised their options on August 4, 2006. The intrinsic value changes based on changes in the fair market value of Dell s common stock.

Other information pertaining to stock options for the three and six month periods ended August 4, 2006 is as follows:

	Three Months Ended August 4, 2006	Six Months Ended August 4, 2006
	(in millions, except per option data)	
Weighted-average grant date fair value of stock options granted per option	$ 6.46	$ 7.24
Total intrinsic value of options exercised[(a)]	$ 61	$ 134

(a) The total intrinsic value of options exercised represents the total pre-tax intrinsic value (the difference between the stock price at exercise and the exercise price, multiplied by the number of options exercised) that was received by the option holders who exercised their options during the three and six month periods ended August 4, 2006.

At August 4, 2006, $227 million of total unrecognized stock-based compensation expense, net of estimated forfeitures, related to stock options is expected to be recognized over a weighted-average period of approximately 1.3 years.

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Non-vested Restricted Stock Activity Non-vested restricted stock awards at August 4, 2006 and activities during the six-month period ended August 4, 2006 were as follows:

		Number of Shares (in millions)	Weighted-Average Grant Date Fair Value (per share)
Non-vested restricted stock	February 3, 2006	2	$ 34.66
Granted		18	29.12
Vested		(1)	27.75
Forfeited		(1)	30.21
Non-vested restricted stock	August 4, 2006	18	$ 29.66

For the three and six month periods ended August 4, 2006, the weighted-average fair value of restricted stock awards granted during the period was $25.91 and $29.12 per share, respectively. At August 4, 2006, $422 million of unrecognized stock-based compensation expense, net of estimated forfeitures, related to non-vested restricted stock awards cost is expected to be recognized over a weighted-average period of approximately 2.6 years.

Expense Information under SFAS 123(R)

For the three and six month periods ended August 4, 2006, stock-based compensation expense, net of income taxes, was allocated as follows:

	Three Months Ended August 4, 2006	Six Months Ended August 4, 2006
	(in millions)	
Stock-based compensation expense:		
Cost of net revenue	$ 18	$ 36
Operating expenses	86	181
Stock-based compensation expense before taxes	104	217
Income tax benefit	(31)	(65)
Stock-based compensation expense	$ 73	$ 152

Prior to the adoption of SFAS 123(R), net income included compensation expense related to restricted stock awards but did not include stock-based compensation expense for employee stock options or the purchase discount under Dell s ESPP. Total stock-based compensation expense was $104 million and $217 million for the three and six month periods ended August 4, 2006, respectively. As a result of adopting SFAS 123(R), income before income taxes and net income were lower by $75 million and $53 million, respectively, for the three-month period ended August 4, 2006, and $165 million and $116 million, respectively, for the six-month period ended August 4, 2006, than if Dell had not adopted SFAS 123(R). The impact on both basic and diluted earnings per share for the three- and six-month periods ended August 4, 2006 was $.02 and $.05 per share, respectively. The remaining $29 million and $52 million of pre-tax stock compensation expense for the three and six month periods ended August 4, 2006, respectively, is associated with restricted stock awards that, consistent with APB 25, are expensed over the associated vesting period. Stock-based compensation expense recognized for the first three and six month periods ended August 4, 2006 is based on awards expected to vest, reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if

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