

VMWARE, INC.
 Form 10-Q
 August 02, 2012

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

Form 10-Q
 (Mark One)

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

For the quarterly period ended June 30, 2012
 OR

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

For transition period from to
 Commission File Number 001-33622

VMWARE, INC.
 (Exact name of registrant as specified in its charter)

Delaware 94-3292913
 (State or other jurisdiction of (I.R.S. Employer
 incorporation or organization) Identification Number)

3401 Hillview Avenue 94304
 Palo Alto, CA (Zip Code)
 (Address of principal executive offices)
 (650) 427-5000
 (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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
 Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of July 26, 2012, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 426,466,973 of which 126,466,973 shares were Class A common stock and 300,000,000 were Class B common

stock.

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VMware, VMworld, VMware vSphere, VMware vCloud, Zimbra, SpringSource, VMware vCenter, VMware vShield, Cloud Foundry, VMware View, VMware Horizon, Rabbit MQ, GemFire, Socialcast, SlideRocket, Digital Fuel, NeoAccel, PacketMotion, Shavlik and WaveMaker are registered trademarks or trademarks of VMware, Inc. in the United States and other jurisdictions. All other marks and names mentioned herein may be trademarks of their respective companies.

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FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

VMware, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	For the Three Months Ended		For the Six Months Ended	
	June 30,	2011	June 30,	2011
	2012		2012	
Operating activities:				
Net income	\$ 191,729	\$ 220,158	\$ 383,165	\$ 345,970
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	89,392	74,709	175,158	155,658
Stock-based compensation, excluding amounts capitalized	100,900	85,442	182,706	166,015
Excess tax benefits from stock-based compensation	(32,701)	(101,256)	(86,383)	(151,264)
Gain on sale of Terremark investment	—	(56,000)	—	(56,000)
Other	373	2,864	(555)	3,826
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	(91,296)	(54,757)	135,254	26,583
Other assets	(69,444)	(16,133)	(117,150)	(34,053)
Due to/from EMC, net	(43,403)	(35,265)	12,145	25,435
Accounts payable	4,894	(11,105)	17,419	(1,707)
Accrued expenses	95,753	102,780	936	34,211
Income taxes receivable from EMC	—	141,000	—	176,444
Income taxes payable	12,367	4,674	67,733	37,601
Deferred income taxes, net	(1,416)	11,119	(36,371)	(958)
Unearned revenue	134,177	94,566	233,872	212,952
Net cash provided by operating activities	391,325	462,796	967,929	940,713
Investing activities:				
Additions to property and equipment	(44,336)	(95,186)	(78,007)	(122,232)
Purchase of leasehold interest (see Note H)	—	(173,126)	—	(173,126)
Capitalized software development costs	—	(25,437)	—	(52,859)
Purchases of available-for-sale securities	(1,253,605)	(529,038)	(1,955,068)	(1,127,805)
Sales of available-for-sale securities	348,437	223,491	770,754	376,588
Maturities of available-for-sale securities	277,099	277,390	534,076	492,969
Sale of strategic investments	—	76,000	—	78,513
Business acquisitions, net of cash acquired	(102,166)	(189,138)	(102,166)	(204,088)
Transfer of net assets under common control	—	(7,973)	—	(20,463)
Other investing	(2,677)	31,858	(4,174)	(27,142)
Net cash used in investing activities	(777,248)	(411,159)	(834,585)	(779,645)
Financing activities:				
Proceeds from issuance of common stock	33,554	110,543	144,595	200,714
Repurchase of common stock	(178,195)	(132,660)	(178,195)	(280,389)
Excess tax benefits from stock-based compensation	32,701	101,256	86,383	151,264
	(51,346)	(48,666)	(64,983)	(70,578)

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Shares repurchased for tax withholdings on vesting of restricted stock

Net cash provided by (used in) financing activities	(163,286	) 30,473	(12,200	) 1,011
Net increase (decrease) in cash and cash equivalents	(549,209	) 82,110	121,144	162,079
Cash and cash equivalents at beginning of the period	2,626,109	1,708,934	1,955,756	1,628,965
Cash and cash equivalents at end of the period	\$2,076,900	\$1,791,044	\$2,076,900	\$1,791,044
Non-cash items:				
Changes in capital additions, accrued but not paid	\$17,980	\$(985	) \$15,330	\$6,221
Changes in tax withholdings on vesting of restricted stock, accrued but not paid	6,029	3,656	6,837	2,938

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

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VMware, Inc.

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Revenues:				
License	\$517,222	\$464,806	\$999,149	\$883,805
Services	605,804	456,404	1,179,059	881,126
Total revenues	1,123,026	921,210	2,178,208	1,764,931
Operating expenses (1):				
Cost of license revenues	56,553	48,928	113,296	104,946
Cost of services revenues	122,669	103,547	236,841	197,426
Research and development	248,594	189,241	470,984	358,404
Sales and marketing	391,501	314,560	754,913	617,484
General and administrative	91,799	78,042	173,099	146,277
Operating income	211,910	186,892	429,075	340,394
Investment income	6,945	3,715	12,688	7,121
Interest expense with EMC	(1,158)	(972)	(2,445)	(1,931)
Other income (expense), net	(3,560)	56,639	(1,275)	56,804
Income before income taxes	214,137	246,274	438,043	402,388
Income tax provision	22,408	26,116	54,878	56,418
Net income	\$191,729	\$220,158	\$383,165	\$345,970
Net income per weighted-average share, basic for Class A and Class B	\$0.45	\$0.52	\$0.90	\$0.83
Net income per weighted-average share, diluted for Class A and Class B	\$0.44	\$0.51	\$0.88	\$0.80
Weighted-average shares, basic for Class A and Class B	427,223	419,657	426,106	418,557
Weighted-average shares, diluted for Class A and Class B	434,647	430,473	434,014	429,984

(1) Includes stock-based compensation as follows:

Cost of license revenues	\$524	\$438	\$964	\$904
Cost of services revenues	7,103	5,740	12,922	11,328
Research and development	48,027	46,074	87,404	87,958
Sales and marketing	33,883	23,264	59,117	45,787
General and administrative	11,363	9,926	22,299	20,038

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

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VMware, Inc.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in thousands)

(unaudited)

	For the Three Months Ended		For the Six Months Ended	
	June 30,		June 30,	
	2012	2011	2012	2011
Net income	\$191,729	\$220,158	\$383,165	\$345,970
Other comprehensive income:				
Changes in market value of available-for-sale securities:				
Unrealized gains (losses), net of taxes of \$(96), \$1,352, \$1,028 and \$1,196	(157	) 2,029	1,677	1,794
Reclassification of (gains) losses recognized during the period, net of taxes of \$(283), \$(22,494), \$53 and \$(12,788)	(461	) (33,742	) 86	(19,181
Net change in market value of available-for-sale securities	(618	) (31,713	) 1,763	(17,387
Changes in market value of effective foreign currency forward exchange contracts:				
Unrealized gains (losses), net of taxes of \$10, \$0, \$10 and \$0	194	—	194	—
Reclassification of (gains) losses recognized during the period, net of taxes of \$(40), \$0, \$10 and \$0	(728	) —	50	—
Net change in market value of effective foreign currency forward exchange contracts	(534	) —	244	—
Total other comprehensive income	(1,152	) (31,713	) 2,007	(17,387
Total comprehensive income, net of taxes	\$190,577	\$188,445	\$385,172	\$328,583

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

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VMware, Inc.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

	June 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	\$2,076,900	\$1,955,756
Short-term investments	3,269,969	2,556,450
Accounts receivable, net of allowance for doubtful accounts of \$2,492 and \$3,794	748,698	882,857
Due from EMC, net	61,654	73,799
Deferred tax asset	151,704	128,471
Other current assets	127,528	80,439
Total current assets	6,436,453	5,677,772
Property and equipment, net	553,124	525,490
Capitalized software development costs, net and other	109,532	154,236
Deferred tax asset	172,190	156,855
Intangible assets, net	402,425	407,375
Goodwill	1,827,068	1,759,080
Total assets	\$9,500,792	\$8,680,808
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$77,026	\$49,747
Accrued expenses and other	590,268	587,650
Unearned revenues	1,850,681	1,764,109
Total current liabilities	2,517,975	2,401,506
Note payable to EMC	450,000	450,000
Unearned revenues	1,091,709	944,309
Other liabilities	120,415	114,711
Total liabilities	4,180,099	3,910,526
Commitments and contingencies (see Note M)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 127,264 and 123,610 shares	1,273	1,236
Class B convertible common stock, par value \$.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3,000	3,000
Additional paid-in capital	3,377,466	3,212,264
Accumulated other comprehensive income	3,183	1,176
Retained earnings	1,935,771	1,552,606
Total stockholders' equity	5,320,693	4,770,282
Total liabilities and stockholders' equity	\$9,500,792	\$8,680,808

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

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VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (“VMware” or the “Company”) is the leader in virtualization and virtualization-based cloud infrastructure solutions utilized by businesses to help them transform the way they build, deliver and consume information technology (“IT”) resources in a manner that is evolutionary and based on their specific needs. VMware’s virtualization infrastructure software solutions run on industry-standard desktop computers and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

The financial statements and accompanying notes are prepared in accordance with accounting principles generally accepted in the United States of America.

Unaudited Interim Financial Information

These accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. In the opinion of management, these unaudited consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s consolidated cash flows, results of operations and financial condition for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2012. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware’s 2011 Annual Report on Form 10-K.

VMware was incorporated as a Delaware corporation in 1998, was acquired by EMC Corporation (“EMC”) in 2004 and conducted its initial public offering of VMware’s Class A common stock in August 2007. As of June 30, 2012, EMC holds approximately 79.3% of VMware’s outstanding common stock, including 38.7 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements. VMware and EMC engage in intercompany transactions, including agreements regarding the use of EMC’s and VMware’s intellectual property and real estate, agreements regarding the sale of goods and services to one another, and an agreement for EMC to resell VMware’s products and services to third party customers. In geographic areas where VMware has not established its own subsidiaries, VMware contracts with EMC subsidiaries for support services and for personnel who are managed by VMware. Additionally, beginning in the second quarter of 2011, VMware incurs costs to operate the Mozy service on behalf of EMC. These costs, plus a mark-up to approximate third-party costs and a management fee, are reimbursed to VMware by EMC and recorded as an offset to the costs VMware incurred on the consolidated statements of income. See Note O to the consolidated financial statements for further information regarding intercompany transactions between VMware and EMC.

Management believes the assumptions underlying the consolidated financial statements are reasonable. However, the amounts recorded for VMware’s intercompany transactions with EMC may not be considered arm’s length with an unrelated third party by nature of EMC’s majority ownership of VMware. Therefore, the financial statements included herein may not necessarily reflect the cash flows, results of operations and financial condition had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, VMware’s historical financial information is not necessarily indicative of what the Company’s cash flows, results of operations and financial condition will be in the future if and when VMware contracts at arm’s length with unrelated third parties for the services the Company receives from and provides to EMC.

Prior period financial statements have been reclassified to conform to current period presentation.

Principles of Consolidation

The consolidated financial statements include the accounts of VMware and its subsidiaries. All intercompany transactions and balances between VMware and its subsidiaries have been eliminated. All intercompany transactions

with EMC in the consolidated statements of cash flows will be settled in cash, and changes in the current intercompany balances are presented as a component of cash flows from operating activities.

Use of Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management

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VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses during the reporting periods, and the disclosure of contingent liabilities at the date of the financial statements. Estimates are used for, but not limited to, capitalized software development costs, trade receivable valuation, certain accrued liabilities, useful lives of fixed assets and intangible assets, valuation of acquired intangibles, revenue reserves, income taxes, stock-based compensation and contingencies. Actual results could differ from those estimates.

New Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update No. 2011-05, Presentation of Comprehensive Income (“ASU 2011-05”). ASU 2011-05 eliminated the option to report other comprehensive income and its components in the statement of changes in equity. Comprehensive income must be presented in one continuous statement of comprehensive income or two separate consecutive statements. In December 2011, the FASB issued an amendment to ASU 2011-05 that defers the requirement to present reclassification adjustments out of accumulated other comprehensive income on the face of the consolidated statement of income. VMware adopted this accounting standard update, as amended, on January 1, 2012, and presents comprehensive income in accordance with the requirements of the standard in this Quarterly Report on Form 10-Q.

B. Research and Development and Capitalized Software Development Costs

Development costs of software to be sold, leased, or otherwise marketed are subject to capitalization beginning when the product’s technological feasibility has been established and ending when the product is available for general release. Judgment is required in determining when technological feasibility is established, and as the Company’s business, products and go-to-market strategy have evolved, management has continued to evaluate when technological feasibility is established. Following the release of vSphere 5 and the comprehensive suite of cloud infrastructure technologies in the third quarter of 2011, management determined that VMware’s go-to-market strategy had changed from single solutions to product suite solutions. As a result of this change in strategy, and the related increased importance of interoperability between VMware’s products, the length of time between achieving technological feasibility and general release to customers significantly decreased. For future releases, management expects VMware’s products to be available for general release soon after technological feasibility has been established. VMware’s expensed and capitalized research and development (“R&D”) costs may not be comparable to VMware’s peer companies due to differences in judgment as to when technological feasibility has been reached or differences in judgment regarding when the product is available for general release. Additionally, future changes in management’s judgment as to when technological feasibility is established, or additional changes in VMware’s business, including its go-to-market strategy, could materially impact the amount of costs capitalized. For example, if the length of time between technological feasibility and general availability were to increase again in the future, the amount of capitalized costs would likely increase.

Generally accepted accounting principles require annual amortization expense of capitalized software development costs to be the greater of the amounts computed using the ratio of current gross revenue to a product’s total current and anticipated revenues, or the straight-line method over the product’s remaining estimated economic life. To date, VMware has amortized these costs using the straight-line method as it is the greater of the two amounts. The costs are amortized over periods ranging from 18 to 24 months, which represent the product’s estimated economic life. The ongoing assessment of the recoverability of these costs requires considerable judgment by management with respect to certain external factors such as anticipated future revenue, estimated economic life, and changes in software and hardware technologies. Material differences in amortization amounts could occur as a result of changes in the periods over which VMware actually generates revenues or the amounts of revenues generated.

Unamortized software development costs were \$62.3 million and \$104.9 million as of June 30, 2012 and December 31, 2011, respectively, and are included in capitalized software development costs, net and other on the consolidated balance sheets.

In the three and six months ended June 30, 2012, all software development costs were expensed as incurred and were included in R&D expenses on the accompanying consolidated statement of income. In the three months ended June 30, 2011, VMware capitalized \$29.6 million (including \$4.2 million of stock-based compensation) of costs incurred for the development of software products. In the six months ended June 30, 2011, VMware capitalized \$61.9 million (including \$9.0 million of stock-based compensation) of costs incurred for the development of software products. These amounts have been excluded from R&D expenses on the accompanying consolidated statements of income. Amortization expense from capitalized amounts was \$20.8 million and \$19.8 million for the three months ended June 30, 2012 and 2011, respectively. Amortization expense from capitalized amounts was \$42.6 million and \$48.3 million for the six months ended June 30, 2012 and 2011, respectively. Amortization expense is included in cost of license revenues on the consolidated statements of income.

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VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

C. Earnings per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the period, as calculated using the treasury stock method. Potentially dilutive securities primarily include stock options, unvested restricted stock units, and purchase options under VMware's employee stock purchase plan. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. VMware uses the two-class method to calculate earnings per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.

The following table sets forth the computations of basic and diluted net income per share for the three and six months ended June 30, 2012 and 2011 (table in thousands, except per share data):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Net income	\$ 191,729	\$ 220,158	\$ 383,165	\$ 345,970
Weighted-average shares, basic for Class A and Class B	427,223	419,657	426,106	418,557
Effect of dilutive securities	7,424	10,816	7,908	11,427
Weighted-average shares, diluted for Class A and Class B	434,647	430,473	434,014	429,984
Net income per weighted-average share, basic for Class A and Class B	\$0.45	\$0.52	\$0.90	\$0.83
Net income per weighted-average share, diluted for Class A and Class B	\$0.44	\$0.51	\$0.88	\$0.80

For the three months ended June 30, 2012 and 2011, stock options to purchase 0.4 million and 0.9 million shares, respectively, of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the three months ended June 30, 2012, 2.7 million shares of restricted stock were excluded from the diluted earnings per share calculations. For the three months ended June 30, 2011, no shares of restricted stock were excluded from the diluted earnings per share calculations.

For the six months ended June 30, 2012 and 2011, stock options to purchase 0.4 million and 1.2 million shares, respectively, of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the six months ended June 30, 2012 and 2011, 1.5 million and 0.4 million shares of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive.

D. Investments

Investments as of June 30, 2012 and December 31, 2011 consisted of the following (tables in thousands):

	June 30, 2012			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. Government and agency obligations	\$475,556	\$1,220	\$(73)	\$476,703
U.S. and foreign corporate debt securities	1,488,144	2,800	(821)	1,490,123
Foreign governments and multi-national agency obligations	39,138	14	(29)	39,123
Municipal obligations	1,160,540	2,442	(756)	1,162,226
Asset-backed securities	36,648	53	(10)	36,691
Mortgage-backed securities	65,122	129	(148)	65,103
Total investments	\$3,265,148	\$6,658	\$(1,837)	\$3,269,969

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VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

	December 31, 2011			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. Government and agency obligations	\$516,795	\$1,842	\$(23)	) \$518,614
U.S. and foreign corporate debt securities	1,134,009	1,404	(2,036)	) 1,133,377
Foreign governments and multi-national agency obligations	58,455	30	(87)	) 58,398
Municipal obligations	768,282	1,396	(437)	) 769,241
Asset-backed securities	27,107	2	(23)	) 27,086
Mortgage-backed securities	49,778	128	(172)	) 49,734
Total investments	\$2,554,426	\$4,802	\$(2,778)	) \$2,556,450

Both the realized gains and realized losses on investments were not material for the three and six months ended June 30, 2012. During the three months ended June 30, 2011, a realized gain of \$56.0 million was recorded in other income (expense), net on the consolidated income statement for the sale of VMware's investment in Terremark Worldwide, Inc. All other realized gains and losses on investments were not material for the three and six months ended June 30, 2011. In addition, VMware evaluated its investments as of June 30, 2012 and December 31, 2011 and determined that there were no unrealized losses that indicated an other-than-temporary impairment.

As of June 30, 2012 and December 31, 2011, VMware did not have investments in a material continuous unrealized loss position for twelve months or greater. Unrealized losses on investments as of June 30, 2012, and December 31, 2011, which have been in a net loss position for less than twelve months, were classified by investment category as follows (table in thousands):

	June 30, 2012		December 31, 2011	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government and agency obligations	\$214,612	\$(73)	) \$50,604	\$(23)
U.S. and foreign corporate debt securities	500,126	(819)	) 539,228	(2,036)
Foreign governments and multi-national agency obligations	31,175	(29)	) 43,026	(87)
Municipal obligations	407,195	(756)	) 298,187	(406)
Asset-backed securities	9,399	(10)	) 20,025	(23)
Mortgage-backed securities	38,309	(148)	) 32,817	(172)
Total	\$1,200,816	\$(1,835)	) \$983,887	\$(2,747)

Contractual Maturities

The contractual maturities of investments held at June 30, 2012 consisted of the following (table in thousands):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	\$1,275,888	\$1,276,571
Due after 1 year through 5 years	1,929,232	1,933,370
Due after 5 years	60,028	60,028
Total investments	\$3,265,148	\$3,269,969

E. Fair Value Measurements

Generally accepted accounting principles provide that fair value is an exit price, representing the amount that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, generally accepted

accounting principles established a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) inputs are quoted prices in

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VMware, Inc.

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active markets for identical assets or liabilities; (Level 2) inputs other than the quoted prices included within Level 1 that are observable for the assets or liabilities, either directly or indirectly; and (Level 3) unobservable inputs for the assets or liabilities in which there is little or no market data, which requires VMware to develop its own assumptions. VMware's Level 1 classification of the fair value hierarchy includes money market funds and certain available-for-sale fixed income securities because these securities are valued using quoted prices in active markets for identical assets. VMware's Level 2 classification includes the remainder of the available-for-sale fixed income securities because these securities are priced using quoted market prices for similar instruments and non-binding market prices that are corroborated by observable market data. VMware obtains the fair values of its Level 2 financial instruments based upon fair values obtained from its custody bank. In addition, VMware obtains fair values of its Level 2 financial instruments from the asset manager of each of its portfolios. VMware validates the fair value provided by its custody bank by comparing it against the independent pricing information obtained from the asset managers. Independently, the custody bank and the asset managers use professional pricing services to gather pricing data which may include quoted market prices for identical or comparable instruments, or inputs other than quoted prices that are observable either directly or indirectly. VMware is ultimately responsible for the financial statements and underlying estimates. Additionally, VMware's Level 2 classification includes foreign currency forward contracts as the valuation inputs for these are based upon quoted prices and quoted pricing intervals from public data sources. These contracts were not material for any period presented. VMware does not have any material assets or liabilities that fall into Level 3 of the fair value hierarchy.

The following tables set forth the fair value hierarchy of VMware's money market funds and available-for-sale securities, including those securities classified within cash and cash equivalents on the consolidated balance sheets, that were required to be measured at fair value as of June 30, 2012 and December 31, 2011 (tables in thousands):

	June 30, 2012		
	Level 1	Level 2	Total
Money-market funds	\$1,644,790	\$—	\$1,644,790
U.S. Government and agency obligations	283,364	193,339	476,703
U.S. and foreign corporate debt securities	—	1,554,617	1,554,617
Foreign governments and multi-national agency obligations	—	39,123	39,123
Municipal obligations	—	1,168,226	1,168,226
Asset-backed securities	—	36,691	36,691
Mortgage-backed securities	—	65,103	65,103
Total cash equivalents and investments	\$1,928,154	\$3,057,099	\$4,985,253

	December 31, 2011		
	Level 1	Level 2	Total
Money-market funds	\$1,345,904	\$—	\$1,345,904
U.S. Government and agency obligations	170,744	347,870	518,614
U.S. and foreign corporate debt securities	—	1,143,378	1,143,378
Foreign governments and multi-national agency obligations	—	58,397	58,397
Municipal obligations	—	769,241	769,241
Asset-backed securities	—	27,086	27,086
Mortgage-backed securities	—	49,734	49,734
Total cash equivalents and investments	\$1,516,648	\$2,395,706	\$3,912,354

F. Derivative Instruments

VMware conducts business in several foreign currencies and has international sales and expenses denominated in foreign currencies, subjecting the Company to foreign currency risk. To mitigate this risk, VMware enters into hedging activities as described below. The counterparties to VMware's foreign currency forward contracts are

multi-national commercial banks considered to be credit-worthy. VMware does not enter into speculative foreign exchange contracts for trading purposes.

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Cash Flow Hedging Activities

To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware entered into foreign currency forward contracts starting in the fourth quarter of 2011. The Company designates these forward contracts as cash flow hedging instruments as the accounting criteria for such designation has been met. Therefore, the effective portion of gains or losses resulting from changes in the fair value of these hedges is initially reported in accumulated other comprehensive income on the consolidated balance sheet, and is subsequently reclassified to the related operating expense line item in the consolidated statements of income in the same period that the underlying expenses are incurred. Interest charges or “forward points” on VMware’s forward contracts are excluded from the assessment of hedge effectiveness and are recorded in other income (expense), net in the consolidated statements of income as incurred. For the three and six months ended June 30, 2012, all amounts recognized on the consolidated statements of income related to VMware’s cash flow hedging program were immaterial.

VMware generally enters into cash flow hedges semi-annually with maturities of six months or less. As of June 30, 2012 and December 31, 2011, VMware had forward contracts to purchase currency designated as cash flow hedges with a total notional value of \$11.0 million and \$47.1 million, respectively. The fair value of these forward contracts was immaterial as of June 30, 2012 and therefore excluded from the fair value tables above. For the three and six months ended June 30, 2012, all cash flow hedges were considered effective.

Balance Sheet Hedging Activities

In order to manage exposure to foreign currency fluctuations, VMware enters into foreign currency forward contracts to hedge a portion of its net outstanding monetary assets and liabilities against movements in certain foreign exchange rates. These forward contracts are not designated as hedging instruments under applicable accounting guidance, and therefore all changes in the fair value of the forward contracts are reported in other income (expense), net in the consolidated statements of income. The gains and losses on VMware’s foreign currency forward contracts generally offset the majority of the gains and losses associated with the underlying foreign-currency denominated assets and liabilities that VMware hedges.

VMware’s foreign currency forward contracts are generally traded on a monthly basis with a typical contractual term of one month. As of June 30, 2012 and December 31, 2011, VMware had outstanding forward contracts with a total notional value of \$261.5 million and \$324.1 million, respectively. The fair value of these forward contracts was immaterial as of June 30, 2012 and December 31, 2011 and therefore excluded from the fair value tables above.

G. Business Combinations, Goodwill and Intangible Assets, Net**Business Combinations**

The results of operations of the acquired businesses mentioned below have been included in VMware’s consolidated financial statements from the date of purchase. Pro forma results of operations have not been presented as the results of the acquired businesses were not material to VMware’s consolidated results of operations in the three and six months ended June 30, 2012 and 2011.

In the six months ended June 30, 2012, VMware acquired three businesses. The aggregate consideration for these acquisitions was \$102.2 million, net of cash acquired. The following table summarizes the allocation of the consideration to the fair value of the tangible and intangible assets acquired in the six months ended June 30, 2012 (table in thousands):

Other current assets	\$ 531	
Intangible assets	33,800	
Goodwill	70,798	
Other assets	106	
Total tangible and intangible assets acquired	105,235	
Unearned revenues	(100)
Deferred tax liabilities, net	(1,460)

Accrued liabilities and other	(1,509)
Total liabilities assumed	(3,069)
Fair value of tangible and intangible assets acquired and liabilities assumed	\$ 102,166	

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Intangible Assets, Net

Changes in the carrying amount of intangible assets, net, excluding goodwill for the six months ended June 30, 2012 consisted of the following (table in thousands):

Balance, January 1, 2012	\$ 407,375	
Additions to intangible assets related to business combinations	33,800	
Change in accumulated amortization	(38,750)
Balance, June 30, 2012	\$ 402,425	

The following table summarizes the fair value of the intangible assets acquired by VMware through business combinations in the six months ended June 30, 2012 (table in thousands):

	Weighted-Average Useful Lives (in years)	Fair Value Amount
Purchased technology	5.9	\$ 33,800
Total intangible assets acquired, net, excluding goodwill		\$ 33,800

Goodwill

Changes in the carrying amount of goodwill for the six months ended June 30, 2012 consisted of the following (table in thousands):

Balance, January 1, 2012	\$ 1,759,080	
Increase in goodwill related to business combinations	70,798	
Deferred tax adjustments to purchase price allocations on previous acquisitions	(2,814)
Other adjustments to purchase price allocations on previous acquisitions	4	
Balance, June 30, 2012	\$ 1,827,068	

H. Property and Equipment, Net

Property and equipment, net, as of June 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	June 30, 2012	December 31, 2011
Equipment and software	\$ 563,494	\$ 512,754
Buildings and improvements	371,985	340,596
Furniture and fixtures	63,802	61,023
Construction in progress	75,670	68,707
Total property and equipment	1,074,951	983,080
Accumulated depreciation	(521,827	) (457,590
Total property and equipment, net	\$ 553,124	\$ 525,490

Depreciation expense was \$32.9 million and \$31.3 million in the three months ended June 30, 2012 and 2011, respectively, and \$65.7 million and \$62.0 million in the six months ended June 30, 2012 and 2011, respectively.

In the three months ended June 30, 2011, VMware closed an agreement to purchase the right, title and interest in a ground lease covering the property and improvements located adjacent to VMware's existing Palo Alto, California campus for a total cost of \$225.0 million. VMware paid the seller \$45.0 million in the three months ended March 31, 2011 as a good faith deposit and in the three months ended June 30, 2011, VMware paid the remaining \$180.0 million. Based upon the preliminary respective fair values, \$51.9 million of the purchase price was recorded to property and equipment, net on the consolidated balance sheet for the estimated fair value of the buildings and site improvements. The remaining \$173.1 million of the purchase price was attributed to the fair value of the ground lease and was recorded to intangible assets, net on the consolidated balance

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sheet. These amounts are reflected on the consolidated statements of cash flows for the three and six months ended June 30, 2011.

In the three months ended September 30, 2011, the gross amount classified to property and equipment, net was increased by \$22.0 million to \$73.9 million to reflect the final assumptions regarding VMware's intended use of the existing structures. As a result of this adjustment, the gross amount of the value recorded to intangible assets, net on the consolidated balance sheet was decreased by the same amount.

As of June 30, 2012 and December 31, 2011, construction in progress primarily represented buildings and site improvements related to VMware's Palo Alto campus expansion that had not yet been placed into service.

I. Accrued Expenses and Other

Accrued expenses and other as of June 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	June 30, 2012	December 31, 2011
Salaries, commissions, bonuses, and benefits	\$279,223	\$287,248
Accrued partner liabilities	110,274	124,359
Other	200,771	176,043
Total	\$590,268	\$587,650

Accrued partner liabilities relate to rebates and marketing development fund accruals for channel partners, system vendors and systems integrators, as well as accrued royalties.

J. Unearned Revenues

Unearned revenues as of June 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	June 30, 2012	December 31, 2011
Unearned license revenues	\$375,644	\$389,225
Unearned software maintenance revenues	2,356,977	2,133,512
Unearned professional services revenues	209,769	185,681
Total unearned revenues	\$2,942,390	\$2,708,418

Unearned license revenues are recognized either ratably or upon the delivery of existing products, future products or services. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive a promotional product at no additional charge.

VMware regularly offers product promotions as a strategy to improve awareness of its emerging products. To the extent promotional products have not been delivered and VSOE of fair value cannot be established, the revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. Increasingly, unearned license revenue may also be recognized ratably, which is generally due to a right to receive unspecified future products or a lack of VSOE of fair value on the software maintenance element of the arrangement. At June 30, 2012, the ratable component represented over half of the total unearned license revenue balance. Unearned software maintenance revenues are attributable to VMware's maintenance contracts and are recognized ratably over terms of one to five years with a weighted-average remaining term at June 30, 2012 of approximately 1.9 years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

K. Note Payable to EMC

In April 2007, VMware declared an \$800.0 million dividend to EMC paid in the form of a note payable, with interest payable quarterly in arrears and original maturity date of April 2012. In August 2007, VMware repaid \$350.0 million of the note payable, and as of June 30, 2012, \$450.0 million remained outstanding. In June 2011, VMware and EMC amended and restated the note to extend the maturity date of the note to April 16, 2015 and to modify the principal amount of the note to reflect the outstanding balance of \$450.0 million. The interest rate of the 90-day LIBOR plus 55

basis points continues to reset quarterly. For the three months ended June 30, 2012 and 2011, \$1.2 million and \$1.0 million, respectively, of interest expense were recorded related to the note payable. For the six months ended June 30, 2012 and 2011, \$2.4 million and \$1.9 million, respectively, of interest expense were recorded related to the note payable. The note may be repaid prior to the maturity date

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without penalty. No repayments of principal were made during the three and six months ended June 30, 2012 and 2011.

L. Income Taxes

Although VMware files a consolidated federal tax return with EMC, VMware calculates its income tax provision on a stand-alone basis. The Company's effective tax rate in the periods presented is the result of the mix of income earned in various tax jurisdictions that apply a broad range of income tax rates. The rate at which the provision for income taxes is calculated differs from the U.S. federal statutory income tax rate primarily due to different tax rates in foreign jurisdictions where income is earned and considered to be indefinitely reinvested.

VMware's effective income tax rate was 10.5% and 10.6% for the three months ended June 30, 2012 and 2011, respectively. The effective income tax rate was 12.5% and 14.0%, respectively, for the six months ended June 30, 2012 and 2011. The lower effective rate for the three and six months ended June 30, 2012, compared with the three and six months ended June 30, 2011, was primarily attributable to a jurisdictional shift of income from the U.S. to lower-tax non-U.S. jurisdictions, partially offset by a decrease in the release of unrecognized tax benefits from uncertain tax positions as a percentage of income before tax, as well as by the expiration of the federal research tax credit.

VMware's rate of taxation in foreign jurisdictions is lower than the U.S. tax rate. VMware's international income is primarily earned by VMware's subsidiaries in Ireland, where the statutory tax rate is 12.5%. Management does not believe that any recent or currently expected developments in non-U.S. tax jurisdictions are reasonably likely to have a material impact on VMware's effective tax rate. As of June 30, 2012, VMware's total cash, cash equivalents, and short-term investments were \$5,346.9 million, of which \$2,694.0 million were held outside the U.S. If these overseas funds are needed for its operations in the U.S., VMware would be required to accrue and pay U.S. taxes on related undistributed earnings to repatriate these funds. However, all income earned abroad, except for previously taxed income for U.S. tax purposes, is considered indefinitely reinvested in VMware's foreign operations and no provision for U.S. taxes has been provided with respect thereto. At this time, it is not practicable to estimate the amount of tax that may be payable were VMware to repatriate these funds, and VMware's current plans do not demonstrate a need to repatriate them to fund its U.S. operations. VMware will meet its U.S. liquidity needs through cash flows from operations, external borrowings, or both. VMware utilizes a variety of tax planning and financing strategies in an effort to ensure that its worldwide cash is available in the locations in which it is needed.

As of June 30, 2012, VMware had gross unrecognized tax benefits totaling \$87.3 million, which excludes \$10.6 million of offsetting tax benefits. Approximately \$82.6 million of VMware's net unrecognized tax benefits, not including interest, if recognized, would reduce income tax expense and lower VMware's effective tax rate in the period or periods recognized. The \$90.1 million of net unrecognized tax benefits, including interest, were classified as a non-current liability on the consolidated balance sheet. It is reasonably possible that within the next 12 months audit resolutions could potentially reduce total unrecognized tax benefits by between approximately \$7.0 million and \$9.0 million. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.

VMware recognizes interest expense and penalties related to income tax matters in the income tax provision. VMware recognized approximately \$0.4 million and \$1.6 million in interest and penalties for the three and six months ended June 30, 2012 and had accrued \$7.5 million of interest and penalties as of June 30, 2012, associated with the net unrecognized tax benefits. These amounts are included as components of the \$90.1 million of net unrecognized tax benefits as of June 30, 2012.

M. Commitments and Contingencies

Litigation

From time to time, VMware is subject to legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to intellectual property, contracts, employment and other matters. VMware accrues for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Significant judgment is required in both the

determination of probability and the determination as to whether a loss is reasonably estimable. These accruals are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. As of June 30, 2012 and December 31, 2011, the amounts accrued were not material. To the extent there is a reasonable possibility that the losses could exceed the amounts already accrued, management believes that the amount of any such additional loss would also be immaterial to VMware's consolidated financial position and results of operations.

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Operating Lease Commitments

VMware leases office facilities and equipment under various operating leases. Facility leases generally include renewal options. VMware's future lease commitments at June 30, 2012 were as follows (table in thousands):

2012	\$26,395
2013	51,171
2014	43,814
2015	34,425
2016	29,044
Thereafter	562,814
Total minimum lease payments	\$747,663

The amount of the future lease commitments after 2016 is primarily for the ground leases on VMware's Palo Alto, California headquarter facilities, which expire in 2046. As several of VMware's operating leases are payable in foreign currencies, the operating lease payments may fluctuate in response to changes in the exchange rate between the U.S. Dollar and the foreign currencies in which the commitments are payable.

N. Stockholders' Equity

VMware Stock Repurchase Programs

In February 2012, VMware's Board of Directors authorized the repurchase of up to \$600.0 million of VMware's Class A common stock through the end of 2013. In February 2011, a committee of VMware's Board of Directors authorized the repurchase of up to \$550.0 million of VMware's Class A common stock, which was completed in the second quarter of 2012.

From time to time, stock repurchases may be made pursuant to the February 2012 authorization in open market transactions or privately negotiated transactions as permitted by securities laws and other legal requirements. VMware is not obligated to purchase any shares under its stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased will depend on a variety of factors, including VMware's stock price, cash requirements for operations and business combinations, corporate and regulatory requirements and other market and economic conditions. Purchases can be discontinued at any time that VMware feels additional purchases are not warranted.

In both the three and six months ended June 30, 2012, VMware repurchased and retired 1.8 million shares of its Class A common stock at a weighted-average price of \$96.50 per share for an aggregate purchase price of \$178.2 million, including commissions. In the three and six months ended June 30, 2011, VMware repurchased and retired 1.4 million shares and 3.2 million shares, respectively, of its Class A common stock at a weighted-average price of \$91.60 per share and \$88.50 per share, respectively, for an aggregate purchase price of \$132.7 million and \$280.4 million, respectively, including commissions. The amount of repurchased shares was classified as a reduction to additional paid-in capital. As of June 30, 2012, the authorized amount remaining for repurchase was \$507.1 million.

VMware Employee Stock Purchase Plan

The following table summarizes Employee Stock Purchase Plan (the "ESPP") activity in the three and six months ended June 30, 2012 and 2011 (table in thousands, except per share amounts):

	Purchase Period Ended	
	January 31,	
	2012	2011
Cash proceeds	\$32,861	\$26,813
Class A common shares purchased	424	407
Weighted-average price per share	\$77.58	\$65.90

As of June 30, 2012, \$34.6 million of ESPP withholdings were recorded as a liability on the consolidated balance sheet for the next purchase in July 2012.

VMware Restricted Stock

VMware restricted stock units primarily consist of restricted stock unit (“RSU”) awards granted to employees. RSUs are valued based on the VMware stock price on the date of grant, and shares underlying RSU awards are not issued until the

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restricted stock units vest. Upon vesting, each RSU converts into one share of VMware Class A common stock. In the first half of 2012, VMware granted performance stock unit (“PSU”) awards to certain of its executives and employees. The awards will vest through the first quarter of 2015 if certain employee specific or VMware designated performance targets are achieved. If minimum performance thresholds are achieved, each PSU award will convert into VMware’s Class A common stock at a ratio ranging from 0.5 to 3.0 shares for each PSU, depending upon the degree of achievement of the performance target designated by each individual award. If minimum performance thresholds are not achieved, then no shares will be issued under that PSU award. As of June 30, 2012, 0.4 million PSUs were outstanding and are included in the table below.

The following table summarizes restricted stock activity since January 1, 2012 (stock units in thousands):

	Number of Stock Units	Weighted- Average Grant Date Fair Value (per stock unit)
Outstanding, January 1, 2012	9,540	\$72.74
Granted	5,052	106.17
Vested	(2,148	) 66.85
Forfeited	(748	) 74.39
Outstanding, June 30, 2012	11,696	88.61

The total fair value of VMware stock units that vested in the six months ended June 30, 2012 was \$199.9 million. As of June 30, 2012, stock units representing 11.7 million shares of VMware were outstanding, with an aggregate intrinsic value of \$1,064.8 million based on VMware’s closing price as of June 30, 2012. These stock units are scheduled to vest through 2016.

VMware Shares Repurchased for Tax Withholdings

In both the three months ended June 30, 2012 and 2011, VMware repurchased or withheld and retired 0.6 million shares of Class A common stock, for \$57.5 million and \$52.3 million, respectively, to cover tax withholding obligations. In both the six months ended June 30, 2012 and 2011, VMware repurchased or withheld and retired 0.8 million shares of Class A common stock, for \$72.0 million and \$73.5 million, respectively, to cover tax withholding obligations. These amounts differ from the amounts of cash remitted for tax withholding obligations on the consolidated statement of cash flows due to the timing of payments. Pursuant to the respective award agreements, these shares were repurchased or withheld in conjunction with the net share settlement upon the vesting of restricted stock and restricted stock units during the period. The value of the repurchased or withheld shares, including restricted stock units, was classified as a reduction to additional paid-in capital.

O. Related Party Transactions

In the second quarter of 2011, VMware acquired certain assets relating to EMC’s Mozy cloud-based data storage and data center services, including certain data center assets and a license to certain intellectual property. EMC retained ownership of the Mozy business and its remaining assets. EMC continues to be responsible to Mozy customers for Mozy products and services and continues to recognize revenue from such products and services. VMware entered into an operational support agreement with EMC through the end of 2012, pursuant to which VMware took over responsibility to operate the Mozy service on behalf of EMC. Pursuant to the support agreement, costs incurred by VMware to support EMC’s Mozy services, plus a mark-up intended to approximate third-party costs and a management fee, are reimbursed to VMware by EMC. On the consolidated statements of income, in the three months ended June 30, 2012 and 2011, such amounts as described above were approximately \$16.4 million and \$12.2 million, respectively. In the six months ended June 30, 2012 and 2011, such amounts were \$30.9 million and \$12.2 million, respectively. These amounts were recorded as a reduction to the costs VMware incurred.

In the second quarter of 2010, VMware acquired certain software product technology and expertise from EMC's Ionix IT management business for cash consideration of \$175.0 million. EMC retained the Ionix brand and will continue to offer customers the products acquired by VMware, pursuant to the ongoing reseller agreement between EMC and VMware. During the six months ended June 30, 2011, a \$12.5 million contingent payment was made to EMC. This payment was recorded as an equity transaction and was an offset to the initial capital contribution from EMC. As of December 31, 2011, all contingent payments under the agreement had been made.

Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's hardware and sells them to end-users. In the three months ended June 30, 2012 and 2011, VMware recognized revenues of

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\$45.6 million and \$14.2 million, respectively, from products and services sold pursuant to VMware's reseller arrangement with EMC. In the six months ended June 30, 2012 and 2011, VMware recognized revenues of \$80.6 million and \$34.2 million, respectively, from such contractual arrangement with EMC. As of June 30, 2012, \$107.6 million of revenues from products and services sold under the reseller arrangement were included in unearned revenues.

In the three months ended June 30, 2012 and 2011, VMware recognized professional services revenues of \$23.6 million and \$16.4 million, respectively, for services provided to EMC's customers pursuant to VMware's contractual agreements with EMC. In the six months ended June 30, 2012 and 2011, VMware recognized professional services revenues of \$42.3 million and \$30.8 million, respectively, from such contractual agreements with EMC. As of June 30, 2012, \$6.7 million of revenues from professional services to EMC customers were included in unearned revenues.

In the three months ended June 30, 2012 and 2011, VMware recognized revenues of \$2.1 million and \$0.5 million, respectively, from server and desktop products and services purchased by EMC for internal use pursuant to VMware's contractual agreements with EMC. In the six months ended June 30, 2012 and 2011, VMware recognized revenues of \$3.8 million and \$1.0 million, respectively, from such contractual agreements with EMC. As of June 30, 2012, \$22.7 million of revenues from server and desktop products and services purchased by EMC for internal use were included in unearned revenues.

VMware purchased storage systems and software, as well as consulting services, from EMC for \$5.9 million and \$7.5 million in the three months ended June 30, 2012 and 2011, respectively, and for \$23.9 million and \$13.3 million in the six months ended June 30, 2012 and 2011, respectively.

In certain geographic regions where VMware does not have an established legal entity, VMware contracts with EMC subsidiaries for support services and EMC personnel who are managed by VMware. The costs incurred by EMC on VMware's behalf related to these employees are passed on to VMware and VMware is charged a mark-up intended to approximate costs that would have been charged had VMware contracted for such services with an unrelated third party. These costs are included as expenses in VMware's consolidated statements of income and primarily include salaries, benefits, travel and rent. Additionally, EMC incurs certain administrative costs on VMware's behalf in the U.S. that are also recorded as expenses. The total cost of the services provided to VMware by EMC as described above was \$21.2 million and \$18.0 million in the three months ended June 30, 2012 and 2011, respectively, and \$49.0 million and \$42.7 million in the six months ended June 30, 2012 and 2011, respectively.

In the three and six months ended June 30, 2012, no payments were made by either VMware or EMC under the tax sharing agreement. In the three and the six months ended June 30, 2011, EMC paid VMware \$141.0 million and \$176.4 million, respectively, under the tax sharing agreement and no payments were made by VMware to EMC. Payments between VMware and EMC under the tax sharing agreement primarily relate to VMware's portion of federal income taxes on EMC's consolidated tax return. Payments from VMware to EMC primarily relate to periods for which VMware had stand-alone federal taxable income, while payments from EMC to VMware relate to periods for which VMware had a stand-alone federal taxable loss. The amounts that VMware either pays to or receives from EMC for its portion of federal income taxes on EMC's consolidated tax return differ from the amounts VMware would owe on a stand-alone basis and the difference is presented as a component of stockholders' equity. For all periods presented, the difference was not material.

In the three months ended June 30, 2012 and 2011, \$1.2 million and \$1.0 million, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on VMware's consolidated statements of income. In the six months ended June 30, 2012 and 2011, \$2.4 million and \$1.9 million, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on VMware's consolidated statements of income. VMware's interest expense as a separate, stand-alone company may be higher or lower than the amounts reflected in the consolidated financial statements.

As of June 30, 2012, VMware had \$61.7 million net due from EMC, which consisted of \$88.6 million due from EMC, partially offset by \$26.9 million due to EMC. These amounts resulted from the related party transactions described above. In addition to the \$61.7 million net due from EMC as of June 30, 2012, VMware had an immaterial amount of net income taxes payable to EMC, which is included in accrued expenses and other on VMware's consolidated balance sheets. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

P. Segment Information

VMware operates in one operating segment. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assessing performance. VMware's chief operating decision maker allocates resources and assesses performance

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based upon discrete financial information at the consolidated level. Since VMware operates in one operating segment, all required financial segment information can be found in the consolidated financial statements.

Revenues by geographic area for the three months ended June 30, 2012 and 2011 were as follows (table in thousands):

	For the Three Months Ended		For the Six Months Ended	
	June 30, 2012	2011	June 30, 2012	2011
United States	\$550,659	\$450,327	\$1,035,633	\$849,877
International	572,367	470,883	1,142,575	915,054
Total	\$1,123,026	\$921,210	\$2,178,208	\$1,764,931

No country other than the United States had material revenues for the three and six months ended June 30, 2012 or 2011.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of June 30, 2012 and December 31, 2011 were as follows (table in thousands):

	June 30, 2012	December 31, 2011
United States	\$466,115	\$429,678
International	45,331	46,477
Total	\$511,446	\$476,155

No country other than the United States accounted for 10% or more of these assets at June 30, 2012 or December 31, 2011, respectively.

Q. Subsequent Events

In July 2012, VMware, Inc. entered into a definitive agreement to acquire Nicira, Inc. ("Nicira"), a developer of software-defined networking solutions, for approximately \$1,050.0 million in cash plus approximately \$210.0 million of assumed unvested equity awards. The acquisition is subject to regulatory approvals and other customary closing conditions. The parties expect the acquisition to close during the second half of 2012. The acquisition has been approved by the boards of directors of both VMware and Nicira and the stockholders of Nicira.

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

All dollar amounts expressed as numbers in this MD&A (except share and per share amounts) are in millions.

Overview

Our primary source of revenues is the licensing of virtualization and virtualization-based cloud infrastructure solutions and related support and services for use by businesses and organizations of all sizes and across numerous industries in their information technology ("IT") infrastructure.

We have developed a multi-channel distribution model to expand our global presence and to reach various segments of the industry. In the second quarter and first half of 2012, we derived over 85% of our sales from our channel partners, which include distributors, resellers, system vendors and systems integrators. Sales to our channel partners often involve three tiers of distribution: a distributor, a reseller and an end-user customer. Our sales force works collaboratively with our channel partners to introduce them to customers and new sales opportunities. As we expand geographically, we expect to continue to add additional channel partners.

Although we believe we are currently the leading provider of virtualization infrastructure software solutions, we face competitive threats to our leadership position from a number of companies, some of which have significantly greater resources than we do, which could result in increased pressure to reduce prices on our offerings. As a result, we believe it is important to continue to invest in strategic initiatives related to product research and development, market expansion and associated support functions to expand our industry leadership. We believe that we will be able to continue to meet our product development objectives through continued investment in our existing infrastructure, supplemented with strategic hires and acquisitions, funded through the operating cash flows generated from the sale of our products and services. We believe this is the appropriate priority for the long-term health and growth of our business.

We expect to grow our business by broadening our virtualization infrastructure software solutions technology and product portfolio, increasing product awareness, promoting the adoption of virtualization and building long-term relationships with our customers through the adoption of enterprise license agreements ("ELAs"). Since the introduction of VMware vSphere in 2009, we have introduced more products that build on the vSphere foundation, including VMware vSphere 5 and a comprehensive suite of cloud infrastructure technologies, as well as VMware View 5. We plan to continue to introduce additional products in the future. We have made, and expect to continue to make, acquisitions designed to strengthen our product offerings or extend our strategy to deliver solutions that can be hosted at customer data centers or at service providers.

Our current financial focus is on long-term revenue growth to generate free cash flows to fund our expansion of industry segment share and to evolve our virtualization-based products for data centers, end-user devices and cloud computing through a combination of internal development and acquisitions. See "Non-GAAP Financial Measures" for further information on free cash flows. In evaluating our results, we also focus on operating margin excluding certain expenses which are included in our total operating expenses calculated in accordance with GAAP. The expenses excluded are stock-based compensation, the net effect of the amortization and capitalization of software development costs and certain other expenses consisting of employer payroll taxes on employee stock transactions, amortization of intangible assets and acquisition-related items. We believe this measure reflects our ongoing business in a manner that allows meaningful period-to-period comparisons. We are not currently focused on short-term operating margin expansion, but rather on investing at appropriate rates to support our growth and future product offerings in what may be a substantially more competitive environment.

Although our customers continue to adopt our product platform as a strategic investment that improves efficiency and flexibility for their business and enables substantial cost savings, we remain cautious about the macroeconomic environment. The volatility we are observing in both the world economy and individual sovereign nations may impact IT spending and demand for our products and services for the remainder of 2012. We expect to continue to manage our resources prudently, while making key investments in support of our long-term growth objectives.

Income Statement Presentation

As we operate our business in one operating segment, our revenues and operating expenses are presented and discussed at the consolidated level.

As a consequence of the timing differences in the recognition of license revenues and software maintenance revenues, variability in operating margin can result from differences between when we quote and contract for our services and when the cost is incurred. Variability in operating margin can also result when we recognize previously unearned foreign denominated software maintenance and license revenues in future periods. Due to our use of the U.S. Dollar as our functional currency, unearned revenue remains at its historical rate when recognized into revenue while our operating expenses in future periods are based upon the foreign exchange rates at that time.

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Sources of Revenues

License revenues

Our license revenues consist of revenues earned from the licensing of our software products. These products are generally licensed on a perpetual basis. License revenues are recognized when the elements of revenue recognition for the licensed software are complete, generally upon electronic shipment of the software. The revenues allocated to the software license included in multiple-element contracts represent the residual amount of the contract after the fair value of the other elements has been determined. While some of our products are licensed on a subscription basis, subscription license revenues are not a material part of our business.

Pricing models have generally been based upon the physical infrastructure, such as the number of physical desktop computers or server processors, on which our software runs. We base pricing for some of our products on virtual, rather than purely physical, entitlements, while continuing to license such products on a perpetual basis. In the third quarter of 2011, we revised the pricing model for VMware vSphere 5 effective with its general availability. VMware vSphere 5 will continue to be licensed perpetually on a per-processor basis. The two physical constraints, number of cores and physical RAM, have been eliminated, however, and replaced with a single virtualization-based entitlement of virtual memory, or vRAM, which can be shared across a large pool of servers.

Software maintenance revenues

Software maintenance revenues are recognized ratably over the contract period. Our contract periods typically range from one to five years and include renewals of software maintenance sold after the initial software maintenance period expires. Vendor-specific objective evidence (“VSOE”) of fair value for software maintenance services is established by the rates charged in stand-alone sales of software maintenance contracts. Customers receive various types of technical support based on the level of support purchased. Customers who are party to software maintenance agreements with us are entitled to receive product updates and upgrades on a when-and-if-available basis.

Professional services revenues

Professional services include solution design, implementation and training. Professional services are not considered essential to the functionality of our products, as these services do not alter the product capabilities and may be performed by our customers or by other vendors. Professional services engagements performed for a fixed fee, for which we are able to make reasonably dependable estimates of progress toward completion, are recognized on a proportional performance basis based on hours incurred and estimated hours of completion. Professional services engagements that are on a time and materials basis are recognized based on hours incurred. Revenues on all other professional services engagements are recognized upon completion. Our professional services may be sold with software products or on a stand-alone basis. VSOE of fair value for professional services is based upon the standard rates we charge for such services when sold separately.

Operating Expenses

Cost of license revenues

Our cost of license revenues principally consist of the amortization of capitalized software development costs and of intangibles, as well as royalty costs in connection with technology licensed from third-party providers and the cost of fulfillment of our software. The cost of fulfillment of our software includes product packaging, personnel costs and related overhead associated with the physical and electronic delivery of our software products.

Cost of services revenues

Our cost of services revenues include the costs of personnel and related overhead to deliver technical support for our products and to provide our professional services.

Research and development expenses

Our research and development (“R&D”) expenses include the personnel and related overhead associated with the R&D of new product offerings and the enhancement of our existing software offerings, net of amounts capitalized.

Sales and marketing expenses

Our sales and marketing expenses include personnel costs, sales commissions and related overhead associated with the sale and marketing of our license and services offerings, as well as the cost of product launches and certain marketing initiatives, including our annual VMworld conferences in the U.S. and Europe. Sales commissions are generally earned and expensed when a firm order is received from the customer and may be expensed in a period other

than the period in which the related revenue is recognized.

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General and administrative expenses

Our general and administrative expenses include personnel and related overhead costs to support the overall business. These expenses include the costs associated with our facilities, finance, human resources, IT infrastructure and legal departments, as well as expenses related to corporate costs and initiatives.

Results of Operations

Revenues

Our revenues in the second quarter and first half of 2012 and 2011 were as follows:

	For the Three Months Ended			For the Six Months Ended				
	June 30, 2012	2011	% Change	June 30, 2012	2011	% Change		
Revenues:								
License	\$517.2	\$464.8	11	% \$999.1	\$883.8	13	%	
Services:								
Software maintenance	519.1	386.3	34	1,011.4	750.1	35		
Professional services	86.7	70.1	24	167.7	131.0	28		
Total services	605.8	456.4	33	1,179.1	881.1	34		
Total revenues	\$1,123.0	\$921.2	22	\$2,178.2	\$1,764.9	23		
Revenues:								
United States	\$550.7	\$450.3	22	% \$1,035.6	\$849.9	22	%	
International	572.3	470.9	22	1,142.6	915.0	25		
Total revenues	\$1,123.0	\$921.2	22	\$				