

VMWARE, INC.

Form 10-Q

November 09, 2015

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 September 30, 2015

OR

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 001-33622

VMWARE, INC.

(Exact name of registrant as specified in its charter)

Delaware

94-3292913

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer 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 October 31, 2015, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 421,019,601 of which 121,019,601 shares were Class A common stock and 300,000,000 were Class B common stock.



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## PART I

## FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(amounts in millions, except per share amounts, and shares in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2015	2014	2015	2014	
Revenues:					
License	\$681	\$639	\$1,896	\$1,814	
Services	991	876	2,883	2,519	
GSA settlement	—	—	(76)	) —	
Total revenues	1,672	1,515	4,703	4,333	
Operating expenses <sup>(1)</sup> :					
Cost of license revenues	46	46	142	143	
Cost of services revenues	212	196	609	519	
Research and development	331	327	958	936	
Sales and marketing	556	529	1,656	1,550	
General and administrative	201	169	568	498	
Realignment charges	—	6	20	4	
Operating income	326	242	750	683	
Investment income	13	11	38	28	
Interest expense with EMC	(7	) (7	) (20	) (18	)
Other income (expense), net	(7	) (2	) (8	) (2	)
Income before income taxes	325	244	760	691	
Income tax provision	69	50	137	131	
Net income	\$256	\$194	\$623	\$560	
Net income per weighted-average share, basic for Class A and Class B	\$0.61	\$0.45	\$1.47	\$1.30	
Net income per weighted-average share, diluted for Class A and Class B	\$0.60	\$0.45	\$1.46	\$1.29	
Weighted-average shares, basic for Class A and Class B	422,329	430,463	424,799	430,408	
Weighted-average shares, diluted for Class A and Class B	423,981	434,118	427,466	434,656	

(1) Includes stock-based compensation as follows:

Cost of license revenues	\$—	\$1	\$1	\$2
Cost of services revenues	11	11	32	31
Research and development	56	61	164	187
Sales and marketing	43	43	124	128
General and administrative	16	17	47	51

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

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VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(in millions)

(unaudited)

	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2015	2014	2015	2014	
Net income	\$256	\$194	\$623	\$560	
Other comprehensive income (loss):					
Changes in market value of available-for-sale securities:					
Unrealized gains (losses), net of taxes of \$1, \$(2), \$1 and \$1	1	(3	) 2	2	
Reclassification of (gains) losses realized during the period, net of taxes of \$0, \$(1), \$0 and \$(2) for all periods	—	(1	) —	(2	)
Net change in market value of available-for-sale securities	1	(4	) 2	—	
Changes in market value of effective foreign currency forward contracts:					
Unrealized gains (losses), net of taxes of \$0 for all periods	1	(3	) (4	) (3	)
Reclassification of (gains) losses realized during the period, net of taxes of \$0 for all periods	(2	) (1	) —	—	
Net change in market value of effective foreign currency forward contracts	(1	) (4	) (4	) (3	)
Total other comprehensive income (loss)	—	(8	) (2	) (3	)
Total comprehensive income, net of taxes	\$256	\$186	\$621	\$557	

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

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VMware, Inc.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(amounts in millions, except per share amounts, and shares in thousands)

(unaudited)

	September 30, 2015	December 31, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$2,083	\$2,071
Short-term investments	5,139	5,004
Accounts receivable, net of allowance for doubtful accounts of \$2 and \$2	1,011	1,520
Due from related parties, net	25	49
Deferred tax assets	254	248
Other current assets	150	238
Total current assets	8,662	9,130
Property and equipment, net	1,124	1,035
Other assets	175	174
Deferred tax assets	204	165
Intangible assets, net	645	748
Goodwill	3,981	3,964
Total assets	\$14,791	\$15,216
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$139	\$203
Accrued expenses and other	622	811
Unearned revenues	2,989	2,982
Total current liabilities	3,750	3,996
Notes payable to EMC	1,500	1,500
Unearned revenues	1,697	1,851
Other liabilities	310	283
Total liabilities	7,257	7,630
Contingencies (refer to Note I)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 121,799 and 129,359 shares	1	1
Class B convertible common stock, par value \$.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3
Additional paid-in capital	2,707	3,380
Accumulated other comprehensive income (loss)	(3	) (1
Retained earnings	4,821	4,198
Total VMware, Inc.'s stockholders' equity	7,529	7,581
Non-controlling interests	5	5
Total stockholders' equity	7,534	7,586
Total liabilities and stockholders' equity	\$14,791	\$15,216
The accompanying notes are an integral part of the condensed consolidated financial statements.		

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VMware, Inc.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Nine Months Ended September 30,	
	2015	2014
Operating activities:		
Net income	\$623	\$560
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	246	255
Stock-based compensation	368	399
Excess tax benefits from stock-based compensation	(27)	(34)
Deferred income taxes, net	(44)	(115)
Impairment of strategic investment	5	—
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	508	293
Other assets	14	(70)
Due to/from related parties, net	31	25
Accounts payable	(36)	41
Accrued expenses	(153)	(4)
Income taxes payable	24	178
Unearned revenues	(148)	237
Net cash provided by operating activities	1,411	1,765
Investing activities:		
Additions to property and equipment	(274)	(254)
Purchases of available-for-sale securities	(2,675)	(2,974)
Sales of available-for-sale securities	1,700	1,551
Maturities of available-for-sale securities	840	483
Purchases of strategic investments	(11)	(41)
Business acquisitions, net of cash acquired	(21)	(1,112)
Decrease (increase) in restricted cash	77	(76)
Other investing	2	(10)
Net cash used in investing activities	(362)	(2,433)
Financing activities:		
Proceeds from issuance of common stock	123	158
Proceeds from issuance of notes payable to EMC	—	1,050
Reduction in capital from EMC	—	(24)
Proceeds from non-controlling interests	4	7
Repurchase of common stock	(1,050)	(450)
Excess tax benefits from stock-based compensation	27	34
Shares repurchased for tax withholdings on vesting of restricted stock	(141)	(119)
Net cash provided by (used in) financing activities	(1,037)	656
Net increase (decrease) in cash and cash equivalents	12	(12)
Cash and cash equivalents at beginning of the period	2,071	2,305
Cash and cash equivalents at end of the period	\$2,083	\$2,293
Supplemental disclosures of cash flow information:		
Cash paid for interest	\$21	\$20
Cash paid for taxes, net	155	65



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Non-cash items:

Changes in capital additions, accrued but not paid	\$(49	)	\$(3	)
Fair value of stock-based awards assumed in acquisitions	—		25	

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

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (“VMware” or the “Company”) is the leader in virtualization infrastructure solutions utilized by organizations to help them transform the way they build, deliver and consume information technology (“IT”) resources. VMware’s virtualization infrastructure solutions, which include a suite of products and services designed to deliver a software-defined data center, 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 (“GAAP”).

Unaudited Interim Financial Information

The accompanying unaudited condensed 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 condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s condensed consolidated results of operations, financial position and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2015. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware’s 2014 Annual Report on Form 10-K.

As of September 30, 2015, EMC Corporation (“EMC”) held 81.3% of VMware’s outstanding common stock and 97.5% of the combined voting power of VMware’s outstanding common stock, including 43 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. On October 12, 2015, Dell, Inc. (“Dell”), Denali Holding Inc. (“Denali”) and EMC entered into a definitive agreement under which Denali has agreed to acquire EMC. Refer to Note M for further information.

Management believes the assumptions underlying the condensed 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. Therefore, the financial statements included herein may not necessarily reflect the results of operations, financial position and cash flows 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 results of operations, financial position and cash flows 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.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and subsidiaries in which VMware has a controlling financial interest. Non-controlling interests are presented as a separate component within total stockholders’ equity and represent the equity and cumulative pro-rata share of the results of operations attributable to the non-controlling interests. Net earnings attributable to the non-controlling interests are included in other income (expense), net on the condensed consolidated statements of income and are not presented separately as the amounts were not material for the periods presented. All intercompany transactions and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with EMC and its subsidiaries are generally settled in cash and are classified on the condensed consolidated statements of cash flows based upon the nature of the underlying transaction.

Reclassification

Certain prior period amounts related to the notes payable to EMC have been reclassified within the financing activities section of the condensed consolidated statements of cash flows. The reclassifications had no effect on total cash flows used in or provided by operating, investing or financing activities as previously reported.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Use of Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management 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, trade receivable valuation, marketing development funds and rebates, useful lives assigned to fixed assets and intangible assets, valuation of goodwill and definite-lived intangibles, income taxes, stock-based compensation, and contingencies. Actual results could differ from those estimates.

## New Accounting Pronouncement

During May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated revenue standard establishes principles for recognizing revenue and develops a common revenue standard for all industries. Upon adoption, entities will be required to recognize the amount of revenue that they expect to be entitled to for the transfer of promised goods or services to their customers. The updated standard is effective for the Company in the first quarter of 2018 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is permitted, but not earlier than the first quarter of 2017. The Company has not selected a transition method and is currently evaluating the effect that ASU 2014-09 will have on its consolidated financial statements and related disclosures.

## B. Business Combination, Definite-Lived Intangible Assets, Net and Goodwill

## Business Combination

On February 2, 2015, VMware acquired all of the outstanding shares of Immidio B.V. (“Immidio”) for approximately \$21 million of cash, net of liabilities assumed. VMware acquired Immidio to expand VMware’s Workspace Environment Management solutions within the End-User Computing product group. The preliminary purchase price primarily included \$8 million of identifiable intangible assets and approximately \$17 million of goodwill that is expected to be non-deductible for tax purposes. The impact of the acquisition was not material to VMware’s condensed consolidated financial statements.

## Definite-Lived Intangible Assets, Net

As of September 30, 2015 and December 31, 2014, definite-lived intangible assets consisted of the following (amounts in tables in millions):

	September 30, 2015			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.6	\$651	\$(281)	) \$370
Leasehold interest	34.9	149	(19)	) 130
Customer relationships and customer lists	8.3	151	(60)	) 91
Trademarks and tradenames	8.6	61	(14)	) 47
Other	2.9	20	(13)	) 7
Total definite-lived intangible assets		\$1,032	\$(387)	) \$645
	December 31, 2014			
	Weighted-Average Useful Lives (in years)	Gross Carrying Amount	Accumulated Amortization	Net Book Value
Purchased technology	6.5	\$699	\$(252)	) \$447
Leasehold interest	34.9	149	(15)	) 134
Customer relationships and customer lists	8.2	157	(53)	) 104
Trademarks and tradenames	8.6	61	(9)	) 52
Other	2.7	18	(7)	) 11

Total definite-lived intangible assets	\$1,084	\$(336	) \$748
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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Amortization expense on definite-lived intangible assets was \$36 million and \$110 million during the three and nine months ended September 30, 2015, respectively, and \$37 million and \$104 million during the three and nine months ended September 30, 2014, respectively.

Based on intangible assets recorded as of September 30, 2015 and assuming no subsequent additions or impairment of underlying assets, the remaining estimated annual amortization expense is expected to be as follows (table in millions):

Remainder of 2015	\$35
2016	128
2017	121
2018	108
2019	87
Thereafter	166
Total	\$645

## Goodwill

The following table summarizes the changes in the carrying amount of goodwill during the nine months ended September 30, 2015 (table in millions):

Balance, January 1, 2015	\$3,964
Increase in goodwill related to a business combination	17
Balance, September 30, 2015	\$3,981

## C. Realignment Charges

During the first quarter of 2015, VMware eliminated approximately 350 positions across all major functional groups and geographies to streamline its operations. As a result of this action, \$20 million of severance-related realignment charges were recognized during the nine months ended September 30, 2015. As of September 30, 2015, \$1 million remained in accrued expenses and other on the condensed consolidated balance sheets and is expected to be paid during 2015.

The following table summarizes the activity for the accrued realignment charges for the nine months ended September 30, 2015 (table in millions):

	Nine Months Ended September 30, 2015			Balance as of September 30, 2015
	Balance as of January 1, 2015	Realignment Charges	Utilization	
Severance-related costs	\$8	\$20	\$(27)	\$1

During the third quarter of 2014, VMware eliminated approximately 90 positions across all major functional groups and geographies to streamline its operations. As a result of these actions, \$7 million of severance-related realignment charges was recognized during the three months ended September 30, 2014.

## D. Net Income 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 unvested restricted stock units, performance stock units, stock options 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 net income per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following table sets forth the computations of basic and diluted net income per share during the three and nine months ended September 30, 2015 and 2014 (net income in millions, shares in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Net income	\$256	\$194	\$623	\$560
Weighted-average shares, basic for Class A and Class B	422,329	430,463	424,799	430,408
Effect of dilutive securities	1,652	3,655	2,667	4,248
Weighted-average shares, diluted for Class A and Class B	423,981	434,118	427,466	434,656
Net income per weighted-average share, basic for Class A and Class B	\$0.61	\$0.45	\$1.47	\$1.30
Net income per weighted-average share, diluted for Class A and Class B	\$0.60	\$0.45	\$1.46	\$1.29

The following table sets forth the weighted-average common share equivalents of Class A common stock that were excluded from the diluted net income per share calculations during the three and nine months ended September 30, 2015 and 2014, because their effect would have been anti-dilutive (shares in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Anti-dilutive securities:				
Employee stock options	2,129	1,180	2,173	1,244
Restricted stock units	365	107	58	37
Total	2,494	1,287	2,231	1,281



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## E. Cash, Cash Equivalents and Investments

Cash, cash equivalents and investments as of September 30, 2015 and December 31, 2014 consisted of the following (tables in millions):

	September 30, 2015			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$770	\$—	\$—	\$770
Cash equivalents:				
Money-market funds	\$1,312	\$—	\$—	\$1,312
Municipal obligations	1	—	—	1
Total cash equivalents	\$1,313	\$—	\$—	\$1,313
Short-term investments:				
U.S. Government and agency obligations	\$642	\$3	\$—	\$645
U.S. and foreign corporate debt securities	3,337	5	(8	) 3,334
Foreign governments and multi-national agency obligations	35	—	—	35
Municipal obligations	823	1	—	824
Asset-backed securities	30	—	—	30
Mortgage-backed securities	271	—	—	271
Total short-term investments	\$5,138	\$9	\$(8	) \$5,139
Other assets:				
Marketable available-for-sale equity securities	\$15	\$1	\$—	\$16
	December 31, 2014			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
Cash	\$885	\$—	\$—	\$885
Cash equivalents:				
Money-market funds	\$1,130	\$—	\$—	\$1,130
U.S. and foreign corporate debt securities	54	—	—	54
Foreign governments and multi-national agency obligations	2	—	—	2
Total cash equivalents	\$1,186	\$—	\$—	\$1,186
Short-term investments:				
U.S. Government and agency obligations	\$542	\$—	\$—	\$542
U.S. and foreign corporate debt securities	3,236	3	(5	) 3,234
Foreign governments and multi-national agency obligations	23	—	—	23
Municipal obligations	930	2	—	932
Asset-backed securities	53	—	—	53
Mortgage-backed securities	221	—	(1	) 220
Total short-term investments	\$5,005	\$5	\$(6	) \$5,004

Refer to Note F for further information regarding the fair value of VMware's cash equivalents and investments.

The realized gains and losses on investments during the three and nine months ended September 30, 2015 and 2014 were not material.



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Unrealized losses on cash equivalents and investments as of September 30, 2015 and December 31, 2014, which have been in a net loss position for less than twelve months, were classified by investment category as follows (table in millions):

	September 30, 2015		December 31, 2014	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and foreign corporate debt securities	\$1,545	\$(7 )	\$1,964	\$(5 )
Mortgage-backed securities	132	(1 )	107	(1 )
Total	\$1,677	\$(8 )	\$2,071	\$(6 )

Unrealized losses on cash equivalents and available-for-sale investments, which have been in a net loss position for twelve months or greater, were not material as of September 30, 2015 and December 31, 2014.

**Contractual Maturities**

The contractual maturities of short-term investments held at September 30, 2015 consisted of the following (table in millions):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	\$1,592	\$1,593
Due after 1 year through 5 years	3,243	3,243
Due after 5 years through 10 years	95	95
Due after 10 years	208	208
Total short-term investments	\$5,138	\$5,139

**F. Fair Value Measurements****Assets and Liabilities Measured and Recorded at Fair Value on a Recurring Basis**

Certain financial assets and liabilities are measured at fair value on a recurring basis. VMware determines fair value using the following hierarchy:

Level 1 - Quoted prices in active markets for identical assets or liabilities

Level 2 - Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are noted active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

VMware's fixed income securities are primarily classified as Level 2, with the exception of some of the U.S.

Government and agency obligations which are classified as Level 1. Additionally, VMware's Level 2 classification includes foreign currency forward contracts and notes payable to EMC. At September 30, 2015 and December 31, 2014, VMware's Level 2 securities were generally priced using non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques.

VMware did not have any material assets or liabilities that fall into Level 3 of the fair value hierarchy as of September 30, 2015 and December 31, 2014, and there have been no transfers between fair value measurement levels during the three and nine months ended September 30, 2015 and 2014.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

The following tables set forth the fair value hierarchy of VMware's money-market funds, available-for-sale securities, and foreign currency forward contracts, that were required to be measured at fair value as of September 30, 2015 and December 31, 2014 (tables in millions):

	September 30, 2015		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$1,312	\$—	\$1,312
Municipal obligations	—	1	1
Total cash equivalents	\$1,312	\$1	\$1,313
Short-term investments:			
U.S. Government and agency obligations	\$472	\$173	\$645
U.S. and foreign corporate debt securities	—	3,334	3,334
Foreign governments and multi-national agency obligations	—	35	35
Municipal obligations	—	824	824
Asset-backed securities	—	30	30
Mortgage-backed securities	—	271	271
Total short-term investments	\$472	\$4,667	\$5,139
Other assets:			
Marketable available-for-sale equity securities	\$16	\$—	\$16
Accrued expenses and other:			
Foreign currency forward contracts	\$—	\$(3)	\$(3)
	December 31, 2014		
	Level 1	Level 2	Total
Cash equivalents:			
Money-market funds	\$1,130	\$—	\$1,130
U.S. and foreign corporate debt securities	—	54	54
Foreign governments and multi-national agency obligations	—	2	2
Total cash equivalents	\$1,130	\$56	\$1,186
Short-term investments:			
U.S. Government and agency obligations	\$353	\$189	\$542
U.S. and foreign corporate debt securities	—	3,234	3,234
Foreign governments and multi-national agency obligations	—	23	23
Municipal obligations	—	932	932
Asset-backed securities	—	53	53
Mortgage-backed securities	—	220	220
Total short-term investments	\$353	\$4,651	\$5,004
Other current assets:			
Foreign currency forward contracts	\$—	\$1	\$1
Accrued expenses and other:			
Foreign currency forward contracts	\$—	\$(1)	\$(1)

VMware has elected not to record its notes payable to EMC at fair value, but has measured the notes at fair value for disclosure purposes. As of September 30, 2015 and December 31, 2014, the fair value of the notes payable to EMC was \$1,499 million and \$1,503 million, respectively. Fair value was estimated based on observable market interest rates (Level 2 inputs).



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

VMware offers a deferred compensation plan for eligible employees that allows participants to defer payment for part or all of their compensation. VMware's results of operations are not significantly affected by this plan since changes in the fair value of the assets substantially offset changes in the fair value of the liabilities. As such, assets and liabilities associated with this plan have not been included in the above tables. Assets and liabilities associated with this plan were both approximately \$18 million and \$8 million as of September 30, 2015 and December 31, 2014, respectively, and are included in other assets and other liabilities on the condensed consolidated balance sheets.

**Assets Measured and Recorded at Fair Value on a Non-Recurring Basis**

VMware evaluated the strategic investments in its portfolio accounted for under the cost method to assess whether any of its strategic investments were other-than-temporarily impaired. VMware uses Level 3 inputs as part of its impairment analysis, including, pre- and post-money valuations of recent financing events and the impact of those on its fully diluted ownership percentages, as well as other available information regarding the issuer's historical and forecasted performance. The estimated fair value of these investments is considered in VMware's impairment review if any events or changes in circumstances occur that might have a significant adverse effect on their value.

During the three and nine months ended September 30, 2015, VMware recognized a charge of approximately \$5 million as a result of determining that a strategic investment was considered to be other-than-temporarily impaired. All other realized gains and losses on investments in the three and nine months ended September 30, 2015 and 2014 were not material. Strategic investments are included in other assets on the condensed consolidated balance sheets. The carrying value of VMware's strategic investments accounted for under the cost method was \$100 million and \$110 million as of September 30, 2015 and December 31, 2014, respectively.

**G. Derivatives and Hedging Activities**

VMware conducts business on a global basis in multiple foreign currencies, subjecting the Company to foreign currency risk. To mitigate this risk, VMware utilizes hedging contracts as described below, which potentially expose the Company to credit risk to the extent that the counterparties may be unable to meet the terms of the agreement. VMware manages counterparty risk by seeking counterparties of high credit quality, by monitoring credit ratings and credit spreads of, and other relevant public information about its counterparties. VMware does not, and does not intend to, use derivative instruments for trading or speculative purposes.

**Cash Flow Hedges**

To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware enters into foreign currency forward contracts. The Company designates these forward contracts as cash flow hedging instruments as the accounting criteria for such designation have 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 (loss) on the condensed consolidated balance sheets and is subsequently reclassified to the related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. During the three and nine months ended September 30, 2015 and 2014 the effective portion of gains or losses reclassified to the condensed consolidated statements of income was not material to the individual functional line items. 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 on the condensed consolidated statements of income as incurred.

VMware enters into forward contracts annually, which have maturities of 12 months or less. As of September 30, 2015 and December 31, 2014, VMware had foreign currency forward contracts designated as cash flow hedges with a total notional value of \$64 million and \$240 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

During the three and nine months ended September 30, 2015 and 2014, all cash flow hedges were considered effective.

**Foreign Currency Forward Contracts Not Designated as Hedges**

VMware has established a program that utilizes foreign currency forward contracts to offset the foreign currency risk associated with net outstanding monetary asset and liability positions. 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 on the condensed consolidated statements of income.

VMware enters into foreign currency forward contracts on a monthly basis, which typically have a contractual term of one month. As of September 30, 2015 and December 31, 2014, VMware had outstanding forward contracts with a total notional

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

value of \$511 million and \$697 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

During the three and nine months ended September 30, 2015, VMware recognized a gain of \$12 million and \$33 million, respectively, relating to the settlement of foreign currency forward contracts. During the three and nine months ended September 30, 2014, VMware recognized a gain of \$29 million and \$24 million, respectively. Gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

The combined gains and losses derived from the settlement of foreign currency forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of \$1 million and \$10 million during the three and nine months ended September 30, 2015, respectively. The combined gains and losses derived from the settlement of foreign currency forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of \$3 million and \$4 million during the three and nine months ended September 30, 2014, respectively. Net gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

**H. Unearned Revenues**

Unearned revenues as of September 30, 2015 and December 31, 2014 consisted of the following (table in millions):

	September 30, 2015	December 31, 2014
Unearned license revenues	\$404	\$488
Unearned software maintenance revenues	3,850	3,905
Unearned professional services revenues	432	440
Total unearned revenues	\$4,686	\$4,833

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or are otherwise recognized ratably over the term of the arrangement. 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 the future product at no additional charge. To the extent the future product has not been delivered and vendor-specific objective evidence (“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. Unearned revenues are impacted by timing of both product promotion offers and delivery of the future products offered as part of a product promotion.

In the event the arrangement does not include professional services, unearned license revenues may also be recognized ratably, if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance element of the arrangement does not exist. Total unearned license revenues may vary over periods for a variety of factors, including the type and level of promotions offered, and the timing of when the products are delivered upon general availability.

Unearned software maintenance revenues are attributable to VMware’s maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at September 30, 2015 was 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.

**I. Contingencies****Litigation**

During the second quarter of 2015, VMware reached an agreement with the Department of Justice (“DOJ”) and the General Services Administration (“GSA”) to pay \$76 million to resolve allegations that VMware’s government sales practices between 2006 and 2013 had violated the federal False Claims Act. The settlement was paid and recorded as a reduction of VMware’s total revenues during the nine months ended September 30, 2015.

On March 27, 2015, Phoenix Technologies (“Phoenix”) filed a complaint against VMware in the U.S. District Court for the Northern District of California asserting claims for copyright infringement and breach of contract relating to a version of Phoenix’s BIOS software that VMware licensed from Phoenix. In the lawsuit, Phoenix is seeking injunctive relief and monetary damages. Trial is currently scheduled for November 2016. VMware believes that it has



meritorious defenses in connection with this lawsuit, and currently a reasonably possible loss or range of loss cannot be estimated.

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

On March 4, 2015, Christoph Hellwig, a software developer who alleges that software code he wrote is used in a component of the Company's vSphere product, filed a lawsuit against VMware in the Hamburg Regional Court in Germany alleging copyright infringement for failing to comply with the terms of an open source General Public License v.2 ("GPL v.2") and seeking an order requiring VMware to comply with the GPL v.2 or cease distribution of any affected code within Germany. VMware believes that it has meritorious defenses in connection with this lawsuit, and currently a reasonably possible loss or range of loss cannot be estimated.

VMware accrues for a liability at the low end of the range of estimated losses when a determination has been made that a loss is both probable and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination that the occurrence of a loss is probable and is reasonably estimable. In making such judgments, VMware considers the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. Legal costs are generally recognized as expense when incurred.

VMware believes that it has valid defenses against each of the ongoing legal matters disclosed. However, given the unpredictable nature of legal proceedings, an unfavorable resolution of one or more legal proceedings, claims, or investigations could have a material adverse effect on VMware's condensed consolidated financial statements. VMware is also subject to other legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to commercial, contracting and sales practices, product liability, intellectual property, employment, class action, whistleblower and other matters. From time to time, VMware also receives inquiries from and has discussions with government entities on various matters. VMware does not believe that any liability from any reasonably foreseeable disposition of such claims and litigation, individually or in the aggregate, would have a material adverse effect on its condensed consolidated financial statements.

J. Stockholders' EquityVMware Stock Repurchases

On January 27, 2015, VMware's Board of Directors authorized the repurchase of up to an additional one billion dollars of VMware's Class A common stock through the end of 2017. Stock will be purchased from time to time, in the open market or through private transactions, subject to market conditions. 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. VMware is not obligated to purchase any shares under its stock repurchase programs. Purchases can be discontinued at any time VMware believes additional purchases are not warranted. All shares repurchased under VMware's stock repurchase programs are retired.

The following table summarizes stock repurchase authorization that remains open as of September 30, 2015 (amount in table in millions):

Authorization Date	Amount Authorized	Expiration Date	Status
January 27, 2015	\$1,000	December 31, 2017	Open

As of September 30, 2015, the cumulative authorized amount remaining for repurchase was \$910 million.

The following table summarizes stock repurchase activity during the three and nine months ended September 30, 2015 and 2014 (aggregate purchase price in millions, shares in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Aggregate purchase price	\$200	\$43	\$1,050	\$450
Class A common shares repurchased	2,408	436	12,524	4,691
Weighted-average price per share	\$83.06	\$98.94	\$83.84	\$95.56

The aggregate purchase price of repurchased shares includes commissions and is classified as a reduction to additional paid-in capital.



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## VMware Stock Options

The following table summarizes stock option activity since January 1, 2015 (shares in thousands):

	Number of Shares	Weighted- Average Exercise Price (per share)
Outstanding, January 1, 2015	5,869	\$50.54
Granted	13	84.68
Forfeited	(213	) 66.83
Exercised	(2,289	) 29.92
Outstanding, September 30, 2015	3,380	63.65

The stock options outstanding as of September 30, 2015 had an aggregate intrinsic value of \$74 million based on VMware's closing price as of September 30, 2015.

## VMware Restricted Stock

VMware's restricted stock primarily consists of restricted stock unit ("RSU") awards granted to employees. RSUs are valued based on VMware's stock price on the date of grant. The shares underlying the RSU awards are not issued until the RSUs vest. Upon vesting, each RSU converts into one share of VMware Class A common stock.

VMware's restricted stock also includes performance stock unit ("PSU") awards, which have been granted to certain of VMware's executives and employees. The PSU awards include performance conditions and, in certain cases, a time-based vesting component. Upon vesting, each PSU award will convert into VMware's Class A common stock at various ratios ranging from 0.5 to 2.0 shares per 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. As of September 30, 2015, the number of PSUs outstanding includes certain PSUs for which performance conditions have concluded but that remain subject to certain service conditions.

The following table summarizes restricted stock activity since January 1, 2015 (units in thousands):

	Number of Units	Weighted- Average Grant Date Fair Value (per unit)
Outstanding, January 1, 2015	12,585	\$88.88
Granted	5,823	86.98
Vested	(3,311	) 92.17
Forfeited	(1,382	) 88.16
Outstanding, September 30, 2015	13,715	87.38

The total fair value of VMware restricted stock that vested during the nine months ended September 30, 2015 was \$281 million. As of September 30, 2015, restricted stock representing 13.7 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of \$1,081 million based on VMware's closing price as of September 30, 2015.

As of September 30, 2015, the total unrecognized compensation cost for stock options and restricted stock was \$909 million and will be recognized through 2019 with a weighted-average remaining period of 1.5 years.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Accumulated Other Comprehensive Income (Loss)

The changes in components of accumulated other comprehensive income (loss) during the nine months ended September 30, 2015 and 2014 were as follows (tables in millions):

	Unrealized Gain on Available-for-Sale Securities	Unrealized Loss on Cash Flow Hedges	Total
Balance, January 1, 2015	\$—	\$(1 )	\$(1 )
Unrealized gain (loss), net of taxes of \$1, \$0 and \$12		(4 )	(2 )
Balance, September 30, 2015	\$2	\$(5 )	\$(3 )
	Unrealized Gain on Available-for-Sale Securities	Unrealized Loss on Cash Flow Hedges	Total
Balance, January 1, 2014	\$4	\$—	\$4
Unrealized gain (loss), net of taxes of \$1, \$0 and \$12		(3 )	(1 )
Amounts reclassified from accumulated other comprehensive income to the condensed consolidated statement of income, net of taxes of \$(2), \$0 and \$(2)	(2 )	—	(2 )
Other comprehensive income (loss), net	—	(3 )	(3 )
Balance, September 30, 2014	\$4	\$(3 )	\$1

Unrealized gains on VMware's available-for-sale securities are reclassified to investment income on the condensed consolidated statements of income in the period that such gains are realized.

The effective portion of gains (losses) resulting from changes in the fair value of forward contracts designated as cash flow hedging instruments are reclassified to its related operating expense line item on the condensed consolidated statements of income in the same period that the underlying expenses are incurred. The amounts recorded to their related operating expense functional line items on the condensed consolidated statements of income during the three and nine months ended September 30, 2015 and 2014 were not material to the individual functional line items.

## K. Related Parties

The information provided below includes a summary of the transactions entered into with EMC and EMC's consolidated subsidiaries (collectively "EMC"). EMC acquired VCE Company LLC ("VCE") during the fourth quarter of 2014. Transactions with VCE from the date EMC acquired the controlling interest in VCE have been included in the tables below.

## Transactions with EMC

VMware and EMC engaged in the following ongoing intercompany transactions, which resulted in revenues and receipts and unearned revenues for VMware:

- Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's products and sells them to end users.

- EMC purchases products and services from VMware for internal use.

- VMware provides professional services to end users based upon contractual agreements with EMC.

- From time to time, VMware and EMC enter into agreements to collaborate on technology projects, and EMC pays VMware for services that VMware provides to EMC in connection with such projects.

- Pursuant to an ongoing distribution agreement, VMware acts as the selling agent for certain products and services of Pivotal Software, Inc. ("Pivotal"), a subsidiary of EMC, in exchange for an agency fee. Under this agreement, cash is collected from the end user by VMware and remitted to Pivotal, net of the contractual agency fee.

- VMware provides various transition services to Pivotal. Support costs incurred by VMware are reimbursed to VMware and are recorded as a reduction to the costs incurred by VMware.



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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Information about VMware's revenues and receipts from such arrangements with EMC during the three and nine months ended September 30, 2015 and 2014 and unearned revenues as of September 30, 2015 and December 31, 2014 consisted of the following (table in millions):

	Revenues and Receipts from EMC				Unearned Revenues from EMC	
	Three Months Ended		Nine Months Ended		September 30, 2015	December 31, 2014
	September 30, 2015	2014	September 30, 2015	2014		
Reseller revenues	\$68	\$47	\$199	\$136	\$256	\$290
Internal-use revenues	4	4	13	17	11	18
Professional services revenues	20	13	68	53	5	9
Agency fee revenues	1	1	4	4	—	—
Reimbursement for transition services	2	—	3	1	n/a	n/a

VMware and EMC engaged in the following ongoing intercompany transactions, which resulted in costs to VMware:

• VMware purchases and leases products and purchases services from EMC.

From time to time, VMware and EMC enter into agreements to collaborate on technology projects, and VMware pays EMC for services provided to VMware by EMC related to such projects.

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 charged to VMware with a mark-up intended to approximate costs that would have been incurred had VMware contracted for such services with an unrelated third party. These costs are included as expenses on VMware's condensed consolidated statements of income and primarily include salaries, benefits, travel and rent expenses. EMC also incurs certain administrative costs on VMware's behalf in the U.S. that are recorded as expenses on VMware's condensed consolidated statements of income.

Information about VMware's costs from such arrangements with EMC for the three and nine months ended September 30, 2015 and 2014 consisted of the following (table in millions):

	Three Months Ended		Nine Months Ended	
	September 30, 2015	2014	September 30, 2015	2014
Purchases and leases of products and purchases of services	\$14	\$15	\$45	\$48
Collaborative technology project costs	1	3	4	10
EMC subsidiary support and administrative costs	24	31	79	107

VMware also purchases EMC products through EMC's channel partners. Purchases of EMC products through EMC's channel partners were \$7 million and \$33 million during the three and nine months ended September 30, 2015, respectively, and \$7 million and \$18 million during the three and nine months ended September 30, 2014, respectively.

**Certain Stock-Based Compensation**

Effective September 1, 2012, Pat Gelsinger was appointed Chief Executive Officer of VMware. Prior to joining VMware, Mr. Gelsinger was the President and Chief Operating Officer of EMC Information Infrastructure Products. Mr. Gelsinger retains certain of his EMC equity awards that were held as of September 1, 2012 and he continues to vest in such awards. Stock-based compensation related to Mr. Gelsinger's EMC awards are being recognized on VMware's condensed consolidated statements of income over the awards' remaining requisite service periods.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Tax Sharing Agreement with EMC

Pursuant to a tax sharing agreement between VMware and EMC, payments are made between VMware and EMC related to VMware's portion of federal income taxes on EMC's consolidated tax return as well as income taxes for states in which combined state income tax returns are filed. The following table summarizes these payments made between VMware and EMC during the three and nine months ended September 30, 2015 and 2014 (table in millions):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Payments from VMware to EMC	\$—	\$—	\$92	\$20

Payments made by VMware to EMC result from VMware having a tax liability. The amount that VMware pays to EMC for its portion of federal income taxes on EMC's consolidated tax return differs from the amount VMware would owe on a separate return basis, and the difference is presented as a component of stockholders' equity. During the three and nine months ended September 30, 2015 and 2014, the difference between the amount of tax calculated on a stand-alone basis and the amount of tax calculated per the tax sharing agreement was not material.

## Due To/From Related Parties, Net

As a result of the related party transactions with EMC described above, amounts due to and from related parties, net as of September 30, 2015 and December 31, 2014 consisted of the following (table in millions):

	September 30,	December 31,
	2015	2014
Due to related parties	\$(50	) \$(76
Due from related parties	75	125
Due (to) from related parties, net	\$25	\$49
Income tax due (to) from related parties	\$(36	) \$(40

Balances due to or from related parties, 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 related parties is governed by the tax sharing agreement with EMC.

## Notes Payable to EMC

VMware and EMC entered into a note exchange agreement on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500 million. The total debt of \$1,500 million includes \$450 million that was exchanged for the \$450 million promissory note issued to EMC in April 2007, as amended and restated in June 2011.

The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: \$680 million due May 1, 2018, \$550 million due May 1, 2020 and \$270 million due December 1, 2022. The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the three and nine months ended September 30, 2015, \$7 million and \$20 million, respectively, of interest expense was recognized. During the three and nine months ended September 30, 2014, \$7 million and \$18 million, respectively, of interest expense was recognized.

## L. Segment Information

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





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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Revenues by geographic area for the three and nine months ended September 30, 2015 and 2014 were as follows (table in millions):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
United States	\$861	\$780	\$2,364	\$2,112
International	811	735	2,339	2,221
Total	\$1,672	\$1,515	\$4,703	\$4,333

Revenues by geographic area are based on the ship-to addresses of VMware's customers. No individual country other than the United States accounted for 10% or more of revenues for the three and nine months ended September 30, 2015 and 2014.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of September 30, 2015 and December 31, 2014 were as follows (table in millions):

	September 30,	December 31,
	2015	2014
United States	\$835	\$801
International	147	117
Total	\$982	\$918

No individual country other than the United States accounted for 10% or more of these assets as of September 30, 2015 and December 31, 2014, respectively.

## M. Subsequent Events

## Dell and EMC Merger

On October 12, 2015, EMC entered into a merger agreement among EMC, Denali and Dell. Upon closing of the transaction, a portion of the merger consideration that EMC shareholders will receive will include shares of Class V common stock that will be registered with the SEC and issued by Denali. It is expected that approximately 0.111 shares of Class V common stock will be issued for each EMC share and that the Class V common stock will be a publicly traded tracking stock that, upon issuance, will track the performance of an approximately 53% economic interest in the VMware business. The closing of the transactions contemplated by the merger agreement is subject to approval of the EMC shareholders as well as various regulatory approvals.

## Virtustream

On October 20, 2015, VMware and EMC announced their intention to form a new cloud services business ("Virtustream"), jointly owned by VMware and EMC. The proposed new cloud business will bring together VMware vCloud Air, Virtustream's Infrastructure-as-a-Service and certain other EMC assets into one company. VMware's level of ownership in Virtustream, the accounting treatment for the transaction, and the effect the transaction will have on VMware's future financial results have not been determined.

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

The following management's discussion and analysis ("MD&A") is provided in addition to the accompanying condensed consolidated financial statements and notes to assist in understanding our results of operations and financial condition. Financial information as of September 30, 2015 should be read in conjunction with our consolidated financial statements for the year ended December 31, 2014 contained in our Form 10-K filed February 26, 2015.

All dollar amounts expressed as numbers in this MD&A (except share and per share amounts) are in millions. Period-over-period changes are calculated based upon the respective underlying, non-rounded data. Unless the context requires otherwise, we are referring to VMware, Inc. and its consolidated subsidiaries when we use the terms "VMware," the "Company," "we," "our" or "us."

Overview

The information technology ("IT") industry is transforming, moving from a hardware-based traditional model to one of a software-defined infrastructure. We are the leader in virtualization infrastructure solutions utilized by organizations to help transform the way they build, deliver and consume IT resources. We develop and market our product and service offerings within three main product groups and we also leverage synergies across these three product and service areas:

SDDC or Software-Defined Data Center

Hybrid Cloud Computing

End-User Computing

We generally sell our solutions using enterprise agreements ("EAs") or as part of our non-EA, or transactional, business. EAs are comprehensive volume license offerings, offered both directly by us and through certain channel partners, that also provide for multi-year maintenance and support.

SDDC or Software-Defined Data Center

Historically, the majority of our license sales have been from our standalone vSphere product, which is included in our compute product category within our SDDC architecture. However, over the last two years, standalone vSphere product license sales are continuing to decline. As the transformation of the IT industry continues, we expect that our growth of license sales will be increasingly derived from sales of our newer products, suites and services solutions across our SDDC portfolio. For example, we have experienced continued growth in sales volumes, production use and number of customers who have purchased VMware NSX, our network virtualization solution, during the nine months ended September 30, 2015. We also continue to see traction of our Virtual SAN product and other newer offerings.

Hybrid Cloud Computing

Hybrid cloud computing is comprised of VMware vCloud Air ("vCloud Air") and VMware vCloud Air Network ("vCAN") Service Providers Program offerings. Revenues derived from these offerings continued to grow during the three and nine months ended September 30, 2015.

On October 20, 2015, we, together with EMC, announced our intention to form a new cloud services business ("Virtustream"), jointly owned by us and EMC. The proposed new cloud business will bring together vCloud Air, Virtustream's Infrastructure-as-a-Service and certain other EMC assets into one company under the Virtustream brand. In connection with the expected formation of Virtustream, we anticipate contributing certain assets relating to our vCloud Air business and possibly cash. The amount of cash to be contributed, if any, will be determined upon finalization of the definitive agreement. Our level of ownership in Virtustream, the accounting treatment for the transaction, and the effect the transaction will have on our future financial results have not been determined.

End-User Computing

Our end-user computing solutions continue to experience strong growth. These solutions include our Horizon workplace suites and enterprise mobile management offerings, led by our AirWatch mobile solutions. Currently, our AirWatch business models include an on-premise solution that we offer through the sale of perpetual licenses and an off-premise solution that we offer as software-as-a-service ("SaaS"). AirWatch products and services continued to contribute to the growth of our end-user computing products during the three and nine months ended September 30, 2015. Our investments in AirWatch resulted in increased operating expenses during the nine months ended September

30, 2015, primarily driven by employee-related costs, including expenses we recognized in connection with installment payments to certain key employees as part of the acquisition, as well as amortization of purchased intangible assets.

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## Dell and EMC Merger

We are a majority-owned and controlled subsidiary of EMC Corporation (“EMC”). As of September 30, 2015, EMC held 81.3% of our outstanding common stock and 97.5% of the combined voting power of our outstanding common stock, including 43 million shares of our Class A common stock and all of our Class B common stock.

On October 12, 2015, Dell, Inc. (“Dell”), Denali Holding Inc. (“Denali”) and EMC entered into a definitive agreement under which Denali has agreed to acquire EMC. Under the terms of the agreement, we will remain a separate, publicly traded company. Upon closing of the transaction, a portion of the merger consideration that EMC shareholders will receive will include shares of Class V common stock that will be registered with the Securities and Exchange Commission and issued by Denali. It is expected that approximately 0.111 shares of Class V common stock will be issued for each EMC share and that the Class V common stock will be a publicly traded tracking stock that, upon issuance, will track the performance of an approximately 53% economic interest in our business. The closing of the transactions contemplated by the merger agreement is subject to approval of the EMC shareholders as well as various regulatory approvals.

## Results of Operations

Approximately 70% of our sales are denominated in the U.S. dollar, however, we also invoice and collect in the euro, the British pound, the Japanese yen, the Australian dollar and the Chinese renminbi in their respective regions. As a result, our financial statements, including our revenues, operating expenses, unearned revenues, and the resulting cash flows derived from the U.S. dollar equivalent of foreign currency transactions are impacted by foreign exchange fluctuations. Foreign currency fluctuations have had a negative impact on the growth rate of our revenues during 2015, the amount of unearned revenues recognized derived from sales denominated in foreign currencies, and the U.S. dollar equivalent of foreign currency cash collections. We have also benefited from operating expenses incurred and paid in currencies other than the U.S. dollar.

## Revenues

Our revenues during the three and nine months ended September 30, 2015 and 2014 were as follows:

	Three Months Ended		\$ Change	% Change	Constant Currency	Nine Months Ended		\$ Change	% Change	Constant Currency	
	September 30,					September 30,					
	2015	2014				2015	2014				
Revenues:											
License Services:	\$681	\$639	\$42	7	% 11	% \$1,896	\$1,814	\$81	4	% 9	%
Software maintenance	863	779	84	11		2,505	2,217	287	13		
Professional services	128	97	30	31		378	302	78	26		
Total services	991	876	114	13		2,883	2,519	365	14		
GSA settlement	—	—	—	n/a		(76 )	—	(76 )	n/a		
Total revenues	\$1,672	\$1,515	\$156	10	14	\$4,703	\$4,333	\$371	9	12	
Revenues:											
United States	\$861	\$780	\$80	10	%	\$2,364	\$2,112	\$252	12	%	
International	811	735	76	10		2,339	2,221	119	5		
	\$1,672	\$1,515	\$156	10	14	\$4,703	\$4,333	\$371	9	12	

Total  
revenues

In order to provide a comparable framework for assessing how our business performed, adjusted for the impact of foreign currency fluctuations, management analyzes year-over-year license and total revenues growth on a constant currency basis. License and total revenues recognized during the current period derived from non-U.S. dollar based transactions were converted into U.S. dollars using the exchange rates that were effective in the comparable prior year period. The calculated current period license and total revenues, adjusted for foreign currency fluctuations, is compared to the license and total revenues of the comparable prior year period, as reported, in calculating license and total revenue growth in constant currency.

Hybrid cloud, including vCAN and vCloud Air, and our SaaS offerings, including our AirWatch mobile solutions, increased to greater than 6% of our total revenues during the three and nine months ended September 30, 2015. vCAN revenues

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are generally included in license revenues and our SaaS revenues, including vCloud Air and our AirWatch mobile solutions, are included in both license and services revenues.

While license and total sales increased during the third quarter of 2015 compared to the same period in 2014, the growth rate of our license sales was at a lower rate than we had expected. We believe contributing factors included (i) increased caution expressed by our customers around longer term technology commitments; (ii) continued weakness in China and Russia; and (iii) the uncertainty during the third quarter as to whether we would continue to operate as a public company.

**License Revenues**

License revenues during the three and nine months ended September 30, 2015 were up 7% and 4%, respectively, compared to the same periods in the prior year. Our license revenues increased primarily as a result of increased sales of our emerging product offerings, including AirWatch mobile solutions and VMware NSX, as well as revenues from our hybrid cloud offerings. Sales of products beyond standalone vSphere, including vSphere with Operations Management, also contributed to license revenues growth, partially offset by a decline in our standalone vSphere product license sales. License revenues during the three and nine months ended September 30, 2015 also benefited as a result of declines in unearned license revenues.

Our license revenues growth rate during 2015 has been negatively impacted by certain factors including, lower sales of standalone vSphere, changes in the value of the U.S. dollar against the foreign currencies in which we invoice, and increased growth derived from our hybrid cloud and SaaS offerings. License revenues that are part of a multi-year perpetual license arrangement are generally recognized upon delivery of the underlying license, whereas revenues derived from our hybrid cloud and SaaS offerings are recognized over a period of time. Growth from our hybrid and SaaS offerings have resulted in less revenue being recognized up-front which has had an adverse impact on our growth rate during 2015.

**Services Revenues**

During the three and nine months ended September 30, 2015, software maintenance revenues benefited from renewals, multi-year software maintenance contracts sold in previous periods and additional maintenance contracts sold in conjunction with new software license sales. In each period presented, customers bought, on a weighted-average basis, more than 24 months of support and maintenance with each new license purchased. Professional services revenues increased during the three and nine months ended September 30, 2015 compared to the same periods in 2014, which is attributable to growth in our license sales and solution offerings. As we continue to invest in our partners and expand our ecosystem of third-party professionals with expertise in our solutions to independently provide professional services to our customers, our professional services revenues will vary based on the delivery channels used in any given period as well as the timing of engagements.

**GSA settlement**

During the second quarter of 2015, we reached an agreement with the Department of Justice (“DOJ”) and the General Services Administration (“GSA”) to pay \$76 to resolve allegations that our government sales practices between 2006 and 2013 had violated the federal False Claims Act. The settlement was paid and recorded as a reduction of our total revenues during the nine months ended September 30, 2015.

**Unearned Revenues**

Our unearned revenues as of September 30, 2015 and December 31, 2014 were as follows:

	September 30, 2015	December 31, 2014
Unearned license revenues	\$404	\$488
Unearned software maintenance revenues	3,850	3,905
Unearned professional services revenues	432	440
Total unearned revenues	\$4,686	\$4,833

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or are otherwise recognized ratably over the term of the arrangement. 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 the future product at no additional charge. To the extent the future product has not been delivered and vendor-specific objective evidence (“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. Unearned license and software maintenance revenues will fluctuate based on sales volume, as well as timing of both product promotion offers and delivery of the future products offered. The amount of unearned license revenues has declined as a result of less license revenues being deferred in connection with our product promotions when comparing the balances as of September 30, 2015 to December 31, 2014.



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In the event the arrangement does not include professional services, unearned license revenues may also be recognized ratably, if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance element of the arrangement does not exist. Total unearned license revenues may vary over periods for a variety of factors, including the type and level of promotions offered, and the timing of when the products are delivered upon general availability.

Unearned software maintenance revenues are attributable to our maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at September 30, 2015 was 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. Our total unearned revenues are impacted by the amount and timing of sales as well as fluctuations in the foreign currencies in which we invoice.

**Cost of License Revenues, Cost of Services Revenues and Operating Expenses**

Our cost of services revenues and operating expenses were primarily impacted by increasing headcount, net of realignment activities discussed below. Headcount during the three and nine months ended September 30, 2015 continued to increase due to organic growth. The increased headcount has resulted in higher cash-based employee-related expenses across most of our income statement expense categories when compared to the same period in 2014, and we expect this trend to continue.

**Cost of License Revenues**

Our cost of license revenues principally consists of the cost of fulfillment of our software, royalty costs in connection with technology licensed from third-party providers and amortization of intangible assets. The cost of fulfillment of our software includes IT development efforts, personnel costs and related overhead associated with the physical and electronic delivery of our software products.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	\$ Change	% Change	2015	2014	\$ Change	% Change
Cost of license revenues	\$46	\$45	\$—	(1 )%	\$141	\$141	\$—	— %
Stock-based compensation	—	1	—	(15 )	1	2	—	(16 )
Total expenses	\$46	\$46	\$—	(1 )	\$142	\$143	\$—	—
% of License revenues	7	% 7	%		8	% 8	%	

Cost of license revenues was flat when comparing three and nine months ended September 30, 2015 and 2014.

**Cost of Services Revenues**

Our cost of services revenues primarily includes the costs of personnel and related overhead to deliver technical support for our products and to provide professional services. Additionally, our costs of services revenues include costs related to our IT development efforts and depreciation on equipment supporting our service offerings. As we continue to invest in and grow business from our hybrid cloud, SaaS and professional services offerings, we expect our total costs of services revenues to continue to increase.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	\$ Change	% Change	2015	2014	\$ Change	% Change
Cost of services revenues	\$201	\$185	\$16	8 %	\$577	\$488	\$88	18 %
Stock-based compensation	11	11	—	—	32	31	1	4
Total expenses	\$212	\$196	\$16	8	\$609	\$519	\$89	17
% of Services revenues	21	% 22	%		21	% 21	%	

Cost of services revenues increased during the three and nine months ended September 30, 2015 compared to the same periods in 2014 primarily driven by the growth in cash-based employee-related expenses of \$19 and \$76,

respectively, due to organic growth in headcount for the three and nine months ended September 30, 2015. Our acquisition of AirWatch, which occurred during the three months ended March 31, 2014, also contributed to the growth in cash-based employee-related expenses during the nine months ended September 30, 2015. In addition, the growth of our hybrid cloud and SaaS offerings led to an increase in our professional services costs of \$5 and \$21 during the three and nine months ended September 30, 2015.

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Additionally, increases in equipment, depreciation and facilities-related costs of \$9 and \$30 during the three and nine months ended September 30, 2015, respectively, contributed to the increase in cost of services revenues. These increases were partially offset by the positive impact of \$14 and \$36 during the three and nine months ended September 30, 2015, respectively, from fluctuations in the exchange rate between the U.S. dollar and the foreign currencies in which we incur expenses. Costs related to our IT development efforts also decreased \$9 and \$17 during the three and nine months ended September 30, 2015, respectively.

**Research and Development Expenses**

Our research and development expenses include the personnel and related overhead associated with the development of our product software and service offerings.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	\$ Change	% Change	2015	2014	\$ Change	% Change
Research and development	\$275	\$266	\$8	3	\$794	\$749	\$45	6
Stock-based compensation	56	61	(4)	(7)	164	187	(23)	(13)
Total expenses	\$331	\$327	\$4	1	\$958	\$936	\$21	2
% of Total revenues	20	% 22	%		20	% 22	%	

Research and development expenses increased during the three and nine months ended September 30, 2015 compared to the same periods in 2014. The increase was primarily due to growth in cash-based employee-related expenses of \$20 and \$68 during the three and nine months ended September 30, 2015, respectively, due to organic growth in headcount. Our acquisition of AirWatch during the three months ended March 31, 2014, also contributed to the growth in cash-based employee-related expenses during the nine months ended September 30, 2015. The increase in research and development expenses during the three and nine months ended September 30, 2015 was partially offset by a decrease in stock-based compensation of \$4 and \$23, respectively, primarily as a result of certain awards becoming fully vested in fiscal year 2014. The positive impact of \$5 and \$12 during the three and nine months ended September 30, 2015, respectively, resulting from fluctuations in the exchange rate between the U.S. dollar and the foreign currencies in which we incur expenses also partially offset the overall increase in research and development expenses. Equipment and depreciation costs also decreased during the three and nine months ended September 30, 2015.

**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. Sales commissions are generally earned and expensed when a firm order is received from the customer. Sales and marketing expenses also include the net impact from the expenses incurred and fees generated by certain marketing initiatives.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	\$ Change	% Change	2015	2014	\$ Change	% Change
Sales and marketing	\$513	\$486	\$30	6	\$1,532	\$1,422	\$113	8
Stock-based compensation	43	43	(2)	(5)	124	128	(5)	(4)
Total expenses	\$556	\$529	\$28	5	\$1,656	\$1,550	\$109	7
% of Total revenues	33	% 35	%		35	% 36	%	

Sales and marketing expenses increased during the three and nine months ended September 30, 2015 compared to the same periods in 2014, primarily driven by growth in cash-based employee-related expenses of \$28 and \$122, respectively, due to organic growth in headcount. Higher commission expense due to increased sales volume and our acquisition of AirWatch during the three months ended March 31, 2014 also contributed to the growth in cash-based employee-related expenses during the nine months ended September 30, 2015. Additionally, costs incurred for marketing programs and initiatives increased by \$14 and \$26 during the three and nine months ended September 30,

2015, respectively. During the nine months ended September 30, 2015, facilities-related costs increased by \$12, and costs incurred for contractors increased by \$9. These increases in expenses during the three and nine months ended September 30, 2015 were partially offset by the positive impact of \$31 and \$83, respectively, from fluctuations in the exchange rate between the U.S. dollar and the foreign currencies in which we incur expenses.

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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 finance, human resources, IT infrastructure and legal, as well as expenses related to corporate costs and initiatives.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	\$ Change	% Change	2015	2014	\$ Change	% Change
General and administrative	\$ 185	\$ 152	\$ 32	21 %	\$ 521	\$ 447	\$ 73	16 %
Stock-based compensation	16	17	—	(2 )	47	51	(4 )	(7 )
Total expenses	\$ 201	\$ 169	\$ 32	19 %	\$ 568	\$ 498	\$ 69	14 %
% of Total revenues	12 %	11 %			12 %	11 %		

General and administrative expenses increased during the three and nine months ended September 30, 2015 compared to the same periods in 2014. We have made and will continue to make installment payments to certain key employees of AirWatch subject to the achievement of specified future employment conditions. We recognized compensation expense of \$36 and \$117 during the three and nine months ended September 30, 2015, respectively, relating to these installment payments compared to \$41 and \$101 during the three and nine months ended September 30, 2014, respectively. Equipment, depreciation and facilities-related costs increased \$14 and \$37 during the three and nine months ended September 30, 2015, respectively. An increase in charitable donations of \$13 and \$16 during the three and nine months ended September 30, 2015, respectively, further contributed to the increase in general and administrative expenses. Other cash-based employee-related expenses increased by \$5 and \$20 during the three and nine months ended September 30, 2015 due to incremental organic growth in headcount. The increase to general and administrative expenses was partially offset by the positive impact from fluctuations in the exchange rate between the U.S. dollar and the foreign currencies in which we incur expenses during the three and nine months ended September 30, 2015.

## Realignment Charges

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	\$ Change	% Change	2015	2014	\$ Change	% Change
Realignment charges	\$—	\$6	\$(6 )	(107 )%	\$20	\$4	\$16	355 %
% of Total revenues	— %	— %			— %	— %		

During the first quarter of 2015, we eliminated approximately 350 positions across all major functional groups and geographies to streamline our operations. As a result of these actions, \$20 of severance-related realignment charges were recognized during the nine months ended September 30, 2015. As of September 30, 2015, \$1 remained in accrued expenses and other on the condensed consolidated balance sheets and is expected to be paid during 2015.

During the third quarter of 2014, we eliminated approximately 90 positions across all major functional groups and geographies to streamline our operations. As a result of these actions, \$7 of severance-related realignment charges was recognized during the three months ended September 30, 2014.

## Other Income (Expense), Net

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2015	2014	\$ Change	% Change	2015	2014	\$ Change	% Change
Other income (expense), net	\$(7 )	\$(2 )	\$(5 )	250 %	\$(8 )	\$(2 )	\$(6 )	300 %
% of Total revenues	— %	— %			— %	— %		

Other income (expense), net during the three months ended September 30, 2015 was primarily related to an impairment charge of approximately \$5 as a result of determining that a strategic investment was impaired.



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### Income Tax Provision

Our quarterly effective tax rate, including discrete items was 21.4% and 18.0% during the three and nine months ended September 30, 2015, respectively. For the three and nine months ended September 30, 2014, our effective tax rate, including discrete items was 20.4% and 18.9%, respectively. The change in our quarterly effective tax rate was primarily due to the shift in the mix of our earnings from our lower tax non-U.S. jurisdictions to the U.S. and the amount and timing of recognition of discrete items including a \$19 benefit recognized in connection with the GSA settlement which occurred during the second quarter of 2015.

Our rate of taxation in non-U.S. jurisdictions is lower than our U.S. tax rate. Our non-U.S. earnings are primarily earned by our subsidiaries organized in Ireland, and as such, our annual effective tax rate can be significantly impacted by the mix of our earnings in the U.S. and non-U.S. jurisdictions.

We are included in the EMC consolidated group for U.S. federal income tax purposes, and expect to continue to be included in such consolidated group for periods in which EMC owns at least 80% of the total voting power and value of our combined outstanding Class A and Class B common stock as calculated for U.S. federal income tax purposes. The percentage of voting power and value calculated for U.S. federal income tax purposes may differ from the percentage of outstanding shares beneficially owned by EMC due to the greater voting power of our Class B common stock as compared to our Class A common stock and other factors. Each member of a consolidated group during any part of a consolidated return year is jointly and severally liable for tax on the consolidated return of such year and for any subsequently determined deficiency thereon. Should EMC's ownership fall below 80% of the total voting power or value of our outstanding stock in any period, then we would no longer be included in the EMC consolidated group for U.S. federal income tax purposes, and our U.S. federal income tax would be reported separately from that of the EMC consolidated group.

Although we file a consolidated federal tax return with EMC, the income tax provision is calculated primarily as though we were a separate taxpayer. However, certain transactions that we and EMC are parties to are assessed using consolidated tax return rules. Our 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 non-U.S. jurisdictions where income is earned.

The EMC consolidated group is routinely under audit by the Internal Revenue Service (the "IRS"). All U.S. federal income tax matters have been concluded for years through 2008. The IRS commenced a federal income tax audit for the tax years 2009 and 2010 in the third quarter of 2012, and commenced an audit of tax year 2011 during the first quarter of 2015. The federal income tax audit for the tax years 2009 and 2010 is ongoing. In addition, we are under corporate income tax audits in various states and non-US jurisdictions.

Our future effective tax rate may be affected by such factors as changes in tax laws, changes in our business, regulations, or rates, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation, the impact of accounting for business combinations and shifts in the amount of earnings in the U.S. compared with other regions in the world as well as the expiration of statute of limitations and settlement of audits.

### Our Relationship with EMC

As of September 30, 2015, EMC owned 43,025,000 shares of Class A common stock and all 300,000,000 shares of Class B common stock, representing 81.3% of our total outstanding shares of common stock and 97.5% of the combined voting power of our outstanding common stock. Refer to Note M to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a discussion of the pending Dell and EMC merger and our intent to form a new cloud services business with EMC.

The information provided below includes a summary of the transactions entered into with EMC and EMC's consolidated subsidiaries (collectively "EMC"). EMC acquired VCE Company LLC ("VCE") during the fourth quarter of 2014. Transactions with VCE from the date EMC acquired the controlling interest in VCE have been included in the tables below.

### Transactions with EMC

We and EMC engaged in the following ongoing intercompany transactions, which resulted in revenues and receipts and unearned revenues for us:

Pursuant to an ongoing reseller arrangement with EMC, EMC bundles our products and services with EMC's products and sells them to end users.

EMC purchases products and services from us for internal use.

We provide professional services to end users based upon contractual agreements with EMC.



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From time to time, we and EMC enter into agreements to collaborate on technology projects, and EMC pays us for services that we provide to EMC in connection with such projects.

Pursuant to an ongoing distribution agreement, we act as the selling agent for certain products and services of Pivotal Software, Inc. (“Pivotal”), a subsidiary of EMC, in exchange for an agency fee. Under this agreement, cash is collected from the end user by us and remitted to Pivotal, net of the contractual agency fee.

We provide various transition services to Pivotal. Support costs incurred by us are reimbursed to us and are recorded as a reduction to the costs incurred by us.

Information about our revenues and receipts from such arrangements with EMC during the three and nine months ended September 30, 2015 and 2014 and unearned revenues as of September 30, 2015 and December 31, 2014 consisted of the following:

	Revenues and Receipts from EMC				Unearned Revenues from EMC	
	Three Months Ended September 30,		Nine Months Ended September 30,		September 30, 2015	December 31, 2014
	2015	2014	2015	2014		
Reseller revenues	\$68	\$47	\$199	\$136	\$256	\$290
Internal-use revenues	4	4	13	17	11	18
Professional services revenues	20	13	68	53	5	9
Agency fee revenues	1	1	4	4	—	—
Reimbursement for transition services	2	—	3	1	n/a	n/a

We and EMC engaged in the following ongoing intercompany transactions, which resulted in costs to us:

• We purchase and lease products and purchase services from EMC.

From time to time, we and EMC enter into agreements to collaborate on technology projects, and we pay EMC for services provided to us by EMC related to such projects.

In certain geographic regions where we do not have an established legal entity, we contract with EMC subsidiaries for support services and EMC personnel who are managed by us. The costs incurred by EMC on our behalf related to these employees are charged to us with a mark-up intended to approximate costs that would have been incurred had we contracted for such services with an unrelated third party. These costs are included as expenses on our condensed consolidated statements of income and primarily include salaries, benefits, travel and rent expenses. EMC also incurs certain administrative costs on our behalf in the U.S. that are recorded as expenses on our condensed consolidated statements of income.

Information about our costs from such arrangements with EMC for the three and nine months ended September 30, 2015 and 2014 consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2015	2014	2015	2014
Purchases and leases of products and purchases of services	\$14	\$15	\$45	\$48
Collaborative technology project costs	1	3	4	10
EMC subsidiary support and administrative costs	24	31	79	107

We also purchase EMC products through EMC's channel partners. Purchases of EMC products through EMC's channel partners were \$7 and \$33 during the three and nine months ended September 30, 2015, respectively, and \$7 and \$18 during the three and nine months ended September 30, 2014, respectively.

#### Certain Stock-Based Compensation

Effective September 1, 2012, Pat Gelsinger was appointed Chief Executive Officer of VMware. Prior to joining VMware, Mr. Gelsinger was the President and Chief Operating Officer of EMC Information Infrastructure Products. Mr. Gelsinger retains certain of his EMC equity awards that were held as of September 1, 2012 and he continues to vest in such awards. Stock-based compensation related to Mr. Gelsinger's EMC awards are being recognized on our condensed consolidated statements of income over the awards' remaining requisite service periods.



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## Tax Sharing Agreement with EMC

Pursuant to a tax sharing agreement between us and EMC, payments are made between us and EMC related to our portion of federal income taxes on EMC's consolidated tax return as well as income taxes for states in which combined state income tax returns are filed. The following table summarizes these payments made between us and EMC during the three and nine months ended September 30, 2015 and 2014:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2015	2014	2015	2014
Payments from us to EMC	\$—	\$—	\$92	\$20

Payments made by us to EMC result from us having a tax liability. The amount that we pay to EMC for our portion of federal income taxes on EMC's consolidated tax return differs from the amount we would owe on a separate return basis, and the difference is presented as a component of stockholders' equity. During the three and nine months ended September 30, 2015 and 2014, the difference between the amount of tax calculated on a stand-alone basis and the amount of tax calculated per the tax sharing agreement was not material.

## Due To/From Related Parties, Net

As a result of the related party transactions with EMC described above, amounts due to and from related parties, net as of September 30, 2015 and December 31, 2014 consisted of the following:

	September 30,	December 31,
	2015	2014
Due to related parties	\$(50	) \$(76
Due from related parties	75	125
Due (to) from related parties, net	\$25	\$49
Income tax due (to) from related parties	\$(36	) \$(40

Balances due to or from related parties, 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 related parties is governed by the tax sharing agreement with EMC.

## Notes Payable to EMC

We and EMC entered into a note exchange agreement on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500. The total debt of \$1,500 includes \$450 that was exchanged for the \$450 promissory note issued to EMC in April 2007, as amended and restated in June 2011. The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: \$680 due May 1, 2018, \$550 due May 1, 2020 and \$270 due December 1, 2022. The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the three and nine months ended September 30, 2015, \$7 and \$20, respectively, of interest expense was recognized. During the three and nine months ended September 30, 2014, \$7 and 18, respectively, of interest expense was recognized.

## Liquidity and Capital Resources

At September 30, 2015 and 2014, we held cash, cash equivalents and short-term investments as follows:

	September 30,	
	2015	2014
Cash and cash equivalents	\$2,083	\$2,293
Short-term investments	5,139	4,801
Total cash, cash equivalents and short-term investments	\$7,222	\$7,094

As of September 30, 2015, we held a diversified portfolio of money market funds and fixed income securities totaling \$6,452. Our fixed income securities are denominated in U.S. dollars and consist of highly liquid debt instruments of the U.S. Government and its agencies, municipal obligations, and U.S. and foreign corporate debt securities. We limit the amount of our domestic and international investments with any single issuer and any single financial institution, and also monitor the diversity



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of the portfolio, thereby diversifying the credit risk. As of September 30, 2015, our total cash, cash equivalents and short-term investments were \$7,222, of which \$5,692 was held outside the U.S. If these overseas funds were needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes on the related undistributed earnings to repatriate these funds. However, our intent is to indefinitely reinvest our non-U.S. earnings in our foreign operations and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

We expect that cash generated by operations will be our primary source of liquidity. We also believe that existing cash and cash equivalents, together with any cash generated from operations will be sufficient to meet normal operating requirements for at least the next twelve months. While we believe our existing cash and cash equivalents and cash to be generated by operations will be sufficient to meet our normal operating requirements, our overall level of cash needs may be impacted by the number and size of acquisitions, investments and stock repurchases. Should we require additional liquidity, we may seek to arrange debt financing or enter into credit facilities.

Our cash flows summarized for the nine months ended September 30, 2015 and September 30, 2014 were as follows:

	Nine Months Ended	
	September 30,	
	2015	2014
Net cash provided by (used in):		
Operating activities	\$1,411	\$1,765
Investing activities	(362	) (2,433
Financing activities	(1,037	) 656
Net increase (decrease) in cash and cash equivalents	\$12	\$(12
Operating Activities		

Cash provided by operating activities decreased by \$354 during the nine months ended September 30, 2015 compared to the same period in 2014 mainly due to the change in unearned revenues as well as the change in income taxes payable as a result of tax payments made to EMC under the tax sharing agreement. Under the tax sharing agreement, we are obligated to pay EMC an amount equal to the tax expense generated by us that EMC may recognize in a given year on its consolidated tax return. During the nine months ended September 30, 2015, we paid \$92 to EMC under the tax sharing agreement compared to \$20 during the nine months ended September 30, 2014. Additionally, cash provided by operating activities during the nine months ended September 30, 2015 also reflects payments for legal settlements, primarily \$76 for the GSA settlement, and increases in payroll and operating expenses resulting from growth in headcount-related expenses driven by organic growth and the AirWatch acquisition, including installment payments made to certain key employees of AirWatch. These decreases were partially offset by a change in accounts receivable as a result of an increase in cash collections.

The strengthening of the U.S. dollar that started in 2014 negatively impacted the U.S. dollar equivalent of our foreign currency collections. Even if the U.S. dollar stabilizes at its current level for the remainder of 2015, our cash flows from operations will remain negatively impacted during 2015. Additionally, cash flows from operations will be further impacted by installment payments of approximately \$28 to certain key employees of AirWatch for the remainder of 2015.

Investing Activities

Cash used in investing activities is generally attributable to the purchase of available-for-sale securities, business acquisitions, and capital expenditures. Cash provided by investing activities is impacted by the sales and maturities of our available-for-sale securities.

Cash used in investing activities decreased during the nine months ended September 30, 2015 compared to the same period in 2014 primarily as a result of our acquisitions, including AirWatch for \$1,068 during the three months ended March 31, 2014. Additionally, the net cash used related to our available-for-sale securities decreased during the nine months ended September 30, 2015 as compared to the same period in 2014.

The increase in restricted cash during the nine months ended September 30, 2014 includes \$75 for amounts held in escrow and payable to certain AirWatch employees, subject to achievement of certain employment conditions. During the nine months ended September 30, 2015, the \$75 was released from escrow and paid to the employees. The release from escrow is reflected as an inflow within investing activities while the payment to the employees is reflected as an

outflow within operating activities.

Financing Activities

Net cash used in financing activities increased during the nine months ended September 30, 2015 compared to the same period in 2014 primarily as a result of an increase in our repurchase of common stock. Additionally, during the nine months

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ended September 30, 2014, we benefited from a cash inflow as a result of our notes payable exchange agreement with EMC. Refer to sections below for further information.

Notes Payable to EMC

As of September 30, 2015, \$1,500 remained outstanding on notes payable to EMC, with interest payable quarterly in arrears.

In connection with our acquisition of AirWatch, we entered into a note exchange agreement with EMC on January 21, 2014 providing for the issuance of three promissory notes in the aggregate principal amount of \$1,500. The total debt of \$1,500 includes \$450 that was exchanged for the \$450 promissory note issued to EMC in April 2007, as amended and restated in June 2011.

The three notes issued have the following principal amounts and maturity dates: \$680 due May 1, 2018, \$550 due May 1, 2020 and \$270 due December 1, 2022.

The notes bear interest at the annual rate of 1.75%. Interest is payable quarterly in arrears. The notes may be prepaid without penalty or premium. We drew down on all three notes in late January 2014.

Stock Repurchase Program

From time to time, we repurchase stock pursuant to authorized stock repurchase programs in open market transactions or privately negotiated transactions as permitted by securities laws and other legal requirements. We are not obligated to purchase any shares under our stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased depends on a variety of factors, including our 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 we believe additional purchases are not warranted. All shares repurchased under our stock repurchase programs are retired. On January 27, 2015, our Board of Directors authorized the repurchase of up to an additional one billion dollars of our Class A common stock through the end of 2017. During the nine months ended September 30, 2015, we repurchased 12.5 million shares for an aggregate purchase price of \$1,050. As of September 30, 2015, the cumulative authorized amount remaining for repurchase under an authorized program was \$910. Refer to Note J to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for further discussion.

We expect to repurchase approximately \$1,250 of our Class A common stock in 2015.

Virtustream

In connection with the expected formation of Virtustream, we anticipate contributing certain assets relating to our vCloud Air business and possibly cash. The amount of cash to be contributed, if any, will be determined upon finalization of the definitive agreement.

Upon closing of the proposed agreement to form Virtustream, we expect that the operations of Virtustream during fiscal 2016, including the operations of vCloud Air, will require both operating and capital investment.

Critical Accounting Policies and Estimates

Our condensed consolidated financial statements are based upon the selection and application of accounting principles generally accepted in the United States of America ("GAAP") that require us to make estimates and assumptions about future events that affect the amounts reported in our financial statements and the accompanying notes. Future events and their effects cannot be determined with certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results could differ from those estimates, and any such differences may be material to our financial statements. We believe that the critical accounting policies set forth within Item 7 of our 2014 Annual Report on Form 10-K may involve a higher degree of judgment and complexity in their application than our other significant accounting policies and represent the critical accounting policies used in the preparation of our financial statements. If different assumptions or conditions were to prevail, the results could be materially different from our reported results.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements, including, without limitation, statements regarding expectations of, or our plans for: the IT industry transformation and our related strategic positioning; maintaining our industry leadership position; the benefits of our products and services to customers and partners; synergies across our SDDC and product areas; sales of licenses that include products beyond VMware vSphere hypervisor continuing to grow; newer products, suites and services solutions driving growth; SaaS revenues and

revenues from our hybrid cloud offerings comprising an increasing percentage of our revenues; our intent to form Virtustream, including our anticipated contribution of assets and possibly cash; sales and related cash collections continuing to increase during the remainder of 2015, offset by installment payments to certain key employees of AirWatch; hybrid cloud and SaaS revenues continuing to grow, but negatively impacting



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the associated license revenues growth rate during the remainder of 2015; the impact of foreign currency fluctuations on financial results, such as revenues, unearned revenues and anticipated and actual cash flows from operations; customer and partner demand for our products and services; variation in and increased total costs of services revenues; the effect on us of the resolutions of pending claims, legal proceedings and investigations and other matters described in Note I of the notes to the condensed consolidated financial statements; variation in, and impact of timing of product promotions on, the recognition of unearned revenues; increasing employee headcount and related impact on operating expense; the impact of shifts in the mix of earnings between U.S. and non-U.S. tax jurisdictions on our estimated annual effective tax rate; the effects of potential developments in U.S. and non-U.S. tax jurisdictions as well as our business strategies on our effective tax rate; the impact of our relationship with EMC on taxes; the timing and completion of the IRS tax audit of the EMC consolidated group; indefinitely reinvesting our overseas earnings outside of the U.S. and not repatriating them to the U.S.; the sufficiency of our liquidity and capital reserves to fund our operations and business strategy; our ability to generate positive cash flows from operations; the impact of acquisitions, investments and stock repurchases on our overall cash needs; our ability to obtain liquidity, arrange debt financings or enter into credit facilities, should additional liquidity be required; and repurchasing approximately \$1,250 of Class A common stock in 2015.

These forward-looking statements involve risks and uncertainties and the cautionary statements set forth above and those contained in the section of this report entitled “Risk Factors” identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. All forward-looking statements in this document are made as of the date hereof, based on information available to us as of the date hereof. We assume no obligation to, and do not currently intend to, update these forward-looking statements.

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Available Information

Our website is located at [www.vmware.com](http://www.vmware.com), and our investor relations website is located at <http://ir.vmware.com>. Our goal is to maintain the Investor Relations website as a portal through which investors can easily find or navigate to pertinent information about us, all of which is made available free of charge, including:

- our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file that material with or furnish it to the Securities and Exchange Commission (“SEC”);
  - announcements of investor conferences, speeches and events at which our executives talk about our products, services and competitive strategies;
  - webcasts of our quarterly earnings calls and links to webcasts of investor conferences at which our executives appear (archives of these events are also available for a limited time);
  - additional information on financial metrics, including reconciliations of non-GAAP financial measures discussed in our presentations to the nearest comparable GAAP measure;
  - press releases on quarterly earnings, product and service announcements, legal developments and international news; corporate governance information including our certificate of incorporation, bylaws, corporate governance guidelines, board committee charters, business conduct guidelines (which constitutes our code of business conduct and ethics) and other governance-related policies;
  - other news, blogs and announcements that we may post from time to time that investors might find useful or interesting; and
  - opportunities to sign up for email alerts and RSS feeds to have information pushed in real time.
- The information found on our website is not part of, and is not incorporated by reference into, this or any other report we file with, or furnish to, the SEC.

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

There were no material changes to our market risk exposures in the three months ended September 30, 2015. See Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk” of our 2014 Annual Report on Form 10-K for a detailed discussion of our market risk exposures.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation required by the Securities Exchange Act of 1934, amended (the “Exchange Act”), under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the Exchange Act, as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

Changes in Internal Controls Over Financial Reporting

There were no changes in our internal control over financial reporting during the most recent fiscal quarter ended September 30, 2015 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Controls

Our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives as specified above. Management does not expect, however, that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all errors and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

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PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Refer to Note I to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a description of legal proceedings. See also the risk factor entitled “We are involved in litigation and regulatory inquiries and proceedings that could negatively affect us” in Part II, Item 1A of this Quarterly Report on Form 10-Q for a discussion of potential risks to our results of operations and financial condition that may arise from legal proceedings.

ITEM 1A. RISK FACTORS

The risk factors that appear below could materially affect our business, financial condition and results of operations. The risks and uncertainties described below are not the only risks and uncertainties facing us. Our business is also subject to general risks and uncertainties that affect many other companies. Specific risk factors related to our status as a controlled subsidiary of EMC, including, among other things, overlapping business opportunities, EMC's ability to control certain transactions and resource allocations and related persons transactions with EMC and its other affiliated companies, are set forth below under the heading “Risks Related to Our Relationship with EMC.”

Risks Related to Recent Announcements

The announcement, and potential completion, of Dell's proposed acquisition of EMC, may have an adverse impact on our business and our stock price.

On October 12, 2015, EMC and Dell announced that Dell's parent company Denali would acquire EMC while maintaining VMware as an independent publicly traded company and issuing a tracking stock, Class V common stock, intended to reflect VMware's economic performance as partial consideration to the EMC shareholders (the “Dell Acquisition”). Upon issuance, the Class V common stock is expected to track the performance of an approximately 53% economic interest in the VMware business.

A number of factors could adversely affect our business or our stock price during the pendency or following the closing of the Dell Acquisition, including:

If the Dell Acquisition is completed, Dell will be able to control matters requiring our stockholders' approval, including the election of a majority of our directors and the other matters over which EMC currently has control, as described in the risk factors below.

Following the closing of the acquisition, Dell could implement changes to our business, including changing our commercial relationship with EMC or taking other corporate actions that our other stockholders may not view as beneficial.

We have arrangements with a number of companies that compete with Dell, and the pendency or completion of the Dell Acquisition could adversely affect our relationship with these companies or other customers, suppliers and partners.

During the pendency of the Dell Acquisition, Denali has a right of consent to matters requiring EMC's approval under our certificate of incorporation, including acquisitions or investments in excess of \$100 million (including the contemplated formation of the new cloud services business), and Denali may choose not to consent to matters that our board of directors believes are in the best interests of VMware.

We anticipate certain synergies and benefits from the Dell Acquisition that may not be realized.

The tracking stock to be issued by Denali, while not a VMware issued security, would increase the supply of publicly traded securities that track VMware's economic performance and could create the perception that the tracking stock dilutes the holdings of our public stockholders, both of which could put downward pressure on our stock price.

Following the closing of the Dell Acquisition, Dell will be highly leveraged and may be required to commit a substantial portion of its cash flows to servicing its indebtedness. This could create the perception that Dell may exercise its control over us to limit our growth in favor of its other businesses or cause us to transfer cash to Dell. In addition, if Dell defaults, or appears in danger of defaulting, on its indebtedness, the trading price of the tracking stock issued by Denali would be adversely affected, which could negatively impact the price of our Class A common stock, and uncertainty as to the impact of such a default on VMware could disrupt our business.

- Some of our products, including our vRealize management products, compete directly with Dell's products, which could result in reduced sales during the pendency or following the closing of the Dell Acquisition.

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The pendency of the Dell Acquisition creates uncertainty for our employees, which could make it difficult to attract and retain employees.

The pendency of the Dell Acquisition could distract management's focus from executing on other strategic initiatives. The Dell Acquisition creates litigation risk. Various lawsuits have been filed against EMC in connection with the Dell Acquisition, and we may be named in these or other lawsuits.

Our recently announced intention to form a new cloud services business with EMC may not be completed and, if completed, may not prove successful.

We recently announced our intention to form a new cloud services business, jointly owned with EMC, in connection with which we expect to transfer employees and to contribute technology and possibly cash to Virtustream, Inc., currently a wholly-owned subsidiary of EMC ("Virtustream"). Although we previously announced our intention to complete the transaction, we have not yet signed, and may not ever sign or consummate, definitive agreements. VMware's level of ownership in Virtustream and the ongoing effect on VMware's financial results have not been determined, and definitive agreements may contain terms materially different from those announced. The cloud services business would increase our investments in the cloud services space, which is intensely competitive and dominated by large companies with very strong balance sheets, and we may need to invest capital into Virtustream on an ongoing basis. In addition, the formation of the cloud services business involves the combination of multiple businesses from VMware and EMC that may overlap and not yield expected synergies. Finally, if we do not form a new cloud services business with EMC, our vCloud Air business may suffer, and it would be difficult to successfully execute a standalone hybrid cloud strategy.

Our stock price declined significantly in October 2015 following announcements regarding the Dell Acquisition, our financial results and guidance for future operating results and our intention to form a cloud services business with EMC, and future announcements concerning these matters could also lead to volatility in our stock price.

Our stock price declined significantly both following the announcement of the Dell Acquisition and following the subsequent announcement of financial results for the third quarter of 2015, our guidance for future operating results and our intent to form the new cloud services business with EMC. Market reaction may reflect uncertainty about the impact of the Dell Acquisition, concern over our future growth rate and concern about our new cloud services business with EMC. Future announcements concerning these matters could also lead to volatility in our stock price.

### Risks Related to Our Business

As the markets for our server and desktop virtualization products have matured we have been increasingly developing and marketing products and services targeted toward the delivery, management and automation of information technology ("IT") infrastructure, platforms and services through cloud-based solutions. If businesses do not find our cloud computing solutions compelling, our revenue growth and operating margins will decline.

Our products and services are based on server virtualization and related technologies that have primarily been used for virtualizing on-premise data center servers and form the foundation for private cloud computing. As the market for data center server virtualization has matured, we have increasingly directed our product development and marketing toward products and services that enable businesses to utilize virtualization as the foundation for public, private and hybrid cloud-based computing, including our VMware vCloud Suite, VMware vSphere with Operations Management, VMware vRealize Suite, our Horizon client virtualization offerings and our AirWatch mobile device management offerings. We have been increasing our focus on our hybrid cloud offerings, which include our vCloud Air service offerings, and we have been increasingly offering software as a service ("SaaS") versions of our on-premises products, including our vRealize and Horizon Suite, and certain AirWatch offerings. These initiatives present new and difficult technological and compliance challenges, and significant investments will be required to develop or acquire solutions to address those challenges. Our success depends on our current and future customers perceiving technological and operational benefits and cost savings associated with the increasing adoption of our private and hybrid cloud solutions as well as our client virtualization and mobile device management solutions. As the market for our server virtualization products matures and the scale of our business increases, our rate of revenue growth will depend largely upon the success of our newer product and service offerings. In addition, to the extent that our newer private and hybrid cloud solutions, as well as our client and network virtualization and mobile device management solutions, are adopted more slowly or less comprehensively than we expect, our revenue growth rates may slow materially or our

revenue may decline substantially.

The large majority of our revenues have come from our server virtualization products including our flagship VMware vSphere product line. Decreases in demand for our server virtualization products could adversely affect our results of operations and financial condition.

The large majority of our revenues have come from our server virtualization products. Although we continue to develop other applications for our virtualization technology such as our network virtualization solution, VMware NSX, our storage

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virtualization solutions, vSAN, Virtual Volumes, our end-user computing products and our hybrid cloud services and expand our offerings into related areas such as our vRealize software-defined data center (“SDDC”) management products and vCloud product suites, we expect that our server virtualization products and related enhancements and upgrades will constitute a majority of our revenues for the foreseeable future. Declines and variability in demand for our server virtualization products could occur as a result of:

- improved products or product versions being offered by competitors in our markets;
- competitive pricing pressures;
- failure to timely execute and implement our product strategy, which could lead to quality issues, integration issues with ecosystem partners, and difficulties in creating and marketing suites of interoperable solutions;
- failure to release new or enhanced versions of our server virtualization products on a timely basis, or at all;
- technological change that we are unable to address with our server virtualization and private cloud products or that changes the way enterprises utilize our products; and
- general economic conditions.

Also, as more and more businesses achieve high levels of virtualization in their data centers, certain markets for our VMware vSphere product line have matured. Our sales of standalone VMware vSphere have declined as a portion of our overall business as we seek to transition our customers to product suites, our newer products and infrastructure-as-a-service offerings. If we fail to introduce compelling new features in future upgrades to our VMware vSphere product line, manage the transition to hybrid cloud platforms, develop new applications for our virtualization technology or provide product suites based on the VMware vSphere platform that address customer requirements for integration, automation and management of their IT systems, overall demand for products and services based on VMware vSphere may decline.

Due to our product concentration, our business, financial condition, results of operations, and cash flows would therefore be adversely affected by a decline in demand for our server virtualization products.

We face intense competition that could adversely affect our operating results.

The virtualization, cloud computing, end-user computing and software-defined data center industries are inter-related and rapidly evolving, and we face intense competition across all the markets for our products and services. Many of our current or potential competitors have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we do.

We face competition from, among others:

Large, diversified enterprise software and hardware companies. These competitors supply a wide variety of products and services to, and have well-established relationships with, our current and prospective end users. For example, small to medium sized businesses and companies in emerging markets that are evaluating the adoption of virtualization-based technologies and solutions may be inclined to consider Microsoft solutions because of their existing use of Windows and Office products. Some of these competitors have in the past and may in the future take advantage of their existing relationships to engage in business practices that make our products and services less attractive to our end users. Other competitors have limited or denied support for their applications running in VMware virtualization environments. In addition, these competitors could integrate competitive capabilities into their existing products and services and make them available without additional charge. For example, Oracle provides free server virtualization software intended to support Oracle and non-Oracle applications, and Microsoft offers its own server virtualization software packaged with its Windows Server product and offers built-in virtualization in the client version of Windows. As a result, existing and prospective VMware customers may elect to use products that are perceived to be “free” or “very low cost” instead of purchasing VMware products and services for certain applications where they do not believe that more advanced and robust capabilities are required.

Companies offering competing platforms based on open source technologies. Open source technologies for virtualization, containerization and cloud platforms such as Xen, KVM, Docker, Rocket and OpenStack provide significant pricing competition and enable competing vendors to leverage these open source technologies to compete directly with our SDDC initiative. Enterprises and service providers have shown significant interest in building their own clouds based on open source projects such as OpenStack, and other companies have indicated their intention to



expand offerings of virtual management and cloud computing solutions as well. Additionally, a number of enterprise IT hardware vendors have released solutions based on OpenStack including HP, IBM and Cisco.

Other industry alliances. Many of our competitors have entered into or extended partnerships or other strategic relationships to offer more comprehensive virtualization and cloud computing solutions than they individually had offered. We expect these trends to continue as companies attempt to strengthen or maintain their positions in the evolving virtualization

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infrastructure and enterprise IT solutions industry. These alliances may result in more compelling product and service offerings than we offer.

Providers of public cloud infrastructure offerings. We compete with infrastructure-as-a service offerings from various public cloud providers such as Amazon, Microsoft, IBM and Google both directly through our vCloud Air offerings and indirectly, as these cloud providers present alternatives to VMware's on-premises server virtualization products. Our partners and members of our developer and technology partner ecosystem. We face competition from our partners. For example, third parties currently selling our products and services could build and market their own competing products and services or market competing products and services of other vendors. Additionally, as formerly distinct sectors of enterprise IT such as software-based virtualization and hardware-based server, networking and storage solutions converge, we also increasingly compete with companies who are members of our developer and technology partner ecosystem. Consequently, we may find it more difficult to continue to work together productively on other projects, and the advantages we derive from our ecosystem could diminish. For example, Nutanix released a hypervisor solution based on KVM.

This competition could result in increased pricing pressure and sales and marketing expenses, thereby materially reducing our operating margins, and could also prevent our new products and services from gaining market acceptance, thereby harming our ability to increase, or causing us to lose, market share.

Our new product and technology initiatives subject us to additional business, legal and competitive risks.

Over the last several years, we have introduced new product and technology initiatives that aim to leverage our virtualization infrastructure software products into the emerging areas of cloud computing and end-user computing as alternatives to the provisioning of physical computing resources. The expansion of our offerings to deliver the SDDC, address IT management and automation, add network and storage virtualization, and enhance our end-user computing capabilities and our hybrid cloud offerings subjects us to additional risks, such as the following:

These initiatives may present new and difficult technological challenges. Significant investments will be required to acquire and develop solutions to those challenges. Customers may choose not to adopt our new product or service offerings and we may be unable to recoup or realize a reasonable return on our investments.

Some of our new initiatives are hosted by third parties whom we do not control but whose failure to prevent service disruptions, or other failures or breaches may require us to issue credits or refunds or indemnify or otherwise be liable to customers or third parties for damages that may occur. Any transition of our services from a third party hosting service to our own data centers would also entail a risk of service disruption during a transition. We may be subject to claims if customers of these service offerings experience service disruptions or failures, security breaches, data losses or other quality issues.

- The success of these new offerings depends upon the cooperation of hardware, software and cloud hosting vendors to ensure interoperability with our products and offer compatible products and services to end users.

- If we are unable to obtain such cooperation, it may be difficult and more costly for us to achieve functionality and service levels that would make our services attractive to end users.

We will need to develop and implement appropriate go-to-market strategies and train our sales force in order to effectively market and sell offerings in product categories in which we may have less experience than our competitors. Accordingly, end users could choose competing products and services over ours, even if such offerings are less advanced than ours.

Our increasing focus on developing and marketing IT management and automation and infrastructure-as-a-service (including software-defined networking and vCloud Air) offerings that enable customers to transform their IT systems requires a greater focus on marketing and selling product suites and more holistic solutions, rather than selling on a product-by-product basis. Consequently, we have developed, and must continue to develop, new strategies for marketing and selling our offerings, and the duration of sales cycles for our offerings has increased as our customers' purchasing decisions become more complex and require additional levels of approval.

• We will need to develop appropriate pricing strategies for our new product initiatives. For example, it has frequently been challenging for software companies to derive significant revenue streams from open source projects, such as certain of our offerings. Additionally, in some cases our new product initiatives are predicated on converting free and trial users to paying customers of the premium tiers of these services, and therefore we must maintain a sufficient

conversion ratio for such services to be profitable. Also, certain of our new product initiatives, such as our vCloud Air hybrid cloud services and our SaaS offerings, have a subscription model. We may not be able to accurately predict subscription renewal rates or their impact on results, and because revenue is recognized for our services over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our results. Moreover, as customers transition to our hybrid cloud and SaaS products and services, our revenue growth rate may be adversely

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impacted, during the period of transition as we will recognize less revenue up-front than we would otherwise recognize as part of a multi-year license arrangement.

The success of our hybrid cloud offerings, including vCloud Air, and our SaaS offerings, will depend on the successful global implementation of the offering and building effective go-to-market strategies. We will need to build sales expertise and infrastructure to support the new offering that is capable of meeting customer requirements for security, reliability and regulatory compliance. Our vCloud Air hybrid cloud offering involves significant capital investment as well as technology risk, and may not be accepted by customers. Further, our newer hybrid cloud and SaaS offerings may lead our team to reduce the time spent on selling our existing product portfolio, which could have a material negative impact on revenues.

As we expand our vCloud Air hybrid cloud offerings globally, we may rely more upon joint ventures with established providers of IT products and services in particular regions, such as our joint venture with the Softbank Group to expand our vCloud Air hybrid cloud service to Japan. Joint ventures require close ongoing cooperation and commitments from the joint venture partners, and the willingness to devote adequate resources as required. If we are unable to continue our strategic alignment with joint venture partners or obtain the cooperation and commitments we are relying upon, our ability to successfully expand our hybrid cloud offerings globally will diminish.

Our new products and services may compete with offerings from companies who are members of our developer and technology partner ecosystem. Consequently, we may find it more difficult to continue to work together productively on other projects, and the advantages we derive from our ecosystem could diminish.

The virtualized end-user computing industry has continued to expand. Other companies are entering, and are developing competing standards for, the end-user computing space, such as Microsoft, Amazon and Citrix, and such companies are likely to introduce their own initiatives that may compete with or not be compatible with our end-user computing initiatives, which could limit the degree to which other vendors develop products and services around our offerings and end users adopt our platforms.

The cloud computing industry is in early stages of expansion. Other companies are entering, and are developing competing standards for the cloud computing space, such as Microsoft, IBM, Cisco, Google and Amazon, as well as numerous vendor offerings based on the OpenStack project. These companies are likely to introduce their own initiatives that may compete with or not be compatible with our cloud initiatives, which could potentially limit the degree to which other vendors develop products and services around our offerings and end users adopt our platforms. Emerging IT sectors, such as cloud computing and SaaS, are frequently subject to a “first mover” effect pursuant to which certain product and service offerings can rapidly capture a significant portion of market share and developer attention. Therefore, because competitive product and service offerings in these sectors have gained broad adoption before ours, it may be difficult for us to displace such offerings regardless of the comparative technical merit, efficacy or cost of our products and services.

Developing and launching new technologies in new areas, as we are continuing to do with our VMware NSX virtual networking, Virtual SAN virtual storage and vCloud Air initiatives, requires significant investments of resources and often entails greater risk than incremental investments in existing industries. If these investments are not successful, our rate of growth may decline or reverse and our operating results will be negatively affected.

In connection with some of our product initiatives, including our hybrid cloud and mobile services, we expect that our customers may increasingly use our services to store and process personal information and other regulated data, increasing our potential exposure to cybersecurity breaches and data loss.

As we continue to develop and expand our hybrid cloud and SaaS offerings, we will need to continue to evolve our processes to meet a number of regulatory, intellectual property and contractual and service compliance challenges as we seek to transform significant portions of our business from a products- to a services-based organization and as our customers increasingly utilize our services to house their data and rely upon our services for their own continuous operations. These challenges include compliance with licenses for open source and third party software embedded in our hybrid cloud and SaaS offerings, maintaining compliance with export control and privacy regulations, protecting our services from external threats, maintaining the continuous service levels and data security expected by our customers, preventing the inappropriate use of our services, compliance with an increasing number of data sovereignty laws and regulations and adapting our go-to-market efforts to clarify the increasing complexity in our

product and service offerings for our customers.

Marketing and selling new technologies to enterprises requires significant investment of time and resources in order to educate customers on the benefits of our new product offerings. These investments can be costly and the additional effort required to educate both customers and our own sales force can distract from their efforts to sell existing products and services.

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As our vSphere-related products continue to mature, our future revenue growth is increasingly dependent on revenue from our new product and technology offerings. Our newer initiatives may be less profitable than our established products, and we may not be successful enough in these newer activities to recoup our investments in them. If any of these risks were to occur, it could damage our reputation, limit our growth and negatively affect our operating results. Our hybrid cloud and SaaS offerings rely upon a number of third-party providers for data center space, equipment, maintenance and other colocation services, and the loss of, or problems with, one or more of these providers may impede the growth of our hybrid cloud offerings, adversely impact our plans to expand the vCloud Air and SaaS services and damage our reputation.

Our hybrid cloud and SaaS offerings, rely upon third-party providers to supply data center space, equipment maintenance and other colocation services. While we have entered into various agreements for the lease of data center space, equipment maintenance and other services, third parties could fail to live up to the contractual obligations under those agreements. For example, a data center landlord may fail to adequately maintain its facilities or provide an appropriate data center infrastructure for which it is responsible. If that were to happen, our ability to deliver services at levels acceptable to our customers and at levels that we have committed to could be impaired. Additionally, if the third parties that we rely on do fail to deliver on their obligations, our reputation could be damaged, our customers could lose confidence in us, and our ability to maintain and expand our hybrid cloud offerings would be impaired. Ongoing uncertainty regarding global economic conditions and the stability of regional financial markets may reduce information technology spending below current expectations and therefore adversely impact our revenues, impede end-user adoption of new products and services and product and service upgrades, and adversely impact our competitive position.

Our business depends on the overall demand for information technology and on the economic health of our current and prospective customers. The purchase of our products and services is often discretionary and may involve a significant commitment of capital and other resources. Weak economic conditions or significant uncertainty regarding the stability of financial markets could adversely impact our business, financial condition and results of operations in a number of ways, including by lengthening sales cycles, affecting the size of enterprise agreements (“EAs”) that customers will commit to, reducing the level of our non-EA transactional sales, lowering prices for our products and services, reducing unit sales and reducing the rate of adoption of our products and services by new customers and the willingness of current customers to purchase upgrades to our existing products and services. For example, a recurrence of the sovereign debt crisis in Europe or that region’s failure to recover from recession would threaten to suppress demand and our customers’ access to credit in that region, which is an important market for our products and services. In addition, recent economic instability in China and Russia has adversely affected our operating results in these countries, and our operating results may be further adversely affected if this economic instability continues or spreads to neighboring markets. In response to sustained economic uncertainty, many national and local governments that are current or prospective customers for our products and services, including the U.S. federal government, have made, or threatened to make, significant spending cutbacks which could reduce the amount of government spending on IT and the potential demand for our products and services from the government sector.

Regional economic uncertainty can also result in general and ongoing tightening in the credit markets, lower levels of liquidity, increases in the rates of default and bankruptcy and significant volatility in the credit, equity and fixed income markets. As a result, current or potential customers may be unable to fund software purchases, which could cause them to delay, decrease or cancel purchases of our products and services. Even if customers are willing to purchase our products and services, if they do not meet our credit requirements, we may not be able to record accounts receivable or unearned revenues or recognize revenues from these customers until we receive payment, which could adversely affect the amount of revenues we are able to recognize in a particular period.

In addition, although we plan to continue making strategic investments in our business, many of our competitors have significantly greater financial, technical and other resources than we do, and to the degree that the economic recovery is anemic or not sustained, they may be better positioned to continue investment in competitive technologies.

Our revenues, unearned revenues, cash flows from operating activities and financial results may be adversely impacted by fluctuation of foreign currency exchange rates. Although foreign currency hedges can offset some of the risk related to foreign currency fluctuations, we will continue to experience foreign currency gains and losses in

certain instances where it is not possible or cost effective to hedge our foreign currency exposures. Our revenues, unearned revenues and cash flows from operating activities may be adversely impacted as a result of fluctuations in the exchange rates between the U.S. dollar and foreign currencies. We invoice and collect in certain non-U.S. dollar denominated currencies, thereby conducting a portion of our transactions in currencies other than the U.S. dollar. Although this practice may alleviate credit risk from our distributors during periods when the U.S. dollar strengthens, it shifts the risk of currency fluctuations to us and may negatively impact our revenues, unearned revenues, anticipated cash flows and financial results due to fluctuations in foreign currency exchange rates, particularly the euro, the British pound, the Japanese yen, the Australian dollar and the Chinese renminbi relative to the U.S. dollar. While variability in operating margin may be

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reduced due to invoicing in certain of the local currencies in which we also recognize expenses, increased exposure to foreign currency fluctuations will introduce additional risk for variability in revenue-related components of our consolidated financial statements and in our cash provided by operating activities. During the first nine months of 2015 and fiscal year 2014 approximately 30% of our sales were invoiced and collected in certain non-U.S. dollar denominated currencies.

We enter into foreign currency forward contracts to hedge a portion of our net outstanding monetary assets and liabilities against movements in certain foreign exchange rates. Although we expect the gains and losses on our foreign currency forward contracts to generally offset the majority of the gains and losses associated with the underlying foreign-currency denominated assets and liabilities that we hedge, our hedging transactions may not yield the results we expect. Additionally, we expect to continue to experience foreign currency gains and losses in certain instances where it is not possible or cost effective to hedge our foreign currency exposures. For example, we experienced a measurable negative impact to our revenues, unearned revenues as well as cash flows from operating activities in the fourth quarter of 2014 and the nine months ended September 30, 2015 due to exchange rate fluctuations and we expect a further negative impact throughout 2015 even if currency exchange rates stabilize at their current levels. The further weakening of foreign currency exchange rates against the U.S. dollar would likely result in additional adverse impact on our revenues, unearned revenues and cash flows from operating activities.

We may not be able to respond to rapid technological changes with new solutions and services offerings, which could have a material adverse effect on our sales and profitability.

The virtualization, cloud computing, end-user computing and SDDC industries are characterized by rapid technological changes, changing customer needs, frequent new software product introductions and evolving industry standards. The introduction of third-party solutions embodying new technologies and the emergence of new industry standards could make our existing and future software solutions obsolete and unmarketable. Cloud computing has proven to be a disruptive technology that is altering the way that businesses consume, manage and provide physical IT resources, applications, data and IT services. We may not be able to establish or sustain our thought leadership in the cloud computing and enterprise software fields, and our customers may not view our products and services as innovative and best-of-breed, which could result in a reduction in market share and our inability to command a pricing premium over competitor products and services. We may not be able to develop updated products and services that keep pace with technological developments and emerging industry standards and that address the increasingly sophisticated needs of our customers or that interoperate with new or updated operating systems and hardware devices or certify our products and services to work with these systems and devices. As a result, we may not be able to accurately predict the lifecycle of our software solutions, and they may become obsolete before we receive the amount of revenues that we anticipate from them. There is no assurance that any of our new offerings would be accepted in the marketplace. Significant reductions in server-related costs or the rise of more efficient infrastructure management software could also affect demand for our software solutions. As hardware and processors become more powerful, we will have to adapt our product and service offerings to take advantage of the increased capabilities. For example, while the introduction of more powerful servers presents an opportunity for us to provide better products for our customers, the migration of servers to microprocessors with an increasing number of multiple cores also allows an end user with a given number of licensed copies of our software to multiply the number of virtualization machines run per server socket without having to purchase additional licenses from us. If we are unable to revise our solutions and offerings in response to new technological developments, our ability to retain or increase market share and revenues in the virtualization software space could be materially adversely affected.

Our operating results may fluctuate significantly, which makes our future results difficult to predict and may result in our operating results falling below expectations or our guidance and cause the price of our Class A common stock to decline.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Our past results should not be relied upon as an indication of our future performance. In addition, a significant portion of our quarterly sales typically occurs during the last two weeks of the quarter, which generally reflects customer buying patterns for enterprise technology. As a result, our quarterly operating results are difficult to predict even in the near term. If our



revenues or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our Class A common stock would likely decline substantially.

In addition, factors that may affect our operating results include, among others:

- general economic conditions in our domestic and international markets and the effect that these conditions have on our customers' capital budgets and the availability of funding for software purchases;
- fluctuations in demand, adoption rates, sales cycles (which have been increasing in length) and pricing levels for our products and services;
- fluctuations in foreign currency exchange rates;
- changes in customers' budgets for information technology purchases and in the timing of their purchasing decisions;

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the timing of recognizing revenues in any given quarter, which, as a result of software revenue recognition policies, can be affected by a number of factors, including product announcements, beta programs and product promotions that can cause revenue recognition of certain orders to be deferred until future products to which customers are entitled become available;

the sale of our products and services in the time frames we anticipate, including the number and size of orders in each quarter;

our ability to develop, introduce and ship in a timely manner new products and services and enhancements that meet customer demand, certification requirements and technical requirements;

the introduction of new pricing and packaging models for our product offerings;

the timing of the announcement or release of upgrades or new products and services by us or by our competitors;

our ability to maintain scalable internal systems for reporting, order processing, license fulfillment, product delivery, purchasing, billing and general accounting, among other functions;

our ability to control costs, including our operating expenses;

changes to our effective tax rate;

the increasing scale of our business and its effect on our ability to maintain historical rates of growth;

our ability to attract and retain highly skilled employees, particularly those with relevant experience in software development and sales;

our ability to conform to emerging industry standards and to technological developments by our competitors and customers;

seasonal factors such as the end of fiscal period budget expenditures by our customers and the timing of holiday and vacation periods;

renewal rates and the amounts of the renewals for EAs as original EA terms expire;

the timing and amount of software development costs that may be capitalized beginning when technological feasibility has been established and ending when the product is available for general release;

unplanned events that could affect market perception of the quality or cost-effectiveness of our products and solutions;

our ability to accurately predict the degree to which customers will elect to purchase our subscription-based offerings in place of licenses to our on-premises offerings; and

the recoverability of benefits from goodwill and acquired intangible assets, and the potential impairment of these assets.

Breaches of our cybersecurity systems could degrade our ability to conduct our business operations and deliver products and services to our customers, delay our ability to recognize revenue, compromise the integrity of our software products, result in significant data losses and the theft of our intellectual property, damage our reputation, expose us to liability to third parties, and require us to incur significant additional costs to maintain the security of our networks and data.

We increasingly depend upon our IT systems to conduct virtually all of our business operations, ranging from our internal operations and product development activities to our marketing and sales efforts and communications with our customers and business partners. Unauthorized parties have attempted to penetrate our network security and our website. Such cyberattacks threaten to misappropriate our proprietary information and cause interruptions of our IT services. Because the techniques used by unauthorized persons to access or sabotage networks change frequently and may not be recognized until launched against a target, we may be unable to anticipate these techniques. Further, if unauthorized access or sabotage remains undetected for an extended period of time, the effects of such breach could be exacerbated. In addition, sophisticated hardware and operating system software and applications that we produce or procure from third parties may contain defects in design or manufacture, including “bugs” and other problems that could unexpectedly interfere with the operation of the system. Our exposure to cybersecurity threats and negative consequences of cybersecurity breaches will likely increase as our vCloud Air and SaaS businesses expand and we store increasing amounts of customer data and host or manage parts of customers’ businesses in cloud-based IT environments.

We have also outsourced a number of our business functions to third party contractors, and our business operations also depend, in part, on the success of our contractors' own cybersecurity measures. We also use third parties to provide colocation services (i.e. data center services) for our hybrid cloud and SaaS offerings. Similarly, we rely upon distributors, resellers, system vendors and systems integrators to sell our products and services and our sales operations depend, in part, on the

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reliability of their cybersecurity measures. Additionally, we depend upon our employees to appropriately handle confidential data and deploy our IT resources in safe and secure fashion that does not expose our network systems to security breaches and the loss of data. Accordingly, if our cybersecurity systems and those of our contractors, partners and vendors fail to protect against unauthorized access, sophisticated cyberattacks and the mishandling of data by our employees, contractors, partners or vendors, our ability to conduct our business effectively could be damaged in a number of ways, including:

- sensitive data regarding our business, including intellectual property and other proprietary data, could be stolen;
- our electronic communications systems, including email and other methods, could be disrupted, and our ability to conduct our business operations could be seriously damaged until such systems can be restored and secured;
- our ability to process customer orders and electronically deliver products and services could be degraded, and our distribution channels could be disrupted, resulting in delays in revenue recognition;
- defects and security vulnerabilities could be exploited or introduced into our software products or our hybrid cloud and SaaS offerings, thereby damaging the reputation and perceived reliability and security of our products and services and potentially making the data systems of our customers vulnerable to further data loss and cyber incidents;
- and

- personally identifiable or confidential data of our customers, employees and business partners could be stolen or lost. Should any of the above events occur, we could be subject to significant claims for liability from our customers, regulatory actions from governmental agencies, our ability to protect our intellectual property rights could be compromised and our reputation and competitive position could be significantly harmed. Also, the regulatory and contractual actions, litigations, investigations, fines, penalties and liabilities relating to data breaches that result in losses of personally identifiable or credit card information of users of our services can be significant in terms of fines and reputational impact, and necessitate changes to our business operations that may be disruptive to us. Additionally, we could incur significant costs in order to upgrade our cybersecurity systems and remediate damages. Consequently, our financial performance and results of operations could be adversely affected.

Operating in foreign countries subjects us to additional risks that may harm our ability to increase or maintain our international sales operations and investments.

Revenues from customers outside the United States comprised 50% and 51%, respectively, of our total revenues during the nine months ended September 30, 2015 and 2014. We have sales, administrative, research and development and technical support personnel in numerous countries worldwide. We expect to continue to add personnel in additional countries. Additionally, our investment portfolio includes investments in non-U.S. financial instruments and holdings in non-U.S. financial institutions, including European institutions. Our international operations subject us to a variety of risks, including:

- the difficulty of managing and staffing international offices and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- increased exposure to foreign currency exchange rate risk;
- difficulties in enforcing contracts and collecting accounts receivable, and longer payment cycles, especially in emerging markets;
- difficulties in delivering support, training and documentation in certain foreign markets;
- tariffs and trade barriers and other regulatory or contractual limitations on our ability to sell or develop our products and services in certain foreign markets;
- economic or political instability and security concerns in countries that are important to our international sales and operations;
- macroeconomic disruptions, such as monetary and credit crises, that can threaten the stability of local and regional financial institutions and decrease the value of our international investments;
- the overlap of different tax structures or changes in international tax laws;
- reduced protection for intellectual property rights, including reduced protection from software piracy, in some countries;
- difficulties in transferring funds from certain countries; and
- difficulties in maintaining appropriate controls relating to revenue recognition practices.

For example, recent economic instability in China and Russia has adversely affected our operating results in these countries, and our operating results may be further adversely affected if this economic instability continues or spreads to

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neighboring markets. Additionally, the Chinese government is working to implement new network security standards that will require IT systems being sold into certain key sectors to be certified as “secure and controllable”. As part of that effort, in December 2014, standards were implemented in the banking sector requiring IT companies selling to Chinese banks to submit their software and other technology to intrusive security testing, include indigenous Chinese intellectual property and encryption technology in their software and disclose source code and other proprietary information to the Chinese government. Implementation of these standards was subsequently suspended in light of concerns communicated by banks and other parties. However, the authorities have indicated that revised standards may be announced in the future. If we are not able to, or choose not to, comply with any such future banking standards and other standards the Chinese government might implement in the future to cover other market sectors within China, our business in China may suffer.

Furthermore, if we fail to comply with legal and regulatory requirements covering the foreign activities of U.S. corporations, such as export control requirements and the Foreign Corrupt Practices Act, as well as with local regulatory requirements in non-U.S. jurisdictions, we may be exposed to significant fines and penalties and reputational harm. These risks will increase as we expand our operations to locations with a higher incidence of corruption and fraudulent business practices. Our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. We expect a significant portion of our growth to occur in foreign countries, which can add to the difficulties in maintaining adequate management and compliance systems and internal controls over financial reporting, and increase challenges in managing an organization operating in various countries.

In addition, potential fallout from recent disclosures related to the U.S. Internet and communications surveillance could also make foreign customers reluctant to purchase cloud computing products and services from U.S.-based companies and impair our growth rate in foreign markets.

Our failure to manage any of these risks successfully could negatively affect our reputation, limit our growth, harm our operations and reduce our international sales.

The failure by customers to renew large license agreement transactions on a satisfactory basis could materially adversely affect our business, financial condition, operating results and cash flow.

Our core customers are large enterprises with multi-year enterprise license agreements, each of which involves substantial aggregate fee amounts. The failure to renew those transactions in the future, at a dollar value at least equal to the original agreement, or to replace those enterprise license agreements with new transactions of similar scope, on terms that are commercially attractive to us could materially adversely affect our business, financial condition, operating results and cash flow.

Our current research and development efforts may not produce significant revenues for several years, if at all. Developing our products and services is expensive. Our investment in research and development may not result in marketable products or services or may result in products and services that take longer to generate revenues, or may generate less revenues, than we anticipate. Our research and development expenses were approximately 20% of our total revenues during both the nine months ended September 30, 2015 and fiscal year ended December 31, 2014. Our future plans include significant investments in software research and development and related product opportunities. We believe that we must continue to dedicate a significant amount of resources to our research and development efforts to maintain our competitive position. However, we may not receive significant revenues from these investments for several years, if at all.

Our sales cycles can be long and unpredictable, our sales efforts require considerable time and expense, and timing of sales is subject to changing purchasing behaviors of our customers. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate significantly.

The timing of our revenues is difficult to predict. Our sales efforts involve educating our customers about the use and benefit of our products and services, including their technical capabilities, potential cost savings to an organization and advantages compared to lower-cost products and services offered by our competitors. Customers typically undertake a significant evaluation process that has in the past resulted in a lengthy sales cycle which typically lasts several months, and may last a year or longer. We spend substantial time, effort and money on our sales efforts without any assurance that our efforts will produce any sales. In addition, product and service purchases are frequently

subject to budget constraints, economic conditions, multiple approvals, and unplanned administrative, processing and other delays. Moreover, the greater number of competitive alternatives, as well as announcements by our competitors that they intend to introduce competitive alternatives at some point in the future, can lengthen customer procurement cycles, cause us to spend additional time and resources to educate end users on the advantages of our product and service offerings and delay product and service sales. Economic downturns and uncertainty can also cause customers to add layers to their internal purchase approval processes, adding further time to a sales cycle. Additionally, as we sell more products and services to domestic and foreign governments, we may encounter lengthier sales cycles, complicated budgeting processes and complex procurement regulations. The growing complexity and variety of our product and service offerings can also increase sales cycles. These factors can have a particular impact on the timing and

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length of our EA sales cycles and our overall sales during any particular fiscal period may have greater variability as a greater portion of our sales is made utilizing EAs.

Additionally, our quarterly sales have historically reflected an uneven pattern in which a disproportionate percentage of a quarter's total sales occur in the last two weeks of each quarter. Similarly, our yearly sales have historically reflected a disproportionate percentage of the year's sales in the fourth fiscal quarter. These patterns make prediction of revenues, earnings and working capital for each financial period especially difficult and uncertain and increase the risk of unanticipated variations in financial condition and results of operations. We believe this uneven sales pattern is a result of many factors including the following:

- the tendency of customers to wait until late in a quarter to commit to a purchase in the hope of obtaining more favorable pricing;

- the fourth quarter influence of customers spending their remaining capital budget authorization prior to new budget constraints in the following year; and

- seasonal influences, such as holiday or vacation periods.

If sales expected from specific customers for a particular quarter are not realized in that quarter or at all, our results could fall short of public expectations and our business, financial condition and results of operations for that period could be materially adversely affected.

We are dependent on our management and our key development personnel, and the loss of key personnel may prevent us from implementing our business plan in a timely manner.

Our success depends largely upon the continued services of our existing management. We are also substantially dependent on the continued service of our key development personnel for product and service innovation and timely development and delivery of upgrades and enhancements to our existing products and services. The market for expert software developers upon whom we rely has become increasingly competitive. We generally do not have employment or non-compete agreements with our existing management or development personnel, and, therefore, they could terminate their employment with us at any time without penalty and could pursue employment opportunities with any of our competitors. Changes to management and key employees can also lead to additional unplanned losses of key employees. The loss of key employees could seriously harm our ability to release new products and services on a timely basis and could significantly help our competitors.

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

To execute on our strategy, we must continue to attract and retain highly qualified personnel. Competition for these personnel is intense, especially for senior sales executives and engineers with high levels of experience in designing and developing software. We may not be successful in attracting and retaining qualified personnel. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Many of the companies with which we compete for experienced personnel have greater resources than we have. Research and development personnel are also aggressively recruited by startup and emerging growth companies, which are especially active in many of the technical areas and geographic regions in which we conduct product and service development. In addition, in making employment decisions, particularly in the high-technology industry, job candidates often consider the value of the stock-based compensation they are to receive in connection with their employment. Declines in the value of our stock could adversely affect our ability to attract or retain key employees and result in increased employee compensation expenses. If we fail to attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could be severely harmed.

Our success depends upon our ability to develop new products and services, integrate acquired products and services, enhance our existing products and services and develop appropriate business and pricing models.

If we are unable to develop new products and services, integrate acquired products and services, enhance and improve our products and support services in a timely manner, or position or price our products and services to meet market demand, customers may not buy new software licenses from us, update to new versions of our software or renew product support. In addition, information technology standards from both consortia and formal standards-setting forums as well as de facto marketplace standards are rapidly evolving. We cannot provide any assurance that the



standards on which we choose to develop new products and services will allow us to compete effectively for business opportunities in emerging areas such as cloud computing.

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New product and service development and introduction involve a significant commitment of time and resources and is subject to a number of risks and challenges including:

- managing the length of the development cycle for new products and services and product and service enhancements, which has frequently been longer than we originally expected;
- increasing complexity of our product offerings as we introduce product suites such as our vCloud Suite and increasingly offer SaaS versions of our products, such as our vRealize, Horizon and AirWatch SaaS offerings, which can significantly increase the development time and effort necessary to achieve the interoperability of product suite components while maintaining product quality;
- growth rates of our emerging products and services may be negatively impacted despite their technical merit by the need to package such products and services in more complex product suite offerings that require more time for customer evaluation and purchase decisions;
- managing customers' transitions to new products and services, which can result in delays in their purchasing decisions;
- adapting to emerging and evolving industry standards and to technological developments by our competitors and customers;
- entering into new or unproven markets with which we have limited experience;
- reacting to trends and predicting which technologies will be successful and develop into industry standards;
- tailoring our business and pricing models appropriately as we enter new markets and respond to competitive pressures and technological changes;
- incorporating and integrating acquired products and technologies; and
- developing or expanding efficient sales channels.

In addition, if we cannot adapt our business models to keep pace with industry trends, including the industry-wide transition to cloud-based computing, our cash flows and results of operations could be negatively impacted. For example, as we increase our adoption of subscription-based pricing models for our products, we may fail to set pricing at levels appropriate to maintain our revenue streams or our customers may choose to deploy products from our competitors that they believe are priced more favorably. Additionally, we may fail to accurately predict subscription renewal rates or their impact on results of operations, and because revenues from subscriptions are recognized for our services over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our results.

Our products and services are highly technical and may contain errors, defects or security vulnerabilities which could cause harm to our reputation and adversely affect our business.

Our products and services are highly technical and complex and, when deployed, have contained and may contain errors, defects or security vulnerabilities. Some errors in our products or services may only be discovered after a product or service has been installed and used by customers. Any errors, defects or security vulnerabilities discovered in our products or services after commercial release could result in loss of revenues or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, financial condition and results of operations. Undiscovered vulnerabilities in our products or services could expose them to hackers or other unscrupulous third parties who develop and deploy viruses, worms, and other malicious software programs that could attack our products or services. In the past, VMware has been made aware of public postings by hackers of portions of our source code. It is possible that the released source code could expose unknown security vulnerabilities in our products and services that could be exploited by hackers or others. We may also inherit unknown security vulnerabilities when we integrate the products or services of companies that we acquire into existing and new VMware products or services.

Actual or perceived security vulnerabilities in our products or services could harm our reputation and lead some customers to return products or services, to reduce or delay future purchases or to use competitive products or services. End users, who rely on our products and services for the interoperability of enterprise servers and applications that are critical to their information systems, may have a greater sensitivity to product errors and security vulnerabilities than customers for software products generally. Any security breaches could lead to interruptions, delays and data loss and protection concerns. By their nature, security breaches are often difficult to detect and the failure to detect a breach for an extended period of time could significantly increase the damage it could cause. In

addition, we could face claims for product liability, tort or breach of warranty, including claims relating to changes to our products and services made by our channel partners. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld, and customers and channel partners may seek indemnification from us for their losses and those of their customers. Defending a lawsuit, regardless of its merit, is costly and time-consuming and may divert management's attention and adversely affect the market's

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perception of us and our products and services. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, financial condition and results of operations could be adversely impacted.

Failure to effectively manage our product and service lifecycles could materially adversely affect our business, financial condition, operating results and cash flow.

As part of the natural lifecycle of our products and services, we periodically inform customers that products or services will be reaching their end of life or end of availability and will no longer be supported or receive updates and security patches. To the extent these products or services remain subject to a service contract with the customer, we offer to transition the customer to alternative products or services. Failure to effectively manage our product and service lifecycles could lead to customer dissatisfaction and contractual liabilities, which could materially adversely affect our business, financial condition, operating results and cash flow.

Our success depends on the interoperability of our products and services with those of other companies.

The success of our products depends upon the cooperation of hardware, software and cloud hosting vendors to ensure interoperability with our products and offer compatible products and services to end users. To the extent that hardware, software and cloud hosting vendors perceive that their products and services compete with ours or those of our controlling stockholder, EMC Corporation (“EMC”), they may have an incentive to withhold their cooperation, decline to share access or sell to us their proprietary APIs, protocols or formats, or engage in practices to actively limit the functionality, compatibility and certification of our products. In addition, vendors may fail to certify or support or continue to certify or support our products for their systems. If any of the foregoing occurs, our product development efforts may be delayed or foreclosed and it may be difficult and more costly for us to achieve functionality and service levels that would make our services attractive to end users, any of which could negatively impact our business and operating results.

We rely on distributors, resellers, system vendors and systems integrators to sell our products and services, and our failure to effectively develop, manage or prevent disruptions to our distribution channels and the processes and procedures that support them could cause a reduction in the number of end users of our products and services.

Our future success is highly dependent upon maintaining and increasing the number of our relationships with distributors, resellers, system vendors and systems integrators. Because we rely on distributors, resellers, system vendors and systems integrators, we may have little or no contact with the ultimate users of our products and services, thereby making it more difficult for us to establish brand awareness, ensure proper delivery and installation of our products and services, service ongoing customer requirements, estimate end-user demand and respond to evolving customer needs.

Recruiting and retaining qualified channel partners and training them in the use of our technology and product offerings requires significant time and resources. In order to develop and expand our distribution channel, we must continue to expand and improve our processes and procedures that support our channel, including our investment in systems and training, and those processes and procedures may become increasingly complex and difficult to manage. The time and expense required for sales and marketing organizations of our channel partners to become familiar with our product and service offerings, including our new product and service developments, may make it more difficult to introduce those products and services to end users and delay end-user adoption of our product and service offerings.

We generally do not have long-term contracts or minimum purchase commitments with our distributors, resellers, system vendors and systems integrators, and our contracts with these channel partners do not prohibit them from offering products or services that compete with ours. Our competitors may be effective in providing incentives to existing and potential channel partners to favor products and services of our competitors or to prevent or reduce sales of our products and services. Certain system vendors now offer competing virtualization products pre-installed on their server products and services. Additionally, our competitors could attempt to require key distributors to enter into exclusivity arrangements with them or otherwise apply their pricing or marketing leverage to discourage distributors from offering our products and services. Accordingly, our channel partners may choose not to offer our products and services exclusively or at all. Our failure to maintain and increase the number of relationships with channel partners would likely lead to a loss of end users of our products and services, which would result in us receiving lower revenues from our channel partners.

Three of our distributors each accounted for 10% or more of our consolidated revenues during the first nine months of 2015. Our agreements with distributors are typically terminable by either party upon 30 to 90 days' prior written notice to the other party, and neither party has any obligation to purchase or sell any products or services under the agreements. While we believe that we have in place, or would have in place by the date of any such termination, agreements with replacement distributors sufficient to maintain our revenues from distribution, if we were to lose the distribution services of a significant distributor, such loss could have a negative impact on our results of operations until such time as we arrange to replace these distribution services with the services of existing or new distributors.

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The concentration of our product sales among a limited number of distributors increases our potential credit risk. Additionally, weakness in credit markets could affect the ability of our distributors, resellers and customers to comply with the terms of credit we provide in the ordinary course of business. Accordingly, if our distributors, resellers and customers find it difficult to obtain credit or comply with the terms of their credit obligations, it could cause significant fluctuations or declines in our product revenues.

Three of our distributors each accounted for 10% or more of our consolidated revenues during the first nine months of 2015. We anticipate that sales of our products to a limited number of distributors will continue to account for a significant portion of our total product revenues for the foreseeable future. The concentration of product sales among certain distributors increases our potential credit risks. For example, approximately 38% of our total accounts receivable as of September 30, 2015 was from these three distributors. Some of our distributors may experience financial difficulties, which could adversely impact our collection of accounts receivable. One or more of these distributors could delay payments or default on credit extended to them. Our exposure to credit risks of our distributors may increase if our distributors and their customers are adversely affected by global or regional economic conditions. Additionally, we provide credit to distributors, resellers, and certain end-user customers in the normal course of business. Credit is generally extended to new customers based upon a credit evaluation. Credit is extended to existing customers based on ongoing credit evaluations, prior payment history, and demonstrated financial stability. We often allow distributors and customers to purchase and receive shipments of products in excess of their established credit limit. We are unable to recognize revenues from such shipments until the collection of those amounts becomes reasonably assured. Any significant delay or default in the collection of significant accounts receivable could result in an increased need for us to obtain working capital from other sources, possibly on worse terms than we could have negotiated if we had established such working capital resources prior to such delays or defaults. Any significant default could result in a negative impact on our results of operations and delay our ability to recognize revenue. We are involved in litigation and regulatory inquiries and proceedings that could negatively affect us.

From time to time, we are involved in various legal, administrative and regulatory proceedings, claims, demands and investigations relating to our business, which may include claims with respect to commercial, product liability, intellectual property, breach of contract, employment, class action, whistleblower and other matters. In the ordinary course of business, we also receive inquiries from and have discussions with government entities regarding the compliance of our contracting and sales practices with laws and regulations.

We have been, and expect to continue to be, subject to intellectual property infringement claims, including claims by entities that do not have operating businesses of their own and therefore limit our ability to seek counterclaims for damages and injunctive relief. In addition to monetary judgments, a judgment could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all.

Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Third parties may also assert infringement claims against our customers and channel partners, which could require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and channel partners from claims of infringement of proprietary rights of third parties in connection with the use of our products.

These matters can be time-consuming, divert management's attention and resources and cause us to incur significant expenses. Allegations made in the course of regulatory or legal proceedings may also harm our reputation, regardless of the merit of such claims. Furthermore, because litigation and the outcome of regulatory proceedings are inherently unpredictable, our business, financial condition or operating results could be materially affected by an unfavorable resolution of one or more of these proceedings, claims, demands or investigations.

See Note I to "Notes to Condensed Consolidated Financial Statements" for a description of certain claims and litigations.

Our business is subject to a variety of U.S. and international laws and regulations regarding data protection.

Our business is subject to federal, state and international laws and regulations regarding privacy and protection of personal data. As Internet commerce continues to evolve, regulation by federal, state and foreign governments or agencies in the areas of data privacy and data security is likely to increase. Other nations have data privacy laws that,

in some respects, are more stringent than privacy standards in the United States. As we expand our operations in these countries, our liability exposure and the complexity and cost of compliance with data and privacy requirements will likely increase. We collect contact and other personal or identifying information from our customers. Additionally, in connection with some of our product initiatives, including our mobile services and our hybrid cloud and SaaS offerings, our customers increasingly use our services to store and process personal information and other regulated data. We post, on our websites, and, where appropriate, within our products, our privacy policies and practices concerning our treatment of personal data. We also often include privacy commitments in our contracts. Any failure by us to comply with our posted privacy policies, other federal, state or international privacy-related or data protection laws and regulations, or the privacy commitments contained in our contracts could result in proceedings against

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us by governmental entities or others, which could have a material adverse effect on our business, financial condition and results of operations. In addition, the increased attention focused upon liability issues as a result of lawsuits and legislative proposals could harm our reputation or otherwise impact the growth of our business.

It is possible that these laws and regulations may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines and penalties, a governmental order requiring that we change our data practices could result, which in turn could have a material adverse effect on our business. Compliance with such an order may involve significant costs or require changes in business practices that result in reduced revenues. Noncompliance could result in penalties being imposed on us or we could be ordered to cease conducting the noncompliant activity.

In addition to government regulation, privacy advocacy and industry groups or other third parties may propose new and different self-regulatory standards that either legally or contractually apply to our customers or us. Any inability to adequately address privacy concerns, even if unfounded, or comply with applicable privacy or data protection laws, regulations and standards, could result in additional cost and liability to us, damage our reputation, reduce sales and harm our business.

Additionally, our virtualization technology is used by cloud computing vendors, and we have expanded our involvement in the delivery and provision of cloud computing through business alliances with various providers of cloud computing services and software and expect to continue to do so in the future. The application of U.S. and international data privacy laws to cloud computing vendors is uncertain, and our existing contractual provisions may prove to be inadequate to protect us from claims for data loss or regulatory noncompliance made against cloud computing providers who we may partner with. Accordingly, the failure to comply with data protection laws and regulations by our customers and business partners who provide cloud computing services could have a material adverse effect on our business.

Since our hybrid cloud and SaaS offerings are web-based, our customers store their data on our servers and our vendors' servers. This data may include personal data. It may also include protected health information ("PHI") that may be subject to federal, state and international health care privacy, data privacy or security laws, including the Health Insurance Portability and Accountability Act ("HIPAA"). HIPAA has been amended by the Health Information Technology for Economic and Clinical Health Act ("HITECH Act") with the result of increased civil penalties. As a result of HIPAA and the HITECH Act, business associates who have access to PHI provided by covered entities and other business associates are now directly subject to HIPAA. When our customers place PHI into our hybrid cloud services, including vCloud Air or our services hosted on our vCloud Air, we may be required to comply with HIPAA's data security requirements and may be liable for sanctions and penalties for failure to do so. Any systems failure or compromise of our security that results in the release of our customers' data could (i) subject us to substantial damage claims from our customers, (ii) expose us to costly regulatory remediation, and (iii) harm our reputation and brand. We may also need to expend significant resources to protect against security breaches.

If we fail to comply with our customer contracts or government contracting regulations, our business could be adversely affected.

Contracts with many of our customers include unique and specialized performance requirements. In particular, our contracts with federal, state, local and non-U.S. governmental customers and our arrangements with distributors and resellers who may sell directly to governmental customers are subject to various procurement regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us to comply with provisions in our customer contracts or any violation of government contracting regulations could result in the imposition of various civil and criminal penalties, which may include termination of contracts, forfeiture of profits, suspension of payments and, in the case of our government contracts, fines and suspension from future government contracting. Further, any negative publicity related to our customer contracts or any proceedings surrounding them, regardless of its accuracy, may damage our business and affect our ability to compete for new contracts. In the ordinary course of business, we also receive inquiries from and have ongoing discussions with government entities regarding the compliance of our contracting and sales practices with laws and regulations. For example, in June 2015, we reached an agreement with the Department of Justice ("DOJ") and the General Services Administration ("GSA") to pay \$76 million to resolve allegations that our government sales practices between 2006 and



2013 had violated the federal False Claims Act. As set forth in the settlement agreement, VMware denied the allegations without admitting liability. A failure in the future to comply with federal and state governmental contracting requirements could result in the termination of customer contracts, our suspension from government work, the imposition of fines or other government sanctions or an inability to compete for new contracts, any of which could adversely affect our business, operating results or financial condition.

If we are unable to protect our intellectual property rights, our competitive position could be harmed or we could be required to incur significant expenses to enforce our rights.

We depend on our ability to protect our proprietary technology. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. As such, despite our efforts, the steps we have taken to protect our proprietary rights may not be adequate to preclude misappropriation of our proprietary information or infringement of our intellectual property rights, and our ability to police such

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misappropriation or infringement is uncertain, particularly in countries outside of the United States. Further, with respect to patent rights, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims. To the extent that additional patents are issued from our patent applications, which are not certain, they may be contested, circumvented or invalidated in the future. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, we rely on confidentiality or license agreements with third parties in connection with their use of our products and technology. There is no guarantee that such parties will abide by the terms of such agreements or that we will be able to adequately enforce our rights, in part because we rely on “click-wrap” and “shrink-wrap” licenses in some instances.

Detecting and protecting against the unauthorized use of our products, technology proprietary rights, and intellectual property rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Such litigation could result in substantial costs and diversion of management resources, either of which could harm our business, financial condition and results of operations, and there is no guarantee that we would be successful. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to protecting their technology or intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property, which could result in a substantial loss of our market share.

We provide access to our hypervisor and other selected source code to partners, which creates additional risk that our competitors could develop products that are similar to or better than ours.

Our success and ability to compete depend substantially upon our internally developed technology, which in some cases is incorporated in the source code for our products. We seek to protect the source code, design code, documentation and other information relating to our software, under trade secret, copyright, and other applicable laws. However, we have chosen to provide access to our hypervisor and other selected source code to several dozen of our partners for co-development, as well as for open APIs, formats and protocols. Though we generally control access to our source code and other intellectual property, and enter into confidentiality or license agreements with such partners, as well as with our employees and consultants, this combination of procedural and contractual safeguards may be insufficient to protect our trade secrets and other rights to our technology. Our protective measures may be inadequate, especially because we may not be able to prevent our partners, employees or consultants from violating any agreements or licenses we may have in place or abusing their access granted to our source code. Improper disclosure or use of our source code could help competitors develop products similar to or better than ours.

Our use of “open source” software in our products could negatively affect our ability to sell our products and subject us to possible litigation.

Many of our products and services incorporate so-called “open source” software, and we may incorporate open source software into other products and services in the future. Open source software is generally licensed by its authors or other third parties under open source licenses. Open source licensors generally do not provide warranties or assurance of title or controls on origin of the software, which exposes us to potential liability if the software fails to work or infringes the intellectual property of a third party.

We monitor our use of open source software in an effort to avoid subjecting our products to conditions we do not intend and avoid exposing us to unacceptable financial risk. However, the processes we follow to monitor our use of open source software could fail to achieve their intended result. In addition, although we believe that we have complied with our obligations under the various applicable licenses for open source software that we use, there is little or no legal precedent governing the interpretation of terms in most of these licenses, which increases the risk that a court could interpret the license differently than we do.

From time to time, we receive inquiries or claims from authors or distributors of open source software included in our products regarding our compliance with the conditions of one or more open source licenses. An adverse outcome to a claim could require us to:

pay significant damages;

stop distributing our products that contain the open source software;  
revise or modify our product code to remove alleged infringing code;  
release the source code of our proprietary software; or  
take other steps to avoid or remedy an alleged infringement.

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In March 2015, a software developer who alleges that software code he wrote is used in a component of our vSphere product filed a lawsuit against us in Germany alleging copyright infringement for failing to comply with the terms of an open source license General Public License v.2 (“GPL v.2”), and seeking an order requiring us to comply with the GPL v.2 or cease distribution of any affected code within Germany. Although we believe that the claims in this lawsuit lack merit and intend to vigorously defend the lawsuit, an adverse outcome to this or other claims could have a material adverse impact on our intellectual property rights, our operating results and financial condition.

We offer a number of products under open source licenses that subject us to additional risks and challenges, which could result in increased development expenses, delays or disruptions to the release or distribution of those software solutions, and increased competition.

Several of our product offerings are distributed under open source licenses. Software solutions that are substantially or mostly based on open source software subject us to a number of risks and challenges:

If open source software programmers, most of whom we do not employ, do not continue to develop and enhance open source technologies, our development expenses could be increased and our product release and upgrade schedules could be delayed.

One of the characteristics of open source software is that anyone can modify the existing software or develop new software that competes with existing open source software. As a result, competition can develop without the degree of overhead and lead time required by traditional proprietary software companies. It is also possible for new competitors with greater resources than ours to develop their own open source solutions, potentially reducing the demand for, and putting price pressure on, our solutions.

It is possible that a court could hold that the licenses under which our open source products and services are developed and licensed are not enforceable or that someone could assert a claim for proprietary rights in a program developed and distributed under them. Any ruling by a court that these licenses are not enforceable, or that open source components of our product or services offerings may not be liberally copied, modified or distributed, may have the effect of preventing us from distributing or developing all or a portion of our products or services. In addition, licensors of open source software employed in our offerings may, from time to time, modify the terms of their license agreements in such a manner that those license terms may no longer be compatible with other open source licenses in our offerings or our end-user license agreement or terms of service, and thus could, among other consequences, prevent us from continuing to distribute the software code subject to the modified license or terms of service.

- Actions to protect and maintain ownership and control over our intellectual property could adversely affect our standing in the open source community, which in turn could limit our ability to continue to rely on this community, upon which we are dependent, as a resource to help develop and improve our open source products and services.

If we are unable to successfully address the challenges of integrating offerings based upon open source technology into our business, our ability to realize revenues from such offerings will be negatively affected and our development costs may increase.

Acquisitions could disrupt our business, cause dilution to our stockholders and harm our business, financial condition and results of operations.

We have acquired in the past and plan to acquire in the future other businesses, products or technologies. Acquisitions involve significant risks and uncertainties, which include:

- disrupting our ongoing operations, diverting management from day-to-day responsibilities, increasing our expenses, and adversely impacting our business, financial condition and results of operations;
- failure of the acquired business to further our business strategy;
- uncertainties in achieving the expected benefits of an acquisition, including enhanced revenues, technology, human resources, cost savings, operating efficiencies and other synergies;
- reducing cash available for operations, stock repurchase programs and other uses and resulting in potentially dilutive issuances of equity securities or the incurrence of debt;
- incurring amortization expense related to identifiable intangible assets acquired that could impact our operating results;
-

difficulty integrating the operations, systems, technologies, products and personnel of the acquired businesses effectively;  
retaining and motivating key personnel from acquired companies;

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• assuming the liabilities of the acquired business, including acquired litigation-related liabilities and regulatory compliance issues, and potential litigation or regulatory action arising from a proposed or completed acquisition;

• maintaining good relationships with customers or business partners of the acquired business or our own customers as a result of any integration of operations;

• product liability, customer liability or intellectual property liability associated with the sale of the acquired business's products;

• unidentified issues not discovered during the diligence process, including issues with the acquired business's intellectual property, product quality, security, privacy practices, accounting practices, regulatory compliance or legal contingencies;

• maintaining or establishing acceptable standards, controls, procedures or policies with respect to the acquired business; and

• risks relating to the challenges and costs of closing a transaction.

Additionally, we may not be able to find suitable acquisition candidates, and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we may not ultimately strengthen our competitive position or achieve our goals, or they may be viewed negatively by customers, financial markets or investors. If our acquisitions do not meet our expectations, or if our strategic focus subsequently changes, we may choose to abandon certain acquired product lines and divest from acquired businesses. It is generally difficult for an acquirer to completely recover the cost of an acquisition which is subsequently divested. Accordingly, divestitures of acquired businesses and products may result in us taking charges for impairment of assets and goodwill, and result in cash expenditures in connection with headcount reductions.

The risks described above may be exacerbated as a result of managing multiple acquisitions at the same time. We may also face difficulties due to the lack of experience in new markets, products or technologies or the initial dependence on unfamiliar supply or distribution partners.

In addition to business acquisitions, we also seek to invest in businesses such as venture financed companies and joint ventures that offer complementary products, services or technologies. These investments are accompanied by risks similar to those encountered in an acquisition of a business. Additionally, we do not control entities where we have a minority investment, and therefore cannot ensure that these investments and joint ventures will make decisions that promote or are complementary to our business strategy.

If our goodwill or amortizable intangible assets become impaired, we may be required to record a significant charge to earnings.

We may not realize all the economic benefit from our acquisitions of other companies, which could result in an impairment of goodwill or intangibles. Since the start of 2014, our goodwill balance increased by \$954 million or 32% primarily as a result of acquisitions made during the year. We review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may lead to impairment include a substantial decline in stock price and market capitalization or cash flows, reduced future cash flow estimates related to the assets and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, which would negatively impact our results of operations.

Problems with our information systems could interfere with our business and could adversely impact our operations. We rely on our information systems and those of third parties for processing customer orders, delivering products, providing services and support to our customers, billing and tracking our customers, fulfilling contractual obligations and otherwise running our business. If our systems fail, our disaster and data recovery planning and capacity may prove insufficient to enable timely recovery of important functions and business records. Any disruption in our information systems and those of the third parties upon whom we rely could have a significant impact on our business. In addition, we continuously work to enhance our information systems. For example, we are in the midst of a multi-year project to replace our enterprise resource planning software. The implementation of these types of enhancements is frequently disruptive to the underlying business of an enterprise, which may especially be the case for us due to the size and complexity of our business. Additionally, our information systems may not support new

business models and initiatives and significant investments could be required in order to upgrade them. Any disruptions relating to our systems enhancements, particularly any disruptions impacting our operations during the implementation period, could adversely affect our business in a number of respects. Additionally, delays in adapting our information systems to address new business models could limit the success or result in the failure of such initiatives and impair the effectiveness of our internal controls. Even if we do not encounter these adverse effects, the implementation of these enhancements may be much more costly than we anticipated. If we are unable to successfully

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implement the information systems enhancements as planned, our financial condition, results of operations and cash flows could be negatively impacted.

Our financial results may be adversely impacted by higher than expected tax rates, and we may have exposure to additional tax liabilities.

As a multinational corporation, we are subject to income taxes as well as non-income based taxes, such as payroll, sales, use, value-added, net worth, property and goods and services taxes, in both the United States and various foreign jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we file and changes to tax laws. Significant judgment is required in determining our worldwide provision for income taxes and other tax liabilities. From time to time, we are subject to income and non-income tax examinations. Currently, the EMC consolidated tax group, of which we are a part, is under federal income tax audit for 2009 and 2010 (which is ongoing), and the IRS also commenced the tax audit for 2011 during the first quarter of 2015. While we believe we have complied with all applicable income tax laws, there can be no assurance that a governing tax authority will not have a different interpretation of the law and assess us with additional taxes. Should we be assessed with additional taxes, there could be a material adverse effect on our financial condition or results of operations.

Our future effective tax rate may be affected by such factors as changes in tax laws, our business, rates, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation, the impact of accounting for business combinations, and shifts in the amount of earnings in the U.S. compared with other regions in the world as well as the expiration of statute of limitations and settlements of audits, changes in our international organization, and changes in overall levels of income before tax. For example, the U.S. federal research credit, which provided a significant reduction in our effective tax rate, expired on December 31, 2014. Without the reinstatement of the U.S. federal research credit, our forecast of the 2015 effective tax rate is higher than the 2014 effective tax rate. In addition, in the ordinary course of our global business, there are many intercompany transactions and calculations where the ultimate tax determination is uncertain. Although we believe that our tax estimates are reasonable, we cannot ensure that the final determination of tax audits or tax disputes will not be different from what is reflected in our historical income tax provisions and accruals.

Additionally, our rate of taxation in foreign jurisdictions is lower than the U.S. tax rate. Our international income is primarily earned by our subsidiaries organized in Ireland and as such, our effective tax rate can be impacted by the mix of our earnings in the U.S. and foreign jurisdictions.

During October 2014, Ireland announced revisions to its tax regulations that will require foreign earnings earned by our subsidiaries organized in Ireland to be taxed at higher rates. We will be impacted by the changes in tax regulations in Ireland beginning in 2021, and we may proactively make structural changes that impact our tax rates prior to that date. Additionally, the U.S. and other countries where we do business have been considering changes to existing tax laws. These potential changes could also adversely affect our effective tax rate.

Our business is subject to the risks of earthquakes, fire, floods and other natural catastrophic events such as pandemics, and to interruption by man-made problems, such as computer viruses, unanticipated disruptions in local infrastructure or terrorism, which could result in delays or cancellations of customer orders or the deployment of our products and services.

Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity. A significant natural disaster, such as an earthquake, fire, flood or other act of God, could have a material adverse impact on our business, financial condition and results of operations. As we continue to grow internationally, increasing amounts of our business will be located in foreign countries that may be more subject to political or social instability that could disrupt operations. Furthermore, some of our new product initiatives and business functions are hosted and carried out by third parties that may be vulnerable to disruptions of these sorts, many of which may be beyond our control. In addition, our servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems. Unanticipated disruptions in services provided through localized physical infrastructure, such as utility or telecommunication outages, can curtail the functioning of local offices as well as critical components of our information systems, and adversely affect our ability to process orders, provide



services, respond to customer requests and maintain local and global business continuity. Natural disasters that affect the manufacture of IT products can also delay customer spending on our software, which is often coupled with customer purchases of new servers and IT systems. Furthermore, acts of terrorism or war could cause disruptions in our or our customers' business or the economy as a whole, and disease pandemics could temporarily sideline a substantial part of our or our customers' workforce at any particular time. To the extent that such disruptions result in delays or cancellations of customer orders, or the deployment or availability of our products and services, our revenues would be adversely affected. Additionally, any such catastrophic event could cause us to incur significant costs to repair damages to our facilities, equipment and infrastructure.

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Changes in accounting principles and guidance, or their interpretation, could result in unfavorable accounting charges or effects, including changes to our previously-filed financial statements, which could cause our stock price to decline. We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States. These principles are subject to interpretation by the SEC and various bodies formed to interpret and create appropriate accounting principles and guidance. A change in these principles or guidance, or in their interpretations, may have a significant effect on our reported results and retroactively affect previously reported results. For example, during May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated standard is effective for us in the first quarter of 2018 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is permitted, but not earlier than the first quarter of 2017. We have not selected a transition method and are currently evaluating the effect that ASU 2014-09 will have on our consolidated financial statements and related disclosures.

**Risks Related to Our Relationship with EMC**

As long as EMC controls us, or Class B common stock remains outstanding, other holders of our Class A common stock will have limited ability to influence matters requiring stockholder approval.

As of September 30, 2015, EMC owned 43,025,000 shares of our Class A common stock and all 300,000,000 shares of our Class B common stock, representing 81.3% of the total outstanding shares of common stock or 97.5% of the voting power of outstanding common stock. The holders of our Class A common stock and our Class B common stock have identical rights, preferences and privileges except with respect to voting and conversion rights, the election of directors, certain actions that require the consent of holders of Class B common stock and other protective provisions as set forth in our certificate of incorporation. Holders of our Class B common stock are entitled to 10 votes per share of Class B common stock on all matters except for the election of our Group II directors, in which case they are entitled to one vote per share, and the holders of our Class A common stock are entitled to one vote per share of Class A common stock. The holders of Class B common stock, voting separately as a class, are entitled to elect 80% of the total number of directors on our board of directors that we would have if there were no vacancies on our board of directors at the time. These are our Group I directors. Subject to any rights of any series of preferred stock to elect directors, the holders of Class A common stock and the holders of Class B common stock, voting together as a single class, are entitled to elect our remaining directors, which at no time will be less than one director-our Group II director(s). Accordingly, the holders of our Class B common stock currently are entitled to elect 7 of our 8 directors. Our amended and restated certificate of incorporation provides that, if EMC transfers shares of our Class B common stock to any party other than a successor-in-interest or a subsidiary of EMC prior to a distribution to its stockholders under Section 355 of the Internal Revenue Code of 1986, as amended (a “355 distribution”), those shares will automatically convert into Class A common stock. Additionally, if, prior to a 355 distribution, EMC’s ownership falls below 20% of the outstanding shares of our common stock, all outstanding shares of Class B common stock will automatically convert to Class A common stock. Following a 355 distribution, shares of Class B common stock may convert to Class A common stock if such conversion is approved by VMware stockholders after the 355 distribution and we have obtained a private letter ruling from the Internal Revenue Service. In January 2014, the IRS announced in Revenue Procedure 2014-3 that, generally, it would no longer issue private letter rulings on 355 distributions. For so long as EMC or its successor-in-interest beneficially owns shares of our common stock representing at least a majority of the votes entitled to be cast by the holders of outstanding voting stock, EMC will be able to elect all of the members of our board of directors. To the extent that shares of our Class B common stock remain outstanding following a 355 distribution, these shares will remain entitled to 10 votes per share and the holders of our Class A common stock will continue to have limited ability to influence matters requiring stockholder approval. Furthermore, to the extent that shares of our Class B common stock remain outstanding following a 355 distribution, holders of these shares will remain entitled to elect 80% of the total number of directors on our board of directors and the holders of our Class A common stock will continue to have limited ability to elect members of our board of directors.

In addition, until such time as EMC or its successor-in-interest beneficially owns shares of our common stock representing less than a majority of the votes entitled to be cast by the holders of outstanding voting stock, EMC will have the ability to take stockholder action without the vote of any other stockholder and without having to call a

stockholder meeting, and holders of our Class A common stock will not be able to affect the outcome of any stockholder vote during this period. As a result, EMC will have the ability to control all matters affecting us, including:

- the composition of our board of directors and, through our board of directors, any determination with respect to our business plans and policies;
- any determinations with respect to significant mergers, acquisitions and other business combinations;
- our acquisition or disposition of a significant amount of assets;
- our financing activities;

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certain changes to our certificate of incorporation;

changes to the agreements we entered into in connection with our transition to becoming a public company;

corporate opportunities that may be suitable for us and EMC;

determinations with respect to enforcement of rights we may have against third parties, including with respect to intellectual property rights;

the payment of dividends on our common stock; and

the number of shares available for issuance under our stock plans for our prospective and existing employees.

Our certificate of incorporation and the master transaction agreement entered into between us and EMC in connection with our initial public offering (“IPO”) also contain provisions that require that as long as EMC beneficially owns at least 20% or more of the outstanding shares of our common stock, the prior affirmative vote or written consent of EMC (or its successor-in-interest) as the holder of the Class B common stock is required (subject in each case to certain exceptions) in order to authorize us to:

- consolidate or merge with any other entity;
- acquire the stock or assets of another entity in excess of \$100 million;
- issue any stock or securities except to our subsidiaries or pursuant to our employee benefit plans;
- establish the aggregate annual amount of shares we may issue under employee equity awards;
- dissolve, liquidate or wind us up;
- declare dividends on our stock;
- enter into any exclusive or exclusionary arrangement with a third party involving, in whole or in part, products or services that are similar to EMC’s; and
- amend, terminate or adopt any provision inconsistent with certain provisions of our certificate of incorporation or bylaws.

If EMC indicates to us that it will not provide any requisite consent allowing us to conduct such activities when or if requested, we will not be able to conduct such activities and, as a result, our business and our operating results may be harmed. EMC’s voting control and its additional rights described above may discourage transactions involving a change of control of us, including transactions in which holders of our Class A common stock might otherwise receive a premium for their shares over the then-current market price. EMC is not prohibited from selling a controlling interest in us to a third party and may do so without the approval of the holders of our Class A common stock and without providing for a purchase of any shares of Class A common stock held by persons other than EMC.

Accordingly, shares of Class A common stock may be worth less than they would be if EMC did not maintain voting control over us or if EMC did not have the additional rights described above.

In the event EMC is acquired or otherwise undergoes a change of control, any acquirer or successor will be entitled to exercise the voting control and contractual rights of EMC, and may do so in a manner that could vary significantly from EMC’s historic practice.

By becoming a stockholder in our company, holders of our Class A common stock are deemed to have notice of and have consented to the provisions of our certificate of incorporation and the master transaction agreement with respect to the limitations that are described above.

We engage in related persons transactions with EMC that may divert our resources, create opportunity costs and prove to be unsuccessful.

We currently engage in a number of related persons transactions with EMC (and, if the Dell Acquisition is completed, we may in the future engage in related persons transactions with Dell) that include joint product development, go-to-market, branding, sales, customer service activities, real estate and various support services. Additionally, we contributed technology and transferred employees to Pivotal in 2013 and continue to hold a significant ownership interest in Pivotal. We also recently announced our intention to form a new cloud services business, jointly owned with EMC, in connection with which we expect to contribute technology and transfer employees to Virtustream, Inc., currently a wholly-owned subsidiary of EMC (“Virtustream”), in exchange for shares of common stock of Virtustream, and expect to consolidate Virtustream's results into our financial statements. For more information, refer to Note K to

the Notes to the condensed consolidated financial information and “Our Relationship with EMC” in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this periodic report, and “Transactions with Related Persons” in the proxy statement for our 2015 annual meeting of stockholders.

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We believe that these related persons transactions provide us a unique opportunity to leverage the respective technical expertise, product strengths and market presence of EMC and its subsidiaries for the benefit of our customers and stockholders while enabling us to compete more effectively with competitors who are much larger than us. However, these transactions (or other transactions we may enter into with Dell if the Dell Acquisition is completed) may prove not to be successful and may divert our resources or the attention of our management from other opportunities. Negotiating and implementing these arrangements can be time consuming and cause delays in the introduction of joint product and service offerings and disruptions to VMware's business. We cannot predict whether our stockholders and industry or securities analysts who cover us will react positively to announcements of new related persons transactions with EMC, and such announcements could have a negative impact on our stock price. Our participation in these transactions may also cause certain of our other vendors and ecosystem partners who compete with EMC and its subsidiaries (or, if the Dell Acquisition is completed, Dell and its subsidiaries) to also view us as their competitors. Additionally, if Pivotal requires additional funding, we may be asked to contribute capital resources to Pivotal or accept dilution in our ownership interest, and we may be unable to realize any value from the technology and resources that we contributed to Pivotal. For a description of risks specific to the proposed Virtustream transaction, see "Risks Related to Recent Announcements — Our recently announced intention to form a new cloud services business with EMC may not be completed and, if completed, may not prove successful."

Our business and the business of EMC overlap, and EMC and Dell may compete with us, which could reduce our market share.

We and EMC are IT infrastructure companies providing products and services that overlap in various areas, including software-based network storage, hyper-converged infrastructure products and cloud computing services. Dell, which has proposed to acquire EMC in the Dell Acquisition, and would, upon the consummation of the Dell Acquisition, indirectly control our company also provides products and services that overlap with ours in various areas, including in management and hyper-converged infrastructure products. EMC and Dell compete with us in these areas now and may engage in increased competition with us in the future. In addition, the intellectual property agreement that we have entered into with EMC provides EMC the ability to use our source code and intellectual property, which, subject to limitations, it may use to produce certain products that compete with ours. EMC's rights in this regard extend to its majority-owned subsidiaries, which could include joint ventures where EMC holds a majority position and one or more of our competitors hold minority positions.

EMC, or following the Dell Acquisition, Dell, could assert control over us in a manner that could impede our growth or our ability to enter new markets or otherwise adversely affect our business. Further, EMC, or following the Dell Acquisition, Dell, could utilize its control over us to cause us to take or refrain from taking certain actions, including entering into relationships with channel, technology and other marketing partners, enforcing our intellectual property rights or pursuing business combinations, other corporate opportunities (which EMC is expressly permitted to pursue under our certificate of incorporation) or product development initiatives that could adversely affect our competitive position, including our competitive position relative to that of EMC in markets where we compete with them. In addition, EMC and Dell maintain significant partnerships with certain of our competitors, including Microsoft.

EMC's and Dell's competition in certain markets may affect our ability to build and maintain partnerships.

Our existing and potential partner relationships may be affected by our relationship with EMC and the pendency of the Dell Acquisition. We partner with a number of companies that compete with EMC or Dell in certain markets in which EMC or Dell participate. EMC's majority ownership in us, and the potential that Dell may complete its acquisition of EMC and indirectly control a majority of our common stock, might affect our ability to effectively partner with these companies. These companies may favor our competitors because of our relationship with EMC and the potential Dell Acquisition.

EMC and Dell compete with certain of our significant channel, technology and other marketing partners, including IBM and Hewlett-Packard. Pursuant to our certificate of incorporation and other agreements that we have with EMC, EMC, and, if the Dell Acquisition is completed, Dell, may have the ability to impact our relationship with those of our partners that compete with EMC or Dell, which could have a material adverse effect on our results of operations or our ability to pursue opportunities which may otherwise be available to us.

In order to preserve the ability for EMC to distribute its shares of our Class B common stock on a tax-free basis, we may be prevented from pursuing opportunities to raise capital, to effectuate acquisitions or to provide equity incentives to our employees, which could hurt our ability to grow.

Beneficial ownership of at least 80% of the total voting power is required in order for EMC or its successor-in-interest to affect a tax-free spin-off of VMware or certain other tax-free transactions. We have agreed that for so long as EMC or its successor-in-interest continues to own greater than 50% of the voting control of our outstanding common stock, we will not knowingly take or fail to take any action that could reasonably be expected to preclude EMC's or its successor-in-interest's ability to undertake a tax-free spin-off. Additionally, under our certificate of incorporation and the master transaction agreement we entered into with EMC and under the Dell Acquisition Agreement, we must obtain the consent of EMC or its successor-in-interest, as the holder of our Class B common stock, and EMC must thereafter seek the consent of Dell, to issue stock or other

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VMware securities, except pursuant to employee benefit plans (provided that we obtain Class B common stockholder approval of the aggregate annual number of shares to be granted under such plans), which could cause us to forgo capital raising or acquisition opportunities that would otherwise be available to us. As a result, we may be precluded from pursuing certain growth initiatives.

Third parties may seek to hold us responsible for liabilities of EMC, which could result in a decrease in our income. Third parties may seek to hold us responsible for EMC's liabilities. Under our master transaction agreement with EMC, EMC will indemnify us for claims and losses relating to liabilities related to EMC's business and not related to our business. However, if those liabilities are significant and we are ultimately held liable for them, we cannot be certain that we will be able to recover the full amount of our losses from EMC or its successor-in-interest. Although we have entered into a tax sharing agreement with EMC under which our tax liabilities for most transactions will effectively be determined as if we were not part of any consolidated, combined or unitary tax group of EMC Corporation or its subsidiaries, we nonetheless could be held liable for the tax liabilities of other members of these groups.

We have historically been included in EMC's consolidated group for U.S. federal income tax purposes, as well as in certain consolidated, combined or unitary groups that include EMC Corporation or certain of its subsidiaries for state and local income tax purposes. Pursuant to our tax sharing agreement with EMC, we and EMC generally will make payments to each other such that, with respect to tax returns for any taxable period in which we or any of our subsidiaries are included in EMC's consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of EMC Corporation or its subsidiaries, the amount of taxes to be paid by us will be determined, subject to certain consolidated return adjustments, as if we and each of our subsidiaries included in such consolidated, combined or unitary group filed our own consolidated, combined or unitary tax return. When we become subject to federal income tax audits as a member of EMC's consolidated group, the tax sharing agreement provides that EMC has authority to control the audit and represent EMC and VMware's interests to the IRS. Accordingly, if we and EMC or its successor-in-interest differ on appropriate responses and positions to take with respect to tax questions that may arise in the course of an audit, our ability to affect the outcome of such audits may be impaired. In addition, if EMC effects a 355 Distribution that is subsequently determined to be taxable, VMware could be liable for all or a portion of the tax liability, which could have a material adverse effect on our operating results and financial condition.

We have been included in the EMC consolidated group for U.S. federal income tax purposes since our acquisition by EMC, and expect to continue to be included in such consolidated group for periods in which EMC or its successor-in-interest owns at least 80% of the total voting power and value of our outstanding stock. Each member of a consolidated group during any part of a consolidated return year is jointly and severally liable for tax on the consolidated return of such year and for any subsequently determined deficiency thereon. Similarly, in some jurisdictions, each member of a consolidated, combined or unitary group for state, local or foreign income tax purposes is jointly and severally liable for the state, local or foreign income tax liability of each other member of the consolidated, combined or unitary group. Accordingly, for any period in which we are included in the EMC consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of EMC Corporation and/or its subsidiaries, we could be liable in the event that any income tax liability was incurred, but not discharged, by any other member of any such group.

We are still evaluating the potential impact of the pending Dell Acquisition on our tax sharing agreement with EMC. Any inability to resolve favorably any disputes that arise between us and EMC with respect to our past and ongoing relationships may result in a significant reduction of our revenues and earnings.

Disputes may arise between EMC and us in a number of areas relating to our ongoing relationships, including:

- labor, tax, employee benefit, indemnification and other matters arising from our separation from EMC;
- our reseller arrangements with EMC;
- tax matters that involve us as a member of EMC's consolidated group;
- employee retention and recruiting;
- business combinations involving us;
- our ability to engage in activities with certain channel, technology or other marketing partners;



sales or dispositions by EMC of all or any portion of its ownership interest in us;  
the nature, quality and pricing of services EMC has agreed to provide us or we have agreed to provide to EMC;  
arrangements with third parties that are exclusionary to EMC;

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arrangements with EMC for collaborative product or technology development, marketing and sales activities involving our technology, employees and other resources;

business opportunities that may be attractive to both EMC and us; and

product or technology development or marketing activities or customer agreements which may require the consent of EMC.

We may not be able to resolve any potential conflicts with EMC or its successor-in-interest, and even if we do, the resolution may be less favorable than if we were dealing with an unaffiliated party.

The agreements we enter into with EMC may be amended upon agreement between the parties, and then in some cases only with the consent of Dell under the terms of the Dell Acquisition Agreement. While we are controlled by EMC and during the pendency of the Dell Acquisition, we may not have the leverage to negotiate amendments to these agreements if required on terms as favorable to us as those we would negotiate with an unaffiliated third party, if at all.

Our CEO and some of our directors own EMC common stock or equity awards to acquire EMC common stock, and some of our directors hold management positions with EMC, which could cause conflicts of interests that result in our not acting on opportunities we otherwise may have.

Our CEO and some of our directors own EMC common stock or equity awards to purchase EMC common stock. In addition, some of our directors are executive officers or directors of EMC, and EMC, as the sole holder of our Class B common stock, is entitled to elect 7 of our 8 directors. Ownership of EMC common stock, restricted shares of EMC common stock and equity awards to purchase EMC common stock by our directors and the presence of executive officers or directors of EMC on our board of directors could create, or appear to create, conflicts of interest with respect to matters involving both us and EMC that could have different implications for EMC than they do for us. Provisions of our certificate of incorporation and the master transaction agreement between EMC and us address corporate opportunities that are presented to our directors or officers that are also directors or officers of EMC. There can be no assurance that the provisions in our certificate of incorporation or the master transaction agreement will adequately address potential conflicts of interest or that potential conflicts of interest will be resolved in our favor, or that we will be able to take advantage of corporate opportunities presented to individuals who are officers or directors of both us and EMC or, if the Dell Acquisition is completed, Dell. As a result, we may be precluded from pursuing certain growth initiatives.

EMC's ability to control our board of directors may make it difficult for us to recruit independent directors.

So long as EMC or, if the Dell Acquisition is completed, Dell, beneficially owns shares of our common stock representing at least a majority of the votes entitled to be cast by the holders of outstanding voting stock, EMC, or if the Dell Acquisition is completed, Dell, can effectively control and direct our board of directors. Further, the interests of EMC, Dell and our other stockholders may diverge. Under these circumstances, persons who might otherwise accept our invitation to join our board of directors may decline.

We are a "controlled company" within the meaning of the New York Stock Exchange rules and, as a result, are relying on exemptions from certain corporate governance requirements that provide protection to stockholders of companies that are not "controlled companies."

EMC owns more than 50% of the total voting power of our common stock and, as a result, we are a "controlled company" under the New York Stock Exchange corporate governance standards. As a controlled company, we are exempt under the New York Stock Exchange standards from the obligation to comply with certain New York Stock Exchange corporate governance requirements, including the requirements:

- that a majority of our board of directors consists of independent directors;
- that we have a corporate governance and nominating committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities;
- that we have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities; and

• for an annual performance evaluation of the nominating and governance committee and compensation committee.

While we have voluntarily caused our Compensation and Corporate Governance Committee to currently be composed entirely of independent directors, reflecting the requirements of the New York Stock Exchange, we are not required to

maintain the independent composition of the committee. As a result of our use of the “controlled company” exemptions, holders of our Class A common stock will not have the same protection afforded to stockholders of companies that are subject to all of the New York Stock Exchange corporate governance requirements.

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Our historical financial information as a majority-owned subsidiary of EMC may not be representative of the results of a completely independent public company.

The financial information covering the periods included in this Quarterly Report on Form 10-Q does not necessarily reflect what our financial condition, results of operations or cash flows would have been had we been a completely independent entity during those periods. In certain geographic regions where we do not have an established legal entity, we contract with EMC subsidiaries for support services and EMC personnel who are managed by us. The costs incurred by EMC on our behalf related to these employees are passed on to us and we are charged a mark-up intended to approximate costs that would have been charged had we contracted for such services with an unrelated third party. These costs are included as expenses on our condensed consolidated statements of income. Additionally, we and EMC engage in intercompany transactions, including agreements regarding the use of EMC's and our intellectual property and real estate, agreements regarding the sale of goods and services to one another and to Pivotal, and an agreement for EMC to resell our products and services to third party customers. If EMC were to distribute its shares of our common stock to its stockholders or otherwise divest itself of all or a significant portion of its VMware shares, there would be numerous implications to VMware, including the fact that VMware would lose the benefit of these arrangements with EMC. There can be no assurance that VMware would be able to renegotiate these arrangements with EMC, its successor-in-interest or, if the Dell Acquisition is completed, Dell, or replace them on the same or similar terms. Additionally, our business could face significant disruption and uncertainty as we transition from these arrangements with EMC. Moreover, our historical financial information is not necessarily indicative of what our financial condition, results of operations or cash flows will be in the future if and when we contract at arm's length with independent third parties for the services we have received and currently receive from EMC. During the three and nine months ended September 30, 2015, we recognized revenues of \$95 million and \$287 million, respectively, and as of September 30, 2015, \$272 million of sales were included in unearned revenues from such transactions with EMC. For additional information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and notes thereto.

### Risks Related to Owning Our Class A Common Stock

The price of our Class A common stock has fluctuated substantially in recent years and may fluctuate substantially in the future.

The trading price of our Class A common stock has fluctuated significantly since our IPO in August 2007. For example, between January 1, 2014 and September 30, 2015, the closing trading price of our Class A common stock was volatile, ranging between \$75.06 and \$111.80 per share. Our trading price could fluctuate substantially in the future due to the factors discussed in this Risk Factors section and elsewhere in this Quarterly Report on Form 10-Q, including upon the announcement from time to time of new strategic transactions.

Substantial amounts of Class A common stock are held by our employees and EMC, and all of the shares of our Class B common stock, which may be converted to Class A common stock upon request of the holder, are held by EMC. Shares of Class A common stock held by EMC (including shares of Class A common stock that might be issued upon the conversion of Class B common stock) are eligible for sale subject to the volume, manner of sale and other restrictions of Rule 144 of the Securities Act of 1933, as amended (the "Securities Act"), which allows the holder to sell up to the greater of 1% of our outstanding Class A common stock or our four-week average weekly trading volume during any three-month period and following the expiration of their contractual restrictions. Additionally, EMC possesses registration rights with respect to the shares of our common stock that it holds. If EMC chooses to exercise such rights, its sale of the shares that are registered would not be subject to the Rule 144 limitations. Additionally, the provisions of our charter documents and the agreements that we entered into with EMC prior to our IPO enable EMC to elect to distribute all of its holdings of our Class A and Class B common stock to EMC stockholders and require us to register the shares so they could be resold in the public trading markets. If a significant amount of the shares that become eligible for resale enter the public trading markets in a short period of time, the market price of our Class A common stock may decline. Additionally, if our Class B common stock is distributed to EMC stockholders and remains outstanding, it would trade separately from and potentially at a premium to our Class A common stock, and could thereby contribute additional volatility to the price of our Class A common stock.

Additionally, broad market and industry factors may decrease the market price of our Class A common stock, regardless of our actual operating performance. The stock market in general and technology companies in particular have often experienced extreme price and volume fluctuations. Our public float is also relatively small due to EMC's holdings, which can result in greater volatility in our stock compared to that of other companies with a market capitalization similar to ours. In addition, in the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted, including against us, and, if not resolved swiftly, can result in substantial costs and a diversion of management's attention and resources.

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If securities or industry analysts change their recommendations regarding our stock adversely, our stock price and trading volume could decline.

The trading market for our Class A common stock is influenced by the research and reports that industry or securities analysts publish about us, our business, our market or our competitors. If any of the analysts who cover us change their recommendation regarding our stock adversely, or provide more favorable relative recommendations about our competitors, our stock price would likely decline.

Delaware law and our certificate of incorporation and bylaws contain anti-takeover provisions that could delay or discourage takeover attempts that stockholders may consider favorable.

As our controlling stockholder, EMC has the ability to prevent a change in control of VMware. Provisions in our certificate of incorporation and bylaws may also have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

- the division of our board of directors into three classes, with each class serving for a staggered three-year term, which prevents stockholders from electing an entirely new board of directors at any annual meeting;

- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors;

- following a 355 distribution of Class B common stock by EMC to its stockholders, the restriction that a beneficial owner of 10% or more of our Class B common stock may not vote in any election of directors unless such person or group also owns at least an equivalent percentage of Class A common stock or obtains approval of our board of directors prior to acquiring beneficial ownership of at least 5% of Class B common stock;

- the prohibition of cumulative voting in the election of directors or any other matters, which would otherwise allow less than a majority of stockholders to elect director candidates;

- the requirement for advance notice for nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders' meeting;

- the ability of the board of directors to issue, without stockholder approval, up to 100,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of common stock; and

- in the event that EMC or its successor-in-interest no longer owns shares of our common stock representing at least a majority of the votes entitled to be cast in the election of directors, stockholders may not act by written consent and may not call special meetings of the stockholders.

Until such time as EMC or its successor-in-interest ceases to beneficially own 20% or more of the outstanding shares of our common stock, the affirmative vote or written consent of the holders of a majority of the outstanding shares of the Class B common stock will be required to:

- amend certain provisions of our bylaws or certificate of incorporation;

- make certain acquisitions or dispositions;

- declare dividends, or undertake a recapitalization or liquidation;

- adopt any stockholder rights plan, "poison pill" or other similar arrangement;

- approve any transactions that would involve a merger, consolidation, restructuring, sale of substantially all of our assets or any of our subsidiaries or otherwise result in any person or entity obtaining control of us or any of our subsidiaries; or

- undertake certain other actions.

In addition, we have elected to apply the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our certificate of incorporation and bylaws and under Delaware law could discourage potential takeover attempts and could reduce the price that investors might be willing to pay for shares of our common stock.

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

### (a) Sales of Unregistered Securities

None.



Table of Contents**(b) Use of Proceeds from Public Offering of Common Stock**

None.

**(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers**

Purchases of equity securities during the three months ended September 30, 2015:

	Total Number of Shares Purchased (1)	Average Price Paid Per Share (1)(2)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Publicly Announced Plans or Programs (1)(3)
July 1 – July 31, 2015	947,178	\$83.39	947,178	\$ 1,031,378,401
August 1 – August 31, 2015	822,883	85.66	822,883	960,889,434
September 1 – September 30, 2015	637,879	79.14	637,879	910,407,828
	2,407,940	\$83.04	2,407,940	910,407,828

In January 2015, VMware's Board of Directors authorized the repurchase of up to an additional one billion dollars of VMware's Class A common stock through the end of 2017. The January 2015 authorization was in addition to the authorization approved in August 2014 for the repurchase of up to one billion dollars of VMware's Class A common stock through the end of 2016. VMware's Class A common stock has been, and may in the future be, purchased pursuant to our stock repurchase authorizations, from time to time, in the open market or through private transactions, subject to market conditions. We are not obligated to purchase any shares under our stock repurchase program. Subject to applicable laws, repurchases under our stock repurchase program may be made at such times and in such amounts as we deem appropriate. 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 under our stock repurchase program can be discontinued at any time that we feel additional purchases are not warranted.

(1) The average price paid per share excludes commissions.

(2) Represents the amounts remaining in the VMware stock repurchase authorizations.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 4. MINE SAFETY DISCLOSURES**

Not Applicable.



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ITEM 5. OTHER INFORMATION

None.

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## ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference		
		Filed Herewith	Form/ File No.	Date
3.1	Amended and Restated Certificate of Incorporation		S-1/A-2	7/9/2007
3.2	Amended and Restated Bylaws		8-K	3/8/2011
10.5	Amended and Restated Real Estate License Agreement between VMware, Inc. and EMC Corporation dated September 21, 2015	X		
31.1	Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X		
31.2	Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	X		
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X		
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	X		
101.INS	XBRL Instance Document	X		
101.SCH	XBRL Taxonomy Extension Schema	X		
101.CAL	XBRL Taxonomy Extension Calculation Linkbase	X		
101.DEF	XBRL Taxonomy Extension Definition Linkbase	X		
101.LAB	XBRL Taxonomy Extension Label Linkbase	X		
101.PRE	XBRL Taxonomy Extension Presentation Linkbase	X		

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

VMWARE, INC.

Dated: November 9, 2015

By: /s/ Kevan Kryslar  
Kevan Kryslar  
Senior Vice President, Chief Accounting Officer  
(Principal Accounting Officer)

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