VMWARE, INC.
Form 10-Q
November 07, 2016
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
(Mark One)
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2016
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File Number 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<br>Palo Alto, CA | 94304 |
| (Address of principal executive offices) | (Zip Code) |

(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 þ No o

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 þ No o

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

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

As of October 31, 2016, the number of shares of common stock, par value $0.01 per share, of the registrant outstanding was 411,565,890 of which 111,565,890 shares were Class A common stock and 300,000,000 were Class B common stock.

TABLE OF CONTENTS

Table of Contents

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, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Revenue: | | | | |
| License | $691 | $ 681 | $1,907 | $1,896 |
| Services | 1,087 | 991 | 3,153 | 2,883 |
| GSA settlement | — | — | — | (76 ) |
| Total revenue | 1,778 | 1,672 | 5,060 | 4,703 |
| Operating expenses[1]: | | | | |
| Cost of license revenue | 40 | 46 | 121 | 142 |
| Cost of services revenue | 226 | 212 | 658 | 609 |
| Research and development | 389 | 331 | 1,109 | 958 |
| Sales and marketing | 564 | 556 | 1,708 | 1,656 |
| General and administrative | 178 | 201 | 516 | 568 |
| Realignment | — | — | 52 | 20 |
| Operating income | 381 | 326 | 896 | 750 |
| Investment income | 21 | 13 | 56 | 38 |
| Interest expense with Dell | (7 ) | (7 ) | (20 ) | (20 ) |
| Other income (expense), net | (8 ) | (7 ) | (8 ) | (8 ) |
| Income before income taxes | 387 | 325 | 924 | 760 |
| Income tax provision | 68 | 69 | 179 | 137 |
| Net income | $319 | $ 256 | $745 | $623 |
| Net income per weighted-average share, basic for Class A and Class B | $0.76 | $ 0.61 | $1.76 | $1.47 |
| Net income per weighted-average share, diluted for Class A and Class B | $0.75 | $ 0.60 | $1.75 | $1.46 |
| Weighted-average shares, basic for Class A and Class B | 421,704 | 422,329 | 423,341 | 424,799 |
| Weighted-average shares, diluted for Class A and Class B | 425,008 | 423,981 | 425,851 | 427,466 |

(1) Includes stock-based compensation as follows:

| | | | | |
|---|---|---|---|---|
| Cost of license revenue | $— | $ — | $2 | $1 |
| Cost of services revenue | 13 | 11 | 38 | 32 |
| Research and development | 80 | 56 | 224 | 164 |
| Sales and marketing | 51 | 43 | 146 | 124 |
| General and administrative | 26 | 16 | 62 | 47 |

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

VMware, Inc.
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(in millions)
(unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net income | $319 | $256 | $745 | $623 |
| Other comprehensive income (loss): | | | | |
| Changes in market value of available-for-sale securities: | | | | |
| Unrealized gains (losses), net of taxes of $(2), $1, $12 and $1 | (4) | 1 | 19 | 2 |
| Reclassification of (gains) losses realized during the period, net of taxes of $0, $0, $3 and $0 | — | — | 4 | — |
| Net change in market value of available-for-sale securities | (4) | 1 | 23 | 2 |
| Changes in market value of effective foreign currency forward contracts: | | | | |
| Unrealized gains (losses), net of taxes of $0 for all periods | — | 1 | — | (4) |
| 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) | 1 | (4) |
| Total other comprehensive income (loss) | (4) | — | 24 | (2) |
| Total comprehensive income (loss), net of taxes | $315 | $256 | $769 | $621 |

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

4

Table of Contents

VMware, Inc.
CONDENSED CONSOLIDATED BALANCE SHEETS
(amounts in millions, except per share amounts, and shares in thousands)
(unaudited)

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 2,654 | $ 2,493 |
| Short-term investments | 5,600 | 5,016 |
| Accounts receivable, net of allowance for doubtful accounts of $2 and $2 | 1,119 | 1,633 |
| Due from related parties, net | 23 | 74 |
| Other current assets | 159 | 144 |
| Total current assets | 9,555 | 9,360 |
| Property and equipment, net | 1,050 | 1,128 |
| Other assets | 232 | 193 |
| Deferred tax assets | 462 | 456 |
| Intangible assets, net | 538 | 616 |
| Goodwill | 4,032 | 3,993 |
| Total assets | $ 15,869 | $ 15,746 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $ 104 | $ 138 |
| Accrued expenses and other | 649 | 746 |
| Unearned revenue | 3,279 | 3,245 |
| Total current liabilities | 4,032 | 4,129 |
| Notes payable to Dell | 1,500 | 1,500 |
| Unearned revenue | 1,815 | 1,831 |
| Other liabilities | 388 | 363 |
| Total liabilities | 7,735 | 7,823 |
| Contingencies (refer to Note I) | | |
| Stockholders' equity: | | |
| Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 113,870 and 121,947 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 | 2,174 | 2,728 |
| Accumulated other comprehensive income (loss) | 16 | (8) |
| Retained earnings | 5,940 | 5,195 |
| Total VMware, Inc.'s stockholders' equity | 8,134 | 7,919 |
| Non-controlling interests | — | 4 |
| Total stockholders' equity | 8,134 | 7,923 |
| Total liabilities and stockholders' equity | $ 15,869 | $ 15,746 |

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

Table of Contents

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2016 | 2015 |
| Operating activities: | | |
| Net income | $745 | $623 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 261 | 246 |
| Stock-based compensation | 472 | 368 |
| Excess tax benefits from stock-based compensation | (7) | (27) |
| Deferred income taxes, net | (24) | (44) |
| Impairment of strategic investments | 12 | 5 |
| Gain on sales of strategic investments | (1) | — |
| Loss on disposal of assets | 12 | — |
| Other | (1) | — |
| Changes in assets and liabilities, net of acquisitions: | | |
| Accounts receivable | 513 | 508 |
| Other assets | (22) | 14 |
| Due to/from related parties, net | 55 | 31 |
| Accounts payable | (26) | (36) |
| Accrued expenses | (64) | (153) |
| Income taxes payable | (26) | 24 |
| Unearned revenue | 18 | (148) |
| Net cash provided by operating activities | 1,917 | 1,411 |
| Investing activities: | | |
| Additions to property and equipment | (109) | (274) |
| Purchases of available-for-sale securities | (3,337) | (2,675) |
| Sales of available-for-sale securities | 1,769 | 1,700 |
| Maturities of available-for-sale securities | 1,015 | 840 |
| Proceeds from disposal of assets | 3 | — |
| Purchases of strategic investments | (33) | (11) |
| Sales of strategic investments | 1 | 2 |
| Business acquisitions, net of cash acquired | (59) | (21) |
| Decrease (increase) in restricted cash | (2) | 77 |
| Net cash used in investing activities | (752) | (362) |
| Financing activities: | | |
| Proceeds from issuance of common stock | 106 | 123 |
| Proceeds from non-controlling interests | — | 4 |
| Payment to acquire non-controlling interests | (4) | — |
| Repurchase of common stock | (1,016) | (1,050) |
| Excess tax benefits from stock-based compensation | 7 | 27 |
| Shares repurchased for tax withholdings on vesting of restricted stock | (97) | (141) |
| Net cash used in financing activities | (1,004) | (1,037) |
| Net increase in cash and cash equivalents | 161 | 12 |
| Cash and cash equivalents at beginning of the period | 2,493 | 2,071 |

| | | |
|---|---|---|
| Cash and cash equivalents at end of the period | $2,654 | $2,083 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid for interest | $21 | $21 |
| Cash paid for taxes, net | 212 | 155 |
| Non-cash items: | | |
| Changes in capital additions, accrued but not paid | $(15 ) | $(49 ) |

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

Table of Contents

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 a leader in virtualization and cloud infrastructure solutions that enable businesses to transform the way they build, deliver and consume information technology (“IT”) resources in a manner that is based on their specific needs. 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, servers and mobile devices 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 2016. 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 2015 Annual Report on Form 10-K.

Effective September 7, 2016, Dell Technologies Inc. (“Dell”) (formerly Denali Holding Inc.) acquired EMC Corporation (“EMC”) which resulted in a change in control of VMware (the “Dell Acquisition”). As a result of the Dell Acquisition, EMC became a wholly-owned subsidiary of Dell and VMware became an indirectly-held, majority-owned subsidiary of Dell. As of September 30, 2016, Dell controlled 82.9% of VMware’s outstanding common stock and 97.7% of the combined voting power of VMware’s outstanding common stock held by EMC, including 43 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock.

In connection with the Dell Acquisition, Michael S. Dell was elected to the VMware Board of Directors as Chairman and Egon Durban was elected to the VMware Board. Additionally, both Joseph M. Tucci, VMware’s Chairman of the Board, and John R. Egan resigned from the VMware Board.

As VMware is a majority-owned and controlled subsidiary of Dell, its results of operations and financial position are consolidated with Dell’s financial statements. Pushdown accounting was not applied as a result of the Dell Acquisition and consequently no change in basis was reflected in VMware’s condensed consolidated financial statements.

References to transactions with Dell within the financial statements and accompanying notes include transactions with EMC prior to September 7, 2016.

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable. However, the amounts recorded for VMware’s intercompany transactions with Dell and its consolidated subsidiaries 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 Dell.

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. The portion of results of operations attributable to the non-controlling interests is eliminated in other income (expense), net on the condensed consolidated statements of income and is not presented separately as the amount was not material for the periods presented. During the second quarter of 2016, VMware acquired all of the non-controlling interests previously presented as a separate component within total stockholders' equity. Refer to Note B for further discussion. All intercompany transactions and

Table of Contents

VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with Dell and its consolidated 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.

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 revenue 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 Pronouncements

During October 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-16, Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory (Topic 740), which requires entities to recognize at the transaction date the income tax consequences of intra-entity asset transfers. Previous guidance requires the tax effects from intra-entity asset transfers to be deferred until that asset is sold to a third party or recovered through use. The updated standard is effective in annual and interim periods in fiscal years beginning after December 15, 2017, with early adoption permitted during the first interim period of a fiscal year, and requires a modified retrospective transition method. The Company is currently evaluating the effect that ASU 2016-16 will have on its consolidated financial statements and related disclosures.

During March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718), which impacts the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. The updated standard is effective for interim and annual periods beginning after December 15, 2016 and permits early adoption in any interim or annual period. The Company is currently evaluating the effect that ASU 2016-09 will have on its consolidated financial statements and related disclosures.

During February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires a lessee to recognize a lease liability for the obligation to make lease payments and a right-to-use asset for the right to use the underlying asset for the lease term. This ASU also requires additional disclosure regarding leasing arrangements. The updated lease standard is effective for interim and annual periods beginning after December 15, 2018 and requires a modified retrospective adoption, with early adoption permitted. The Company is currently evaluating the effect that ASU 2016-02 will have on its consolidated financial statements and related disclosures, and expects that most of its lease commitments will be subject to the updated standard and recognized as lease liabilities and right-of-use assets upon adoption of ASU 2016-02.

During May 2014, the FASB issued 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. In 2016, the FASB issued ASU 2016-08, ASU 2016-10 and ASU 2016-12, which provide interpretive clarifications on the new guidance in Topic 606. The updates are effective for the Company for interim and annual periods beginning after December 15, 2017 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is permitted for annual periods beginning after December 15, 2016. The Company has not selected a transition method and is currently evaluating the effect that the updates will have on its consolidated financial statements and related disclosures.

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

Business Combination

On June 21, 2016, VMware acquired all of the outstanding shares of Arkin Net, Inc. ("Arkin") for approximately $67 million of cash, net of liabilities assumed. VMware acquired Arkin, a provider of software-defined data center security and operations, as part of a strategy to accelerate customers' adoption of VMware NSX and software-defined data centers. The pro forma financial information assuming the acquisition had occurred as of the beginning of the calendar year prior to the year of acquisition, as well as the revenue and earnings generated during the current year, were not material for disclosure purposes.

Table of Contents
VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

The following table summarizes the preliminary allocation of the consideration to the fair value of the assets acquired and liabilities assumed (table in millions):

| | |
|---|---|
| Cash | $7 |
| Intangible assets | 26 |
| Goodwill | 38 |
| Deferred tax assets | 5 |
| Other acquired assets | 1 |
| Total assets acquired | 77 |
| Deferred tax liabilities | (10 ) |
| Total liabilities assumed | (10 ) |
| Fair value of assets acquired and liabilities assumed | $67 |

The identifiable intangible assets acquired were primarily related to purchased technology with estimated useful lives of four to five years. Goodwill is not expected to be deductible for U.S. income tax purposes.

Prior to the closing of the acquisition on June 21, 2016, EMC owned approximately 16% of the outstanding shares of Arkin. As a result of the acquisition, cash paid to EMC was approximately $13 million.

Definite-Lived Intangible Assets, Net

As of September 30, 2016 and December 31, 2015, definite-lived intangible assets consisted of the following (amounts in tables in millions):

| | September 30, 2016 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Lives (in years) | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Purchased technology | 6.6 | $ 632 | $ (337 ) | $ 295 |
| Leasehold interest | 34.9 | 149 | (23 ) | 126 |
| Customer relationships and customer lists | 8.2 | 135 | (60 ) | 75 |
| Trademarks and tradenames | 8.6 | 61 | (22 ) | 39 |
| Other | 5.4 | 5 | (2 ) | 3 |
| Total definite-lived intangible assets | | $ 982 | $ (444 ) | $ 538 |

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Lives (in years) | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Purchased technology | 6.6 | $ 648 | $ (298 ) | $ 350 |
| Leasehold interest | 34.9 | 149 | (20 ) | 129 |
| Customer relationships and customer lists | 8.4 | 148 | (62 ) | 86 |
| Trademarks and tradenames | 8.6 | 61 | (16 ) | 45 |
| Other | 2.9 | 20 | (14 ) | 6 |
| Total definite-lived intangible assets | | $ 1,026 | $ (410 ) | $ 616 |

Amortization expense on definite-lived intangible assets was $33 million and $99 million during the three and nine months ended September 30, 2016, respectively, and $36 million and $110 million during the three and nine months ended September 30, 2015, respectively.

Table of Contents
VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

Based on intangible assets recorded as of September 30, 2016 and assuming no subsequent additions, dispositions or impairment of underlying assets, the remaining estimated annual amortization expense is expected to be as follows (table in millions):

| | |
|---|---|
| Remainder of 2016 | $32 |
| 2017 | 125 |
| 2018 | 115 |
| 2019 | 92 |
| 2020 | 42 |
| Thereafter | 132 |
| Total | $538 |

Goodwill

The following table summarizes the changes in the carrying amount of goodwill during the nine months ended September 30, 2016 (table in millions):

| | |
|---|---|
| Balance, January 1, 2016 | 3,993 |
| Increase in goodwill related to a business combination | 39 |
| Balance, September 30, 2016 | $4,032 |

Joint Venture

During the year ended December 31, 2014, VMware established a joint venture intended to expand VMware vCloud Air services in Japan. At December 31, 2015, VMware had a controlling interest in the joint venture and approximately 51% of the ownership. Accordingly, VMware consolidated the financial results of the joint venture. During the second quarter of 2016, VMware acquired all of the remaining non-controlling interests in the joint venture for $4 million.

C. Realignment

On January 22, 2016, VMware approved a plan to streamline its operations, with plans to reinvest the associated savings in field, technical and support resources associated with growth products. As a result of these actions, approximately 800 positions were eliminated during the nine months ended September 30, 2016. VMware recognized $49 million of severance-related realignment expenses during the nine months ended September 30, 2016 on the condensed consolidated statements of income. Additionally, VMware consolidated certain facilities as part of this plan, which resulted in the recognition of $3 million of related expenses during the nine months ended September 30, 2016 on the condensed consolidated statements of income. Actions associated with this plan were substantially completed by June 30, 2016.

During fiscal 2015, VMware eliminated approximately 350 positions across all major functional groups and geographies to streamline its operations. As a result of these actions, $20 million of realignment expenses were recognized during the nine months ended September 30, 2015, which consisted of severance-related costs.

Table of Contents
VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

The following table summarizes the activity for the accrued realignment expenses for the nine months ended September 30, 2016 and September 30, 2015 (tables in millions):

| | For the Nine Months Ended September 30, 2016 | | | |
|---|---|---|---|---|
| | Balance as of January 1, 2016 | Realignment | Utilization | Balance as of September 30, 2016 |
| Severance-related costs | $3 | $ 49 | $ (51 ) | $ 1 |
| Costs to exit facilities | — | 3 | (1 ) | 2 |
| Total | $3 | $ 52 | $ (52 ) | $ 3 |

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

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, including performance stock units, and stock options, including 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.
The following table sets forth the computations of basic and diluted net income per share during the three and nine months ended September 30, 2016 and 2015 (net income in millions, shares in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net income | $319 | $ 256 | $745 | $ 623 |
| Weighted-average shares, basic for Class A and Class B | 421,704 | 422,329 | 423,344 | 424,799 |
| Effect of dilutive securities | 3,304 | 1,652 | 2,510 | 2,667 |
| Weighted-average shares, diluted for Class A and Class B | 425,008 | 423,981 | 425,854 | 427,466 |
| Net income per weighted-average share, basic for Class A and Class B | $0.76 | $ 0.61 | $1.76 | $ 1.47 |
| Net income per weighted-average share, diluted for Class A and Class B | $0.75 | $ 0.60 | $1.75 | $ 1.46 |

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, 2016 and 2015, because their effect would have been anti-dilutive (shares in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Anti-dilutive securities: | | | | |
| Employee stock options | 1,655 | 2,129 | 2,027 | 2,173 |
| Restricted stock units | 3,632 | 365 | 2,416 | 58 |
| Total | 5,287 | 2,494 | 4,443 | 2,231 |

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, 2016 and December 31, 2015 consisted of the following (tables in millions):

| | September 30, 2016 | | | |
|---|---|---|---|---|
| | Cost or Amortized Cost | Unrealized Gains | Unrealized Losses | Aggregate Fair Value |
| Cash | $565 | $ — | $ — | $ 565 |
| Cash equivalents: | | | | |
| Money-market funds | $2,015 | $ — | $ — | $ 2,015 |
| Time deposits | 35 | — | — | 35 |
| Municipal obligations | 39 | — | — | 39 |
| Total cash equivalents | $2,089 | $ — | $ — | $ 2,089 |
| Short-term investments: | | | | |
| U.S. Government and agency obligations | $818 | $ 2 | $ — | $ 820 |
| U.S. and foreign corporate debt securities | 4,109 | 19 | (2 ) | 4,126 |
| Foreign governments and multi-national agency obligations | 35 | — | — | 35 |
| Municipal obligations | 401 | — | — | 401 |
| Asset-backed securities | 5 | — | — | 5 |
| Mortgage-backed securities | 213 | 1 | (1 ) | 213 |
| Total short-term investments | $5,581 | $ 22 | $ (3 ) | $ 5,600 |
| Other assets: | | | | |
| Marketable available-for-sale equity securities | $15 | $ 7 | $ — | $ 22 |

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Cost or Amortized Cost | Unrealized Gains | Unrealized Losses | Aggregate Fair Value |
| Cash | $725 | $ — | $ — | $ 725 |
| Cash equivalents: | | | | |
| Money-market funds | $1,763 | $ — | $ — | $ 1,763 |
| Time deposits | 5 | — | — | 5 |
| Total cash equivalents | $1,768 | $ — | $ — | $ 1,768 |
| Short-term investments: | | | | |
| Time deposits | $12 | $ — | $ — | $ 12 |
| U.S. Government and agency obligations | 753 | — | (3 ) | 750 |
| U.S. and foreign corporate debt securities | 3,263 | 1 | (12 ) | 3,252 |
| Foreign governments and multi-national agency obligations | 35 | — | — | 35 |
| Municipal obligations | 705 | 1 | — | 706 |
| Asset-backed securities | 20 | — | — | 20 |
| Mortgage-backed securities | 243 | — | (2 ) | 241 |
| Total short-term investments | $5,031 | $ 2 | $ (17 ) | $ 5,016 |
| Other assets: | | | | |
| Marketable available-for-sale equity securities | $15 | $ 3 | $ — | $ 18 |

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

VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

VMware evaluated its available-for-sale investments as of September 30, 2016 and December 31, 2015 to determine whether or not any security had experienced an other-than-temporary decline in fair value. As of September 30, 2016 and December 31, 2015, VMware did not consider any of its available-for-sale investments to be other-than-temporarily impaired. The realized gains and losses on investments during the three and nine months ended September 30, 2016 and 2015 were not significant.

Unrealized losses on cash equivalents and available-for-sale investments as of September 30, 2016 and December 31, 2015, which have been in a net loss position for less than twelve months, were classified by asset class as follows (table in millions):

| | September 30, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government and agency obligations | $ 170 | $ — | $ 657 | $ (3) |
| U.S. and foreign corporate debt securities | 915 | (2) | 2,564 | (11) |
| Mortgage-backed securities | 88 | (1) | 171 | (1) |
| Total | $ 1,173 | $ (3) | $ 3,392 | $ (15) |

As of September 30, 2016 and December 31, 2015, unrealized losses on cash equivalents and available-for-sale investments in the other investment categories, which have been in a net loss position for less than twelve months, were not significant. 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 significant as of September 30, 2016 and December 31, 2015.

Contractual Maturities

The contractual maturities of short-term investments held at September 30, 2016 consisted of the following (table in millions):

| | Amortized Cost Basis | Aggregate Fair Value |
|---|---|---|
| Due within one year | $ 1,693 | $ 1,694 |
| Due after 1 year through 5 years | 3,545 | 3,562 |
| Due after 5 years through 10 years | 111 | 112 |
| Due after 10 years | 232 | 232 |
| Total short-term investments | $ 5,581 | $ 5,600 |

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 forward contracts and notes payable to Dell. At September 30, 2016 and December 31, 2015, 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.

13

Table of Contents
VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

VMware did not have any significant assets or liabilities that fell into Level 3 of the fair value hierarchy as of September 30, 2016 and December 31, 2015, and there have been no transfers between fair value measurement levels during the three and nine months ended September 30, 2016 and 2015.
The following tables set forth the fair value hierarchy of VMware's cash equivalents, available-for-sale securities, and forward contracts that were required to be measured at fair value as of September 30, 2016 and December 31, 2015 (tables in millions):

| | September 30, 2016 | | |
|---|---|---|---|
| | Level 1 | Level 2 | Total |
| Cash equivalents: | | | |
| Money-market funds | $2,015 | $— | $2,015 |
| Time deposits | — | 35 | 35 |
| Municipal obligations | — | 39 | 39 |
| Total cash equivalents | $2,015 | $74 | $2,089 |
| Short-term investments: | | | |
| U.S. Government and agency obligations | $485 | $335 | $820 |
| U.S. and foreign corporate debt securities | — | 4,126 | 4,126 |
| Foreign governments and multi-national agency obligations | — | 35 | 35 |
| Municipal obligations | — | 401 | 401 |
| Asset-backed securities | — | 5 | 5 |
| Mortgage-backed securities | — | 213 | 213 |
| Total short-term investments | $485 | $5,115 | $5,600 |
| Other assets: | | | |
| Marketable available-for-sale equity securities | $22 | $— | $22 |

| | December 31, 2015 | | |
|---|---|---|---|
| | Level 1 | Level 2 | Total |
| Cash equivalents: | | | |
| Money-market funds | $1,763 | $— | $1,763 |
| Time deposits | — | 5 | 5 |
| Total cash equivalents | $1,763 | $5 | $1,768 |
| Short-term investments: | | | |
| Time deposits | $— | $12 | $12 |
| U.S. Government and agency obligations | 543 | 207 | 750 |
| U.S. and foreign corporate debt securities | — | 3,252 | 3,252 |
| Foreign governments and multi-national agency obligations | — | 35 | 35 |
| Municipal obligations | — | 706 | 706 |
| Asset-backed securities | — | 20 | 20 |
| Mortgage-backed securities | — | 241 | 241 |
| Total short-term investments | $543 | $4,473 | $5,016 |
| Other assets: | | | |
| Marketable available-for-sale equity securities | $18 | $— | $18 |
| Accrued expenses and other: | | | |
| Forward contracts | $— | $(1) | $(1) |

VMware has elected not to record its notes payable to Dell at fair value, but has measured the notes at fair value for disclosure purposes. As of September 30, 2016, the fair value of the notes payable to Dell approximated its carrying value due to the minimal difference between the fair market interest rate as of September 30, 2016 and the fixed interest rate for the notes

14

payable to Dell. As of December 31, 2015, the fair value of the notes payable to Dell was approximately $1,474 million. Fair value was estimated primarily based on observable market interest rates (Level 2 inputs).

VMware offers a deferred compensation plan for eligible employees that allows participants to defer payment for part or all of their compensation. The net impact to the condensed consolidated statements of income is not significant 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 $33 million and $20 million as of September 30, 2016 and December 31, 2015, 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 has strategic investments in its portfolio accounted for under the cost method, which are periodically assessed for other-than-temporary impairment. VMware evaluates these investments 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. If VMware determines that an other-than-temporary impairment has occurred, VMware writes down the investments to their fair value.

During the three and nine months ended September 30, 2016, VMware determined that certain strategic investments were considered to be other-than-temporarily impaired and accordingly, approximately $7 million and $12 million, respectively, was recognized as an impairment charge. During the three and nine months ended September 30, 2015, approximately $5 million was recognized as an impairment charge. All other realized gains and losses on investments during the three and nine months ended September 30, 2016 and 2015 were not significant. Strategic investments are included in other assets on the condensed consolidated balance sheets. The carrying value of VMware’s strategic investments was $124 million and $103 million as of September 30, 2016 and December 31, 2015, 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 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, 2016 and 2015, the effective portion of gains or losses reclassified to the condensed consolidated statements of income was not significant. 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 twelve months or less. As of September 30, 2016 and December 31, 2015, VMware had forward contracts designated as cash flow hedges with a total notional value of $54 million and $213 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, 2016 and 2015, all cash flow hedges were considered effective.

Forward Contracts Not Designated as Hedges

VMware has established a program that utilizes 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 forward contracts on a monthly basis, which typically have a contractual term of one month. As of September 30, 2016 and December 31, 2015, VMware had outstanding forward contracts with a total notional value of $539 million and $721 million, respectively. The notional value represents the gross amount of foreign currency that will be bought or sold upon maturity of the forward contract.

VMware recognized a loss of $12 million during the nine months ended September 30, 2016 relating to the settlement of forward contracts. During the three and nine months ended September 30, 2015, VMware recognized gains of $12 million and $33 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 forward contracts and the underlying foreign currency denominated assets and liabilities resulted in a net loss of $10 million during the nine months ended September 30, 2015, respectively, and were not significant for all other periods presented. Net gains and losses are recorded in other income (expense), net on the condensed consolidated statements of income.

H. Unearned Revenue

Unearned revenue as of September 30, 2016 and December 31, 2015 consisted of the following (table in millions):

| | September 30, 2016 | December 31, 2015 |
|---|---|---|
| Unearned license revenue | $ 425 | $ 428 |
| Unearned software maintenance revenue | 4,201 | 4,174 |
| Unearned professional services revenue | 468 | 474 |
| Total unearned revenue | $ 5,094 | $ 5,076 |

Unearned license revenue is 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. In the event the arrangement does not include professional services, unearned license revenue 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.

Unearned software maintenance revenue is attributable to VMware’s maintenance contracts and are generally recognized ratably over the contract period. The weighted-average remaining term at September 30, 2016 was approximately two years. Unearned professional services revenue results primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

Unearned license and software maintenance revenue will fluctuate based upon a variety of factors including sales volume, the timing of both product promotion offers and delivery of the future products offered, and the amount of arrangements sold with ratable revenue recognition. Additionally, the amount of unearned revenue derived from transactions denominated in a foreign currency is impacted by fluctuations in the foreign currencies in which VMware invoices.

I. Contingencies

Litigation

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 in process of being rescheduled to 2017. 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.

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.

Table of Contents

VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

On July 8, 2016, the German court issued a written decision dismissing Mr. Hellwig's lawsuit because he failed to show that his protectable software code had been used in VMware's product. On August 9, 2016, a Notice of Appeal was filed.

While VMware believes that it has valid defenses against each of the above legal matters, 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.

On November 17, 2015, Francis M. Ford, a VMware Class A stockholder, filed an action in the Delaware Chancery Court against certain current and former VMware directors, among others, alleging that the directors breached their fiduciary duties in connection with the Dell Acquisition, and the proposed issuance of tracking stock that is intended to track the performance of VMware. The plaintiff does not assert claims directly against VMware, but purports to bring class claims on behalf of other VMware Class A stockholders and derivative claims on behalf of VMware. In addition, on November 10, 2015, David Jacobs, also a VMware stockholder, filed an action in Massachusetts Superior Court against, among others, EMC and four directors who serve on both the EMC board and the VMware board, setting forth similar allegations to those in the Ford matter. While VMware does not believe that the cases represent material adverse exposures, no assurances can be given that the litigation will not have any adverse consequences for the company or the directors named in the suits.

VMware accrues for a liability when a determination has been made that a loss is both probable and the amount of the loss can be reasonably estimated. If only a range can be estimated and no amount within the range is a better estimate than any other amount, an accrual is recorded for the minimum amount in the range. 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 is also subject to other legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business or in connection with business mergers and acquisitions, including claims with respect to commercial, contracting and sales practices, product liability, intellectual property, employment, corporate and securities law, class action, whistleblower and other matters. From time to time, VMware also receives inquiries from and has discussions with government entities and stockholders on various matters. As of September 30, 2016, amounts accrued relating to these other matters arising as part of the ordinary course of business were not considered material. 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' Equity

### VMware Stock Repurchases

During April 2016, VMware's board of directors authorized the repurchase of up to an aggregate of $1,200 million of VMware's Class A common stock through the end of 2016. The aggregate authorized stock repurchase amount of $1,200 million included the amount remaining from VMware's previous stock repurchase authorization announced on January 27, 2015 of $835 million. All shares repurchased under VMware's stock repurchase programs are retired. The cumulative authorized amount remaining for stock repurchases as of September 30, 2016 was utilized during the fourth quarter of fiscal 2016.

The following table summarizes stock repurchase activity during the three and nine months ended September 30, 2016 and 2015 (aggregate purchase price in millions, shares in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |

| | | | | |
|---|---|---|---|---|
| Aggregate purchase price | $1,016 | $200 | $1,016 | $1,050 |
| Class A common shares repurchased | 13,999 | 2,408 | 13,999 | 12,524 |
| Weighted-average price per share | $72.57 | $83.06 | $72.57 | $83.84 |

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

Table of Contents
VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

VMware Stock Options

Stock option activity was not significant during the nine months ended September 30, 2016. As of September 30, 2016, there were 2.2 million stock options outstanding. The stock options outstanding as of September 30, 2016 had an aggregate intrinsic value of $43 million based on VMware's closing stock price as of September 30, 2016.

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.

The following table summarizes restricted stock activity during the nine months ended September 30, 2016 (units in thousands):

| | Number of Units | Weighted-Average Grant Date Fair Value (per unit) |
|---|---|---|
| Outstanding, January 1, 2016 | 18,693 | $ 77.29 |
| Granted | 11,008 | 57.73 |
| Vested | (4,660 ) | 79.72 |
| Forfeited | (2,916 ) | 77.01 |
| Outstanding, September 30, 2016 | 22,125 | 67.08 |

The total fair value of VMware restricted stock that vested during the nine months ended September 30, 2016 was $272 million. As of September 30, 2016, restricted stock representing 22.1 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of $1,623 million based on VMware's closing stock price as of September 30, 2016.

As of September 30, 2016, the total unrecognized compensation cost for stock options and restricted stock was $1,080 million and will be recognized through 2020 with a weighted-average remaining period of 1.4 years.

Table of Contents
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, 2016 and 2015 were as follows (tables in millions):

| | Unrealized Gain (Loss) on Available-for-Sale Securities | Unrealized Gain (Loss) on Forward Contracts | Total |
|---|---|---|---|
| Balance, January 1, 2016 | $ (7) | $ (1) | $ (8) |
| Unrealized gains (losses), net of taxes of $12, $0 and $12 | 19 | — | 19 |
| Amounts reclassified from accumulated other comprehensive income (loss) to the consolidated statement of income, net of taxes of $3, $0 and $3 | 4 | 1 | 5 |
| Balance, September 30, 2016 | $ 16 | $ — | $ 16 |

| | Unrealized Gain (Loss) on Available-for-Sale Securities | Unrealized Gain (Loss) on Forward Contracts | Total |
|---|---|---|---|
| Balance, January 1, 2015 | $ — | $ (1) | $ (1) |
| Unrealized gains (losses), net of taxes of $1, $0 and $1 | 2 | (4) | (2) |
| Balance, September 30, 2015 | $ 2 | $ (5) | $ (3) |

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, 2016 and 2015 were not significant to the individual functional line items.

K. Related Parties

The information provided below includes a summary of the transactions entered into with Dell and Dell's consolidated subsidiaries including EMC (collectively "Dell") from the effective date of the Dell Acquisition through September 30, 2016. References to transactions with Dell include transactions with EMC prior to September 7, 2016.

Transactions with Dell

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

- Pursuant to ongoing reseller arrangements with Dell, Dell bundles VMware's products and services with Dell's products and sells them to end users.
- Dell purchases products and services from VMware for internal use.
- VMware provides professional services to end users based upon contractual agreements with Dell.
- 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 Dell, 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 services to Pivotal. Support costs incurred by VMware are reimbursed to VMware and are recorded as a reduction to the costs incurred by VMware.

Table of Contents
VMware, Inc.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)
(unaudited)

Information about VMware's revenue and receipts from such arrangements during the three and nine months ended September 30, 2016 and 2015 and unearned revenue from such arrangements as of September 30, 2016 and December 31, 2015 consisted of the following (table in millions):

| | Revenue and Receipts | | | | Unearned Revenue | |
|---|---|---|---|---|---|---|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | | As of September 30, | As of December 31, |
| | 2016 | 2015 | 2016 | 2015 | 2016 | 2015 |
| Reseller revenue | $98 | $ 68 | $261 | $199 | $553 | $ 292 |
| Internal-use revenue | 5 | 4 | 24 | 13 | 17 | 11 |
| Professional services revenue | 28 | 20 | 79 | 68 | — | 3 |
| Agency fee revenue | 1 | 1 | 3 | 4 | — | — |
| Reimbursement for services to Pivotal | — | 2 | 1 | 3 | | |