

VMWARE, INC.
Form 10-Q
May 09, 2008
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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 March 31, 2008

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For transition period from _____ to _____

Commission File Number 001-33622

VMWARE, INC.

(Exact name of registrant as specified in its charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

94-3292913
(I.R.S. Employer
Identification Number)

3401 Hillview Avenue

Palo Alto, CA
(Address of principal executive offices)

94304
(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 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 Smaller reporting company

(Do not check if a 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 May 1, 2008, the number of shares of common stock, par value \$.01 per share, of the registrant outstanding was 384,025,360, of which 84,025,360 shares were Class A common stock and 300,000,000 were Class B common stock.

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Table of Contents**PART I****FINANCIAL INFORMATION****Item 1. FINANCIAL STATEMENTS****VMware, Inc.****CONSOLIDATED BALANCE SHEETS****(in thousands, except per share amounts)****(unaudited)**

	March 31, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 1,306,011	\$ 1,231,168
Accounts receivable, less allowance for doubtful accounts of \$1,439 and \$1,603	284,309	283,824
Deferred tax asset, current portion	74,036	54,386
Other current assets	40,392	33,956
Total current assets	1,704,748	1,603,334
Property and equipment, net	325,906	276,983
Other assets, net	62,533	71,695
Deferred tax asset, net of current portion	88,907	72,249
Intangible assets, net	37,622	32,073
Goodwill	681,742	639,366
Total assets	\$ 2,901,458	\$ 2,695,700
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 88,798	\$ 61,503
Accrued expenses	161,950	173,610
Due to EMC, net	20,005	2,759
Income taxes payable to EMC, current portion	34,858	68,823
Deferred revenue, current portion	402,326	363,317
Total current liabilities	707,937	670,012
Note payable to EMC	450,000	450,000
Deferred revenue, net of current portion	238,801	189,479
Deferred tax liability	30,349	27,327
Income taxes payable to EMC, net of current portion	21,575	18,265
Commitments and contingencies (see Note I)		
Stockholders' equity:		
Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 83,679 and 82,924 shares	837	829
Class B convertible common stock, par value \$.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3,000	3,000
Additional paid-in capital	1,442,154	1,352,788

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Accumulated surplus (deficit)	6,805	(16,000)
Total stockholders' equity	1,452,796	1,340,617
Total liabilities and stockholders' equity	\$ 2,901,458	\$ 2,695,700

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

Table of Contents**VMware, Inc.****CONSOLIDATED INCOME STATEMENTS****(in thousands, except per share amounts)****(unaudited)**

	For the Three Months Ended March 31,	
	2008	2007
Revenues:		
License	\$ 293,980	\$ 169,557
Services	144,195	89,138
	438,175	258,695
Operating expenses:		
Cost of license revenues	22,859	20,556
Cost of services revenues	54,311	23,468
Research and development	119,255	54,958
Sales and marketing	149,257	86,707
General and administrative	44,102	26,624
Operating income	48,391	46,382
Investment income	8,004	1,704
Interest (expense) income with EMC, net	(5,819)	1,273
Other income, net	454	59
Income before taxes	51,030	49,418
Income tax provision	7,975	8,338
Net income	\$ 43,055	\$ 41,080
Net income per weighted average share, basic for Class A and Class B	\$ 0.11	\$ 0.12
Net income per weighted average share, diluted for Class A and Class B	\$ 0.11	\$ 0.12
Weighted average shares, basic for Class A and Class B	381,026	332,500
Weighted average shares, diluted for Class A and Class B	398,063	332,500

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

Table of Contents**VMware, Inc.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	For the Three Months Ended March 31,	
	2008	2007
Cash flows from operating activities:		
Net income	\$ 43,055	\$ 41,080
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	37,434	21,197
Stock-based compensation, excluding amounts capitalized	42,161	11,644
Excess tax benefits from stock-based compensation	(22,692)	
Other adjustments	1,336	563
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	846	46,361
Other assets	(8,594)	(602)
Due to (from) EMC, net	17,246	(56,178)
Accounts payable	7,472	(1,968)
Accrued expenses	(15,305)	960
Income taxes payable to EMC	(21,596)	14,696
Deferred income taxes, net	(36,344)	(6,591)
Deferred revenue	88,161	33,740
Net cash provided by operating activities	133,180	104,902
Cash flows from investing activities:		
Additions to property and equipment	(49,022)	(16,584)
Capitalized software development costs	(4,164)	(6,672)
Business acquisitions, net of cash acquired	(33,289)	
Decrease in restricted cash	896	688
Net cash used in investing activities	(85,579)	(22,568)
Cash flows from financing activities:		
Proceeds from exercises of stock options	23,669	
Excess tax benefits from stock-based compensation	22,692	
Shares repurchased for tax withholdings on vesting of restricted stock	(19,119)	
Net cash provided by financing activities	27,242	
Net increase in cash and cash equivalents	74,843	82,334
Cash and cash equivalents at beginning of the period	1,231,168	176,134
Cash and cash equivalents at end of the period	\$ 1,306,011	\$ 258,468
Non-cash items:		
Capital additions, accrued but not paid	\$ 19,110	\$

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

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. ("VMware" or the "Company") is the leading provider of virtualization solutions. VMware's virtualization solutions represent a pioneering approach to computing that separates the operating system and application software from the underlying hardware to achieve significant improvements in efficiency, availability, flexibility and manageability. VMware's broad and proven suite of virtualization solutions addresses a range of complex IT problems that include infrastructure optimization, business continuity, software lifecycle management and desktop management.

Accounting Principles

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

Unaudited Interim Financial Information

These accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated financial statements are unaudited and, in the opinion of management, include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware's consolidated financial condition, results of operations 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 2008. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's 2007 Annual Report on Form 10-K.

VMware historically has received, and continues to receive, certain administrative services from EMC Corporation ("EMC"), and VMware and EMC engage in certain intercompany transactions. The consolidated financial statements include expense allocations for certain corporate functions provided to VMware by EMC, including general corporate expenses. These allocations were based on estimates of the level of effort or resources incurred on behalf of VMware. Additionally, certain other costs incurred by EMC for the direct benefit of VMware, such as rent and salaries and benefits, have been included in VMware's financial statements. Management believes the assumptions underlying the financial statements and the above allocations are reasonable. However, given these intercompany transactions did not arise from transactions negotiated at arm's length with an unrelated third party, the financial statements included herein may not necessarily reflect financial condition, results of operations and cash flows had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, historical results of VMware should not be relied upon as an indicator of the future performance of VMware. VMware's future results of operations, which will include costs and expenses for it to operate as an independent company, including payments to EMC for administrative services provided to VMware pursuant to a master transaction agreement and ancillary agreements entered into with EMC in connection with VMware's initial public offering ("IPO") in August 2007, may be materially different than VMware's historical financial position, results of operations, and cash flows.

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

Principles of Consolidation

The consolidated financial statements include the accounts of VMware and its subsidiaries. All intercompany transactions and balances between VMware and its subsidiaries have been eliminated. All intercompany transactions with EMC in the consolidated statements of cash flows are expected to be settled in cash and changes in the intercompany balances are presented as a component of cash flows from operating activities.

Use of Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management 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 assets and liabilities at the date of the financial statements. Estimates are used for, but not limited to, receivable valuation, useful lives of fixed assets, valuation of acquired intangibles, income taxes, stock-based compensation and contingencies. Actual results could differ from those estimates.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

New Accounting Pronouncements

VMware adopted Financial Accounting Standards (FAS) FAS No. 157, Fair Value Measurements (FAS No. 157) on January 1, 2008. FAS No. 157 defines fair value, establishes a methodology for measuring fair value and expands the required disclosure for fair value measurements. On February 12, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which delays the effective date of FAS No. 157 by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Therefore, beginning on January 1, 2008, this standard applies prospectively to new fair value measurements of financial instruments and recurring fair value measurements of non-financial assets and non-financial liabilities. On January 1, 2009, the beginning of the Company's 2009 fiscal year, the standard will also apply to all other fair value measurements. VMware is currently evaluating the potential impact of FAS No. 157 for non-financial assets and non-financial liabilities on the Company's financial position and results of operations. The adoption of FAS No. 157 for financial assets and liabilities did not have an impact on VMware's consolidated financial position and results of operations. See Note D to VMware's consolidated financial statements.

In December 2007, the FASB issued FAS No. 141 (revised 2007), Business Combinations (FAS No. 141R). This statement establishes principles and requirements for how the acquirer in a business combination (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS No. 141 (revised 2007) is effective for fiscal years beginning after December 15, 2008. The impact of the standard on VMware's financial position and results of operations will be dependent upon the number of and magnitude of acquisitions that are consummated once the standard is effective.

In December 2007, the FASB issued FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51 (FAS No. 160). The objective of this statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and therefore deconsolidation of a subsidiary. FAS No. 160 is effective for fiscal years beginning after December 15, 2008. VMware does not expect the standard to have a material impact on the Company's financial position and results of operations.

B. Significant Accounting Policies

Revenue Recognition

VMware derives revenue from the licensing of software and related services. VMware recognizes revenue for software products and related services in accordance with the American Institute of Certified Public Accountants' Statement of Position (SOP) 97-2, Software Revenue Recognition, as amended. VMware recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collectibility is probable.

The following summarizes the major terms of VMware's contractual relationships with customers and the manner in which VMware accounts for sales transactions.

License revenue

VMware recognizes revenue from the sale of software when risk of loss transfers, which is generally upon electronic shipment.

VMware licenses its software under perpetual licenses through its direct sales force and through its channel of distributors, resellers, x86 system vendors and systems integrators. VMware defers revenue relating to products that have shipped into its channel until its products are sold through the channel. VMware obtains sell-through information from distributors and certain resellers on a monthly basis. For VMware's channel

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partners who do not report sell-through data, VMware determines sell-through based on payment of such distributors and certain resellers accounts receivable balances and other relevant factors. For software sold by x86 system vendors and bundled with their hardware, revenue is recognized in arrears upon the receipt of binding royalty reports.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

For all sales, VMware uses a purchase order, a license agreement and a purchase order, or a master agreement and binding royalty report as evidence of an arrangement. Sales through distributors and resellers are evidenced by a master license agreement, together with purchase orders, on a transaction-by-transaction basis.

The Company's return policy does not allow end-users to return products for a refund. Certain distributors and resellers may rotate stock when new versions of a product are released. VMware estimates future product returns at the time of sale. VMware's estimate is based on historical return rates, levels of inventory held by distributors and resellers and other relevant factors.

VMware offers rebates to certain of its channel partners. When rebates are based on a set percentage of actual sales, VMware recognizes the cost of the rebates as a reduction of revenues when the underlying revenue is recognized. When rebates are earned only if a cumulative level of sales is achieved, VMware recognizes the cost of the rebates as a reduction of revenues proportionally for each sale that is required to achieve the target.

VMware also offers marketing development funds to its channel partners. VMware records the cost of the marketing development funds, based on the maximum potential liability, as a reduction of revenues at the time the underlying revenue is recognized.

Services revenue

Services revenue consists of software maintenance and professional services. VMware recognizes maintenance revenues ratably over the contract period. Professional services include design, implementation and training. Professional services are not considered essential to the functionality of VMware's products as these services do not alter the product capabilities and may be performed by customers or other vendors. Professional services engagements that have durations of 90 days or less are recognized in revenue upon completion of the engagement. Professional services engagements of more than 90 days for which VMware is able to make reasonably dependable estimates of progress toward completion are recognized on a proportional performance basis based upon the hours incurred. Revenue on all other professional services engagements is recognized upon completion.

Multiple element arrangements

VMware's software products are typically sold with maintenance and/or professional services. Vendor-specific objective evidence (VSOE) of fair value for professional services is based upon the standard rates VMware charges for such services when sold separately. VSOE of fair value for maintenance services is established by the rates charged in stand-alone sales of maintenance contracts or the stated renewal rate for maintenance included in the license agreement. The revenues allocated to the software license included in multiple element contracts represent the residual amount of the contract after the fair value of the other elements has been determined.

Customers under maintenance agreements are entitled to receive updates and upgrades on a when-and-if-available basis. In the event an upgrade or new product has been announced but not delivered, and customers will receive that upgrade or new product as part of a current maintenance contract, product revenues are deferred on purchases made after the announcement date until delivery of the upgrade or new product. The amount and elements to be deferred are dependent on whether the company has established VSOE of fair value for the upgrade or new product. VSOE of fair value of these upgrades or new products is established based upon the price set by management. VMware has a history of selling these upgrades or new products on a stand-alone basis.

Deferred revenue includes unearned maintenance fees, professional services fees and license fees.

Research and Development and Capitalized Software Development Costs

Costs incurred in the research and development of new software products are expensed as incurred until technological feasibility is established. Technological feasibility is defined as the earlier of the completion of a detail program design or a working model. Such costs include salaries

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and benefits, including stock-based compensation, consultants, facilities-related costs, equipment costs, and depreciation. Software development costs incurred subsequent to establishing technological feasibility through the general release of the software products are capitalized. Upon general release of the products, capitalized costs are amortized over periods ranging from 18 to 24 months, which represent the products estimated useful lives.

Unamortized software development costs were \$56.9 million and \$66.8 million at March 31, 2008 and December 31, 2007, respectively, and are included in other assets, net.

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For the first quarter of 2008 and 2007, VMware capitalized \$5.0 million (including \$0.9 million of stock-based compensation) and \$7.6 million (including \$0.9 million of stock-based compensation), respectively, of costs incurred for the development of software products. Amortization expense from capitalized amounts was \$14.9 million and \$8.0 million for the first quarter of 2008 and 2007, respectively.

Long-Lived Assets

Intangible assets, other than goodwill, are amortized over their estimated useful lives which range from one to nine years. In the first quarter of 2008 and 2007, VMware amortized \$3.9 million and \$6.3 million, respectively, for purchased intangible assets.

VMware periodically reviews long-lived assets for impairment in accordance with FAS No. 144 Accounting for Impairment or Disposal of Long-Lived Assets. VMware initiates reviews for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate. Each impairment test is based on a comparison of the undiscounted cash flows to the recorded value of the asset. If impairment is indicated, the asset is written down to its estimated fair value. To date, no such impairment has been identified.

Goodwill is carried at its historical cost. VMware tests goodwill for impairment in accordance with FAS No. 142 Goodwill and Other Intangible Assets, in the fourth quarter of each year or more frequently if events or changes in circumstances indicate that the asset might be impaired. To date, there have been no impairments of goodwill or other intangible assets.

Comprehensive Income

Comprehensive income is equal to net income.

C. 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. For purposes of computing basic net income per share, the weighted average number of outstanding shares of common stock excludes unvested restricted stock awards and other unvested restricted stock. 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. Potentially dilutive securities include stock options and unvested restricted stock units, unvested restricted stock awards, and other unvested restricted stock, using the treasury stock method. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. As of March 31, 2008, VMware had 81.1 million shares of Class A common stock and 300.0 million shares of Class B common stock outstanding that were included in the calculation of basic earnings per share. For purposes of calculating earnings per share, VMware uses the two-class method. As both classes share the same rights in dividends, 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 (in thousands, except per share data):

	For the Three Months Ended March 31,	
	2008	2007
Net income	\$ 43,055	\$ 41,080
Shares used in computing basic net income per share	381,026	332,500
Effect of dilutive securities	17,037	
Shares used in computing diluted net income per share	398,063	332,500

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Basic net income per share	\$	0.11	\$	0.12
Diluted net income per share	\$	0.11	\$	0.12

For the three months ended March 31, 2008, stock options to acquire 4.1 million of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the

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three months ended March 31, 2007, there is no difference between basic and diluted earnings per share because there were no outstanding options to purchase shares of VMware common stock or other outstanding potentially dilutive securities.

D. Fair Value Measurements

FAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, FAS No. 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) observable inputs such as quoted prices in active markets; (Level 2) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level 3) unobservable inputs in which there is little or no market data, which requires VMware to develop its own assumptions. This hierarchy requires VMware to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value.

VMware's cash and cash equivalents include money market securities, which are generally classified within Level 1 of the fair value hierarchy because the securities are valued using quoted prices in active markets for identical assets. The following table sets forth the fair value hierarchy of VMware's money market securities that are required to be measured at fair value as of March 31, 2008 (table in thousands):

	March 31, 2008	Fair Value Measurement as of March 31, 2008 (Level 1)
Assets:		
Money market securities	\$ 826,263	\$ 826,263
Liabilities:	\$	\$

E. Business Acquisitions, Goodwill and Intangible Assets***Business Acquisitions***

VMware acquired two companies during the first quarter of 2008 for aggregate cash consideration of \$33.3 million, net of cash acquired and including transaction costs. The acquisitions were not material, neither individually nor in the aggregate. Acquired intangibles totaled \$9.4 million and have estimated useful lives of between one and eight years. The excess of the purchase price over the fair value of the net assets acquired was \$38.5 million and is classified as goodwill on the consolidated balance sheet.

The purchase price for the companies acquired in the first quarter of 2008 has been allocated to the assets acquired and the liabilities assumed based on estimated fair values as of the respective acquisition dates. The purchase price allocations are preliminary and may be adjusted periodically. A final determination of required purchase accounting adjustments will be made upon finalization of integration activities and resolution of certain tax contingencies. The results of operations of the acquired companies have been included in the Company's consolidated results from the respective closing dates forward.

Pro forma results of operations have not been presented for the aforementioned acquisitions as the results of the acquired companies, either individually or in the aggregate, were not material to the Company's consolidated results of operations.

Goodwill

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Changes in the carrying amount of goodwill for the three months ended March 31, 2008 consist of the following (table in thousands):

	March 31, 2008
Balance, January 1, 2008	\$ 639,366
Goodwill acquired	38,513
Adjustments to purchase price allocations	3,863
 Balance, March 31, 2008	 \$ 681,742

Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)****F. Property and Equipment, net**

Property and equipment, net, as of March 31, 2008 and December 31, 2007 consist of the following (table in thousands):

	March 31, 2008	December 31, 2007
Furniture and fixtures	\$ 40,123	\$ 30,678
Equipment and software	206,564	156,641
Buildings and improvements	163,544	129,752
Construction in progress	6,507	32,097
	416,738	349,168
Accumulated depreciation	(90,832)	(72,185)
	\$ 325,906	\$ 276,983

Depreciation expense was \$18.7 million and \$6.9 million for the three months ended March 31, 2008 and 2007, respectively.

G. Accrued Expenses

Accrued expenses for the three months ended March 31, 2008 and the year ended December 31, 2007 consist of (table in thousands):

	March 31, 2008	December 31, 2007
Salaries, commissions, and benefits	\$ 76,382	\$ 93,678
Accrued partner rebates	42,470	42,852
Other	43,098	37,080
	\$ 161,950	\$ 173,610

H. Income Taxes

Although VMware files a federal consolidated tax return with EMC, the Company has calculated its income tax provision on a separate-return basis. The Company's effective tax rate in the periods presented is the result of the mix of income earned in various tax jurisdictions, which apply varying income tax rates. The provision for income taxes differs from the tax computed at the U.S. federal statutory income tax rate due primarily to earnings considered as indefinitely reinvested in foreign operations.

VMware's effective income tax rate was 15.6% and 16.9% for the three months ended March 31, 2008 and 2007, respectively. The reduction in the effective rate for the three months ended March 31, 2008 compared to the three months ended March 31, 2007 was primarily attributable to a change in the mix of income from U.S. to international sources. Income earned abroad is considered indefinitely reinvested in the Company's foreign operations and no provision for U.S. taxes has been provided. This benefit was partially offset due to the expiration of the federal research tax credit; an increase in other non-deductible permanent differences and transfer pricing adjustments relative to the forecasted annual pre-tax income.

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As of March 31, 2008, VMware had \$22.7 million of gross unrecognized tax benefits and \$21.7 million of net unrecognized tax benefits. The net unrecognized tax benefits include interest and penalties of \$0.4 million. The Company reports interest and penalties related to unrecognized tax benefits in income tax expense. If the total amount of net unrecognized tax benefits had been recognized, \$7.6 million would have been recorded to goodwill and the remaining \$14.1 million would have adjusted our effective tax rate. The \$21.7 million of net unrecognized tax benefits are not expected to be paid within the next 12 months and were classified in non-current income taxes payable. As of December 31, 2007, VMware had \$19.2 million of gross unrecognized tax benefits and \$18.3 million of net unrecognized tax benefits. The net unrecognized tax benefits included interest and penalties of \$0.3 million. VMware does not expect significant changes to its unrecognized tax benefits within the next 12 months.

Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)****I. Commitments and Contingencies***Litigation*

VMware is named from time to time as a party to lawsuits in the normal course of its business. In such cases it is the Company's policy to defend against such claims, or if considered appropriate, negotiate a settlement on commercially reasonable terms. However, no assurance can be given that the Company will be able to negotiate settlements on commercially reasonable terms, or at all, or that any litigation resulting from such claims would not have a material adverse effect on the Company's consolidated financial position, liquidity, operating results, or consolidated financial statements taken as a whole.

Operating Lease Commitments

VMware leases office facilities and equipment under various operating leases. Facility leases generally include renewal options. VMware's future lease commitments at March 31, 2008 are as follows (table in thousands):

2008	\$ 20,795
2009	27,948
2010	25,546
2011	23,662
2012	13,802
Thereafter	282,065
Total minimum lease payments	\$ 393,818

The amount of the future lease commitments after 2012 is primarily for the ground lease on the Company's Palo Alto headquarters facilities, which expires in 2057. As several of VMware's operating leases are payable in foreign currencies, the amount of operating lease commitments may fluctuate in response to changes in the exchange rate between the U.S. dollar and the foreign currencies in which the commitments are payable.

J. Stockholders' Equity*VMware Stock Purchase Plan*

In June 2007, VMware adopted its 2007 Employee Stock Purchase Plan that is intended to be qualified under Section 423 of the Code. A total of 6.4 million shares of VMware Class A common stock were reserved for issuance under the Plan. Under the Plan, eligible VMware employees are granted options to purchase shares at the lower of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value at the time of exercise. Options to purchase shares were first granted under the 2007 Employee Stock Purchase Plan on August 13, 2007, the date on which VMware's Form S-1 Registration Statement was declared effective by the Securities and Exchange Commission, and became exercisable on December 31, 2007. Thereafter, options to purchase shares will be granted twice yearly, on or about January 1 and July 1, and will be exercisable on or about the succeeding June 30 or December 31, respectively. For the purchase period ended December 31, 2007, employees purchased 0.6 million shares under the 2007 Employee Stock Purchase Plan at a purchase price per share of \$24.65. The December 31, 2007 purchase was completed in January 2008.

Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)*****VMware Stock Options***

The following table summarizes option activity since January 1, 2008 for VMware stock options (shares in thousands):

	Number of Shares	Weighted Average Exercise Price
Outstanding, January 1, 2008	45,339	\$ 26.76
Granted	1,806	56.72
Forfeited	(344)	38.59
Expired	(1)	24.28
Exercised	(488)	16.25
Outstanding, March 31, 2008	46,312	27.87

Total cash proceeds from the exercise of stock options for the three months ended March 31, 2008 were \$7.9 million. The options exercised had a pre-tax intrinsic value of \$19.7 million for the three months ended March 31, 2008.

VMware Restricted Stock

VMware restricted stock includes restricted stock awards, restricted stock units, and other restricted stock. Other restricted stock includes options exercised by non-employee directors that were required to be exercised within one year of grant, but are subject to a three-year vesting provision. The exercise of those options prior to vesting results in the outstanding shares being subject to repurchase and hence restricted until such time as the respective options vest.

The following table summarizes restricted stock activity since January 1, 2008 for VMware restricted stock (shares in thousands):

	Number of Shares	Weighted Average Grant Date Fair Value
Restricted stock at January 1, 2008	3,565	\$ 24.64
Granted	486	64.90
Vested	(943)	22.79
Forfeited	(9)	22.07
Restricted stock at March 31, 2008	3,099	31.51

As of March 31, 2008, the aggregate intrinsic value of VMware restricted stock was \$130.0 million. These shares are scheduled to vest through 2012.

Shares Repurchased for Tax Withholdings

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During the first quarter of 2008, VMware repurchased 363,337 shares of Class A common stock for \$20.3 million to cover employee tax withholding obligations. As of March 31, 2008, \$1.2 million of the repurchase remained unpaid and was included in accrued liabilities on the Company's consolidated balance sheet. Pursuant to the respective award agreements, these shares were repurchased in conjunction with the net share settlement upon the vesting of restricted stock awards during the quarter. The \$20.3 million is recorded as a reduction to accumulated surplus as of March 31, 2008.

Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)*****Stock-Based Compensation Expense***

The following table summarizes the components of total stock-based compensation expense included in VMware's consolidated income statements for the three months ended March 31, 2008 and 2007 (table in thousands):

	For the Three Months Ended March 31,	
	2008	2007
Cost of license revenues	\$ 263	\$ 36
Cost of services revenues	3,261	494
Research and development	21,097	6,392
Sales and marketing	11,301	2,944
General and administrative	6,239	1,778
Stock-based compensation expense	\$ 42,161	\$ 11,644

For both the three months ended March 31, 2008 and 2007, VMware capitalized \$0.9 million, respectively, of stock-based compensation expense associated with capitalized software development. For the three months ended March 31, 2008 and 2007, VMware capitalized an additional \$0.5 million and \$0.3 million, respectively, of stock-based compensation expense associated with software developed for internal use.

Fair Value of VMware Options

The fair value of each option to acquire VMware Class A common stock granted during the three months ended March 31, 2008 is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the Three Months Ended March 31, 2008
<i>VMware Stock Options</i>	
Dividend yield	None
Expected volatility	38.1%
Risk-free interest rate	2.2%
Expected life (in years)	3.4
Weighted-average fair value at grant date	\$ 16.97
	For the Three Months Ended March 31, 2008
<i>VMware Employee Stock Purchase Plan</i>	
Dividend yield	None
Expected volatility	37.3%
Risk-free interest rate	3.4%
Expected life (in years)	0.5
Weighted-average fair value at grant date	\$ 22.10

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For all options granted in the three months ended March 31, 2008, volatility was based on an analysis of historical and implied volatility of publicly-traded companies with similar characteristics, including industry, stage of life cycle, size and financial leverage. The expected term was calculated based on the historical experience that VMware employees have had with EMC stock option grants as well as the expected term of similar grants of comparable companies. The risk-free interest rate was based on a treasury instrument whose term is consistent with the expected life of the stock options.

Table of Contents**VMWARE, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(unaudited)****K. Related Party Transactions**

In the three months ended March 31, 2008 and 2007, VMware recognized professional service revenues of \$3.3 million and \$4.1 million, respectively, for services provided to EMC's customers pursuant to VMware's contractual agreements with EMC.

As of March 31, 2008, \$5.9 million of revenues from server and desktop products purchased by EMC for internal use was included in deferred revenue.

In the three months ended March 31, 2008 and 2007, VMware purchased \$9.6 million and \$0.6 million, respectively, of storage systems from EMC. Through the third quarter of 2007, the systems purchased from EMC were at EMC's cost. Since the fourth quarter of 2007, the systems purchased from EMC are at a discount off of EMC's list price. In addition, VMware purchased \$1.2 million of software from EMC for VMware's internal use in the first quarter of 2008.

In the three months ended March 31, 2008 and 2007, \$0.3 million and \$2.3 million, respectively, were allocated by EMC to VMware for certain corporate functions provided by EMC, including accounting, treasury, tax, legal and human resources. Additionally, certain other costs incurred by EMC for VMware's direct benefit, such as rent and salaries and benefits were included as expenses in VMware's financial statements. The total of these other costs were \$39.4 million and \$20.2 million in the three months ended March 31, 2008 and 2007, respectively. As part of VMware's tax sharing agreement, VMware paid EMC income taxes of \$62.3 million in the three months ended March 31, 2008, which differed from the amounts owed on a separate return basis. The difference between these amounts is presented as a component of stockholders' equity. In the three months ended March 31, 2008 and 2007, the difference between the amount of tax calculated on a separate return basis and the amount of tax calculated per the tax sharing agreement was \$0.5 million and \$6.6 million, respectively. In the three months ended March 31, 2008, VMware incurred interest expense with EMC, net, of \$5.8 million. In the three months ended March 31, 2007, VMware earned interest income with EMC, net, of \$1.3 million. Interest (expense) income with EMC, net, consists both of interest that has been earned or incurred on VMware's intercompany balance with EMC and from interest expense on the note payable to EMC. In the three months ended March 31, 2008, \$6.0 million of interest expense was recorded related to the note payable with EMC and was included in the \$5.8 million interest expense with EMC, net, recorded on the consolidated income statement. VMware's interest income and VMware's expenses as a separate, stand-alone company may be higher or lower than the amounts reflected in the financial statements.

L. Segment Information

VMware operates in one reportable segment in accordance with the provisions of FAS No. 131 Disclosures about Segments of an Enterprise and Related Information (FAS No. 131). VMware operates in one segment, therefore all financial segment information required by FAS No. 131 can be found in the consolidated financial statements.

Revenues by geographic area are as follows (table in thousands):

	For the Three Months Ended March 31,	
	2008	2007
United States	\$ 225,175	\$ 136,443
International	213,000	122,252
Total	\$ 438,175	\$ 258,695

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Long-lived assets, which include property and equipment, net, and other assets, net, excluding capitalized software and financial instruments, in the United States at March 31, 2008 and December 31, 2007, were \$257.5 million and \$236.5 million, respectively. Long-lived assets internationally at March 31, 2008 and December 31, 2007 were \$39.6 million and \$22.8 million, respectively. No country other than the United States accounted for 10% or more of these assets at March 31, 2008 or December 31, 2007.

Table of Contents**Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

This Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) should be read in conjunction with our interim consolidated financial statements and notes thereto which appear elsewhere in this Quarterly Report on Form 10-Q.

This section and other parts of this Quarterly Report on Form 10-Q contain forward-looking statements, within the meaning of the Federal securities laws, about our business and prospects. The forward-looking statements do not include the potential impact of any mergers, acquisitions, divestitures, securities offerings or business combinations or other developments in our business that may be announced or consummated after the date hereof. Any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements. Without limiting the foregoing, the words outlook, believes, plans, intends, expects, goals, potential, could, may, will, should, seeks, predicts, estimates, anticipates and similar expressions are intended to identify forward-looking statements, and not all forward-looking statements contain these words. Our future results may differ materially from our past results and from those projected in the forward-looking statements due to various uncertainties and risks, including those described in Item 1A of Part II (Risk Factors). The forward-looking statements speak only as of the date of this Quarterly Report and undue reliance should not be placed on these statements. We disclaim any obligation to update any forward-looking statements contained herein after the date of this Quarterly Report.

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

Certain tables may not add due to rounding.

Overview

Our primary source of revenue is the licensing of virtualization software and related support and services through a variety of distribution channels for use by businesses and organizations of all sizes and across numerous industries in their information technology infrastructure. Our virtualization solutions run on industry-standard desktops and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructure. We have developed a multi-channel distribution model to expand our presence and reach various segments of the market. In the first quarters of 2008 and 2007, we derived over 75% of our revenues from our channel partners, which include distributors, resellers, x86 systems vendors and system integrators. We have also developed a network of more than 13,000 indirect channel partners who fulfill orders through our direct channel partners. A majority of our revenues result from contracts that include both perpetual software licenses and ongoing software maintenance contracts. License revenues are recognized when the elements of revenue recognition are complete. Maintenance revenues are recognized ratably over the term of the maintenance period, and include renewals of maintenance sold after the initial maintenance period expires. We also recognize revenues from professional services provided to our customers.

We have achieved significant revenue growth to date and are focused on extending our growth by broadening our product portfolio, enabling choice for customers and driving standards, expanding our network of technology and distribution partners, increasing market awareness and promoting the adoption of virtualization. In addition to selling to new customers, we are also focused on expanding the use of our products within our existing customer base, as much of our license revenues are based on a per desktop or per server arrangement. We believe it is important that, as we grow our sales, we continue to invest in our corporate infrastructure, including customer support, information technology and general and administrative functions. We expect our spending in research and development to continue to increase as we add computer scientists, software engineers, and employees involved in product development and maintenance and continue to enable choice for customers and drive standards. We believe that equity incentives tied directly to the performance of VMware help us compete for top-level engineering and other talent. We also intend to continue to invest in hardware, networking and software tools to increase the efficiency of our research and development efforts.

Our current financial focus is on sustaining our growth in revenues to generate cash flows to expand our market segment share and our virtualization solutions. Although we are currently the leading provider of virtualization solutions, we believe the use of virtualization solutions is at very early stages by customers. We expect to face competitive threats to our leadership from a number of companies, some of which may have significantly greater resources than we do. As a result, we believe it is important to continue to invest in our research and product development, sales and marketing and the support function to maintain or expand our leadership in the virtualization solutions market. This investment could result in contracting operating margins as we invest in our future. We believe that we will be able to continue to fund our product development through operating cash flows as we continue to sell our existing products and services. We believe this is the right priority for the long-term health of our business.

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In evaluating our results, we focus on operating margin excluding stock-based compensation, employer taxes on employee stock transactions, amortization of intangible assets, the write-off of in-process research and development when applicable, and the net effect of the amortization and capitalization of software development costs incurred in the research and development of new software products. A portion of our services revenues are recognized in periods of up to five years subsequent to the initial contract, whereas most of our license revenues are recognized within the first quarter of contract signing. As a result, variability in operating margin can result from differences in when we price our service and when the cost is incurred. Substantially all of our international revenues are for contracts in U.S. dollars to international channel partners. A portion of our operating expenses is in currencies other than the U.S. dollar. This difference may cause variability in operating margins due to fluctuations in the U.S. dollar compared to other currencies. We are not currently focused on short-term operating margin expansion, but rather on investing at appropriate rates to support our growth and future product offerings in what may be a substantially more competitive environment; as a result, our operating margins may decline.

Prior to our initial public offering (IPO) in August 2007, we were a wholly-owned subsidiary of EMC Corporation (EMC), and as such we relied on EMC to provide a number of administrative support services and facilities in other countries. Although we continue to operate under an administrative services agreement and continue to receive support from EMC, we expect our administrative costs to continue to increase. We continue to invest in expanding our own administrative functions, including our finance and legal functions, which may be at a higher cost than the comparable services provided by EMC. We are incurring additional costs as a public company, including audit, investor relations, expanded information systems, stock administration and regulatory compliance costs.

Our Relationship with EMC

As of March 31, 2008, EMC owned 26,500,000 shares of Class A common stock and all 300,000,000 shares of Class B common stock, representing approximately 85% of our total outstanding shares of common stock and 98% of the combined voting power of our outstanding common stock.

In the first quarter of 2008 and 2007, we recognized professional service revenues of \$3.3 and \$4.1, respectively, for services provided to EMC customers pursuant to our contractual agreements with EMC.

As of March 31, 2008, \$5.9 of revenues from server and desktop products purchased by EMC for internal use was included in deferred revenue.

In the first quarter of 2008 and 2007, we purchased \$9.6 and \$0.6, respectively, of storage systems from EMC. Through the third quarter of 2007, the systems purchased from EMC were at EMC's cost. Since the fourth quarter of 2007, the systems purchased from EMC are at a discount off of EMC's list price. In addition, we purchased \$1.2 of software from EMC for our internal use in the first quarter of 2008.

In the first quarter of 2008 and 2007, \$0.3 and \$2.3, respectively, were allocated by EMC to us for certain corporate functions provided by EMC, including accounting, treasury, tax, legal and human resources. Additionally, certain other costs incurred by EMC for our direct benefit, such as rent, salaries and benefits expense were included as expenses in our financial statements. The total of these other costs were \$39.4 and \$20.2 in the first quarter of 2008 and 2007, respectively. As part of VMware's tax sharing agreement, VMware paid EMC income taxes of \$62.3 in the first quarter of 2008, which differed from the amounts owed on a separate return basis. The difference between these amounts is presented as a component of stockholders' equity. In the first quarter of 2008 and 2007, the difference between the amount of tax calculated on a separate return basis and the amount of tax calculated per the tax sharing agreement was \$0.5 and \$6.6, respectively. In the first quarter of 2008, we incurred interest expense with EMC, net, of \$5.8. In the first quarter of 2007, we earned interest income with EMC, net, of \$1.3. Interest (expense) income with EMC, net, consists both of interest that has been earned or incurred on our intercompany balance with EMC and from interest expense on the note payable to EMC. In the first quarter of 2008, \$6.0 of interest expense was recorded related to the note payable with EMC and was included in the \$5.8 interest expense with EMC, net, recorded on the consolidated income statement.

Given that the amounts we recorded for our intercompany transactions with EMC did not arise from transactions negotiated at arm's length with an unrelated third party, the financial statements included herein may not necessarily reflect our financial condition, results of operations and cash flows had we engaged in such transactions with an unrelated third party during all periods presented. Accordingly, our historical results should not be relied upon as an indicator of our future performance as a stand-alone company.

Income Statement Presentation

Sources of Revenues

License revenues. Our license revenues consist of revenues earned from the licensing of our software products. These products are generally licensed on a perpetual basis and are generally priced based upon the number of physical desktops or server processors on which our software

runs.

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Services revenues. Our services revenues consist of software maintenance and professional services. Maintenance revenues are recognized ratably over the contract period. Typically, our contract periods range from one to five years. Customers receive various types of product support based on the level of support purchased. Customers who are party to maintenance agreements with us are entitled to receive product updates and upgrades on a when-and-if-available basis.

Professional services include design, implementation and training. Professional services are not considered essential to the functionality of our products, as these services do not alter the product capabilities and may be performed by our customers or other vendors. Professional services engagements that have durations of ninety days or less are recognized in revenues upon completion of the engagement. Professional services engagements of more than ninety days for which we are able to make reasonably dependable estimates of progress toward completion are recognized on a proportional performance basis based upon the hours incurred. Revenues on all other professional services engagements are recognized upon completion.

Costs of Revenues and Operating Expenses

Cost of license revenues.

Our cost of license revenues principally consists of the cost of fulfillment of our software. This cost includes product packaging and personnel and related overhead associated with the physical and electronic delivery of our software products. The cost also includes amortization of capitalized software development costs.

Cost of services revenues.

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

Research and development expenses.

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

Sales and marketing expenses.

Our sales and marketing expenses include the costs of the personnel and related overhead associated with the sale and marketing of our license and service offerings, as well as the cost of certain specific marketing initiatives, including our semi-annual VMworld conference.

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, facilities, human resources, IT infrastructure and legal departments.

Table of Contents**Results of Operations****Revenues**

Our revenues for the first quarter of 2008 and 2007 are as follows (table in millions):

	For the Three Months Ended March 31,	
	2008	2007
Revenues:		
License	\$ 294.0	\$ 169.6
Services	144.2	89.1
	\$ 438.2	\$ 258.7
Percentage of revenues:		
License	67.1%	65.5%
Services	32.9%	34.5%
	100.0%	100.0%
Revenues:		
United States	\$ 225.2	\$ 136.4
International	213.0	122.3
	\$ 438.2	\$ 258.7
Percentage of revenues:		
United States	51.4%	52.7%
International	48.6%	47.3%
	100.0%	100.0%

Total revenues increased by \$179.5, or 69%, to \$438.2 in the first quarter of 2008, compared with \$258.7 in the first quarter of 2007. The growth in revenues in the first quarter of 2008 reflected an increase of \$124.4 in license revenues and an increase of \$55.1 in services revenues as compared to the first quarter of 2007. International revenues as a percentage of total revenues increased by over 100 basis points to 49% in the first quarter of 2008, compared with 47% in the first quarter of 2007.

Our revenue contracts with international customers are denominated in U.S. dollars.

License Revenues.

Software license revenues increased by \$124.4, or 73%, to \$294.0 in the first quarter of 2008, compared with \$169.6 in the first quarter of 2007. We believe a significant majority of the revenue growth in the first quarter of 2008 compared to the first quarter of 2007 is the result of increased sales volumes, driven largely by greater demand for our virtualization product offerings attributable to wider market acceptance of virtualization as part of organizations' IT infrastructure, a broadened product portfolio and expansion of our network of indirect channel partners. Although we expect our license revenues to continue to grow throughout 2008, we expect the rate of growth to decelerate due primarily to the size and scale of our business and a shift to more customers entering into enterprise agreements, our most comprehensive volume licensing agreement. Under an enterprise agreement, a portion of the revenues is attributed to the license and recognized immediately, but the majority is deferred and recognized as services revenues in future periods. As we increase our sales of enterprise agreements, we expect to have some shift in the mix of our revenues so that license revenues will compose a smaller proportion of our revenue mix and revenue growth in 2008.

We sell our products through a network of channel partners, which includes distributors, resellers, x86 system vendors and systems integrators. As we expand geographically, we may add additional direct channel partners; however, over 80% of the increases in orders in the first quarter of 2008, as compared with the first quarter of 2007, resulted from increased sales volumes through our existing direct channel partners. These increases were driven by several factors, including greater demand for our virtualization product offerings attributable to wider market acceptance of virtualization as part of an organization's IT infrastructure, a broadened product portfolio and expansion of our indirect channel partner network.

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We have more than 13,000 indirect channel partners as of March 31, 2008, an increase of more than 3,000 from December 31, 2007. These indirect channel partners obtain software licenses and services from our distributors and x86 system vendors and market and sell them to end-user customers. In the first quarter of 2008, we introduced new programs for these channel partners to assist them to quickly establish and expand their virtualization practices and drive new customer acquisition. These programs encourage channel loyalty and allow us to reach additional market segments and acquire new customers over the long-term horizon. In addition, we have a direct sales force that complements these efforts. Our sales force works with our channel partners to introduce them to customers and new sales opportunities. Our channel partners also introduce our sales force to their customers.

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We experienced an increase in the number of license orders greater than fifty thousand dollars in the first quarter of 2008, compared to the first quarter of 2007. License orders from our distributors and end-user customers which were greater than fifty thousand dollars were approximately 33% and 27% of license revenues in the first quarter of 2008 and 2007, respectively. Although we remain a high-volume transaction business, we believe an increase in the number of license orders greater than fifty thousand dollars in the comparative periods is a result of broader acceptance of virtualization solutions for organizations' IT infrastructure, a trend toward end-user customers using our products broadly across their organizations, and a result of more customers entering into multi-year enterprise agreements, our most comprehensive volume license offering. We anticipate this trend will continue.

Services Revenues.

Services revenues increased by \$55.1, or 62%, to \$144.2 in the first quarter of 2008, compared with \$89.1 in the first quarter of 2007. Services revenues consist of software maintenance and professional services revenues. The increase in services revenues in the first quarter of 2008 was primarily attributable to growth in our software maintenance revenues. This growth reflects the increase in our license revenues and renewals to customer contracts. Professional services revenues increased due to growing demand for design and implementation services and training programs, as end-user organizations deployed virtualization across their organizations. Given the reasons cited above, including the increased number of multi-year enterprise agreements, we expect that services revenues will compose a larger proportion of our revenue mix and revenue growth in 2008.

Operating Expenses, GAAP and Non-GAAP

Information about our operating expenses with and without stock-based compensation is as follows (table in millions):

	For the Three Months Ended March 31,					
	GAAP	2008 Stock- Based Compen- sation	Non-GAAP	GAAP	2007 Stock- Based Compen- sation	Non-GAAP
Operating expenses:						
Cost of license revenues ⁽¹⁾	\$ 22.9	\$ (0.3)	\$ 22.6	\$ 20.6	\$	\$ 20.6
Cost of services revenues	54.3	(3.3)	51.0	23.5	(0.5)	23.0
Research and development	119.3	(21.1)	98.2	55.0	(6.4)	48.6
Sales and marketing	149.3	(11.3)	138.0	86.7	(2.9)	83.8
General and administrative	44.1	(6.2)	37.9	26.6	(1.8)	24.8
Total operating expenses	\$ 389.9	\$ (42.2)	\$ 347.7	\$ 212.4	\$ (11.6)	\$ 200.8
Percentage of revenues:						
Cost of license revenues	5.2%		5.2%	7.9%		7.9%
Cost of services revenues	12.4		11.6	9.1		8.9
Research and development	27.2		22.4	21.2		18.8
Sales and marketing	34.1		31.5	33.5		32.4
General and administrative	10.1		8.6	10.3		9.6
Total operating expenses	89.0%		79.3%	82.0%		77.6%

(1) Included in the cost of license revenues is the amortization of capitalized software development costs of \$14.9 and \$8.0 in the first quarter of 2008 and 2007, respectively.

Operating expenses without stock-based compensation are non-GAAP financial measures. See **Non-GAAP Financial Measures** below.

Costs of Revenues

Our costs of revenues increased by \$33.1, or 75%, to \$77.2 in the first quarter of 2008, compared with \$44.0 in the first quarter of 2007. The increases in our costs of revenues were primarily attributable to increased direct support, professional services personnel and third-party professional services costs to support the increased services revenues. Included in the costs of revenues is the amortization of capitalized

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software development costs, which were \$14.9 and \$8.0 in the first quarter of 2008 and 2007, respectively.

Table of Contents*Research and Development Expenses*

Our R&D expenses increased by \$64.3, or 117%, to \$119.3 in the first quarter of 2008, compared with \$55.0 in the first quarter of 2007. As a percentage of revenues, R&D expenses were 27% and 21% in the first quarter of 2008 and 2007, respectively. The increase in R&D expenses was primarily attributable to incremental headcount to support the growth of our business, including increased salaries, benefits expense, stock-based compensation expense and consulting fees, resulting from the deployment of additional resources to support new product development. In addition, software capitalization decreased by \$2.6 to \$5.0 (including \$0.9 of stock-based compensation) in the first quarter of 2008, compared with \$7.6 (including \$0.9 of stock-based compensation) in the first quarter of 2007, due primarily to more resources working on products in the first quarter of 2007 that had reached technological feasibility.

Sales and Marketing Expenses

Our sales and marketing expenses increased by \$62.6, or 72%, to \$149.3 in the first quarter of 2008, compared with \$86.7 in the first quarter of 2007. As a percentage of revenues, sales and marketing expenses were 34% in both the first quarter of 2008 and 2007, respectively. The increases in sales and marketing expenses in absolute dollars consisted primarily of higher salaries, benefits expense and stock-based compensation expense due to both increases in sales and marketing personnel and higher commission expense resulting from increased sales volume. Stock-based compensation expense increased by \$8.4 in the first quarter of 2008 as compared with the first quarter of 2007, respectively. A portion of our sales and marketing expenses are denominated in foreign currencies and thus exposed to foreign exchange rate fluctuations. Upon consolidation, as exchange rates vary, the amount of sales and marketing expenses may fluctuate in response to changes in the exchange rate between the U.S. dollar and the foreign currencies in which the expenses are payable.

General and Administrative Expenses

Our general and administrative expenses increased by \$17.5, or 66%, to \$44.1 in the first quarter of 2008, compared with \$26.6 in the first quarter of 2007. As a percentage of revenues, general and administrative expenses were 10% in both the first quarter of 2008 and 2007, respectively. These expenses increased in absolute dollars primarily as a result of additional salaries, benefits expense and stock-based compensation expense resulting from the additional resources to support the growth of our business and to expand our own administrative functions, including our finance, legal, and information technology functions, in response to being a public company. Stock-based compensation expense increased by \$4.5 in the first quarter of 2008 as compared with the first quarter of 2007.

Stock-Based Compensation Expense

Stock-based compensation expenses increased by \$30.5, or 262%, to \$42.2 in the first quarter of 2008, compared with \$11.6 in the first quarter of 2007. Stock-based compensation primarily increased in the first quarter of 2008 as compared with the first quarter of 2007 due to broad-based stock option and restricted stock unit grants made under the VMware 2007 Equity and Incentive Plan beginning in the second quarter of 2007.

Between the time of our acquisition by EMC in January 2004 and June 2007, we did not issue equity awards in our stock to our employees. During this period, employees received stock-based compensation in the form of EMC stock options and restricted stock awards and units as a result of grants made by EMC's Board of Directors. Beginning in June 2007, we granted equity incentive awards under our 2007 Equity and Incentive Plan in anticipation of our IPO. In connection with the IPO in August 2007, we conducted an exchange offer pursuant to which we offered our eligible employees the ability to exchange their existing EMC options and restricted stock awards for options to purchase our Class A common stock and restricted stock awards of our Class A common stock, respectively.

As of March 31, 2008, the total unamortized fair value of outstanding VMware equity-based awards and EMC equity-based awards held by VMware employees was approximately \$418. This amount will be recognized over the awards' requisite service periods, and is expected to result in stock-based compensation expense of approximately \$122, \$126, \$110, \$59, and \$1 for the years ended 2008, 2009, 2010, 2011, and 2012, respectively. The annual expense is subject to the amount of stock-based compensation that may be capitalized as costs incurred with the development of new software products and also software developed for internal use, the amount of awards that ultimately vest, and also the timing and ultimate recognition of expense related to restricted stock units and restricted stock awards if certain performance goals are achieved.

In future quarters, our stock-based compensation expense is expected to increase as a result of additional equity grants in future periods.

Table of Contents**Intangible Assets**

In the first quarter of 2008 and 2007, we amortized \$3.9 and \$6.3, respectively, for purchased intangible assets. Amortization expense was lower in the first quarter of 2008 as compared to the first quarter of 2007 due to decreasing amortization for historical acquisitions offset in part by additional amortization for new acquisitions. The amortization expense was classified as follows in the consolidated income statements (table in millions):

	For the Three Months Ended March 31,	
	2008	2007
Costs of license revenues	\$ 2.3	\$ 5.2
Sales and marketing	0.9	0.6
General and administrative	0.7	0.5
	\$ 3.9	\$ 6.3

Operating Income

Our operating income increased by \$2.0, or 4%, to \$48.4 in the first quarter of 2008, compared with \$46.4 in the first quarter of 2007. Operating margins were 11% and 18% in the first quarter of 2008 and 2007, respectively. Operating margin decreased primarily as a result of the increase in the first quarter of 2008 of stock-based compensation of \$30.5, which decreased operating margin by 7%, and an increase in expense of \$9.8 from the net effect of capitalizing and amortizing software development costs, which decreased operating margin by 2%.

A portion of our costs of revenues, primarily the costs of personnel to deliver technical support on our products, and a portion of our operating expenses mainly related to sales, sales support and research and development, are denominated in foreign currencies, primarily the Euro, the British pound, the Japanese yen, the Indian rupee, the Australian dollar and the Canadian dollar. These costs and the resulting effect on operating income are exposed to foreign exchange rate fluctuations. As a result of fluctuations in the exchange rates between the U.S. dollar and foreign currencies, operating income decreased by \$9.9 in the first quarter of 2008, as compared with the first quarter of 2007. If the dollar continues to weaken in relation to other currencies, such as the Euro, we expect this to continue to have a negative effect on our operating margins.

We continue to expect that our operating expenses will increase in absolute terms and could increase as a percentage of revenues. In the second quarter of 2008, we anticipate that our operating margin could decrease as compared to the first quarter due to our continued product development and market expansion investments as well as our exposure to fluctuations in foreign currency rates.

Investment Income

Investment income was \$8.0 and \$1.7 in the first quarter of 2008 and 2007, respectively. Investment income consists of interest earned on cash and cash equivalent balances. Investment income increased in the first quarter of 2008 compared to the first quarter of 2007 due to higher cash and cash equivalent balances, primarily a result of the proceeds we received in the third quarter of 2007 from our IPO and the sale of shares of our Class A common stock to Intel Capital.

Interest (Expense) Income with EMC, Net

Interest expense with EMC, net, was \$5.8 in the first quarter of 2008. Interest income with EMC, net, was \$1.3 in the first quarter of 2007. In the first quarter of 2008, interest expense with EMC, net, consisted primarily of \$6.0 in interest expense incurred on the note issued to EMC in April 2007, offset by interest income of \$0.2 earned on amounts due to us from EMC on our intercompany balance. The decrease in the amount of interest income in the first quarter of 2008, compared with the first quarter of 2007, is due to lower intercompany balances maintained between EMC and us. We anticipate the trend of lower interest income on our intercompany balances to continue in future periods.

Income Tax Provision

Our effective income tax rate was 15.6% for the first quarter of 2008 and 16.9% for the first quarter of 2007. The reduction in the effective rate for the first quarter of 2008, as compared with the first quarter of 2007, was primarily attributable to a change in the mix of income from U.S. to

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international sources. The income earned abroad is considered indefinitely reinvested in our foreign operations and no provision for U.S. taxes has been provided. This benefit was partially offset due to the expiration of the federal research tax credit, an increase in other non-deductible permanent differences and transfer pricing adjustments relative to our forecasted annual pre-tax income.

Our rate of taxation in foreign jurisdictions is lower than our United States tax rate.

Table of Contents**Non-GAAP Financial Measures**

Regulation S-K Item 10(e), Use of Non-GAAP Financial Measures in Commission Filings, and other Securities Exchange Commission (SEC) regulations define and prescribe the conditions for use of certain non-GAAP financial information. Our measures of costs of revenues and operating expenses without stock-based compensation meet the definition of non-GAAP financial measures. These non-GAAP financial measures, which are used as measures of our performance, should be considered in addition to, not as a substitute for or in isolation from, measures of our financial performance prepared in accordance with GAAP. We provide this information to show the impact of stock-based compensation on our results of operations, as it is excluded from our internal operating plans and measurement of financial performance (although we consider the dilutive impact to our shareholders when awarding stock-based compensation and value such awards accordingly), and because determining the fair value of the related equity awards involves a high degree of judgment and estimation.

Costs of revenues and operating expenses without stock-based compensation have limitations due to the fact that they do not include all expenses related to the compensation of our people. More specifically, if we did not pay out a portion of our compensation in the form of stock-based compensation, the cash salary expense included in our costs of revenues and operating expenses would be higher. We compensate for this limitation by providing supplemental information about outstanding stock-based awards in the footnotes to our financial statements. Stock-based compensation programs are an important element of our compensation structure and all forms of stock-based awards are valued and included as appropriate in results of operations. Management strongly encourages shareholders to review our financial statements and publicly-filed reports in their entirety and not to rely on any single financial measure.

Liquidity and Capital Resources

Our cash flows for the first quarter of 2008 and 2007, respectively, were as follows:

	For the Three Months Ended March 31,	
	2008	2007
Net cash provided by operating activities	\$ 133.2	\$ 104.9
Net cash used in investing activities	\$ (85.6)	\$ (22.6)
Net cash provided by financing activities	\$ 27.2	\$

In the first quarter of 2008, our operating cash flows reflected net income generated during the period of \$43.1, adjusted for non-cash items such as depreciation and amortization expense of \$37.4 and stock-based compensation of \$42.2. This was offset by excess tax benefits from stock-based compensation of \$22.7. FAS No. 123(R), Accounting for Stock-Based Compensation, requires excess tax benefits relating to stock-based compensation deductions be presented as financing cash flows, rather than as cash flows from operating activities. The benefits of tax deductions in excess of the tax-affected compensation could fluctuate significantly from period to period based on the number of stock-based awards exercised, sold or vested, the tax benefit realized and the tax-affected compensation recognized.

Additionally, working capital, including short- and long-term deferred revenue, income taxes payable to EMC and deferred income taxes, net, generated cash flow of \$31.9 in the first quarter of 2008, primarily as the result of an increase in deferred revenue of \$88.2 due to the growth in our business. This was offset by increases in deferred income taxes, net, of \$36.3, and decreases in income taxes payable to EMC of \$21.6 and accrued expenses of \$15.3. As of March 31, 2008, our deferred revenue balance consisted of deferred license revenues of \$32.4 and deferred services revenues of \$608.7, of which \$402.3 of the total deferred revenue balance was classified as current.

In the first quarter of 2007, our operating cash flow reflected net income generated during the period of \$41.1, adjusted for non-cash items such as depreciation and amortization expense of \$21.2 and stock-based compensation of \$11.6. Additionally, working capital, including short- and long-term deferred revenue, income taxes payable and deferred income taxes, net, generated cash flow of \$30.4, primarily as a result of a decrease in accounts receivable of \$46.4 and an increase in deferred revenues of \$33.7. Our deferred revenue balance consisted of deferred license revenues of \$76.4 and deferred service revenues of \$263.9 at March 31, 2007, of which \$262.1 of the total deferred revenue balance was classified as current.

Cash used in investing activities was \$85.6 in the first quarter of 2008 and \$22.6 in the first quarter of 2007. Cash paid for capital additions was \$49.0 and \$16.6 in the first quarter of 2008 and 2007, respectively. Capital additions increased in the first quarter of 2008 as compared to the first quarter of 2007, primarily due to increased costs related to our new headquarters facilities and investment in computer and network equipment. For our new headquarters facilities, we purchased furniture and fixtures and invested cash in the remaining buildings under development. We invested in computer and network equipment to support increased personnel and related infrastructure requirements both

domestically and internationally. We

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expect this investment to continue. In the first quarter of 2008, we also purchased \$19.1 in capital additions that are not reflected in our statement of cash flows as we had not remitted cash for the additions prior to the end of the quarter. Business acquisitions, net of cash acquired, used \$33.3 in the first quarter of 2008. Capitalized software development costs, which exclude stock-based compensation expenses, were \$4.2 and \$6.7 in the first quarter of 2008 and 2007, respectively.

Cash provided by financing activities was \$27.2 in the first quarter of 2008. We had no financing activities in the first quarter of 2007, primarily because we had not yet issued equity awards under our 2007 Employee Equity and Incentive Plan. Cash provided by financing activities in the first quarter of 2008 reflected proceeds from stock option exercises, including the purchase of shares under our 2007 Employee Stock Purchase plan of \$23.7, and excess tax benefits from stock-based compensation of \$22.7. These financing cash inflows were partially offset by \$19.1 of shares repurchased to cover tax withholding obligations in conjunction with the net share settlement upon the vesting of restricted stock. We expect that cash proceeds from exercises of stock options and the excess tax benefit from stock-based compensation will increase over time as more stock options vest and become exercisable, however, these proceeds could fluctuate significantly from period to period based on the number of awards exercised, sold or vested, the tax benefit realized, and the tax-affected compensation recognized.

Our cash and cash equivalents balance was \$1,306.0 in the first quarter of 2008 and \$258.5 in the first quarter of 2007. Based on our current operating and capital expenditure forecasts, we believe that the combination of funds currently available and funds to be generated from operations will be adequate to finance our ongoing operations for at least the next twelve months.

To date, inflation has not had a material impact on our financial results.

Off-Balance Sheet Arrangements, Contractual Obligations, Contingent Liabilities and Commitments

There were no substantial changes to our guarantee and indemnification obligations or our contractual commitments in the first quarter of 2008.

Critical Accounting Policies

Our consolidated financial statements are based on the selection and application of generally accepted accounting principles 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 2007 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. Our significant accounting policies are presented within Note A to our consolidated financial statements of our 2007 Annual Report on Form 10-K.

New Accounting Pronouncements

We adopted Financial Accounting Standards (FAS) FAS No. 157, Fair Value Measurements (FAS No. 157) on January 1, 2008. FAS No. 157 defines fair value, establishes a methodology for measuring fair value, and expands the required disclosure for fair value measurements. On February 12, 2008, the Financial Accounting Standards Board (FASB) FASB issued FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157, which delays the effective date of FAS No. 157 by one year for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). Therefore, beginning on January 1, 2008, this standard applies prospectively to new fair value measurements of financial instruments and recurring fair value measurements of non-financial assets and non-financial liabilities. On January 1, 2009, the beginning of our 2009 fiscal year, the standard will also apply to all other fair value measurements. We are currently evaluating the potential impact of FAS No. 157 for non-financial assets and non-financial liabilities on our financial position and results of operations. The adoption for financial assets and liabilities did not have an impact on our consolidated financial position and results of operations.

In December 2007, the FASB issued FAS No. 141 (revised 2007) or FAS No. 141R, Business Combinations. This statement establishes principles and requirements for how the acquirer in a business combination (i) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (ii) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (iii) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS No. 141 (revised 2007) is effective for fiscal years beginning after

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December 15, 2008. The impact of the standard on our financial position and results of operation will be dependent upon the number of and magnitude of acquisitions that are consummated once the standard is effective.

In December 2007, the FASB issued FAS No. 160 or FAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51. The objective of this statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards for the noncontrolling interest in a subsidiary and therefore deconsolidation of a subsidiary. FAS No. 160 is effective for fiscal years beginning after December 15, 2008. We do not expect the standard to have a material impact on our financial position or results of operations.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Exchange Risk

International revenues as a percentage of total revenues were 48.6% and 47.3% in the first quarter of 2008 and 2007, respectively. Our revenue contracts are denominated in U.S. dollars and the vast majority of our purchase contracts are denominated in U.S. dollars. A portion of our cost of revenues, primarily the cost of personnel to deliver technical support on our products, and a portion of our operating expense related to sales and sales support and research and development, are denominated in foreign currencies, primarily the Euro, the British pound, the Japanese yen, the Indian rupee, the Australian dollar and the Canadian dollar. These costs and the resulting effect on operating income are exposed to foreign exchange rate fluctuations. Upon consolidation, as exchange rates vary, operating expenses may differ materially from expectations. For example, the amount of our operating lease commitments may fluctuate in response to changes in the exchange rate between the U.S. dollar and the foreign currencies as several of our operating leases are payable in foreign currencies.

We do not hedge our exposure to foreign currency fluctuation. In the first quarter of 2008, as a result of fluctuations in the exchange rates between the U.S. dollar and foreign currencies, operating income decreased by \$9.9 million as compared to the first quarter of 2007.

Interest Rate Risk

Our exposure to market risk relates primarily to the variable interest obligation on the note we incurred to fund an \$800.0 million dividend to EMC. The dividend was declared in April 2007, but given retroactive effect as of December 31, 2006. The note may be repaid, without penalty, at any time. Subsequent to receiving the proceeds from our IPO in August 2007, we repaid \$350.0 million of principal on the note. The note matures in April 2012 and bears an interest rate of the 90-day LIBOR plus 55 basis points, with interest payable quarterly in arrears. The interest rate on the note payable as of March 31, 2008 was 5.28%, but the interest rate on the note payable will decrease by approximately 200 basis points for the second quarter of 2008 because of decreases in the 90-day LIBOR. Therefore, we expect our interest expense on the note payable to decrease in the subsequent quarter. If our interest rates were to instantaneously increase (decrease) 100 basis points from the March 31, 2008 rate and assuming no payments on the principal were made during 2008, our annual interest expense would increase (decrease) by \$4.5 million.

Item 4T. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our principal executive officer and principal financial officer have concluded that as of such date, our disclosure controls and procedures were effective.

We are required to comply with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002 for our fiscal year ending December 31, 2008. The management report and auditor attestation on the effectiveness of the Company's internal control over financial reporting must be included in our annual report for the fiscal year ending December 31, 2008.

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PART II

OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

We are named from time to time as a party to lawsuits in the normal course of its business. In such cases it is our policy to defend against such claims, or if considered appropriate, negotiate a settlement on commercially reasonable terms. However, no assurance can be given that we will be able to negotiate settlements on commercially reasonable terms, or at all, or that any litigation resulting from such claims would not have a material adverse effect on our consolidated financial position, liquidity, operating results, or our consolidated financial statements taken as a whole.

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.

Risks Related to Our Business

The virtualization products and services we sell are based on an emerging technology and therefore the potential market for our products remains uncertain.

The virtualization products and services we develop and sell are based on an emerging technology platform and our success depends on organizations and customers perceiving technological and operational benefits and cost savings associated with adopting virtualization solutions. Our relatively limited operating history and the relatively limited extent to which virtualization solutions have been currently adopted may make it difficult to evaluate our business because the potential market for our products remains uncertain. The markets for our virtualization products are new and have grown rapidly from a small base. This has resulted in significant percentage increases in our product sales in recent periods. As the markets for our products mature and the scale of our business increases, the rate of growth in our product sales may be lower than those we have experienced in recent periods. In addition, to the extent that the virtualization market develops more slowly or less comprehensively than we expect, our revenue growth rates may slow materially or our revenue may decline substantially.

We expect to face increasing competition that could result in a loss of customers, reduced revenues or decreased operating margins.

The market for our products is competitive and we expect competition to significantly intensify in the future. For example, Microsoft currently provides products that compete with some of our free offerings and has released a beta version of a product that will likely compete with our entry level enterprise-class products in the future. Microsoft's offerings are positioned to compete with our hypervisor offerings. We also face competition from other companies, including several recent market entrants and there have been a number of announcements of new product initiatives, alliances and consolidation efforts by our competitors. For example, Citrix Systems acquired XenSource, a developer of virtual infrastructure software, and announced an expansion of its alliance with Microsoft, and XenSource products were made available preinstalled on servers of certain x86 vendors. Virtual Iron Software released a new version of its infrastructure product, Sun Microsystems announced a virtualization initiative and Oracle released a Xen-based product. Existing and future competitors may introduce products in the same markets we serve or intend to serve, and competing products may have better performance, lower prices, better functionality and broader acceptance than our products. Our competitors may also add features to their virtualization products similar to features that presently differentiate our product offerings from theirs. Many of our current or potential competitors also have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we do. This competition could result in increased pricing pressure and sales and marketing expenses, thereby materially reducing our operating margins, and could harm our ability to increase, or cause us to lose, market share. Increased competition also may prevent us from entering into or renewing service contracts on terms similar to those that we currently offer and may cause the length of our sales cycle to increase.

Some of our competitors and potential competitors supply a wide variety of products to, and have well-established relationships with, our current and prospective end users. 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 less attractive to our end users. For example, Microsoft has implemented distribution arrangements with x86 system vendors and independent software vendors, or ISVs, related to certain of their operating systems that only permit

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the use of Microsoft's virtualization format and do not allow the use of our corresponding format. Microsoft has also recently implemented pricing policies that require

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customers to pay additional license fees based on certain uses of virtualization technology. These distribution and licensing restrictions, as well as other business practices that may be adopted in the future by our competitors, could materially impact our prospects regardless of the merits of our products. In addition, competitors with existing relationships with our current or prospective end users could in the future integrate competitive capabilities into their existing products and make them available without additional charge. For example, Oracle's announcement promised free server virtualization software intended to support Oracle and non-Oracle applications. By engaging in such business practices, our competitors can diminish competitive advantages we may possess by incentivizing end users to choose products that lack some of the technical advantages of our own offerings.

We also face potential competition from our partners. For example, third parties currently selling our products could build and market their own competing products and services or market competing products and services of third parties. If we are unable to compete effectively, our growth and our ability to sell products at profitable margins could be materially and adversely affected.

Industry alliances or consolidation may result in increased competition.

Some of our competitors have made acquisitions or entered into partnerships or other strategic relationships with one another to offer a more comprehensive virtualization solution than they individually had offered. For example, Citrix Systems recently acquired XenSource, a developer of virtualization solutions and Microsoft recently announced an expansion of its alliance with Citrix. We expect these trends to continue as companies attempt to strengthen or maintain their market positions in the evolving virtualization infrastructure industry. Many of the companies driving this trend have significantly greater financial, technical and other resources than we do and may be better positioned to acquire and offer complementary products and technologies. The companies resulting from these possible combinations may create more compelling product offerings and be able to offer greater pricing flexibility than we can or may engage in business practices that make it more difficult for us to compete effectively, including on the basis of price, sales and marketing programs, technology or product functionality. These pressures could result in a substantial loss of customers or a reduction in our revenues.

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, which could 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 month of the quarter, which we believe 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:

fluctuations in demand, adoption, sales cycles 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;

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 and beta programs;

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

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

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

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

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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; and

general economic conditions in our domestic and international markets.

If operating system and hardware vendors do not cooperate with us or we are unable to obtain early access to their new products, or access to certain information about their new products to ensure that our solutions interoperate with those products, our product development efforts may be delayed or foreclosed.

Our products interoperate with Windows, Linux and other operating systems and the hardware devices of numerous manufacturers. Developing products that interoperate properly requires substantial partnering, capital investment and employee resources, as well as the cooperation of the vendors or developers of the operating systems and hardware. Operating system and hardware vendors may not provide us with early access to their technology and products, assist us in these development efforts or share with or sell to us any application protocol interfaces (APIs), formats, or protocols we may need. If they do not provide us with the necessary early access, assistance or proprietary technology on a timely basis, we may experience product development delays or be unable to expand our products into other areas. To the extent that software or hardware vendors develop products that compete with ours or those of our controlling stockholder, 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, or compatibility, and certification of our products. In addition, hardware or operating system 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 our business and results of operations may be adversely affected.

We rely on distributors, resellers, x86 system vendors and systems integrators to sell our products, 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.

Our future success is highly dependent upon maintaining and increasing the number of our relationships with distributors, resellers, x86 system vendors and systems integrators. By relying on distributors, resellers, x86 system vendors and systems integrators, we may have little or no contact with the ultimate users of our products, thereby making it more difficult for us to establish brand awareness, ensure proper delivery and installation of our products, 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 offerings, including our new product developments, may make it more difficult to introduce those products to end users and delay end user adoption of our product offerings. We generally do not have long-term contracts or minimum purchase commitments with our distributors, resellers, x86 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 of our competitors or to prevent or reduce sales of our products. Certain x86 system vendors have begun to offer competing virtualization products preinstalled on their server products. 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. Accordingly, our channel partners and x86 system vendors may choose not to offer our products 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 which would result in us receiving lower revenues from our channel partners. One of the Company's distribution agreements is with Ingram Micro, which accounted for 23% of our revenues in 2007. The agreement with Ingram Micro under which the Company receives the substantial majority of its Ingram Micro revenues is terminable by either party upon 90 days prior written notice to the other party, and neither party has any obligation to purchase or sell any products under the agreement. The terms of this agreement between Ingram Micro and us are

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substantially similar to the terms of the agreements we have with other distributors, except for certain differences in shipment and payment terms, indemnification

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obligations and product return rights. While we believe that we have in place, or would have in place by the date of any such termination, agreements with other distributors sufficient to maintain our revenues from distribution, if we were to lose Ingram Micro's distribution services, 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.

The concentration of our product sales among a limited number of distributors increases our potential credit risk and could cause significant fluctuations or declines in our product revenues.

One distributor accounted for 23% of revenues in 2007. Additionally, another distributor accounted for 12% of revenues in 2007. 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. 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. 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.

We are dependent on our existing 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 innovation. 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. The loss of key employees could seriously harm our ability to release new products 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 our growth plan, we must attract and retain highly qualified personnel. Competition for these personnel is intense, especially for engineers with high levels of experience in designing and developing software and senior sales executives. We may not be successful in attracting and retaining qualified personnel. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Many of the companies with which we compete for experienced personnel have greater resources than we have. In addition, in making employment decisions, particularly in the high-technology industry, job candidates often consider the value of the stock options, restricted stock grants or other stock-based compensation they are to receive in connection with their employment. A decline in the value of our stock could adversely affect our ability to attract or retain key employees. 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.

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 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. Even if patents are issued from our patent applications, which is 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 contractual and 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 and proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual

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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 do we. 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 or better than ours.

Our success and ability to compete depend substantially upon our internally developed technology, which is incorporated in the source code for our products. We seek to protect the source code, design code, documentation and other written materials for our software, under trade secret and copyright laws. However, we have chosen to provide access to our hypervisor and other selected source code to more than 40 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, our 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.

Claims by others that we infringe their proprietary technology could force us to pay damages or prevent us from using certain technology in our products.

Third parties could claim that our products or technology infringe their proprietary rights. This risk may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility and market exposure as a public company, we face a higher risk of being the subject of intellectual property infringement claims. Any claim of infringement by a third party, even one without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. 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. Any of these events could seriously harm our business, operating results and financial condition. Third parties may also assert infringement claims against our customers and channel partners. Any of these claims 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. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or channel partners, which could materially reduce our income.

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

A significant portion of the products or technologies acquired, licensed or developed by us may incorporate so-called open source software, and we may incorporate open source software into other products in the future. Such open source software is generally licensed by its authors or other third parties under open source licenses, including, for example, the GNU General Public License, the GNU Lesser General Public License, Apache-style licenses, Berkeley Software Distribution, BSD-style licenses and other open source licenses. We monitor our use of open source software in an effort to avoid subjecting our products to conditions we do not intend. Although we believe that we have complied with our obligations under the various applicable licenses for open source software that we use such that we have not triggered any such conditions, there is little or no legal precedent governing the interpretation of many of the terms of certain of these licenses, and therefore the potential impact of these terms on our business is somewhat unknown and may result in unanticipated obligations regarding our products and technologies. For example, we may be subjected to certain conditions, including requirements that we offer our products that use the open source software for no cost, that we make available source code for modifications or derivative works we create based upon, incorporating or using the open source software and/or that we license such modifications or derivative works under the terms of the particular open source license.

If an author or other third party that distributes such open source software were to allege that we had not complied with the conditions of one or more of these licenses, we could be required to incur significant legal expenses defending against such allegations. If our defenses were not successful, we could be subject to significant damages, enjoined from the distribution of our products that contained the open source software and required to comply with the foregoing conditions,

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which could disrupt the distribution and sale of some of our products. In addition, if we combine our proprietary software with open source software in a certain manner, under some open source licenses we could be required to release the source code of our proprietary software, which could substantially help our competitors develop products that are similar to or better than ours.

In addition to risks related to license requirements, usage of open source software can lead to greater risks than use of third party commercial software, as open source licensors generally do not provide warranties or assurance of title or controls on origin of the software. We have established processes to help alleviate these risks, including a review process for screening requests from our development organizations for the use of open source, but we cannot be sure that all open source is submitted for approval prior to use in our products. In addition, many of the risks associated with usage of open source, such as the lack of warranties or assurances of title, cannot be eliminated, and could, if not properly addressed, negatively affect our business.

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, including their technical capabilities, potential cost savings to an organization and advantages compared to lower-cost products 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 purchases are frequently subject to budget constraints, multiple approvals, and unplanned administrative, processing and other delays. Additionally, 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 offerings and delay product sales.

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 month, weeks and days of each quarter. This pattern makes prediction of revenues, earnings and working capital for each financial period especially difficult and uncertain and increases 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 first nine months of the following year;

seasonal influences.

If sales expected from a specific customer 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 could be materially adversely affected.

Our current research and development efforts may not produce significant revenues for several years, if at all.

Developing our products is expensive. Our investment in research and development may not result in marketable products or may result in products that take longer to generate revenues, or generate less revenues, than we anticipate. Our research and development expenses were \$119.3 million, or 27% of our total revenues, in the three months ended March 31, 2008, and \$285.9 million, or 22% of our total revenues, in 2007. 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.

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.

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The markets for our software solutions are characterized by rapid technological changes, changing customer needs, frequent new software product introductions and evolving industry standards. The introduction of third-party solutions

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embodying new technologies and the emergence of new industry standards could make our existing and future software solutions obsolete and unmarketable. We may not be able to develop updated products 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 to work with these systems and devices. 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 expected migration of servers from dual-core to quad-core microprocessor technology will also allow an end user with a given number of licensed copies of our software to double the number of virtualization machines run per server socket without having to purchase additional licenses from us. 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. If any of the foregoing events were to occur, our ability to retain or increase market share and revenues in the virtualization software market could be materially adversely affected.

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

If we are unable to develop new products and services, or to enhance and improve our products and support services in a timely manner or to position and/or price our products and services to meet market demand, customers may not buy new software licenses or renew software license updates and 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 will allow us to compete effectively for business opportunities in emerging areas.

New product development and introduction involves 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 product enhancements, which has frequently been longer than we originally expected;

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;

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, our revenues could be negatively impacted.

Our ability to sell our products is dependent on the quality of our support and services offerings, and our failure to offer high-quality support and services could have a material adverse effect on our sales and results of operations.

Once our products are integrated within our customers' hardware and software systems, our customers may depend on our support organization to resolve any issues relating to our products. A high level of support is critical for the successful marketing and sale of our products. If we or our channel partners do not effectively assist our customers in deploying our products, succeed in helping our customers quickly resolve post-deployment issues, and provide effective ongoing support, our ability to sell our products to existing customers would be adversely affected, and our reputation with potential customers could be harmed. In addition, as we expand our operations internationally, our support organization will face additional challenges, including those associated with delivering support, training and documentation in languages other than English. As a result, our failure to maintain high-quality support and services, or to adequately assist our channel partners in providing high-quality support and services, could result in customers choosing to use our competitors' products instead of ours in the future.

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Adverse economic conditions or reduced information technology spending may adversely impact our revenues.

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 is often discretionary and may involve a significant commitment of capital and other resources. Weak economic conditions, or a reduction in information technology spending even if economic conditions improve, would likely adversely impact our business, financial condition and results of operations in a number of ways, including by lengthening sales cycles, lowering prices for our products and services and reducing unit sales.

We may engage in future acquisitions that could disrupt our business, cause dilution to our stockholders and harm our business, financial condition and results of operations.

In the future we may seek to acquire other businesses, products or technologies. However, 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. Acquisitions may disrupt our ongoing operations, divert management from day-to-day responsibilities, increase our expenses and adversely impact our business, financial condition and results of operations. Future acquisitions may reduce our cash available for operations and other uses and could result in an increase in amortization expense related to identifiable intangible assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt. We have limited historical experience with the integration of acquired companies. There can be no assurance that we will be able to manage the integration of acquired businesses effectively or be able to retain and motivate key personnel from these businesses. Any difficulties we encounter in the integration process could divert management from day-to-day responsibilities, increase our expenses and have a material adverse effect on our business, financial condition and results of operations. In addition, we review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable and are required to test goodwill for impairment at least annually. We may be required to record a significant charge to earnings in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets resulting from an acquisition or otherwise is determined, resulting in an adverse impact on our results of operations.

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

In 2007, we derived approximately 46%, and in the three months ended March 31, 2008, we derived approximately 49%, of our revenues from customers outside the United States. We have sales and technical support personnel in numerous countries worldwide. We expect to continue to add personnel in additional countries. 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 in certain foreign markets;

economic or political instability and security concerns in countries that are important to our international sales and operations;

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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.

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As we continue to expand our business globally, 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 establishing and maintaining adequate management systems and internal controls over financial reporting and increase challenges in managing an organization operating in various countries.

Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales.

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

Our products are highly technical and complex and, when deployed, have contained and may contain errors, defects or security vulnerabilities. Some errors in our products may only be discovered after a product has been installed and used by customers. Any errors, defects or security vulnerabilities discovered in our products 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 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. Actual or perceived security vulnerabilities in our products could harm our reputation and lead some customers to return products, to reduce or delay future purchases or use competitive products. 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. In addition, we could face claims for product liability, tort or breach of warranty, including claims relating to changes to our products made by our channel partners. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and time-consuming and may divert management's attention and adversely affect the market's perception of us and our products. 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.

Our independent registered public accounting firm identified a material weakness in the design and operation of our internal controls as of December 31, 2006, which we remediated in 2007. We cannot assure you that material weaknesses will not exist or be identified in future periods.

Our independent registered public accounting firm reported to our board of directors a material weakness in the design and operation of our internal controls as of December 31, 2006 related to the capitalization of software development costs. A material weakness is defined by the standards issued by the Public Company Accounting Oversight Board as a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The material weakness resulted from a lack of adequate internal controls to ensure the timely identification and accumulation of costs once a project reaches technological feasibility under applicable accounting standards. Our historical consolidated financial statements reflect adjustments to properly state our capitalized software development costs for the periods included therein. Our independent registered public accounting firm was not engaged to audit the effectiveness of our internal control over financial reporting as of December 31, 2006. If such an evaluation had been performed, additional material weaknesses may have been identified. Our independent registered public accounting firm was also not engaged to audit the effectiveness of our internal control over financial reporting as of December 31, 2007. If such an evaluation had been performed, material weaknesses may have been identified.

We remediated the material weakness found in our internal controls as of December 31, 2006 by implementing additional formal policies, procedures and processes, hiring additional accounting personnel and increasing management review and oversight over the financial statement close process. Under Section 404 of the Sarbanes-Oxley Act of 2002 and the current rules of the SEC, our management and independent registered public accounting firm will be required to evaluate and report on the effectiveness of our internal control over financial reporting as of December 31, 2008. If additional material weaknesses in our internal controls are discovered in the future, we may fail to meet our future reporting obligations, our financial statements may contain material misstatements and the price of our common stock may decline.

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If we fail to implement and maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud. As a result, our stockholders could lose confidence in our financial reporting, which could harm our business and the trading price of our common stock.

We are preparing for compliance with Section 404 by remediating the previously identified material weakness in our internal controls and by assessing, strengthening and testing our system of internal controls. In particular, we believe we will need to increase the number of our accounting personnel and improve our processes and systems to ensure timely and accurate reporting of our financial results in accordance with reporting obligations as a stand-alone public company. However, the continuous process of strengthening our internal controls and complying with Section 404 is expensive and time-consuming, and requires significant management attention. We cannot be certain that these measures will provide adequate control over our financial processes and reporting. In addition, we have identified certain processes that need to be automated in order to ensure that we have effective internal control over financial reporting. If we are not able to automate these processes in a timely fashion, we will not be able to ensure compliance. Furthermore, as we grow our business, our internal controls will become more complex and we will require significantly more resources to ensure our internal controls overall remain effective. Failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations. If we or our independent registered public accounting firm identify material weaknesses, the disclosure of that fact, even if quickly remedied, could reduce the market's confidence in our financial statements and harm our stock price. In addition, if we are unable to comply with Section 404, our non-compliance could subject us to a variety of administrative sanctions, including the suspension or delisting of our common stock from the New York Stock Exchange and the inability of registered broker-dealers to make a market in our common stock, which could further reduce our stock price.