VMWARE, INC.
Form 10-Q
November 05, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 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)

Delaware	**94-3292913**
(State or other jurisdiction of	**(I.R.S. Employer**
incorporation or organization)	**Identification Number)**
3401 Hillview Avenue	
Palo Alto, CA	**94304**
(Address of principal executive offices)	**(Zip Code)**

(650) 427-5000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x 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 x (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

As of October 29, 2008, the number of shares of common stock, par value $.01 per share, of the registrant outstanding was 389,602,066, of which 89,602,066 shares were Class A common stock and 300,000,000 were Class B common stock.

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I

FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

VMware, Inc.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

	September 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,691,372	$ 1,231,168
Accounts receivable, less allowance for doubtful accounts of $2,351 and $1,603	287,943	283,824
Deferred tax asset, current portion	44,004	54,386
Income taxes receivable, net	82,228	
Other current assets	49,120	33,956
Total current assets	2,154,667	1,603,334
Property and equipment, net	370,613	276,983
Other assets, net	97,665	71,695
Deferred tax asset, net of current portion	56,980	72,249
Intangible assets, net	48,513	32,073
Goodwill	730,276	639,366
Total assets	$ 3,458,714	$ 2,695,700
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 80,263	$ 61,503
Accrued expenses	160,129	173,610
Due to EMC, net	36,249	2,759
Income taxes payable, current portion		68,823
Deferred revenue, current portion	482,366	363,317
Total current liabilities	759,007	670,012
Note payable to EMC	450,000	450,000
Deferred revenue, net of current portion	297,997	189,479
Deferred tax liability	42,026	27,327
Income taxes payable, net of current portion	28,419	18,265
Total liabilities	1,577,449	1,355,083
Commitments and contingencies (see Note J)		
Stockholders equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 89,452 and 82,924 shares	895	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	1,756,638	1,352,788
Retained earnings (accumulated deficit)	120,732	(16,000)
Total stockholders equity	1,881,265	1,340,617
Total liabilities and stockholders equity	$ 3,458,714	$ 2,695,700

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

3

Table of Contents

VMware, Inc.

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues:				
License	$ 285,086	$ 247,481	$ 863,299	$ 621,086
Services	187,035	110,335	503,125	292,250
	472,121	357,816	1,366,424	913,336
Operating expenses:				
Cost of license revenues	21,535	19,158	66,033	60,546
Cost of services revenues	52,919	39,493	166,122	90,946
Research and development	85,315	67,840	318,698	194,379
Sales and marketing	167,914	125,736	475,478	311,432
General and administrative	43,418	39,839	129,682	97,166
Operating income	101,020	65,750	210,411	158,867
Investment income	7,654	7,300	21,968	11,718
Interest expense with EMC, net	(3,823)	(6,743)	(13,221)	(13,261)
Other expense, net	(1,321)	(19)	(497)	(106)
Income before income taxes	103,530	66,288	218,661	157,218
Income tax provision	20,242	1,610	39,982	17,236
Net income	$ 83,288	$ 64,678	$ 178,679	$ 139,982
Net income per weighted-average share, basic for Class A and Class B	$ 0.21	$ 0.18	$ 0.47	$ 0.41
Net income per weighted-average share, diluted for Class A and Class B	$ 0.21	$ 0.18	$ 0.45	$ 0.41
Weighted-average shares, basic for Class A and Class B	387,621	356,431	383,876	340,565
Weighted-average shares, diluted for Class A and Class B	394,232	368,567	397,093	344,736

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

4

Table of Contents

VMware, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Cash flows from operating activities:				
Net income	$ 83,288	$ 64,678	$ 178,679	$ 139,982
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	40,644	27,643	117,537	72,462
Stock-based compensation, excluding amounts capitalized	35,317	31,737	119,550	59,354
Excess tax benefits from stock-based compensation	(5,844)		(85,271)	
Other adjustments	1,242	(528)	2,300	(394)
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	20,803	37,062	(3,483)	30,972
Other assets	(2,369)	5,994	(15,650)	(2,666)
Due to/from EMC, net	2,904	15,644	43,190	(74,436)
Accounts payable	10,880	8,578	(250)	20,959
Accrued expenses	(21,309)	(667)	(25,265)	10,801
Income taxes payable/receivable	28,013	22,888	(68,995)	60,397
Deferred income taxes, net	(8,876)	(22,446)	37,843	(45,074)
Deferred revenue	58,812	7,750	227,134	116,505
Net cash provided by operating activities	243,505	198,333	527,319	388,862
Cash flows from investing activities:				
Additions to property and equipment	(32,664)	(42,375)	(133,585)	(91,294)
Purchase of headquarters facilities from EMC		(132,564)		(132,564)
Capitalized software development costs	(37,961)	(22,314)	(53,895)	(32,858)
Purchase of long-term investment			(1,750)	
Business acquisitions, net of cash acquired	(57,363)	(54,108)	(90,652)	(75,518)
Decrease (increase) in restricted cash		555	896	(5,139)
Net cash used in investing activities	(127,988)	(250,806)	(278,986)	(337,373)
Cash flows from financing activities:				
Proceeds from issuance of common stock	34,090	1,256,293	167,417	1,256,293
Excess tax benefits from stock-based compensation	5,844		85,271	
Shares repurchased for tax withholdings on vesting of restricted stock	(4,339)		(40,817)	
Repayment of note payable to EMC		(350,000)		(350,000)
Net cash provided by financing activities	35,595	906,293	211,871	906,293
Net increase in cash and cash equivalents	151,112	853,820	460,204	957,782
Cash and cash equivalents at beginning of the period	1,540,260	280,096	1,231,168	176,134
Cash and cash equivalents at end of the period	$ 1,691,372	$ 1,133,916	$ 1,691,372	$ 1,133,916

Non-cash items:								
Changes in capital additions, accrued but not paid	$	11,919	$		$	24,115	$	

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

Table of Contents

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (VMware or the Company) is the leading provider of virtual infrastructure software solutions from the desktop to the datacenter. VMware s virtual infrastructure software 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 infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

These accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. 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 VMware 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. 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 the 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.

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, amortization of capitalized software development costs and contingencies. Actual results could differ from those estimates.

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. During 2008, the Financial Accounting Standards Board (FASB) issued the following amendments to FAS No. 157:

FASB Staff Position No. 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 amends FAS No. 157 to remove certain leasing transactions from its scope.

6

Table of Contents

FASB Staff Position No. FAS 157-2, Effective Date of FASB Statement No. 157 delays the effective date of FAS No. 157 from 2008 to 2009 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).

FASB Staff Position No. 157-3, Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active (FSP FAS No. 157-3) clarifies the application of FAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSP FAS No. 157-3 is effective October 2008, including prior periods for which financial statements have not been issued.

The adoption of FAS No. 157 for financial assets and liabilities and its amendments did not have an impact on VMware s consolidated financial position and results of operations. VMware is currently evaluating the potential impact of FAS No. 157-2 for non-financial assets and non-financial liabilities on VMware s financial position and results of operations. See Note D to VMware s consolidated financial statements.

In April 2008, the FASB issued a FASB Staff Position on FAS No. 142-3, Determination of the Useful Life of Intangible Assets (FSP FAS No. 142-3). FSP FAS No. 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FAS No. 142, Goodwill and Other Intangible Assets (FAS No. 142). The intent of FSP FAS No. 142-3 is to improve the consistency between the useful life of a recognized intangible asset under FAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS No. 141 (revised 2007), Business Combinations , and other U.S. generally accepted accounting principles. This FSP FAS No. 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. VMware is currently evaluating the potential impact of FSP FAS No. 142-3 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.

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 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.

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

VMware 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.

Table of Contents

Services revenue

Services revenue consists of software maintenance and professional services. VMware recognizes software 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 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 software 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 software maintenance services is established by the rates charged in stand-alone sales of software maintenance contracts or the stated renewal rate for software 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 software 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 software 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 software 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 detailed program design or a working model. Such costs include salaries 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. The determination of estimates relating to technological feasibility and useful lives requires the exercise of judgment. Changes in judgment as to when technological feasibility is reached and the determination of useful lives could materially impact the amount of costs capitalized and VMware s results of operations.

Unamortized software development costs were $92.2 million and $66.8 million at September 30, 2008 and December 31, 2007, respectively, and are included in other assets, net.

In the three months ended September 30, 2008 and 2007, VMware capitalized $45.8 million (including $7.8 million of stock-based compensation) and $27.6 million (including $5.3 million of stock-based compensation), respectively, of costs incurred for the development of software products. In the nine months ended September 30, 2008 and 2007, VMware capitalized $65.6 million (including $11.7 million of stock-based compensation) and $39.6 million (including $6.7 million of stock-based compensation), respectively, of costs incurred for the development of software products. Amortization expense from capitalized amounts was $11.0 million and $9.2 million in the three months ended September 30, 2008 and 2007, respectively. Amortization expense from capitalized amounts was $40.2 million and $25.9 million in the nine months ended September 30, 2008 and 2007, respectively.

Long-Lived Assets

Intangible assets, other than goodwill, are amortized over their estimated useful lives, during which the assets are expected to contribute directly or indirectly to future cash flows, and which range from one to nine years. In the three months ended September 30, 2008 and 2007, VMware amortized $5.1 million and $6.6 million, respectively, for purchased intangible assets. The amortization expense for the nine months ended September 30, 2008 and 2007 was $12.8 million and $19.2 million, respectively.

VMware 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 amounts of the assets may not be fully recoverable or that the useful lives of these assets are no longer appropriate.

Table of Contents

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 potentially dilutive securities. 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, 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 September 30, 2008, VMware had 88.3 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 September 30,		For the Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Net income	$ 83,288	$ 64,678	$ 178,679	$ 139,982
Weighted-average shares, basic for Class A and Class B	387,621	356,431	383,876	340,565
Effect of dilutive securities	6,611	12,136	13,217	4,171
Weighted-average shares, diluted for Class A and Class B	394,232	368,567	397,093	344,736
Net income per weighted-average share, basic for Class A and Class B	$ 0.21	$ 0.18	$ 0.47	$ 0.41
Net income per weighted-average share, diluted for Class A and Class B	$ 0.21	$ 0.18	$ 0.45	$ 0.41

The following shares attributable to outstanding stock options and restricted stock were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive (in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	**2007**	**2008**	**2007**
Shares of stock options excluded from calculation of diluted EPS	12,631	255	7,151	255
Shares of restricted stock excluded from calculation of diluted EPS	5,956		5,491	

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.

VMware s cash and cash equivalents as of September 30, 2008 were $1,691.4 million and included $1,029.8 million of money market securities, which are classified within Level 1 of the fair value hierarchy because the securities are valued using quoted prices in active markets for identical assets. There were no other financial assets or liabilities carried at fair value as of September 30, 2008.

Table of Contents

E. Business Acquisitions, Goodwill and Intangible Assets

Business Acquisitions

VMware acquired two companies during the first three months of 2008 for aggregate cash consideration of $33.3 million, net of cash acquired and including transaction costs. 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 $38.7 million and is classified as goodwill on the consolidated balance sheet as of September 30, 2008.

On July 1, 2008, VMware acquired all of the outstanding capital stock of a privately-held application performance management software company with headquarters in San Mateo, California, and principal R&D facilities in Herzliya, Israel. The results of this company s operations have been included in VMware s consolidated financial statements since that date. VMware will leverage this company s technology to enhance VMware s portfolio of application and infrastructure management products. In addition, the Company s R&D facility and team will form the core of VMware s new development center in Israel. The following table summarizes the estimated fair values of the assets acquired and liabilities assumed at the date of this acquisition (in thousands):

Cash	$ 216
Intangible assets	19,804
Goodwill	48,143
Assets acquired	1,740
Total liabilities assumed	(9,079)
Total purchase price	$ 60,824
Cash consideration	$ 58,436
Value of options assumed	2,388
Total consideration	$ 60,824

The purchase prices for the companies acquired in the nine months ended September 30, 2008 have 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. 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 VMware 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 VMware s consolidated results of operations.

Table of Contents

Goodwill

Changes in the carrying amount of goodwill for the nine months ended September 30, 2008 consist of the following (table in thousands):

Balance, January 1, 2008	$ 639,366
Goodwill acquired	86,655
Adjustments to purchase price allocations	4,255
Balance, September 30, 2008	$ 730,276

As of September 30, 2008, $519.2 million of goodwill consisted of EMC s purchase accounting for VMware.

F. Property and Equipment, net

Property and equipment, net, as of September 30, 2008 and December 31, 2007 consist of the following (table in thousands):

	September 30, 2008	December 31, 2007
Furniture and fixtures	$ 45,555	$ 30,678
Equipment and software	258,856	156,641
Buildings and improvements	179,372	129,752
Construction in progress	23,369	32,097
	507,152	349,168
Accumulated depreciation	(136,539)	(72,185)
	$ 370,613	$ 276,983

Depreciation expense was $24.5 million and $64.6 million for the three and nine months ended September 30, 2008, respectively, and $11.8 million and $27.4 million for the three and nine months ended September 30, 2007, respectively.

During the second quarter of 2008, VMware reviewed and revised the estimated useful lives of certain assets after considering (i) the estimated future benefits the Company expects to receive from those assets, (ii) the pattern of consumption of those benefits and (iii) the information available regarding those benefits, and prospectively increased the estimated useful lives of computers and other related equipment from 2 years to 3 years to match the length of the related warranty contracts. For the three months ended September 30, 2008, these changes in estimates reduced depreciation expense by $3.9 million and increased diluted earnings per share by $0.01, from what would have been reported otherwise in the three months ended September 30, 2008. There was no impact on basic earnings per share for the three months ended September 30, 2008. For the nine months ended September 30, 2008, these changes in estimates reduced depreciation expense by $8.7 million and increased both basic and diluted earnings per share by $0.02 from what would have been reported otherwise in the nine months ended September 30, 2008.

G. Accrued Expenses

Accrued expenses as of September 30, 2008 and December 31, 2007 consist of (table in thousands):

	September 30, 2008	December 31, 2007
Salaries, commissions, and benefits	$ 81,511	$ 93,678
Accrued partner liabilities	49,229	42,852

Other	29,389	37,080
	$ 160,129	$ 173,610

H. Income Taxes

Although VMware files a federal consolidated tax return with EMC, VMware has calculated its income tax provision on a stand-alone basis. VMware s effective tax rate in the periods presented is the result of the mix of income earned in various tax jurisdictions that apply a broad range of income tax rates. The 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 19.6% and 18.3% for the three and nine months ended September 30, 2008, respectively. The effective income tax rate was 2.4% and 11.0% for the three and nine months ended September 30, 2007, respectively. The effective tax rate for the three months ended September 30, 2007 reflects a benefit of $5.5 million related to the adjustments to the expected annual effective income tax rate from 17.2% for the six months ended June 30, 2007 to 11.0% for

Table of Contents

the nine months ended September 30, 2007. The increase in the effective rates for the three and nine months ended September 30, 2008 compared to the three and nine months ended September 30, 2007, respectively, were primarily attributable to the expiration of the federal research tax credit, an increase in transfer pricing adjustments relative to VMware s forecasted annual pre-tax income, an increase in state taxes, and a change in the mix of income from international sources to U.S. sources. Income earned abroad is considered indefinitely reinvested in VMware s foreign operations and no provision for U.S. taxes has been provided with respect thereto.

As of September 30, 2008, VMware had $31.7 million of gross unrecognized tax benefits and $29.4 million of unrecognized tax benefits, net of federal tax benefit. The gross and net unrecognized tax benefits included interest and penalties of $1.2 million and $0.9 million, respectively. VMware 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 $21.8 million would have adjusted VMware s effective tax rate. The $29.4 million of net unrecognized tax benefits are not expected to be paid within the next 12 months. $28.4 million of net unrecognized tax benefits were classified in non-current income taxes payable. VMware does not expect significant changes to its unrecognized tax benefits within the next 12 months.

As of September 30, 2008, VMware had a net income tax receivable of $82.2 million, which was principally comprised of amounts due from EMC; however, this amount was net of approximately $14.8 million of current income taxes payable due to various governmental authorities. The receivable arose because VMware had a stand-alone taxable loss for the nine months ended September 30, 2008, which was primarily attributable to tax deductions arising from both non-qualified stock option exercises and from restricted stock when the restrictions lapse. Under the tax sharing agreement with EMC, EMC is obligated to pay to VMware an amount equal to the tax benefit that EMC will recognize on its consolidated tax return.

The Emergency Economic Stabilization Act of 2008, which contains the Tax Extenders and Alternative Minimum Tax Relief Act of 2008, was signed into law on October 3, 2008. Under the Act, the research credit was retroactively extended for amounts paid or incurred after December 31, 2007 and before January 1, 2010. The effects of the change in the tax law will be recognized in VMware s fourth quarter, which is the quarter in which the law was enacted. VMware is currently in the process of analyzing the impact of the new law.

I. 401(k) Savings Plan

Prior to March 2008, VMware employees participated in the EMC Corporation 401(k) Savings Plan (the EMC Plan), and EMC cross-charged VMware for the costs associated with VMware employees who participated in the EMC Plan.

In 2008, VMware established a defined contribution retirement savings program, the VMware Inc. 401(k) Savings Plan (the VMware Plan), which is qualified under Section 401(k) of the Internal Revenue Code of 1986 (the Code). This plan is available solely to employees of VMware. In March 2008, VMware employees began participating in the VMware Plan and ceased participation in the EMC Plan. In March 2008, $96.4 million of assets and $1.1 million of participant loans were transferred from the EMC Plan into the VMware Plan.

VMware matches pre-tax employee contributions up to 6% of eligible compensation during each pay period, subject to a $750 maximum match each quarter per employee. Matching contributions are immediately 100% vested. During the three and nine months ended September 30, 2008, VMware contributions for employees were $2.4 million and $6.7 million, respectively. Employees may elect to invest their contributions in a variety of funds. VMware s matching contribution mirrors the investment allocation of the employee s contribution.

J. 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.

Table of Contents

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 September 30, 2008 are as follows (table in thousands):

Remainder of 2008	$ 7,147
2009	29,036
2010	28,155
2011	26,086
2012	16,506
Thereafter	294,757
Total minimum lease payments	$ 401,687

The amount of the future lease commitments after 2012 is primarily for the ground lease on VMware s Palo Alto, California 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.

K. Stockholders Equity

VMware Stock Purchase Plan

In June 2007, VMware adopted its 2007 Employee Stock Purchase Plan (the ESPP) 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 ESPP. Under the ESPP, 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 ESPP on August 13, 2007, the date on which VMware s Form S-1 Registration Statement was declared effective by the SEC, and became exercisable on December 31, 2007. Options to purchase shares are granted twice yearly, on or about January 1 and July 1, and are 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 ESPP at a purchase price per share of $24.65. This purchase was completed in January 2008. For the purchase period ended June 30, 2008, employees purchased 0.4 million shares under the ESPP at a purchase price per share of $45.78. This purchase was completed in June 2008.

VMware Stock Options

In September 2008, VMware completed an offer to exchange certain employee stock options issued under VMware s 2007 Equity and Incentive Plan (Exchange Offer). Certain previously granted options were exchanged for new, lower-priced stock options granted on a one-for-one basis. Options for an aggregate of 4,103,975 shares of VMware s Class A common stock were exchanged. Options granted pursuant to the Exchange Offer have an exercise price of $33.95 per share, will vest over a four-year period from September 10, 2008 with no credit for past vesting and will have a new six-year option term. The Exchange Offer will result in incremental stock-based compensation expense of $18.0 million to be recognized over the four-year vesting term.

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)	10,729	42.12

Forfeited (1)	(7,110)	54.71
Expired	(2)	22.17
Exercised	(6,094)	21.69
Outstanding, September 30, 2008	42,862	26.60

(1) Includes options for 4,103,975 shares exchanged in the Exchange Offer.

Total cash proceeds from the exercise of stock options for the nine months ended September 30, 2008 were $132.9 million. The options exercised during the nine months ended September 30, 2008 had a pre-tax intrinsic value of $216.5 million.

Table of Contents

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.

In September 2008, VMware awarded 5,302,448 restricted stock units to certain employees, including a portion for international employees who were not eligible to participate in the Exchange Offer and a portion for retention purposes. These awards generally will vest over a three-year or four-year period. These awards will result in stock-based compensation expense of $164.5 million to be recognized over the three-year or four-year vesting term.

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	5,914	36.77
Vested	(1,947)	22.25
Forfeited	(270)	78.36
Restricted stock at September 30, 2008	7,262	33.17

As of September 30, 2008, the aggregate intrinsic value of VMware restricted stock was $191.6 million. These shares are scheduled to vest through 2012.

Shares Repurchased for Tax Withholdings

During the nine months ended September 30, 2008, VMware repurchased 744,130 shares of Class A common stock, for $40.8 million to cover employee tax withholding obligations. Pursuant to the respective agreements, these shares were repurchased in conjunction with the net share settlement upon the vesting of restricted stock during the quarter. The $40.8 million is recorded as a reduction to retained earnings as of September 30, 2008.

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 and nine months ended September 30, 2008 and 2007 (table in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2008	2007	2008	2007
Cost of license revenues	$ 264	$ 212	$ 803	$ 322
Cost of services revenues	3,660	2,195	10,716	3,608
Research and development	15,331	13,033	55,907	27,677
Sales and marketing	13,138	9,594	36,138	16,778
General and administrative	2,924	6,703	15,986	10,969
Stock-based compensation expense	$ 35,317	$ 31,737	$ 119,550	$ 59,354

For the three and nine months ended September 30, 2008, VMware capitalized $7.8 million and $11.7 million, respectively, of stock-based compensation expense associated with capitalized software development (See Note B to VMware s consolidated financial statements). For the three and nine months ended September 30, 2008, VMware capitalized an additional $0.5 million and $1.3 million, respectively, of stock-based compensation expense associated with software developed for internal use.

For the three and nine months ended September 30, 2007, VMware capitalized $5.3 million and $6.7 million, respectively, of stock-based compensation expense associated with capitalized software development. For the three and nine months ended September 30, 2007, the amount of stock-based compensation expense capitalized for software developed for internal use was not material.

Table of Contents

Fair Value of VMware Options

The fair value of each option to acquire VMware Class A common stock granted during the three and nine months ended September 30, 2008 and 2007 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 September 30,		For the Nine Months Ended September 30,	
VMware Stock Options	**2008**	**2007**	**2008**	**2007**
Dividend yield	None	None	None	None
Expected volatility	39.2%	39.2%	38.7%	39.2%
Risk-free interest rate	2.6%	4.5%	2.5%	5.0%
Expected term (in years)	3.4	3.4	3.4	3.4
Weighted-average fair value at grant date	$ 19.40	$ 13.55	$ 18.81	$ 8.19