VMWARE, INC.
Form 10-Q
October 29, 2010
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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, 2010

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes 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	x	Accelerated filer	¨
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨

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

As of October 22, 2010, the number of shares of common stock, par value $.01 per share, of the registrant outstanding was 414,395,630, of which 114,395,630 shares were Class A common stock and 300,000,000 were Class B common stock.

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VMware, VMworld, VMware vSphere and SpringSource are registered trademarks or trademarks of VMware, Inc. in the United States and/or other jurisdictions. All other marks and names mentioned herein may be trademarks of their respective companies.

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PART I

FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

VMware, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	For the Nine Months Ended September 30, 2010	For the Nine Months Ended September 30, 2009
Cash flows from operating activities:				
Net income	$ 84,600	$ 38,219	$ 237,559	$ 140,689
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	71,117	55,420	183,461	141,730
Stock-based compensation, excluding amounts capitalized	73,657	62,352	205,190	163,623
Excess tax benefits from stock-based compensation	(78,703)	(8,365)	(167,204)	(12,838)
Gain on acquisition		(5,859)		(5,859)
Other	261	2,606	6,120	3,240
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	51,553	5,091	159,241	85,782
Other assets	(59,179)	(8,820)	(83,430)	(7,924)
Due to/from EMC, net	13,629	(5,645)	15,931	(15,056)
Accounts payable	(1,971)	(2,203)	4,589	(30,585)
Accrued expenses	1,631	20,404	28,527	34,292
Income taxes receivable from EMC		20,028	2,508	107,927
Income taxes payable	11,697	(9,840)	42,821	11,270
Deferred income taxes, net	(4,088)	(11,596)	(8,435)	(26,195)
Deferred revenue	32,495	47,574	140,896	111,829
Net cash provided by operating activities	196,699	199,366	767,774	701,925
Cash flows from investing activities:				
Additions to property and equipment	(31,137)	(14,245)	(91,245)	(79,913)
Capitalized software development costs	(7,023)	(8,844)	(48,194)	(53,524)
Purchases of available-for-sale securities	(964,655)		(1,624,706)	
Sales and maturities of available-for-sale securities	155,112		155,112	
Purchase of strategic investments		(5,720)		(31,465)
Sale of strategic investments	2,648		2,648	
Business acquisitions, net of cash acquired	(125,820)	(356,278)	(292,970)	(356,278)
Transfer of net assets under common control			(175,000)	
Decrease in restricted cash			206	549

Net cash used in investing activities	(970,875)	(385,087)	(2,074,149)	(520,631)
Cash flows from financing activities:				
Proceeds from issuance of common stock	139,939	84,917	355,846	166,523
Repurchase of common stock	(141,440)		(285,940)	
Excess tax benefits from stock-based compensation	78,703	8,365	167,204	12,838
Shares repurchased for tax withholdings on vesting of restricted stock	(24,533)	(7,060)	(70,116)	(25,306)
Net cash provided by financing activities	52,669	86,222	166,994	154,055
Net increase (decrease) in cash and cash equivalents	(721,507)	(99,499)	(1,139,381)	335,349
Cash and cash equivalents at beginning of the period	2,068,587	2,275,660	2,486,461	1,840,812
Cash and cash equivalents at end of the period	$ 1,347,080	$ 2,176,161	$ 1,347,080	$ 2,176,161
Non-cash items:				
Changes in capital additions, accrued but not paid	$ 3,252	$ 4,388	$ 5,087	$ (12,089)
Fair value of stock options assumed in acquisition	$	$ 16,187	$	$ 16,187

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

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VMware, Inc.

CONSOLIDATED STATEMENTS OF INCOME

(in thousands, except per share amounts)

(unaudited)

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	For the Nine Months Ended September 30, 2010	For the Nine Months Ended September 30, 2009
Revenues:				
License	$ 343,239	$ 240,271	$ 979,081	$ 725,236
Services	371,006	249,480	1,042,601	690,500
	714,245	489,751	2,021,682	1,415,736
Operating expenses (1):				
Cost of license revenues	46,333	37,529	126,723	85,741
Cost of services revenues	80,229	58,544	226,641	166,481
Research and development	175,429	133,509	475,297	360,290
Sales and marketing	251,745	185,222	700,236	506,787
General and administrative	66,497	51,711	195,406	148,299
Operating income	94,012	23,236	297,379	148,138
Investment income	2,349	1,621	4,029	7,179
Interest expense with EMC, net	(1,245)	(1,319)	(3,103)	(5,992)
Other income (expense), net	1,629	8,336	(6,977)	6,887
Income before income taxes	96,745	31,874	291,328	156,212
Income tax provision (benefit)	12,145	(6,345)	53,769	15,523
Net income	$ 84,600	$ 38,219	$ 237,559	$ 140,689
Net income per weighted-average share, basic for Class A and Class B	$ 0.21	$ 0.10	$ 0.58	$ 0.36
Net income per weighted-average share, diluted for Class A and Class B	$ 0.20	$ 0.09	$ 0.56	$ 0.35
Weighted-average shares, basic for Class A and Class B	411,755	396,366	408,082	392,712
Weighted-average shares, diluted for Class A and Class B	426,581	402,888	421,949	397,433

(1) Includes stock-based compensation as follows:

Cost of license revenues	$ 395	$ 330	$ 1,170	$ 973
Cost of services revenues	4,387	4,003	12,601	10,941
Research and development	43,124	34,250	117,292	84,587
Sales and marketing	18,102	15,763	49,601	42,908
General and administrative	7,649	8,006	24,526	24,214

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

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VMware, Inc.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

	September 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,347,080	$ 2,486,461
Short-term investments	1,557,106	27,360
Accounts receivable, net	378,454	534,196
Due from EMC, net	11,042	26,402
Deferred tax asset, current portion	84,332	63,360
Other current assets	188,148	44,701
Total current assets	3,566,162	3,182,480
Property and equipment, net	418,639	402,356
Capitalized software development costs, net and other	153,905	169,293
Deferred tax asset, net of current portion	128,943	102,529
Intangible assets, net	223,102	94,557
Goodwill	1,575,102	1,115,769
Total assets	$ 6,065,853	$ 5,066,984
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 59,415	$ 50,566
Accrued expenses and other	361,645	334,523
Deferred revenue, current portion	1,025,636	908,953
Total current liabilities	1,446,696	1,294,042
Note payable to EMC	450,000	450,000
Deferred revenue, net of current portion	479,972	416,345
Deferred tax liability	40,262	60,300
Other liabilities	114,281	103,346
Total liabilities	2,531,211	2,324,033
Commitments and contingencies (see Note K)		
Stockholders equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 114,227 and 102,785 shares	1,142	1,028
Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3,000	3,000
Additional paid-in capital	3,242,296	2,339,079
Accumulated other comprehensive income	13,862	4,563
Retained earnings	274,342	395,281

Total stockholders equity	3,534,642	2,742,951
Total liabilities and stockholders equity	$ 6,065,853	$ 5,066,984

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 infrastructure software solutions from the desktop to the data center and to the cloud. VMware s virtualization infrastructure software solutions run on industry-standard desktop computers and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

These accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. In the opinion of management, these unaudited consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware s consolidated cash flows, results of operations and financial condition for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2010. 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 2009 Annual Report on Form 10-K.

VMware was incorporated as a Delaware corporation in 1998 and continued to operate in large measure as a stand-alone company following the Company s acquisition by EMC Corporation (EMC) in 2004 and following VMware s initial public offering of VMware s Class A common stock in August 2007. As of September 30, 2010, EMC holds 80.1% of VMware s outstanding common stock, including 31.7 million shares of VMware s Class A common stock and all of VMware s Class B common stock, and VMware is considered a controlled company under the rules of the New York Stock Exchange. VMware historically has received, and continues to receive, certain administrative services from EMC, and VMware and EMC engage in certain intercompany transactions. Costs incurred by EMC for the direct benefit of VMware, such as rent, salaries and benefits, plus a mark-up intended to approximate third-party costs, are included in VMware s consolidated financial statements. Management believes the assumptions underlying the consolidated financial statements are reasonable. However, given that 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 cash flows, results of operations and financial condition had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, VMware s historical financial information is not necessarily indicative of what the Company s cash flows, results of operations and financial condition will be in the future if and when VMware contracts at arm s-length with unrelated third parties for services the Company has received and currently receives from EMC.

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

Approximately $5 million of expenses, which were recorded during the third quarter of 2009, should have been recorded during the second quarter of 2009. As a result, operating expenses for the second quarter of 2009 were understated and operating expenses for the third quarter of 2009 were overstated by approximately $5 million. Prior period amounts are shown as previously reported and do not reflect these differences. The Company performed an evaluation and concluded that this amount is not material to either period and that there is no impact to the year ended December 31, 2009.

Principles of Consolidation

The consolidated financial statements include the accounts of VMware and its subsidiaries. All intercompany transactions and balances between VMware and its subsidiaries have been eliminated. All intercompany transactions with EMC in the consolidated statements of cash flows will be settled in cash, and changes in the 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 liabilities at the date of the financial statements. Estimates are used for, but not limited to, capitalized software development costs, receivable valuation, certain accrued liabilities, useful lives of fixed assets and intangible assets, valuation of acquired intangibles, revenue reserves, income taxes, stock-based compensation, and contingencies. Actual results could differ from those estimates.

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VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

B. Significant Accounting Policies

Revenue Recognition

VMware derives revenues from the licensing of software and related services. VMware recognizes revenues 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 revenues

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

VMware licenses most of its software under perpetual licenses through its channel of distributors, resellers, x86 system vendors, systems integrators and through its direct sales force. VMware also licenses certain software products on a subscription basis. Revenues relating to products that have shipped into a channel are deferred until the 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 information based on payment of such distributors and certain resellers accounts receivable balances and other relevant factors. For software sold by x86 system vendors that is bundled with their hardware, unless the Company has a separate license agreement with the end user, revenue is recognized in arrears upon the receipt of binding royalty reports.

For all sales, VMware uses one of the following to constitute evidence of an arrangement:

- a purchase order or equivalent;
- a license agreement and a purchase order or equivalent;
- a license agreement which includes language that the agreement also serves as the purchase order; or
- a master agreement and a binding royalty report.

Sales through distributors and resellers are evidenced by a master distribution agreement, together with purchase orders or equivalent, on a transaction-by-transaction basis.

With the exception of one of VMware s desktop products, 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 based on historical return rates, levels of inventory held by distributors and resellers, and other relevant factors. Returns have not been material to date and have been in line with VMware s expectations.

VMware offers rebates to certain channel partners. When rebates are based on a set percentage of actual sales, VMware recognizes the amount 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 amount 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 certain channel partners. VMware records the amount 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 revenues

Services revenues consist of software maintenance and professional services. VMware recognizes software maintenance revenues ratably over the contract period, which typically ranges from one to five years. 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 performed for a fixed fee, for which VMware is able to make reasonably dependable estimates of progress toward completion, are recognized on a proportional performance basis based on hours and direct expenses incurred. Professional services engagements that are on a time and materials basis are recognized based upon hours incurred. Revenues on all other professional services engagements are recognized upon completion.

VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Multiple element arrangements

VMware software products are typically sold with software maintenance services. Vendor-specific objective evidence (VSOE) of fair value for software maintenance services is established by the rates charged in stand-alone sales of software maintenance contracts or the stated renewal rate for software maintenance included in the license agreement. VMware software products may also be sold with professional services. VSOE of fair value for professional services is based upon the standard rates VMware charges for such services when sold separately. VMware perpetual software products may be sold with products licensed on a subscription basis. VSOE of fair value for subscription license products is established by the rates charged in stand-alone sales of subscription license products. 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, and various types of technical support based on the level of support purchased. In the event specific features or functionality, entitlements, or the release number of an upgrade or new product have been announced but not delivered, and customers will receive that upgrade or new product as part of a current software maintenance contract, a specified upgrade is deemed created and 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. On occasion, 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 such upgrades or new products on a stand-alone basis.

Deferred revenues include unearned software maintenance fees, professional services fees, and license fees.

Cash and Cash Equivalents and Short-Term Investments

VMware invests a portion of its excess cash primarily in money market funds, highly liquid debt instruments of the U.S. government and its agencies, U.S. municipal obligations, and U.S. and foreign corporate debt securities. VMware classifies all highly liquid investments with maturities of three months or less from date of purchase as cash equivalents and all highly liquid investments with maturities of greater than three months from date of purchase as short-term investments. VMware classifies its investments as available-for-sale. VMware may sell these securities at any time for use in current operations or for other purposes, such as consideration for acquisitions and strategic investments, and consequently, VMware may or may not hold securities, with stated maturities greater than twelve months, until maturity. As a result, VMware classifies its investments, which include securities with maturities beyond twelve months, as current assets in the accompanying consolidated balance sheets.

VMware carries its fixed income investments, as well as its equity investments in public companies that have readily determinable fair values, at fair value and reports unrealized gains and losses on these investments, net of estimated tax provisions or benefits, in accumulated other comprehensive income, a component of stockholders equity. Unrealized losses which are determined to be other than temporary, as well as realized gains and losses are recorded to VMware s consolidated statements of income. Realized gains and losses on the sale of fixed income securities issued by the same issuer and of the same type are determined using the first-in first-out (FIFO) method. Equity investments, for which VMware has the ability to exercise significant influence over the investee, are accounted for using the equity method of accounting. Under the equity method, VMware s investment is initially recorded at cost and subsequently adjusted through other income (expense), net on a go forward basis to recognize VMware s share of the investee s income (loss) after the acquisition date. VMware periodically evaluates whether declines in fair values of its investments below their cost basis are other-than-temporary. This evaluation consists of several qualitative and quantitative factors, including VMware s ability and intent to hold the investment until a forecasted recovery occurs, as well as any decline in the investment quality of the security and the severity of the unrealized loss.

In addition, VMware has restrictions on certain cash amounts pursuant to the terms of various agreements. VMware includes this restricted cash in other current assets in the accompanying consolidated balance sheets. The amount of restricted cash was not material in any period presented.

Allowance for Doubtful Accounts

VMware maintains an allowance for doubtful accounts for estimated probable losses on uncollectible accounts receivable. The allowance is based upon the creditworthiness of VMware s customers, historical experience, the age of the receivable and current market and economic conditions. Uncollectible amounts are charged against the allowance account. The allowance for doubtful accounts was $4.7 million and $2.5 million as of September 30, 2010 and December 31, 2009, respectively.

Research and Development and Capitalized Software Development Costs

Costs related to research and development (R&D) are generally charged to expense as incurred. Capitalization of material development costs of software to be sold, leased, or otherwise marketed are subject to capitalization beginning when technological

VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

feasibility has been established and ending when the product is available for general release. Judgment is required in determining when technological feasibility is established. Changes in judgment as to when technological feasibility is established, or changes in VMware s business, including go-to-market strategy, would likely materially impact the amount of costs capitalized. For example, if the length of time between technological feasibility and general availability declines in the future, the amount of costs capitalized would likely decrease with a corresponding increase in R&D expense. In addition, VMware s R&D expenses and amounts capitalized as software development costs may not be comparable to VMware s peer companies due to differences in judgment as to when technological feasibility has been reached or differences in judgment regarding when the product is available for general release. Generally accepted accounting principles require annual amortization expense of capitalized software development costs to be the greater of the amounts computed using the ratio of current gross revenue to a product s total current and anticipated revenues, or the straight-line method over the product s remaining estimated economic life. To date, VMware has amortized these costs using the straight-line method as it is the greater of the two amounts. The costs are amortized over periods ranging from 18 to 24 months, which represent the product s estimated economic life. The ongoing assessment of the recoverability of these costs requires considerable judgment by management with respect to certain external factors such as anticipated future revenue, estimated economic life, and changes in software and hardware technologies. Material differences in amortization amounts could occur as a result of changes in the periods over which VMware actually generates revenues or the amounts of revenues generated.

Unamortized software development costs were $113.0 million and $129.4 million as of September 30, 2010 and December 31, 2009, respectively.

In the three months ended September 30, 2010 and 2009, VMware capitalized $8.3 million (including $1.2 million of stock-based compensation) and $10.6 million (including $1.8 million of stock-based compensation), respectively, of costs incurred for the development of software products. In the nine months ended September 30, 2010 and 2009, VMware capitalized $54.6 million (including $8.1 million of stock-based compensation) and $65.4 million (including $11.8 million of stock-based compensation), respectively, of costs incurred for the development of software products. These amounts have been excluded from R&D expenses on the accompanying consolidated statements of income. Amortization expense from capitalized amounts was $26.1 million and $27.0 million for the three months ended September 30, 2010 and 2009, respectively. Amortization expense from capitalized amounts was $71.1 million and $55.3 million for the nine months ended September 30, 2010 and 2009, respectively. Amortization expense is included in cost of license revenues on the consolidated statements of income.

Intangible Assets and Goodwill

Intangible assets, other than goodwill, are amortized over their estimated useful lives which range up to 13 years, during which the assets are expected to contribute directly or indirectly to future cash flows. In the three months ended September 30, 2010 and 2009, VMware amortized $9.9 million and $3.4 million, respectively, for intangible assets. The amortization expense for the nine months ended September 30, 2010 and 2009 was $22.6 million and $10.0 million, respectively.

VMware reviews intangible assets for impairment in the fourth quarter of each year or more frequently if 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.

Goodwill is initially carried at its historical cost. VMware tests goodwill for impairment 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.

Business Acquisitions

For business acquisitions, VMware recognizes the identifiable assets acquired, the liabilities assumed, and any non-controlling interests in an acquiree, which are measured based on the acquisition date fair value. Goodwill is measured as the excess of consideration transferred, the fair value of any non-controlling interest, and the fair value of previously held equity interest over the net amounts of the identifiable assets acquired and the liabilities assumed at the acquisition date.

VMware uses significant estimates and assumptions, including fair value estimates, to determine the fair value of assets acquired and liabilities assumed and when applicable, the related useful lives of the acquired assets, as of the business combination date. When those estimates are provisional, VMware refines them as necessary, during the measurement period. The measurement period is the period after the acquisition date, not to exceed one year, in which VMware may gather new information about facts and circumstances that existed as of the acquisition date to adjust the provisional amounts recognized. Measurement period adjustments are applied retrospectively. All other adjustments are recorded to the consolidated statements of income.

Costs to effect an acquisition are recorded in general and administrative expenses on the consolidated statements of income as the expenses are incurred.

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VMware, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

Concentrations of Risks

Financial instruments, which potentially subject VMware to concentrations of credit risk, consist principally of cash and cash equivalents, short-term investments and accounts receivable. Cash on deposit with banks exceeds the amount of insurance provided on such deposits. These deposits may be redeemed upon demand. VMware places cash, cash equivalents and short-term investments primarily in money market funds and fixed income securities and limits the amount of investment with any single issuer and any financial institution. VMware holds a diversified portfolio of money market funds and fixed income securities, which primarily consist of various government and agency securities, corporate notes and bonds, commercial paper, and municipal notes and bonds. VMware s fixed income investment portfolio is denominated in U.S. dollars and consists of securities with various maturities.

VMware monitors the counterparty risk to ensure adequate diversification amongst the financial institutions holding the funds. VMware also monitors counterparty risk to financial institutions with which VMware enters into derivatives to ensure that these financial institutions are of high credit quality.

C. Earnings per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities, as calculated using the treasury stock method, outstanding during the period. Potentially dilutive securities include stock options, unvested restricted stock units, unvested restricted stock awards, other unvested restricted stock, and purchase options under VMware s employee stock purchase plan. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. As of September 30, 2010, VMware had 113.9 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. VMware uses the two-class method to calculate earnings per share as both classes share the same rights in dividends, therefore basic and diluted earnings per share are the same for both classes.

The following table sets forth the computations of basic and diluted net income per share (table in thousands, except per share data):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income	$ 84,600	$ 38,219	$ 237,559	$ 140,689
Weighted-average shares, basic for Class A and Class B	411,755	396,366	408,082	392,712
Effect of dilutive securities	14,826	6,522	13,867	4,721
Weighted-average shares, diluted for Class A and Class B	426,581	402,888	421,949	397,433
Net income per weighted-average share, basic for Class A and Class B	$ 0.21	$ 0.10	$ 0.58	$ 0.36
Net income per weighted-average share, diluted for Class A and Class B	$ 0.20	$ 0.09	$ 0.56	$ 0.35

For the three months ended September 30, 2010 and 2009, stock options to purchase 1.6 million and 17.1 million shares, respectively, of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the nine months ended September 30, 2010 and 2009, stock options to purchase 3.3 million and 22.0 million shares, respectively, of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive.

For the three months ended September 30, 2009, 1.0 million shares of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. No shares of restricted stock were excluded from the diluted earnings per share calculations for the three months ended September 30, 2010. For the nine months ended September 30, 2010 and 2009, 0.1 million and 1.2 million shares of restricted stock, respectively, were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive.

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D. Investments

During the three months ended June 30, 2010, VMware began investing in fixed income securities. Investments as of September 30, 2010 consist of the following (table in thousands):

	September 30, 2010			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. government and agency obligations	$ 320,346	$ 557	$ (37)	$ 320,866
U.S. and foreign corporate debt securities	457,188	901	(147)	457,942
Foreign governments and agency obligations	71,539	136	(1)	71,674
Municipal obligations	658,478	266	(677)	658,067
Asset-backed securities	7,197			7,197
Total fixed income securities	1,514,748	1,860	(862)	1,515,746
Equity securities	20,000	21,360		41,360
Total investments	$ 1,534,748	$ 23,220	$ (862)	$ 1,557,106

The net amount of realized gains on investments in the three and nine months ended September 30, 2010 were not material.

As of September 30, 2010, VMware did not have investments in a continuous unrealized loss position for twelve months or greater. Unrealized losses on investments as of September 30, 2010 that have been in a net loss position for less than twelve months are classified by investment category as follows (table in thousands):

	Fair Value	Gross Unrealized Losses
U.S. government and agency obligations	$ 51,294	$ (37)
U.S. and foreign corporate debt securities	117,062	(147)
Foreign governments and agency obligations	7,917	(1)
Municipal obligations	374,894	(677)
Total investments	$ 551,167	$ (862)

VMware evaluated its investments in fixed income securities and publicly traded equity securities as of September 30, 2010 and determined that there were no unrealized losses that indicated an other-than-temporary impairment.

Contractual Maturities

The contractual maturities of investments held at September 30, 2010 consist of the following (table in thousands):

	September 30, 2010	
	Amortized Cost Basis	**Aggregate Fair Value**
Due within one year	$ 781,121	$ 781,045
Due after 1 year through 5 years	588,147	589,221
Due after 5 years	145,480	145,480
Total	$ 1,514,748	$ 1,515,746

E. Fair Value Measurements and Derivative Instruments

Fair Value Measurements

Generally accepted accounting principles provide 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 is determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, generally accepted accounting principles established a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) inputs are quoted prices in active markets for identical assets or liabilities; (Level 2) inputs other than the quoted prices included within Level 1 that are observable for the assets or liabilities, either directly or indirectly; and (Level 3) unobservable inputs for the assets or liabilities in which there is little or no market data, which requires VMware to develop its own assumptions.

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VMware s Level 1 classification of the fair value hierarchy includes money market funds, available-for-sale equity securities and certain available-for-sale fixed income securities because these securities are valued using quoted prices in active markets for identical assets. VMware s Level 2 classification includes the remainder of the available-for-sale fixed income securities because these securities are priced using quoted market prices for similar instruments and non-binding market prices that are corroborated by observable market data.

The following table sets forth the fair value hierarchy of VMware s money market funds and available-for-sale securities, including those securities classified within cash and cash equivalents on the consolidated balance sheet, that are required to be measured at fair value as of September 30, 2010 (table in thousands):

	Level 1	Level 2	Total
Money-market funds	$ 1,151,257	$	$ 1,151,257
U.S. government and agency obligations	45,183	275,683	320,866
U.S. and foreign corporate debt securities		497,031	497,031
Foreign governments and agency obligations		74,674	74,674
Municipal obligations		663,417	663,417
Asset-backed securities		58,679	58,679
Equity securities	41,360		41,360
Total cash equivalents and investments	$ 1,237,800	$ 1,569,484	$ 2,807,284

VMware s valuation inputs for foreign currency forward contracts are based on quoted prices and quoted pricing intervals from public data sources. These contracts are typically classified within Level 2 of the fair value hierarchy and are discussed below in the derivative instruments section. VMware does not have any assets or liabilities that fall into Level 3 of the fair value hierarchy.

Derivative Instruments

In conjunction with the general release of VMware vSphere in May 2009, VMware started to invoice and collect in the Euro, the British Pound, the Japanese Yen, and the Australian Dollar in their respective regions. In order to manage its exposure to foreign currency fluctuations, since July 2009, VMware has entered into foreign currency forward contracts to hedge a portion of its net outstanding monetary assets and liabilities against movements in certain foreign exchange rates. These forward contracts are not designated as hedging instruments under applicable accounting guidance, and therefore all changes in the fair value of the forward contracts are reported in other income (expense), net in the consolidated statements of income. The gains and losses on our foreign currency forward contracts generally offset the majority of the gains and losses associated with the underlying foreign-currency denominated assets and liabilities that VMware hedges. VMware does not enter into speculative foreign exchange contracts for trading purposes.

VMware s foreign currency forward contracts are generally traded monthly with a typical contractual term of one month. As of September 30, 2010, VMware had outstanding forward contracts with a total notional value of $153.3 million. The fair value of these forward contracts was immaterial as of September 30, 2010 and therefore excluded from the table above. The fair value was measured under Level 2 sources as discussed above.

F. Business Combinations, Intangible Assets and Goodwill

Business Combinations

Business Acquisitions

The results of operations of all acquired companies and transferred net assets mentioned below have been included in VMware s consolidated financial statements from the respective dates of purchase or transfer, as applicable. Pro forma results of operations have not been presented as the results of the acquired companies and transferred net assets were not material, individually or in aggregate, to the consolidated results of operations in the three and nine months ended September 30, 2010.

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In the nine months ended September 30, 2010, VMware acquired six companies. The aggregate consideration in these acquisitions was $293.0 million, net of cash acquired. The following table summarizes the allocation of the consideration paid to the fair value of the tangible and intangible assets acquired and liabilities assumed in the nine months ended September 30, 2010 (table in thousands):

Other current assets	$ 6,328
Intangible assets	114,100
Goodwill	182,840
Deferred tax assets	45,931
Total tangible and intangible assets acquired	349,199
Deferred revenue	(21,425)
Deferred tax liabilities	(30,103)
Accrued liabilities and other	(4,701)
Total liabilities assumed	(56,229)
Fair value of tangible and intangible assets acquired and liabilities assumed	$ 292,970

Transfer of Net Assets Under Common Control

In April 2010, VMware acquired certain software product technology and expertise from EMC s Ionix information technology (IT) management business for cash consideration of $175.0 million. EMC retained the Ionix brand and will continue to offer customers the products acquired by VMware, pursuant to the ongoing reseller agreement between EMC and VMware. Additionally, contingent obligations totaling up to $25.0 million may be payable to EMC by the end of the second anniversary of the transfer. These obligations are subject to EMC s revenue achievements as described in the asset purchase agreement. The acquired software product technology and expertise will complement VMware s existing development efforts and expand its vCenter product family.

The net assets and expertise acquired from EMC constituted a business and were accounted for as a business combination between entities under common control pursuant to generally accepted accounting principles. Accordingly, VMware included the carrying values of the transferred assets and liabilities as of the date of transfer in its consolidated financial statements, as well as recorded the excess of the carrying values over the cash consideration as an equity transaction. Contingent consideration, if any, paid by VMware to EMC will be recorded as an equity transaction when due. VMware did not revise its historical consolidated financial statements as the historical impact of the acquired net assets was not material.

The following table summarizes the net carrying values as of the transfer date of the tangible and intangible assets and liabilities transferred to VMware and the capital contribution from EMC (table in thousands):

Property and equipment	$ 3,046
Other assets	1,873
Deferred tax asset	48,618

Intangible assets	37,029
Goodwill	275,260
Total tangible and intangible assets acquired	365,826
Deferred revenue	(18,363)
Deferred tax liabilities	(2,082)
Other liabilities	(2,210)
Capital contribution from EMC	(168,171)
Total liabilities assumed and capital received	(190,826)
Tangible and intangible assets acquired and liabilities assumed, and capital received	$ 175,000

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Intangible Assets

The following table summarizes the fair value of the intangible assets acquired in conjunction with all acquisitions in the nine months ended September 30, 2010 and excludes the intangible assets transferred from EMC in the three months ended June 30, 2010 (table in thousands):

	Weighted-Average Useful Lives (in years)	Fair Value Amount
Purchased technology	4.9	$ 70,100
Customer relationships and customer lists	6.4	36,000
Trademarks and tradenames	4.4	8,000
Total intangible assets acquired, excluding goodwill		$ 114,100

The following table summarizes the net carrying value of the intangible assets transferred from EMC as of the transfer date pursuant to the Ionix transaction referenced above (table in thousands):

	Weighted-Average Useful Lives (in years)	Net Carrying Value
Purchased technology	4.3	$ 19,423
Customer relationships and customer lists	9.6	15,133
Trademarks and tradenames	5.0	2,473
Total intangible assets acquired, excluding goodwill		$ 37,029

Goodwill

Changes in the carrying amount of goodwill for the nine months ended September 30, 2010 consist of the following (table in thousands):

Balance, January 1, 2010	$ 1,115,769
Increase in goodwill related to business combinations	458,100
Deferred tax adjustments to purchase price allocations on previous acquisitions	2,209
Other adjustments to purchase price allocations on previous acquisitions	(976)

Balance, September 30, 2010	$ 1,575,102

G. Property and Equipment, Net

Property and equipment, net, as of September 30, 2010 and December 31, 2009 consist of the following (table in thousands):

	September 30, 2010	December 31, 2009
Equipment and software	$ 411,536	$ 327,148
Buildings and improvements	267,177	256,758
Furniture and fixtures	52,127	48,075
Construction in progress	4,376	5,892
Total property and equipment	735,216	637,873
Accumulated depreciation	(316,577)	(235,517)
Total property and equipment, net	$ 418,639	$ 402,356

Depreciation expense was $29.0 million and $24.9 million in the three months ended September 30, 2010 and 2009, respectively, and $82.7 million and $76.3 million in the nine months ended September 30, 2010 and 2009, respectively.

VMware, Inc.

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H. Accrued Expenses

Accrued expenses as of September 30, 2010 and December 31, 2009 consist of the following (table in thousands):

	September 30, 2010	December 31, 2009
Salaries, commissions, bonuses and benefits	$ 173,188	$ 174,207
Accrued partner liabilities	79,017	77,264
Other	109,440	83,052
Total accrued expenses	$ 361,645	$ 334,523

Accrued partner liabilities relate to rebates and marketing development fund accruals for channel partners, x86 system vendors, and system integrators, as well as accrued royalties.

I. Note Payable to EMC

In April 2007, VMware declared an $800.0 million dividend to EMC paid in the form of a note payable, of which $450.0 million remained outstanding as of September 30, 2010. The note matures in April 2012, with interest payable quarterly in arrears commencing June 30, 2007. The interest rate resets quarterly and bears an interest rate of the 90-day LIBOR plus 55 basis points. For the three months ended September 30, 2010 and 2009, $1.2 million and $1.3 million, respectively, of interest expense was recorded related to the note payable. For the nine months ended September 30, 2010 and 2009, $3.1 million and $5.6 million, respectively, of interest expense was recorded related to the note payable. The note may be repaid, without penalty, at any time commencing July 2007. No repayments of principal were made during the three and nine months ended September 30, 2010, respectively.

J. Income Taxes

Although VMware files a consolidated federal tax return with EMC, VMware calculates 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 rate at which the provision for income taxes is calculated differs from the U.S. federal statutory income tax rate primarily due to differential tax rates in foreign jurisdictions where income is earned and considered to be indefinitely reinvested.

For the three months ended September 30, 2010 and 2009, VMware s effective income tax rate was 12.6% and a negative 19.9%, respectively. The effective income tax rate was 18.5% and 9.9%, respectively, for the nine months ended September 30, 2010 and 2009. The increase in the effective rate for the three and nine months ended September 30, 2010, as compared to the three and nine months ended September 30, 2009, was mainly attributable to the expiration of the U.S. Federal R&D tax credit, an increase in foreign withholding taxes and an increase in other non-deductible expenses. These increases were partially offset by a decrease in unrecognized tax benefits from uncertain tax positions as a percentage of income before tax, as well as by discrete tax benefits related to foreign exchange rates and employee stock purchase plan disqualifying dispositions. During the three months ended September 30, 2010, VMware released $5.3 million in international tax reserves associated with uncertain tax positions, which reduced the effective income tax rate for the quarter by 5.5%. Management has determined that these reserves are no longer required due to the expiration of the applicable statutes of limitations and the acceptance of a ruling by the tax authorities. All income earned abroad, except for previously taxed income for U.S. tax purposes, is considered indefinitely reinvested in VMware s foreign operations and no provision for U.S. taxes has been provided with respect thereto.

As of September 30, 2010, VMware had $85.3 million of gross unrecognized tax benefits, which excludes $8.2 million of offsetting tax benefits not recognized on the consolidated balance sheets. VMware s net unrecognized tax benefits of $82.4 million as of September 30, 2010, if recognized, would benefit VMware s effective income tax rate. It is reasonably possible that VMware may pay an immaterial amount of the $82.4 million of net unrecognized tax benefits within the next 12 months. However, based on the status of audit examinations and the protocol of finalizing audits, it is not possible to accurately estimate the amount to be paid within the next 12 months. The net unrecognized tax benefits of $82.4 million were classified as a non-current liability on the consolidated balance sheet as of September 30, 2010.

VMware recognizes interest expense and penalties related to income tax matters in the income tax provision. VMware recognized approximately $2.4 million in interest and penalties for the nine months ended September 30, 2010 and as of September 30, 2010 had $6.3 million of interest and penalties associated with the net unrecognized tax benefits accrued on the consolidated balance sheet. These amounts are not included as components of the $82.4 million of net unrecognized tax benefits at September 30, 2010.

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K. 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 VMware 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 VMware 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 consolidated cash flows, results of operations, and financial position, 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 September 30, 2010 are as follows (table in thousands):

2010	$ 9,634
2011	38,004
2012	28,924
2013	22,649
2014	18,782
Thereafter	292,912
Total minimum lease payments	$ 410,905

The amount of the future lease commitments after 2014 is primarily for the ground lease on VMware s Palo Alto, California headquarter facilities, which expires in 2057. As several of VMware s operating leases are payable in foreign currencies, the operating lease payments may fluctuate in response to changes in the exchange rate between the U.S. Dollar and the foreign currencies in which the commitments are payable.

L. Stockholders Equity

Stock Repurchase Program

In March 2010, VMware s Board of Directors approved a stock repurchase program, authorizing the purchase of up to $400.0 million of its Class A common stock through the end of 2011. From time to time, stock will be purchased pursuant to this program in the open market or through private transactions, subject to market conditions. In the three months ended September 30, 2010, VMware repurchased and retired 1,853,551 shares of its Class A common stock at a weighted-average price of $76.31 per share for an aggregate purchase price of $141.4 million, including commissions. In the nine months ended September 30, 2010, VMware repurchased and retired 4,258,009 shares of its Class A common stock at a weighted-average price of $67.15 per share for an aggregate purchase price of $285.9 million, including commissions. The amount of repurchased shares was recorded as a reduction to retained earnings. VMware is not obligated to purchase any shares under its stock repurchase program. Subject to applicable corporate and securities laws, repurchases under the stock repurchase program may be made at such times and in such amounts as VMware deems appropriate. Purchases under the stock repurchase program can be discontinued at any time that VMware feels additional purchases are not warranted.

VMware Employee Stock Purchase Plan

For the purchase period ended July 31, 2010, 576,480 shares of Class A common stock were purchased under the Employee Stock Purchase Plan (the ESPP) at a purchase price per share of $38.74. For the purchase period ended January 31, 2010, 933,975 shares of Class A common stock were purchased under the ESPP at a purchase price per share of $24.45. The total cash proceeds from the purchases of these shares under the ESPP were $22.3 million and $22.8 million, respectively.

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VMware Stock Options

The following table summarizes option activity since January 1, 2010 for VMware stock options (shares in thousands):

	VMware Stock Options	
	Number of shares	Weighted-Average Exercise Price (per share)
Outstanding, January 1, 2010	41,507	$ 28.34
Granted	3,295	57.18
Forfeited	(1,860)	29.79
Expired	(138)	82.72
Exercised	(12,710)	24.44
Outstanding, September 30, 2010	30,094	32.81

Cash proceeds from the exercise of VMware stock options for the nine months ended September 30, 2010 were $310.7 million. The options exercised during the nine months ended September 30, 2010 had a pre-tax intrinsic value of $515.7 million. As of September 30, 2010, 30.1 million stock options were outstanding, with an aggregate intrinsic value of $1,583.3 million based upon the closing share price as of September 30, 2010.

VMware Restricted Stock

VMware restricted stock primarily consists of restricted stock units granted to employees and also includes restricted stock awards and other restricted stock. The following table summarizes restricted stock activity since January 1, 2010 (shares in thousands):

	VMware Restricted Stock	
	Number of shares	Weighted-Average Grant Date Fair Value (per share)
Outstanding, January 1, 2010	9,211	$ 33.21
Granted	4,079	73.90
Vested	(3,246)	32.11
Forfeited	(551)	35.60
Outstanding, September 30, 2010	9,493	50.94

The total fair value of VMware restricted stock-based awards that vested in the nine months ended September 30, 2010 was $221.1 million. As of September 30, 2010, restricted stock unit awards and other restricted stock representing 9.5 million shares of VMware were outstanding, with an aggregate intrinsic value of $806.3 million based on the closing share price as of September 30, 2010. Shares underlying restricted stock unit awards are not issued until the restricted stock units vest. These shares are scheduled to vest through 2014.

Shares Repurchased for Tax Withholdings

During the three months ended September 30, 2010 and 2009, VMware repurchased or withheld and retired 332,240 shares and 208,558 shares of Class A common stock for $27.0 million and $7.1 million, respectively, to cover tax withholding obligations. During the nine months ended September 30, 2010 and 2009, VMware repurchased or withheld and retired 1,085,149 shares and 885,036 shares of Class A common stock for $72.6 million and $25.3 million, respectively. Pursuant to the respective agreements, these shares were repurchased or withheld in conjunction with the net share settlement upon the vesting of restricted stock and restricted stock units during the period. The amount of repurchased or withheld shares, including restricted stock units, was recorded as a reduction to retained earnings.

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Stock-Based Compensation Expense

The following table summarizes the components of total stock-based compensation expense included in VMware s consolidated statements of income for the three and nine months ended September 30, 2010 and 2009 (table in thousands):

	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	For the Nine Months Ended September 30, 2010	For the Nine Months Ended September 30, 2009
Cost of license revenues	$ 395	$ 330	$ 1,170	$ 973
Cost of services revenues	4,387	4,003	12,601	10,941
Research and development	43,124	34,250	117,292	84,587
Sales and marketing	18,102	15,763	49,601	42,908
General and administrative	7,649	8,006	24,526	24,214
Total stock-based compensation expense	$ 73,657	$ 62,352	$ 205,190	$ 163,623

For the three months ended September 30, 2010 and 2009, VMware capitalized $1.2 million and $1.8 million, respectively, of stock-based compensation expense associated with capitalized software development. For the nine months ended September 30, 2010 and 2009, VMware capitalized $8.1 million and $11.8 million, respectively, of stock-based compensation expense associated with capitalized software development.

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, 2010 and 2009 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

VMware Stock Options	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	For the Nine Months Ended September 30, 2010	For the Nine Months Ended September 30, 2009
Dividend yield	None	None	None	None
Expected volatility	37.3%	35.1%	38.0%	36.0%
Risk-free interest rate	1.1%	2.1%	1.5%	2.0%
Expected term (in years)	3.5	3.9	3.5	3.9
Weighted-average fair value at grant date	$ 26.09	$ 10.90	$ 17.96	$ 9.78

VMware Employee Stock Purchase Plan	For the Three Months Ended September 30, 2010	For the Three Months Ended September 30, 2009	For the Nine Months Ended September 30, 2010	For the Nine Months Ended September 30, 2009
Dividend yield	None	None	None	None
Expected volatility	34.2%	43.0%	33.1%	50.9%
Risk-free interest rate	0.2%	0.4%	0.2%	0.3%
Expected term (in years)	0.5	0.6	0.5	0.5

Weighted-average fair value at grant date	$ 19.11	$ 8.08	$ 15.18	$ 7.79

For all equity awards granted in the three and nine months ended September 30, 2010 and 2009, VMware s expected dividend yield input was zero as VMware has not historically paid, and does not expect in the future to pay, cash dividends on its common stock. VMware s expected volatility was based on an analysis of historical stock prices and implied volatilities of publicly-traded companies with similar characteristics, including industry, stage of life cycle, size, financial leverage, as well as the implied volatilities of VMware s Class A common stock. The expected term was calculated based upon an analysis of the expected terms of similar grants of comparable publicly-traded companies. The risk-free interest rate was based on a zero-coupon U.S. Treasury instrument whose term is consistent with the expected term of the stock options.

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M. Comprehensive Income

The following table sets forth the components of comprehensive income for the three and nine months ended September 30, 2010 and 2009, respectively (table in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
Net income	$ 84,600	$ 38,219	$ 237,559	$ 140,689
Comprehensive income:				
Unrealized gains and losses on available-for-sale securities, net of taxes of $4,195, $669, $5,699 and $1,854	6,858	1,092	9,299	3,026
Reclassification of (gains) losses on available-for-sale securities recognized during the period, net of taxes of $3, $0, $3 and $0	8		8	
Total comprehensive income, net of taxes	$ 91,466	$ 39,311	$ 246,866	$ 143,715

In each period presented on VMware s consolidated balance sheets, accumulated other comprehensive income consisted of unrealized gains and losses on available-for-sale securities, net of taxes.

N. Related Party Transactions

In April 2010, VMware acquired certain software product technology and expertise from EMC s Ionix IT management business for cash consideration of $175.0 million. EMC retained the Ionix brand and will continue to offer customers the products acquired by VMware, pursuant to the ongoing reseller agreement between EMC and VMware. See Note F for further information.

Pursuant to the ongoing reseller arrangement with EMC that commenced in 2009, EMC bundles VMware s products and services with EMC s hardware and sells them to end users. In the three months ended September 30, 2010 and 2009, VMware recognized revenues of $8.0 million and $1.5 million, respectively, from products sold pursuant to VMware s reseller arrangement with EMC. In the nine months ended September 30, 2010 and 2009, VMware recognized revenues of $25.0 million and $4.1 million, respectively, from products sold pursuant to VMware s reseller arrangement with EMC. As of September 30, 2010, $41.8 million of revenues from products sold under the reseller arrangement were included in deferred revenue.

In the three months ended September 30, 2010 and 2009, VMware recognized professional services revenues of $16.6 million and $4.9 million, respectively, for services provided to EMC s customers pursuant to VMware s contractual agreements with EMC. In the nine months ended September 30, 2010 and 2009, VMware recognized professional services revenues of $38.6 million and $15.0 million, respectively, from such contractual arrangements with EMC. As of September 30, 2010, $2.3 million of revenues from professional services to EMC customers were included in deferred revenue.

In the three months ended September 30, 2010 and 2009, VMware recognized revenues of $2.5 million and $0.7 million, respectively, from server and desktop products and services purchased by EMC for internal use pursuant to VMware s contractual agreements with EMC. In the nine months ended September 30, 2010 and 2009, VMware recognized $4.8 million and $2.0 million, respectively, from such contractual arrangements with EMC. As of September 30, 2010, $4.7 million of revenues from server and desktop products and services purchased by EMC for internal use were included in deferred revenue.

VMware purchased storage systems and software, as well as consulting services, from EMC for $6.7 million and $1.0 million in the three months ended September 30, 2010 and 2009, respectively, and for $13.2 million and $8.2 million in the nine months ended September 30, 2010 and 2009, respectively.

In certain geographic regions where VMware does not have an established legal entity, VMware contracts with EMC subsidiaries for support services and EMC employees who are managed by VMware s personnel. The costs incurred by EMC on VMware s behalf related to these employees are passed on to VMware and VMware is charged a mark-up intended to approximate costs that would have been charged had VMware contracted for such services with an unrelated third party. These costs are included as expenses in VMware s consolidated statements of income and primarily include salaries and benefits, travel and rent. Additionally, EMC incurs certain costs on VMware s behalf in the U.S., which historically primarily related to a shared system for travel. In the fourth quarter of 2009, VMware implemented its own travel system in the U.S. and is now incurring these costs directly. The total cost of these services provided to VMware by EMC was $18.0 million and $24.9 million in the three months ended September 30, 2010 and 2009, respectively, and $49.8 million and $78.0 million in the nine months ended September 30, 2010 and 2009, respectively.

As calculated under VMware s tax sharing agreement with EMC, VMware paid EMC $5.1 million in the nine months ended September 30, 2010 for its portion of EMC s 2009 consolidated federal income taxes. No payments were made by VMware to EMC during the three months ended September 30, 2010. During the three and nine months ended September 30, 2009, VMware paid $11.7 million and $14.2 million, respectively, for its portion of EMC s taxes related to the consolidated state income tax returns and

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

consolidated federal income tax return for various periods, and the conclusion of the 2005 and 2006 federal income tax audit. Under the same tax sharing agreement, EMC paid VMware $2.5 million during the nine months ended September 30, 2010 for a refund of an overpayment related to the consolidated federal and state income taxes for the fiscal year ended December 31, 2008. No payments were made by EMC to VMware during the three months ended September 30, 2010. During the three and nine months ended September 30, 2009, EMC paid VMware $19.7 million and $107.6 million, respectively, for the VMware stand-alone federal taxable loss for the fiscal year ended December 31, 2008 and for a refund of an overpayment related to VMware s portion of EMC s 2007 federal consolidated tax return. The amounts that VMware pays to EMC for its portion of federal income taxes on EMC s consolidated tax return differ from the amounts VMware would owe on a stand-alone basis, and the difference is presented as a component of stockholders equity.

Interest expense with EMC, net, primarily consists of interest expense on the note payable to EMC. In the three months ended September 30, 2010 and 2009, $1.2 million and $1.3 million, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC, net, recorded on the consolidated statements of income. In the nine months ended September 30, 2010 and 2009, $3.1 million and $5.6 million, respectively, of interest expense was recorded related to the note payable. VMware s interest income and expenses as a separate, stand-alone company may be higher or lower than the amounts reflected in the consolidated financial statements.

As of September 30, 2010, VMware had $38.0 million due from EMC, which was partially offset by $27.0 million due to EMC. The net amount due from EMC as of September 30, 2010 was $11.0 million and resulted from the related party transactions described above. In addition to the $11.0 million due from EMC, as of September 30, 2010, VMware had $118.1 million of income taxes receivable due from EMC, which is included in other current assets, and $6.2 million of income taxes payable due to EMC, which is included in accrued expenses and other, on VMware s consolidated balance sheets. A large portion of the income tax receivable is related to 2010 federal income taxes and is expected to be received from EMC after the 2010 consolidated federal tax return extension is filed. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

O. Segment Information

Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assessing performance. VMware operates in one operating segment, therefore all required financial segment information can be found in the consolidated financial statements.

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	2009	2010	2009
United States	$ 362,350	$ 246,070	$ 1,013,265	$ 723,804
International	351,895	243,681	1,008,417	691,932
Total	$ 714,245	$ 489,751	$ 2,021,682	$ 1,415,736

Long-lived assets by geographic area, which primarily include property and equipment, net in the United States, at September 30, 2010 and December 31, 2009 are as follows (table in thousands):

	September 30, 2010	December 31, 2009
United States	$ 307,335	$ 297,232
International	44,712	42,758
Total	$ 352,047	$ 339,990

No country other than the United States accounted for 10% or more of these assets at September 30, 2010 or December 31, 2009.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
All dollar amounts expressed as numbers in this MD&A (except per share amounts) are in millions.

Overview

Our primary source of revenues is the licensing of virtualization infrastructure software solutions and related support and services for use by businesses and organizations of all sizes and across numerous industries in their information technology (IT) infrastructure. Our solutions run on industry-standard desktop computers and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures. Our virtualization software solutions help eliminate the complexity of maintaining and managing IT infrastructures, reduce both capital and operating costs and provide a more flexible and dynamic IT environment to better support the needs of business. With our latest platform, VMware vSphere, we are helping companies along the path of cloud computing by providing compatible IT infrastructures for both businesses and cloud service providers.

We have developed a multi-channel distribution model to expand our presence and to reach various segments of the industry. In the third quarter and first nine months of 2010 we derived over 85% of our sales from our channel partners, which include distributors, resellers, x86 system vendors and system integrators. The remainder is primarily derived from direct sales. We have also developed a network of indirect channel partners who fulfill orders through our direct channel partners.

The 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 for the licensed software are complete. Software maintenance revenues are recognized ratably over the term of the software maintenance period and include renewals of software maintenance sold after the initial software maintenance period expires. We also recognize revenues from professional services provided to our customers primarily as services are performed. Vendor-specific objective evidence (VSOE) of fair value for software maintenance services is established by the rates charged in stand-alone sales of software maintenance contracts or the stated renewal rate for software maintenance included in the license agreement. Our software products may also be sold with professional services. VSOE of fair value for professional services is based upon the standard rates we charge for such services when sold separately. 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.

Our current financial focus is on long-term revenue growth to generate free cash flows[1] to fund our expansion of industry segment share and to evolve our virtualization-based products for data centers, desktop computers and cloud computing through a combination of internal development and acquisitions. We expect to grow our business by broadening our virtualization infrastructure software solutions technology and product portfolio, increasing product awareness, promoting the adoption of virtualization, and building long-term relationships with our customers through the adoption of enterprise license agreements (ELAs). Since the introduction in 2009 of VMware vSphere, the next generation of VMware Infrastructure, and VMware View 4, which is integrated with VMware vSphere, we have introduced more products, including the latest versions of the above mentioned products in the third quarter of 2010, that build on the vSphere foundation. We plan to continue to introduce additional products through 2010 and beyond. Additionally, we have made, and expect to continue to make, acquisitions designed to strengthen our product offerings and/or extend our strategy to deliver solutions that can be hosted at customer data centers or at service providers.

From mid-2008 and through most of 2009, we observed that customers responded to the economic downturn with reductions in IT spending. As a result, customers were subjecting larger orders, such as ELAs, to a longer review process and in certain cases were purchasing products to meet their immediate needs, foregoing larger discounts offered under ELAs. While the overall macroeconomic environment appears to be improving, we believe that we have benefited from previously pent-up demand, and it is unclear if our recent improved sales results reflect a long-term improving trend. We therefore remain conservative in our planning and expect to continue to manage our resources prudently, while making key investments with the objective of maximizing long-term growth.

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

[1] Free cash flow, a non-GAAP financial measure, is defined as net cash provided by operating activities plus the excess tax benefits from stock-based compensation, less capital expenditures and capitalized software development costs. Each adjusting item is separately presented on our consolidated statements of cash flows. See Liquidity and Capital Resources Non-GAAP Financial Measures for further information from the sale of our products and services. We believe this is the appropriate priority for the long-term health and growth of our business.

In evaluating our results, we also focus on operating margin excluding stock-based compensation, employer payroll taxes on employee stock transactions, amortization of intangible assets, acquisition-related items and the net effect of the amortization and capitalization of software development costs, as we believe this measure reflects our ongoing business in a manner that allows meaningful period-to-period comparisons. We are not currently focused on short-term operating margin expansion, but rather on investing at appropriate rates to support our growth and future product offerings in what may be a substantially more competitive environment.

Our maintenance-related services revenues are typically recognized ratably over periods from one to five years subsequent to the initial contract, whereas our license revenues are generally recognized upon electronic shipment of the software. As a consequence, variability in operating margin can result from differences in when we quote and contract for our services and when the cost is incurred. Variability in operating margin can also result when we recognize our foreign denominated deferred maintenance revenues in future periods. Due to our use of the U.S. Dollar as our functional currency, deferred revenue remains at its historical rate when recognized into revenue while our operating expenses in future periods are based upon the foreign exchange rates at that time. Our deferred revenue, both current and long-term, represents a liability on our consolidated balance sheets as the requirements of revenue recognition have not yet been met, and it consists of amounts received from customers and amounts billed but not collected for which revenue has not yet been recognized. As of September 30, 2010, over 90% of our deferred revenue balance will be recognized as revenue with the passage of time or with the delivery of professional services. The remainder is tied solely to product release events. We believe our overall deferred revenue balance improves predictability of future revenues and that it is a key indicator of the health and growth of our business.

Historically, most of our revenue contracts with international channel partners were denominated in U.S. Dollars, but a portion of our operating expenses were, and continue to be, denominated in currencies other than the U.S. Dollar. This currency difference between our revenues and operating expenses historically caused variability in our operating margins due to fluctuations in the U.S. Dollar as compared to other currencies. In conjunction with the general release of VMware vSphere in the second quarter of 2009, we started to invoice and collect in the Euro, the British Pound, the Japanese Yen and the Australian Dollar in their respective regions. As a result of invoicing in these local currencies in which we also have expenses, variability in operating margin due to foreign currency fluctuations has been reduced. However, increased exposure to foreign currency fluctuations introduces additional risk for variability in revenue-related components of our consolidated financial statements. In order to manage our exposure to foreign currency fluctuations, since July 2009, we have entered into foreign currency forward contracts to hedge a portion of our net outstanding monetary assets and liabilities against movements in certain foreign exchange rates. These forward contracts are not designated as hedging instruments under applicable accounting guidance, and therefore all changes in the fair value of the forward contracts are reported in other income (expense), net in the consolidated statements of income. The gains and losses on our foreign currency forward contracts generally offset the majority of the gains and losses associated with the underlying foreign-currency denominated assets and liabilities that we hedge.

Our Relationship with EMC

As of September 30, 2010, EMC owned 31,677,000 shares of Class A common stock and all 300,000,000 shares of Class B common stock, representing approximately 80.1% of our total outstanding shares of common stock and 97.3% of the combined voting power of our outstanding common stock.

In April 2010, we acquired certain software product technology and expertise from EMC s Ionix IT management business for cash consideration of $175.0. EMC retained the Ionix brand and will continue to offer customers the products acquired by us, pursuant to the ongoing reseller agreement we have with EMC. The net assets and expertise acquired from EMC constituted a business and were accounted for as a business combination between entities under common control pursuant to generally accepted accounting principles.

Pursuant to the ongoing reseller arrangement with EMC that commenced in 2009, EMC bundles our products and services with EMC s hardware and sells them to end users. In the third quarter of 2010 and 2009, we recognized revenues of $8.0 and $1.5, respectively, from products sold pursuant to our reseller arrangement with EMC. In the first nine months of 2010 and 2009, we recognized revenues of $25.0 and $4.1, respectively, from products sold pursuant to our reseller arrangement with EMC. As of September 30, 2010, $41.8 of revenues from products sold under the reseller arrangement were included in deferred revenue.

In the third quarter of 2010 and 2009, we recognized professional services revenues of $16.6 and $4.9, respectively, for services provided to EMC s customers pursuant to our contractual agreements with EMC. In the first nine months of 2010 and 2009, we recognized professional services revenues of $38.6 and $15.0, respectively, from such contractual arrangements with EMC. As of September 30, 2010, $2.3 of revenues from professional services to EMC customers were included in deferred revenue.

In the third quarter of 2010 and 2009, we recognized revenues of $2.5 and $0.7, respectively, from server and desktop products and services purchased by EMC for internal use pursuant to our contractual agreements with EMC. In the first nine months of 2010 and 2009, we recognized $4.8 and $2.0, respectively, from such contractual arrangements with EMC. As of September 30, 2010, $4.7 of revenues from server and desktop products and services purchased by EMC for internal use were included in deferred revenue.

We purchased storage systems and software, as well as consulting services, from EMC for $6.7 and $1.0 in the third quarter of 2010 and 2009, respectively, and $13.2 and $8.2 in the first nine months of 2010 and 2009, respectively.

In certain geographic regions where we do not have an established legal entity, we contract with EMC subsidiaries for support services and EMC employees who are managed by our personnel. The costs incurred by EMC on our behalf related to these employees are passed on to us and we are charged a mark-up intended to approximate costs that would have been charged had we contracted for such services with an unrelated third party. These costs are included as expenses in our consolidated statements of income and primarily include salaries and benefits, travel and rent. Additionally, EMC incurs certain costs on our behalf in the U.S., which historically primarily related to a shared system for travel. In the fourth quarter of 2009, we implemented our own travel system in the U.S. and are now incurring these costs directly. The total cost of these services provided to us by EMC was $18.0 and $24.9 in the third quarter of 2010 and 2009, respectively, and $49.8 and $78.0 in the first nine months of 2010 and 2009, respectively.

As calculated under our tax sharing agreement with EMC, we paid EMC $5.1 in the first nine months of 2010 for our portion of EMC s 2009 consolidated federal income taxes. No payments were made by us to EMC during the third quarter of 2010. During the third quarter and first nine months of 2009, we paid $11.7 and $14.2, respectively, for our portion of EMC s taxes related to the consolidated state income tax returns and consolidated federal income tax return for various periods, and the conclusion of the 2005 and 2006 federal income tax audit. Under the same tax sharing agreement, EMC paid us $2.5 during the first nine months of 2010 for a refund of an overpayment related to the consolidated federal and state income taxes for the fiscal year ended December 31, 2008. No payments were made by EMC to us during the third quarter of 2010. During the third quarter and first nine months of 2009, EMC paid us $19.7 and $107.6, respectively, for our stand-alone federal taxable loss for the fiscal year ended December 31, 2008 and for a refund of an overpayment related to our portion of EMC s 2007 federal consolidated tax return. The amounts that we pay to EMC for our portion of federal income taxes on EMC s consolidated tax return differ from the amounts we would owe on a stand-alone basis, and the difference is presented as a component of stockholders equity.

Interest expense with EMC, net, primarily consists of interest expense on the note payable to EMC. In the third quarter of 2010 and 2009, $1.2 and $1.3, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC, net, recorded on the consolidated statements of income. In the first nine months of 2010 and 2009, $3.1 and $5.6, respectively, of interest expense was recorded related to the note payable. Our interest income and expenses as a separate, stand-alone company may be higher or lower than the amounts reflected in the consolidated financial statements.

As of September 30, 2010, we had $38.0 due from EMC, which was partially offset by $27.0 due to EMC. The net amount due from EMC as of September 30, 2010 was $11.0 and resulted from the related party transactions described above. In addition to the $11.0 due from EMC, as of September 30, 2010, we had $118.1 of income taxes receivable due from EMC, which is included in other current assets, and $6.2 of income taxes payable due to EMC, which is included in accrued expenses and other, on our consolidated balance sheets. A large portion of the income tax receivable is related to 2010 federal income taxes and is expected to be received from EMC after the 2010 consolidated federal tax return extension is filed. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

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

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

Sources of Revenues

License revenues

Our license revenues consist of revenues earned from the licensing of our software products. These products are generally priced and licensed on a perpetual basis based upon the number of physical desktop computers or server processors on which our software runs. Certain products are licensed on a subscription basis. Effective September 1, 2010, our management solutions are priced on a per-virtual-machine basis. The new model better aligns to customer use cases to manage the number of virtual machines, rather than to the management of physical hardware.

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Software maintenance revenues

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

Professional services revenues

Professional services include design, implementation and training. Professional services are not considered essential to the functionality of our products, as these services do not alter the product capabilities and may be performed by our customers or by other vendors. Professional services engagements performed for a fixed fee, for which we are able to make reasonably dependable estimates of progress toward completion, are recognized on a proportional performance basis based on hours incurred and estimated hours of completion. Professional services engagements that are on a time and materials basis are recognized based on hours incurred. Revenues on all other professional services engagements are recognized upon completion.

Operating Expenses

Cost of license revenues

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

Cost of services revenues

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

Research and development expenses

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

Sales and marketing expenses

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

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.

Results of Operations

Revenues

Our revenues for the third quarter and first nine months of 2010 and 2009 are as follows:

	For the Three Months Ended September 30, 2010	2009	% Change	For the Nine Months Ended September 30, 2010	2009	% Change
Revenues:						
License	$ 343.2	$ 240.3	43%	$ 979.1	$ 725.2	35%
Services:						
Software maintenance	314.1	212.8	48	871.8	577.6	51
Professional services	56.9	36.7	55	170.8	112.9	51
Total services	371.0	249.5	49	1,042.6	690.5	51
	$ 714.2	$ 489.8	46	$ 2,021.7	$ 1,415.7	43
Revenues:						
United States	$ 362.3	$ 246.1	47%	$ 1,013.3	$ 723.8	40%
International	351.9	243.7	44	1,008.4	691.9	46
	$ 714.2	$ 489.8	46	$ 2,021.7	$ 1,415.7	43

Total revenues increased by $224.5 or 46%, to $714.2 in the third quarter of 2010, compared with $489.8 in the third quarter of 2009. The revenue mix in the third quarter of 2010 reflected an increase of $103.0 in license revenues and an increase of $121.5 in services revenues as compared with the third quarter of 2009. Total revenues increased by $605.9, or 43%, to $2,021.7 in the first nine months of 2010, compared with $1,415.7 in the first nine months of 2009, reflecting an increase of $253.8 in license revenues and an increase of $352.1 in services revenues. The shift in our revenue mix year-over-year is primarily due to increases in services revenues which continued to benefit from strong maintenance renewals, multi-year software maintenance contracts sold in previous periods and additional maintenance contracts sold in conjunction with software licenses. Geographically, both U.S. and international revenues increased in the third quarter and first nine months of 2010 as compared to the same periods in the prior year. In the U.S., the federal market was particularly strong compared to the same period last year. Internationally, revenues increased due to strong demand across all regions, despite on-going macro-economic concerns, particularly in Europe.

We sell our products primarily 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. Our 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 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.

Historically, most of our revenue contracts with international customers were denominated in U.S. Dollars. In conjunction with the general release of VMware vSphere in the second quarter of 2009, we began to invoice and collect in the Euro, the British Pound, the Japanese Yen and the Australian Dollar in their respective regions. While variability in operating margin due to foreign exchange fluctuations is reduced as a result of invoicing in these local currencies in which we also have expenses, additional risk of variability in revenues due to foreign currency fluctuations is introduced when these locally denominated revenues are remeasured into U.S. Dollars. Given that we began to invoice and collect in currencies other than the U.S. Dollar during the second quarter of 2009, the third quarter of 2010 is the first period in which we were able to determine the year-over-year impact of foreign currency fluctuations on our revenues. We calculate the foreign currency impact on our revenues as the difference between revenues translated at current exchange rates and the same revenues translated at prior-period exchange rates. Our growth in revenues in the third quarter of 2010 was negatively impacted from a strengthening in the U.S. Dollar against the foreign currencies in which we invoice as compared with the same period in the prior year. On a constant currency basis, our revenue growth would have been 47% in the third quarter of 2010 compared to the third quarter of 2009, as compared with the 46% shown in the table above. The uncertainty and volatility of currency fluctuations will continue to impact our results.

The macroeconomic environment continues to generate some uncertainty around how much will be spent on IT over the foreseeable future. We believe that our customers continue to adopt our product platform as a strategic investment that delivers substantial cost savings, improved efficiency and flexibility for their business. Although we have observed an increase in customer spending that began in the fourth quarter of 2009 and has extended through the first nine months of 2010, we believe the increase was primarily in response to fiscal year-end spending trends, product promotions, and previously pent-up demand. In the face of continuing economic uncertainty, currency volatility, and potential decelerated IT spending, we are planning conservatively for the remainder of 2010 and into 2011.

License Revenues

Software license revenues increased by $103.0 or 43%, to $343.2 in the third quarter of 2010, compared with $240.3 in the third quarter of 2009. Software license revenues increased by $253.8 or 35%, to $979.1 in the first nine months of 2010, compared with $725.2 in the first nine months of 2009. We believe license revenues benefited from strong customer demand for the vSphere platform, a foundation to cloud computing, as well as growing interest in our desktop solutions. However, despite customer interest in deploying virtualization solutions as they update their IT infrastructure, we believe demand for our products remains subject to the challenges that our customers face due to continuing uncertainty in the economic environment. Although we believe there is generally a quick return on investment in virtualization, organizations often update their IT infrastructure when deploying virtualization, and the hardware investment is a capital outlay that is several times larger than that of our software.

We have promoted the adoption of virtualization and built long-term relationships with our customers through the adoption of enterprise license agreements (ELAs). ELAs continue to be an important component of our revenue growth and are offered both directly and through certain channel partners. ELAs are core to our strategy to build long-term relationships with customers as they commit to our virtualization infrastructure software solutions in their data centers. ELAs provide a base from which to sell additional products, such as our application and infrastructure management suite, our disaster recovery products, and our desktop products. Under a typical ELA, a portion of the revenues is attributed to the license and recognized immediately, but the remainder is deferred and recognized as services maintenance revenues in future periods. In addition, ELAs typically include an initial maintenance period that is longer than other types of license sales.

In the third quarter and first nine months of 2010, we observed an increase in the volume of our ELAs as compared to the third quarter and first nine months of 2009, due in part to growing international customer interest. In addition, during the third quarter and first nine months of 2010, customers are generally renewing their ELAs at a dollar value higher than the original transaction and with an average maintenance term of three years. The increase in the value of the renewed ELAs includes additional products and upgrades added to the renewed ELAs, as well as the expanding use of originally purchased products within the customer s environment.

Services Revenues

Services revenues increased $121.5 or 49%, to $371.0 in the third quarter of 2010, compared with $249.5 in the third quarter of 2009. Services revenues increased $352.1 or 51%, to $1,042.6 in the first nine months of 2010, compared with $690.5 in the first nine months of 2009. The increase in services revenues during the third quarter and the first nine months of 2010 was primarily attributable to growth in our software maintenance revenues.

Software maintenance revenues increased $101.3 or 48%, to $314.1 in the third quarter of 2010, compared with $212.8 in the third quarter of 2009. Software maintenance revenues increased $294.3 or 51%, to $871.8 in the first nine months of 2010, compared with $577.6 in the first nine months of 2009. In the third quarter and first nine months of 2010, software maintenance revenues benefited from strong renewals, multi-year software maintenance contracts sold in previous periods, and additional maintenance contracts sold in conjunction with software licenses. In the third quarter, consistent with previous quarters, customers continue to buy, on average, more than 24 months of support and maintenance with each new license purchased, which we believe illustrates our customers commitment to VMware as a core element of their data center architecture.

Professional services revenues increased $20.2 or 55%, to $56.9 in the third quarter of 2010, compared with $36.7 in the third quarter of 2009. Professional services revenues increased $57.9 or 51%, to $170.8 in the first nine months of 2010, compared with $112.9 in the first nine months of 2009. In the third quarter and first nine months of 2010, professional services revenues increased largely due to incremental services revenues from our acquired businesses and customer training related to vSphere deployments. We do not expect strong growth in our professional services revenues as we continue to invest in our partners and the eco-system to broadly offer the best set of solutions to our customers. As a result of this strategy, our professional services revenue can vary based on the delivery channels used in any given period as well as the timing of engagements.

Operating Expenses

Information about our operating expenses is as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2010	**2009**	**2010**	**2009**
Operating expenses:				