VMWARE, INC.
Form 10-Q
May 01, 2014

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 March 31, 2014
OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to
Commission File Number 001-33622

VMWARE, INC.
(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	94-3292913 (I.R.S. Employer 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	o	(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 April 25, 2014, the number of shares of common stock, par value $0.01 per share, of the registrant outstanding was 430,515,393 of which 130,515,393 shares were Class A common stock and 300,000,000 were Class B common stock.

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VMware, VMworld, vSphere, vCloud, vCenter, VMware View, vCloud Suite, Horizon Suite, VMware NSX, Virtual SAN, vCloud Hybrid Service, AirWatch, vShield, Desktone, Dynamic Ops, Nicira, Wanova and Virsto are registered trademarks or trademarks of VMware in the United States and other jurisdictions. All other marks and names mentioned herein may be trademarks of their respective companies.

PART I
FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
VMware, Inc.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(amounts in millions, except per share amounts, and shares in thousands)
(unaudited)

	For the Three Months Ended March 31,	
	2014	2013
Revenues:		
License	$561	$488
Services	799	703
Total revenues	1,360	1,191
Operating expenses (1):		
Cost of license revenues	50	57
Cost of services revenues	151	125
Research and development	293	271
Sales and marketing	474	417
General and administrative	151	98
Realignment charges	—	63
Operating income	241	160
Investment income	9	8
Interest expense with EMC	(5)	(1)
Other income (expense), net	—	(3)
Income before income taxes	245	164
Income tax provision (benefit)	46	(9)
Net income	$199	$173
Net income per weighted-average share, basic for Class A and Class B	$0.46	$0.41
Net income per weighted-average share, diluted for Class A and Class B	$0.46	$0.40
Weighted-average shares, basic for Class A and Class B	430,546	428,005
Weighted-average shares, diluted for Class A and Class B	434,729	432,631

(1) Includes stock-based compensation as follows:

Cost of license revenues	$1	$1
Cost of services revenues	9	7
Research and development	60	62
Sales and marketing	41	36
General and administrative	17	14
Realignment charges	—	5

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

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

	For the Three Months Ended March 31,	
	2014	2013
Net income	$199	$173
Other comprehensive income:		
Changes in market value of available-for-sale securities:		
Unrealized gains, net of taxes of $1 for all periods	1	1
Reclassification of (gains) realized during the period, net of taxes of $0 for all periods	—	(1)
Total other comprehensive income	1	—
Total comprehensive income, net of taxes	$200	$173

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

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

	March 31, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$2,788	$2,305
Short-term investments	3,828	3,870
Accounts receivable, net of allowance for doubtful accounts of $2 and $2	830	1,220
Deferred tax assets	201	190
Other current assets	150	96
Total current assets	7,797	7,681
Property and equipment, net	886	845
Other assets, net	190	107
Deferred tax assets	89	60
Intangible assets, net	831	607
Goodwill	3,906	3,027
Total assets	$13,699	$12,327
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$93	$109
Accrued expenses and other	596	608
Due to related parties, net	26	18
Unearned revenues	2,572	2,558
Total current liabilities	3,287	3,293
Note payable to EMC	1,500	450
Unearned revenues	1,600	1,534
Other liabilities	242	234
Total liabilities	6,629	5,511
Contingencies (see Note I)		
Stockholders’ equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 130,884 and 130,349 shares	1	1
Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3	3
Additional paid-in capital	3,550	3,496
Accumulated other comprehensive income	5	4
Retained earnings	3,511	3,312
Total stockholders’ equity	7,070	6,816
Total liabilities and stockholders’ equity	$13,699	$12,327

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

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

	For the Three Months Ended March 31,	
	2014	2013
Operating activities:		
Net income	$199	$173
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	83	91
Stock-based compensation	128	116
Excess tax benefits from stock-based compensation	(15)	(22)
Deferred income taxes, net	(29)	(28)
Non-cash realignment charges	—	14
Other	1	(2)
Changes in assets and liabilities, net of acquisitions:		
Accounts receivable	418	380
Other assets	(29)	(41)
Due to/from related parties, net	33	59
Accounts payable	(11)	(8)
Accrued expenses	(104)	(115)
Income taxes payable	41	2
Unearned revenues	35	57
Net cash provided by operating activities	750	676
Investing activities:		
Additions to property and equipment	(77)	(78)
Purchases of available-for-sale securities	(531)	(737)
Sales of available-for-sale securities	411	486
Maturities of available-for-sale securities	153	182
Business acquisitions, net of cash acquired	(1,068)	(184)
Increase in restricted cash	(76)	(1)
Other investing	(10)	1
Net cash used in investing activities	(1,198)	(331)
Financing activities:		
Proceeds from issuance of common stock	88	68
Proceeds from issuance of note payable to EMC	1,500	—
Repayment of note payable to EMC	(450)	—
Reduction in capital from EMC	(24)	—
Repurchase of common stock	(169)	(182)
Excess tax benefits from stock-based compensation	15	22
Shares repurchased for tax withholdings on vesting of restricted stock	(29)	(22)
Net cash provided by (used in) financing activities	931	(114)
Net increase in cash and cash equivalents	483	231
Cash and cash equivalents at beginning of the period	2,305	1,609
Cash and cash equivalents at end of the period	$2,788	$1,840
Non-cash items:		
Changes in capital additions, accrued but not paid	$(7)	$(13)
Fair value of stock options assumed in acquisition	24	—

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

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

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (“VMware” or the “Company”) is the leader in virtualization infrastructure solutions utilized by organizations to help them transform the way they build, deliver and consume information technology (“IT”) resources. VMware’s virtualization infrastructure solutions, which include a suite of products designed to deliver a software-defined data center, run on industry-standard desktop computers and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

These accompanying unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. In the opinion of management, these unaudited condensed consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s condensed consolidated results of operations, financial position and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2014. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware’s 2013 Annual Report on Form 10-K.

As of March 31, 2014, EMC held approximately 79.6% of VMware’s outstanding common stock and 97.2% of the combined voting power of VMware’s outstanding common stock, including 43 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements.

Management believes the assumptions underlying the condensed consolidated financial statements are reasonable. However, the amounts recorded for VMware’s intercompany transactions with EMC and Pivotal Software, Inc. (“Pivotal”, previously known as “GoPivotal, Inc.”) may not be considered arm’s length with an unrelated third party. Therefore, the financial statements included herein may not necessarily reflect the financial position, results of operations and cash flows had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, VMware’s historical financial information is not necessarily indicative of what the Company’s financial position, results of operations and cash flows will be in the future if and when VMware contracts at arm’s length with unrelated third parties for the services the Company receives from and provides to EMC and Pivotal.

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and its subsidiaries after elimination of intercompany transactions and account balances between VMware and its subsidiaries. All intercompany transactions with EMC and Pivotal in the condensed consolidated statements of cash flows will be settled in cash, and changes in the current intercompany balances are presented as a component of cash flows from operating, investing and financing activities.

Use of Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses during the reporting periods, and the disclosure of contingent liabilities at the date of the financial statements. Estimates are used for, but not limited to trade receivable valuation, marketing rebates, useful lives assigned to fixed assets and intangible assets, valuation of goodwill and definite-lived intangibles, income taxes, stock-based compensation and contingencies. Actual results could differ from those estimates.

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B. Business Combinations, Goodwill and Intangible Assets, Net

Business Combinations

On February 24, 2014, VMware acquired for cash all of the outstanding membership units of A.W.S. Holding, LLC ("AirWatch Holding"), the sole member and equity holder of AirWatch LLC ("AirWatch"). AirWatch is a leader in enterprise mobile management and security solutions. VMware acquired AirWatch to expand VMware's solutions within the enterprise mobile and security space. The total preliminary purchase price of $1,128 million included cash of $1,104 million and the fair value of assumed unvested equity attributed to pre-combination services totaling $24 million.

Merger consideration totaling $300 million, including $75 million being held in escrow, will be payable to certain employees of AirWatch subject to specified future employment conditions and will be recognized as expense over the requisite service period on a straight-line basis. Compensation expense totaling $19 million was recognized from the date of acquisition through March 31, 2014.

VMware assumed all of AirWatch's unvested stock options and restricted stock outstanding at the completion of the acquisition with an estimated fair value of $134 million. Of the total consideration, $24 million was allocated to the purchase price and $110 million was allocated to future services and will be expensed over the remaining requisite service periods on a straight-line basis. The estimated fair value of the stock options assumed by the Company was determined using the Black-Scholes option pricing model. The share conversion ratio of 0.4 was applied to convert AirWatch's outstanding stock awards into shares of VMware's common stock.

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

Cash	$36	
Other current assets	60	
Intangible assets	250	
Goodwill	879	
Other acquired assets	17	
Total assets acquired	1,242	
Unearned revenues	(45	)
Other assumed liabilities	(69	)
Total liabilities assumed	(114	)
Fair value of assets acquired and liabilities assumed	$1,128	

The excess of the purchase consideration over the fair value of net tangible and identifiable intangible assets acquired was recorded as goodwill. The estimated fair value assigned to the tangible assets, identifiable intangible assets, and assumed liabilities were based on management's estimates and assumptions. The preliminary allocation of the purchase price was based on a preliminary valuation and assumptions and is subject to change within the purchase price allocation period. Additionally, indirect taxes, income taxes payable and deferred taxes may be subject to change as additional information is received and tax returns are finalized. VMware expects to finalize the allocation of purchase consideration as soon as practicable and no later than one year from the acquisition date.

Management expects that the majority of goodwill and identifiable intangible assets will be deductible for U.S. income tax purposes.

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

The following table summarizes the components of the intangible assets acquired and their estimated useful lives by VMware in conjunction with the acquisitions of AirWatch (amounts in table in millions):

	Useful Lives (in years)	Weighted-Average Useful Lives (in years)	Fair Value Amount
Purchased technology	2 - 6	5.9	$118
Customer relationships and customer lists	2 - 8	7.9	78
Trademarks and tradenames	8	8	40
Other	2 - 8	3.2	14
Total intangible assets, net, excluding goodwill			$250

The following net income pro forma financial information summarizes the combined net income for VMware and AirWatch, which was significant for purposes of the unaudited pro forma financial information disclosure, as though the companies were combined at the beginning of the Company’s fiscal year 2013. The amount of revenue of AirWatch was not considered material, and as such, has not been included in the unaudited pro forma financial information disclosure below.

Supplemental information on an unaudited pro forma basis, as if AirWatch had been acquired on January 1, 2013, is presented as follows (table in millions):

	For the Three Months Ended March 31,	
	2014	2013
Pro forma adjusted net income	$162	$114

Goodwill

The following table summarizes the changes in the carrying amount of goodwill for the three months ended March 31, 2014 (table in millions):

Balance, January 1, 2014	$3,027
Increase in goodwill related to business combination	879
Balance, March 31, 2014	$3,906

C. Realignment Charges

In January 2013, VMware approved and initiated a business realignment plan to streamline its operations. The realignment plan included the elimination of approximately 710 positions and personnel across all major functional groups and geographies. In the three months ended March 31, 2013, $63 million of realignment charges were recorded on the condensed consolidated statements of income, which consisted of workforce reduction charges and asset impairments. As of December 31, 2013, the plan had been completed.

D. 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 outstanding during the period, as calculated using the treasury stock method. Potentially dilutive securities primarily include unvested restricted stock units, stock options and purchase options under VMware’s employee stock purchase plan. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. VMware uses the two-class method to calculate 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.

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

The following table sets forth the computations of basic and diluted net income per share for the three months ended March 31, 2014 and 2013 (table in millions, except per share data):

	For the Three Months Ended March 31,	
	2014	2013
Net income	$199	$173
Weighted-average shares, basic for Class A and Class B	431	428
Effect of dilutive securities	4	5
Weighted-average shares, diluted for Class A and Class B	435	433
Net income per weighted-average share, basic for Class A and Class B	$0.46	$0.41
Net income per weighted-average share, diluted for Class A and Class B	$0.46	$0.40

For both the three months ended March 31, 2014 and 2013, stock options to purchase 1 million shares 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 March 31, 2014, the number of shares of restricted stock that were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive was not material. For the three months ended March 31, 2013, 2 million shares of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive.

E. Investments

Investments as of March 31, 2014 and December 31, 2013 consisted of the following (tables in millions):

	March 31, 2014			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. Government and agency obligations	$558	$—	$—	$558
U.S. and foreign corporate debt securities	2,314	6	(1)	2,319
Foreign governments and multi-national agency obligations	44	—	—	44
Municipal obligations	768	3	—	771
Mortgage-backed securities	137	—	(1)	136
Total investments	$3,821	$9	$(2)	$3,828

	December 31, 2013			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. Government and agency obligations	$537	$—	$—	$537
U.S. and foreign corporate debt securities	2,351	6	(3)	2,354
Foreign governments and multi-national agency obligations	37	—	—	37
Municipal obligations	811	3	—	814
Mortgage-backed securities	129	—	(1)	128
Total investments	$3,865	$9	$(4)	$3,870

VMware evaluated its fixed income investments as of March 31, 2014 and December 31, 2013 to determine whether or not any security had experienced an other-than-temporary decline in fair value. As of March 31, 2014 and December 31, 2013,

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

VMware did not consider any of its fixed income investments to be other-than-temporarily impaired. Both the realized gains and realized losses on fixed income investments in the three months ended March 31, 2014 and 2013 were not material.

Unrealized losses on investments as of March 31, 2014 and December 31, 2013, which have been in a net loss position for less than twelve months, were classified by investment category as follows (table in millions):

	March 31, 2014		December 31, 2013	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. and foreign corporate debt securities	$536	$(1)	$750	$(3)
Mortgage-backed securities	42	—	91	(1)
Total	$578	$(1)	$841	$(4)

As of March 31, 2014 and December 31, 2013, unrealized losses on investments in other investment categories, which have been in a net loss position for less than twelve months, were not material. Additionally, unrealized losses on investments, which have been in a net loss position for twelve months or greater, were not material as of March 31, 2014 and December 31, 2013.

Strategic Investments

VMware evaluated the strategic investments in its portfolio that are accounted under the cost method, to assess whether any of its strategic investments were other-than-temporarily impaired. VMware uses Level 3 inputs as part of its impairment analysis, including, pre- and post-money valuations of recent financing events and the impact of those on its fully diluted ownership percentages, as well as other available information regarding the issuer’s historical and forecasted performance. The estimated fair value of these investments is considered in VMware's impairment review if any events or changes in circumstances occur that might have a significant adverse effect on their value. During the three months ended March 31, 2014 and 2013, VMware did not recognize impairment charges on any of the strategic investments in its portfolio.

During the three months ended March 31, 2014, VMware did not have material realized gains or realized losses on strategic investments. During the three months ended March 31, 2013, VMware did not have realized gains or realized losses on strategic investments.

Contractual Maturities

The contractual maturities of investments held at March 31, 2014 consisted of the following (table in millions):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	$956	$956
Due after 1 year through 5 years	2,674	2,681
Due after 5 years	191	191
Total investments	$3,821	$3,828

F. Fair Value Measurements

Certain financial assets and liabilities are measured at fair value on a recurring basis.

VMware’s Level 1 classification of the fair value hierarchy includes money market funds and certain available-for-sale fixed income securities because these securities are valued using quoted prices in active markets for identical assets. Fixed income available-for-sale securities consist of high quality, investment-grade securities from diverse issuers. VMware’s Level 2 classification includes the remainder of the available-for-sale fixed income securities because these securities are priced using inputs other than quoted prices that are observable either directly or indirectly. The valuation techniques used to measure the fair value of financial instruments having Level 2 inputs were derived from non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques. VMware’s procedures include controls to ensure that appropriate fair values are recorded such as comparing prices obtained from multiple independent sources.

VMware is ultimately responsible for the financial statements and underlying estimates.

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

Additionally, VMware's Level 2 classification includes foreign currency forward contracts as the valuation inputs for these are based upon quoted prices and quoted pricing intervals from public data sources. The fair value of these contracts was not material for any period presented.

VMware does not have any material assets or liabilities that fall into Level 3 of the fair value hierarchy as of March 31, 2014 and December 31, 2013, and there have been no transfers between fair value measurement levels during the three months ended March 31, 2014 and 2013.

The following tables set 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 condensed consolidated balance sheets, that were required to be measured at fair value as of March 31, 2014 and December 31, 2013 (tables in millions):

	March 31, 2014		
	Level 1	Level 2	Total
Money-market funds	$2,255	$—	$2,255
U.S. Government and agency obligations	411	147	558
U.S. and foreign corporate debt securities	—	2,329	2,329
Foreign governments and multi-national agency obligations	—	44	44
Municipal obligations	—	771	771
Mortgage-backed securities	—	136	136
Total	$2,666	$3,427	$6,093

	December 31, 2013		
	Level 1	Level 2	Total
Money-market funds	$1,808	$—	$1,808
U.S. Government and agency obligations	385	152	537
U.S. and foreign corporate debt securities	—	2,366	2,366
Foreign governments and multi-national agency obligations	—	37	37
Municipal obligations	—	816	816
Mortgage-backed securities	—	128	128
Total	$2,193	$3,499	$5,692

G. Derivatives and Hedging Activity

VMware conducts business in several foreign currencies and has international sales and expenses denominated in foreign currencies, subjecting the Company to foreign currency risk. To mitigate this risk, VMware enters into hedging activities as described below. The counterparties to VMware's foreign currency forward contracts are multi-national commercial banks considered to be credit-worthy. VMware does not enter into speculative foreign exchange contracts for trading purposes.

Cash Flow Hedging Activities

To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware enters into foreign currency forward contracts. The Company designates these forward contracts as cash flow hedging instruments as the accounting criteria for such designation has been met. Therefore, the effective portion of gains or losses resulting from changes in the fair value of these hedges is initially reported in accumulated other comprehensive income on the condensed consolidated balance sheet and is subsequently reclassified to the related operating expense line item in the condensed consolidated statements of income in the same period that the underlying expenses are incurred. For the three months ended March 31, 2014 and 2013, the effective portion of gains or losses reclassified to the condensed consolidated statements of income were not material. Interest charges or "forward points" on VMware's forward contracts are excluded from the assessment of hedge effectiveness and are recorded in other income (expense), net in the condensed consolidated statements of income as incurred.

VMware generally enters into cash flow hedges semi-annually with maturities of six months or less. As of March 31, 2014 and December 31, 2013, VMware had forward contracts to purchase foreign currency designated as cash flow hedges with a total notional value of $41 million and $82 million, respectively. The fair value of these forward contracts was immaterial as of

March 31, 2014 and December 31, 2013, and therefore excluded from the fair value tables above. For the three months ended March 31, 2014 and 2013, all cash flow hedges were considered effective.

Balance Sheet Hedging Activities

In order to manage exposure to foreign currency fluctuations, VMware enters 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 condensed consolidated statements of income.

VMware's foreign currency forward contracts are generally traded on a monthly basis with a typical contractual term of one month. As of March 31, 2014 and December 31, 2013, VMware had outstanding forward contracts with a total notional value of $399 million and $498 million, respectively. The fair value of these forward contracts was immaterial as of March 31, 2014 and December 31, 2013 and therefore excluded from the fair value tables above. Losses derived from the settlement of foreign forward contracts during the three months ended March 31, 2014 were immaterial, and a gain of $11 million was recognized during the three months ended March 31, 2013. The combined gains and losses derived from the settlement of foreign forward contracts and the underlying foreign-currency denominated assets and liabilities were immaterial during the three months ended March 31, 2014 and 2013.

H. Unearned Revenues

Unearned revenues as of March 31, 2014 and December 31, 2013 consisted of the following (table in millions):

	March 31, 2014	December 31, 2013
Unearned license revenues	$459	$465
Unearned software maintenance revenues	3,378	3,304
Unearned professional services revenues	335	323
Total unearned revenues	$4,172	$4,092

Unearned license revenues are either recognized ratably, recognized upon delivery of existing or future products or services, or will be recognized ratably upon delivery of future products or services. Future products include, in some cases, products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive a promotional product at no additional charge. VMware regularly offers product promotions to improve awareness of its emerging products. To the extent promotional products have not been delivered and VSOE of fair value is not established, revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. Unearned license revenue may also be recognized ratably, which is generally due to a right to receive unspecified future products.

Unearned software maintenance revenues are attributable to VMware's maintenance contracts and are recognized ratably, typically over terms of one to five years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are recognized as the services are delivered.

I. Contingencies

Litigation

VMware is subject to legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to commercial, product liability, intellectual property, employment, class action, whistleblower and other matters. In the ordinary course of business, VMware also receives inquiries from and has ongoing discussions with government entities regarding the compliance of its contracting and sales practices with laws and regulations. VMware accrues for a liability when and if a determination has been made that a loss is both probable of occurrence and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination of probability and the determination as to whether a loss is reasonably estimable. VMware considers the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. As of March 31, 2014 and December 31, 2013, the amounts accrued were not material. To the extent there is a reasonable possibility that the losses could exceed the amounts already accrued, management believes that the amount of any such additional loss would also be immaterial to VMware’s condensed consolidated financial position, results of operations and cash flows.

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J. Stockholders' Equity
VMware Stock Repurchases
The following table summarizes stock repurchase authorizations that remain open as of March 31, 2014 (amounts in table in millions):

Authorization Date	Amount Authorized	Expiration Date	Status
August 2013	$700	End of 2015	Open

From time to time, future stock repurchases may be made pursuant to the August 2013 authorization in open market transactions or privately negotiated transactions as permitted by securities laws and other legal requirements. VMware is not obligated to purchase any shares under its stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased will depend on a variety of factors, including VMware's stock price, cash requirements for operations and business combinations, corporate and regulatory requirements and other market and economic conditions. Purchases can be discontinued at any time that VMware feels additional purchases are not warranted. All shares repurchased under VMware's stock repurchase programs are retired.
The following table summarizes stock repurchase activity in the three months ended March 31, 2014 and 2013 (table in millions, except per share amounts):

	For the Three Months Ended March 31,	
	2014	2013
Aggregate purchase price	$ 169	$ 182
Class A common shares repurchased	2	2
Weighted-average price per share	$ 95.56	$ 77.05

The amount of repurchased shares includes commissions and was classified as a reduction to additional paid-in capital. As of March 31, 2014, the cumulative authorized amount remaining for repurchase was $491 million.
VMware Stock Options
The following table summarizes option activity since January 1, 2014 (shares in millions):

	Number of Shares	Weighted-Average Exercise Price (per share)
Outstanding, January 1, 2014	6	$ 44.12
Granted	1	14.64
Exercised	(1)	39.13
Outstanding, March 31, 2014	6	38.12

The above table includes stock options substituted for unvested stock options in connection with business combinations. As a result, the weighted-average exercise price per share may be less than the VMware stock price at time of grant.
VMware Restricted Stock
VMware restricted stock primarily consists of restricted stock unit ("RSU") awards granted to employees. RSUs are valued based on the VMware stock price on the date of grant, and shares underlying RSU awards are not issued until the restricted stock units vest. Upon vesting, each RSU converts into one share of VMware Class A common stock. VMware restricted stock also includes performance stock unit ("PSU") awards, which have been granted to certain of VMware's executives and employees. The PSU awards include performance conditions and, in certain cases, a time-based vesting component. Upon vesting, each PSU award will convert into VMware's Class A common stock at various ratios ranging from 0.5 to 3.0 shares per PSU, depending upon the degree of achievement of the performance target designated by each individual award. If minimum performance thresholds are not achieved, then no shares will be issued.

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VMware, Inc.
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The following table summarizes restricted stock activity since January 1, 2014 (units in millions):

	Number of Units	Weighted-Average Grant Date Fair Value (per unit)
Outstanding, January 1, 2014	13	$85.85
Granted	1	97.60
Vested	(1)	92.76
Outstanding, March 31, 2014	13	86.15

As of March 31, 2014, the 13 million units outstanding included 12 million of RSUs and 1 million of PSUs. The above table includes RSUs substituted for unvested RSUs in connection with business combinations.

The total fair value of VMware restricted stock, including restricted stock, RSUs and PSUs, that vested in the three months ended March 31, 2014 was $72 million. As of March 31, 2014, restricted stock representing 13 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of $1,349 million based on VMware's closing price as of March 31, 2014.

Accumulated Other Comprehensive Income

The changes in components of accumulated other comprehensive income in the three months ended March 31, 2014 were as follows (table in millions):

	Unrealized Gains on Available-for-Sale Securities	Total
Balance, January 1, 2014	$4	$4
Other comprehensive gain before reclassifications, net of taxes of $1	1	1
Other comprehensive income, net	1	1
Balance, March 31, 2014	$5	$5

Gains (losses) on VMware's available-for-sale securities are reclassified to investment income on the condensed consolidated statement of income in the same period that they are realized.

The effective portion of gains (losses) resulting from changes in the fair value of forward contracts designated as cash flow hedging instruments are reclassified to its related operating expense line item on the condensed consolidated statement of income in the same period that the underlying expenses are incurred. The amounts recorded to their related operating expense line items on the condensed consolidated statements of income in the three months ended March 31, 2014 were not material.

K. Related Parties

EMC Reseller Arrangement, Other Services and Note Payable

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

- Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's products and sells them to end-users.
- EMC purchases products and services from VMware for internal use.
- VMware recognizes revenues for professional services based upon such contractual agreements with EMC.
- From time to time, VMware and EMC enter into agreements to collaborate on technology projects, and EMC pays VMware for services that VMware provides to EMC in connection with such projects.

Information about VMware's revenues and receipts and unearned revenues from such arrangements with EMC for the three months ended March 31, 2014 and 2013 consisted of the following (table in millions):

	Revenues and Receipts from EMC		Unearned Revenues from EMC	
	For the Three Months Ended March 31,		As of March 31,	As of December 31,
	2014	2013	2014	2013
Reseller revenues	$ 46	$ 36	$ 173	$ 188
Professional services revenues	23	15	13	12
Internal-use revenues	7	3	14	20
Collaborative technology project receipts	—	2	n/a	n/a

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

- VMware purchases products and services for internal use from EMC.
- From time to time, VMware and EMC enter into agreements to collaborate on technology projects, and VMware pays EMC for services provided to VMware by EMC related to such projects.
- In certain geographic regions where VMware does not have an established legal entity, VMware contracts with EMC subsidiaries for support services and EMC personnel who are managed by VMware. The costs incurred by EMC on VMware's behalf related to these employees are 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 condensed consolidated statements of income and primarily include salaries, benefits, travel and rent. EMC also incurs certain administrative costs on VMware's behalf in the U.S. that are recorded as expenses in VMware's condensed consolidated statements of income.
- VMware incurs interest expense on its note payable with EMC. See below.

Information about VMware's costs from such arrangements with EMC for the three months ended March 31, 2014 and 2013 consisted of the following (table in millions):

	For the Three Months Ended March 31,	
	2014	2013
Purchases of products and services	$ 21	$ 13
Collaborative technology project costs	3	1
EMC subsidiary support and administrative costs	41	36
Interest expense on note payable	5	1

Certain Stock-Based Compensation

Effective September 1, 2012, Pat Gelsinger succeeded Paul Maritz as Chief Executive Officer of VMware. Prior to joining VMware, Pat Gelsinger was the President and Chief Operating Officer of EMC Information Infrastructure Products. Paul Maritz remains a board member of VMware and currently serves as Chief Executive Officer of Pivotal, a majority-owned subsidiary of EMC in which VMware has an ownership interest, and as an executive officer of EMC. Both Paul Maritz and Pat Gelsinger retain and continue to vest in certain of their respective equity awards that they held as of September 1, 2012. Stock-based compensation related to Pat Gelsinger's EMC awards will be recognized on VMware's condensed consolidated statements of income over the awards' remaining requisite service periods. Effective since September 1, 2012, stock-based compensation costs related to Paul Maritz's VMware awards have been charged to EMC and have not been recognized by VMware.

Pivotal

During 2013, VMware transferred certain assets and liabilities to Pivotal. VMware contributed certain assets, including intellectual property, to Pivotal, and Pivotal assumed substantially all liabilities, related to certain of its Cloud Application Platform products and services, including VMware's Cloud Foundry, VMware vFabric (including

Spring and GemFire) and

Cetas organizations, except for certain tangible assets related to Cloud Foundry. As of March 31, 2014, VMware's ownership interest in Pivotal is 28%.

Additionally, VMware and Pivotal entered into an agreement pursuant to which VMware will act as the selling agent for the products and services it contributed to Pivotal in exchange for a customary agency fee. In the three months ended March 31, 2014, VMware recognized revenues of $2 million from its contractual arrangement with Pivotal.

VMware also agreed to provide various transition services to Pivotal. Pursuant to the support agreement, costs incurred by VMware to support Pivotal services are reimbursed to VMware by Pivotal. During the three months ended March 31, 2014, VMware provided transition services of $2 million that are reimbursable by Pivotal and which were recorded as a reduction to the costs VMware incurred. Additionally, VMware purchased an immaterial amount of products and services for internal use from Pivotal in the three months ended March 31, 2014.

Tax Sharing Agreement with EMC

Pursuant to a tax sharing agreement between VMware and EMC, VMware has made payments to EMC and EMC has made payments to VMware. The following table summarizes these payments made between VMware and EMC during the three months ended March 31, 2014 and 2013 (table in millions):

	For the Three Months Ended March 31,	
	2014	2013
Payments from VMware to EMC	$20	$—

Payments between VMware and EMC under the tax sharing agreement relate to VMware's portion of federal income taxes on EMC's consolidated tax return as well as the state payments for combined states. Payments from EMC to VMware relate to periods where VMware had a stand-alone loss for U.S. federal and state income tax purposes or where VMware had federal tax credits in excess of federal tax liabilities. Payments from VMware to EMC are for estimated tax payments primarily for U.S. federal income tax purposes. The amounts that VMware either pays to or receives from EMC for its portion of federal income taxes on EMC’s consolidated tax return differ from the amounts VMware would owe on a separate return basis and the difference is presented as a component of stockholders’ equity. In the three months ended March 31, 2014 and 2013, the difference between the amount of tax calculated on a stand-alone basis and the amount of tax calculated per the tax sharing agreement was not material.

Due To/From Related Parties, Net

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

	As of March 31, 2014
Due to EMC	$(70)
Due from EMC	53
Due to Pivotal	(11)
Due from Pivotal	2
Due (to) from related parties, net	$(26)
Income tax payable due to EMC	$(30)

Balances due to or from related parties, which are unrelated to tax obligations, are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

Note Payable to EMC

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

The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: $680 million due May 1, 2018, $550 million due May 1, 2020 and $270 million due December 1, 2022. The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. For the three months ended March 31, 2014 and 2013, $5 million and $1 million, respectively, of interest expense were recorded related to the notes payable. No additional repayments of principal were made during the first three months of 2014.

L. Segment Information

VMware operates in one reportable operating segment, thus all required financial segment information can be found in the condensed consolidated financial statements. Operating segments are defined as components of an enterprise about which separate financial information is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and assessing performance. VMware's chief operating decision maker allocates resources and assesses performance based upon discrete financial information at the consolidated level.

Revenues by geographic area for the three months ended March 31, 2014 and 2013 were as follows (table in millions):

	For the Three Months Ended March 31,	
	2014	2013
United States	$649	$568
International	711	623
Total	$1,360	$1,191

It is not practicable for VMware to determine revenues by country other than the United States for the three months ended March 31, 2014 and 2013.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of March 31, 2014 and December 31, 2013 were as follows (table in millions):

	March 31, 2014	December 31, 2013
United States	$776	$741
International	60	58
Total	$836	$799

No individual country other than the United States accounted for 10% or more of these assets as of March 31, 2014 and December 31, 2013, respectively.

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

Overview

We are the leader in virtualization infrastructure solutions utilized by organizations to help transform the way they build, deliver and consume information technology ("IT") resources. We develop and market our product and service offerings within three main product groups, and we also seek to leverage synergies across these three product areas.

- SDDC or Software-Defined Data Center
- End-User Computing
- Hybrid Cloud Computing

We pioneered the development and application of virtualization technologies with x86 server-based computing, separating application software from the underlying hardware. The benefits to our customers include lower IT costs and a more automated and resilient systems infrastructure capable of responding dynamically to variable business demands. Our broad and proven suite of virtualization technologies are designed to establish secure and, reliable IT environments and address a range of complex IT challenges that include cost reduction, operational inefficiencies, access to cloud computing capacity, business continuity and corporate end-user computing device management. Our solutions enable organizations to aggregate multiple servers, storage infrastructure and networks together into shared pools of capacity that can be allocated dynamically, securely and reliably to applications as needed. Once created, these internal computing infrastructures, or "clouds," can be dynamically extended by our customers to the public cloud environment. When linked, this results in a "hybrid" computing cloud of highly available internal and external computing resources that organizations can access on demand. Our customers' deployments range in size from a single virtualized server for small businesses to thousands of virtual machines for our Fortune 1000 enterprise customers.

We have articulated a vision for the software-defined data center ("SDDC"), where increasingly infrastructure is virtualized and delivered as a service, enabling control of the data center to be entirely automated by software. The SDDC is designed to transform the data center into an on-demand service that addresses application requirements by abstracting, pooling, and automating the services that are required from the underlying hardware. SDDC promises to dramatically simplify data center operations and lower costs. The VMware vCloud Suite, which is our first integrated solution toward realizing the SDDC vision and is based upon our VMware vSphere virtualization platform, was initially introduced in late 2012. The VMware vCloud Suite addresses virtualization of not only CPU and memory, but also networks and associated security services. In addition, the vCloud Suite delivers a new approach to management, leveraging policy-based automation. VMware vCloud Suite is engineered for hybrid cloud computing so that it federates with other pools of infrastructure.

We believe that our solutions enable organizations to realize significant operational and cost efficiencies as they transition their underlying legacy IT infrastructure. We work closely with more than 1,200 technology partners, including leading server, microprocessor, storage, networking, software and security vendors. We have shared the economic opportunities surrounding virtualization with our partners by facilitating solution development through open application programming interface ("APIs") formats and protocols and providing access to our source code and technology. The endorsement and support of our partners further enhances the awareness, reputation and adoption of our virtualization solutions.

We expect to grow our business by building long-term relationships with our customers, which includes continuing to sell our solutions through enterprise license agreements ("ELAs"). ELAs are comprehensive volume license offerings offered both directly by us and through certain channel partners that provide for multi-year maintenance and support. Under a typical ELA, a portion of the revenues is attributed to license revenues and the remainder is primarily attributed to software maintenance revenues. In addition, the initial maintenance and support period is typically longer for ELAs compared to our transactional business. We believe that ELAs facilitate our objective of building long-term relationships with our customers as they commit to our virtual infrastructure solutions in their data centers. ELAs comprised 25% and 29% of our overall sales during the first quarters of 2014 and 2013, respectively, with the balance primarily represented by our non-ELA, or transactional business.

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Acquisition of AirWatch
On February 24, 2014, we acquired A.W.S. Holding, LLC (“AirWatch Holding”), the sole member and equity holder of AirWatch LLC (“AirWatch”). AirWatch is a leader in enterprise mobile management and security solutions. The acquisition of AirWatch expands our portfolio of mobile solutions within the enterprise mobile and security space. Revenues recognized subsequent to the closing date of the acquisition of AirWatch were not significant. We expect that the acquisition of AirWatch will increase our operating expenses during 2014 specifically related to acquisition-related costs as well as increased compensation costs.
Results of Operations
Revenues
Our revenues in the first quarter of 2014 and 2013 were as follows:

	For the Three Months Ended March 31,				
	2014	2013	$ Change	% Change	
Revenues:					
License	$561	$488	$72	15	%
Services:					
Software maintenance	701	605	96	16	
Professional services	98	98	—	—	
Total services	799	703	96	14	
Total revenues	$1,360	$1,191	$169	14	
Revenues:					
United States	$649	$568	$80	14	%
International	711	623	89	14	
Total revenues	$1,360	$1,191	$169	14	

License Revenues
License revenues in the first quarter of 2014 were up 15% compared to the first quarter of 2013. Our revenue growth rate was favorably impacted during the first quarter of 2014 by an increase in license sales volume compared to the same period in the prior year. License revenue recognized during the first quarter of 2014 relating to sales transactions where revenue recognition was deferred at the time of sale also increased compared to the same period in the prior year.
Our revenue growth rate was negatively impacted by the contribution to Pivotal and the disposition of other net assets under our realignment plan. License revenues related to Pivotal and all dispositions under our realignment plan were $12 during the first quarter of 2013.
Services Revenues
In the first quarter of 2014, software maintenance revenues benefited from renewals, multi-year software maintenance contracts sold in previous periods, and additional maintenance contracts sold in conjunction with new software license sales. In each period presented, customers bought, on 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 and hybrid cloud strategy.
Our revenue growth rate was negatively impacted by the contribution to Pivotal and the disposition of other net assets under our realignment plan. Service revenues related to Pivotal and all dispositions under our realignment plan were $30 during the first quarter of 2013.
Foreign Currency
We invoice and collect in the Euro, the British Pound, the Japanese Yen, the Australian Dollar and Chinese Renminbi in their respective regions. As a result, our total revenues are affected by changes in the value of the U.S. Dollar against these currencies. Foreign currencies did not have a material impact when comparing license revenues in the first quarter of 2014 to the first quarter of 2013.

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Unearned Revenues

Our unearned revenues as of March 31, 2014 and December 31, 2013 were as follows:

	March 31, 2014	December 31, 2013
Unearned license revenues	$459	$465
Unearned software maintenance revenues	3,378	3,304
Unearned professional services revenues	335	323
Total unearned revenues	$4,172	$4,092

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or will be recognized ratably over the term of the arrangement. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive a promotional product at no additional charge and to the extent promotional products have not been delivered and vendor-specific objective evidence (“VSOE”) of fair value cannot be established, the revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. Increasingly, unearned license revenue may also be recognized ratably, which is generally due to a right to receive unspecified future products or a lack of VSOE of fair value on the software maintenance element of the arrangement. The amount of total unearned license revenues may vary over periods due to the type and level of promotions offered, the portion of license contracts sold with a ratable recognition element, and when promotional products are delivered upon general availability.

Unearned software maintenance revenues are attributable to our maintenance contracts and are generally recognized ratably, typically over terms from one to five years with a weighted-average remaining term at March 31, 2014 of approximately 1.9 years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

Cost of License and Services Revenues, and Operating Expenses

Cost of License Revenues

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

	For the Three Months Ended March 31,			
	2014	2013	$ Change	% Change
Cost of license revenues	$49	$56	$(7)	(13)%
Stock-based compensation	1	1	—	—
Total expenses	$50	$57	$(7)	(12)
% of Total revenues	4%	5%		

Cost of license revenues decreased in the first quarter of 2014 compared to the first quarter of 2013 primarily due to a decrease of $13 in amortization of capitalized software development costs which was partially offset by an increase in cost of fulfillment of our software. As of December 31, 2013, all previously capitalized software development costs were fully amortized and as such we do not expect significant amortization of capitalized software development costs during 2014.

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Cost of Services Revenues

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

	For the Three Months Ended March 31,			
	2014	2013	$ Change	% Change
Cost of services revenues	$ 142	$ 118	$ 25	21 %
Stock-based compensation	9	7	2	27
Total expenses	$ 151	$ 125	$ 27	21
% of Total revenues	11 %	10 %		

Cost of services revenues increased in the first quarter of 2014 compared to the first quarter of 2013 primarily due to an increase of $22 in employee-related expenses and an increase in costs we incur to provide technical support. These increases were generally proportional to the increases in services revenues for the same comparable period. Equipment and depreciation costs also contributed to the increase in cost of services revenues. The increases were partially offset by a decrease of $10 of operating expenses related to Pivotal.

Research and Development Expenses

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

	For the Three Months Ended March 31,			
	2014	2013	$ Change	% Change
Research and development	$ 233	$ 209	$ 24	12 %
Stock-based compensation	60	62	(2)	(3)
Total expenses	$ 293	$ 271	$ 22	8
% of Total revenues	22 %	23 %		

R&D expenses increased in the first quarter of 2014 compared to the first quarter of 2013 primarily due to growth in employee-related expenses of $27, which was primarily driven by planned incremental growth in headcount. Additionally, contractor costs and equipment and depreciation expenses also increased by $9 in the first quarter of 2014 compared to the same comparable period. The increases in expenses were partially offset by a decrease of $15 of research and development expenses related to Pivotal.

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Sales and Marketing Expenses

Our sales and marketing expenses include personnel costs, sales commissions and related overhead associated with the sale and marketing of our license and services offerings, as well as the cost of product launches. Sales commissions are generally earned and expensed when a firm order is received from the customer and may be expensed in a period other than the period in which the related revenue is recognized. Sales and marketing expenses also include the net impact from the expenses incurred and fees generated by certain marketing initiatives, including o