VMWARE, INC.
Form 10-Q
August 08, 2008
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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 June 30, 2008

OR

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

Commission File Number 001-33622

VMWARE, INC.

(Exact name of registrant as specified in its charter)

Delaware	**94-3292913**
(State or other jurisdiction of incorporation or organization)	**(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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer ¨ Accelerated filer ¨ Non-accelerated filer x Smaller reporting company ¨

(Do not check if a smaller reporting company)

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

As of August 1, 2008, the number of shares of common stock, par value $.01 per share, of the registrant outstanding was 388,682,977, of which 88,682,977 shares were Class A common stock and 300,000,000 were Class B common stock.

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PART I

FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

VMware, Inc.

CONSOLIDATED BALANCE SHEETS

(in thousands, except per share amounts)

(unaudited)

	June 30, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,540,260	$ 1,231,168
Accounts receivable, less allowance for doubtful accounts of $1,160 and $1,603	309,719	283,824
Deferred tax asset, current portion	31,470	54,386
Income taxes receivable, net	99,649	
Other current assets	46,741	33,956
Total current assets	2,027,839	1,603,334
Property and equipment, net	349,851	276,983
Other assets, net	62,909	71,695
Deferred tax asset, net of current portion	48,261	72,249
Intangible assets, net	33,783	32,073
Goodwill	684,338	639,366
Total assets	$ 3,206,981	$ 2,695,700
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 66,986	$ 61,503
Accrued expenses	171,283	173,610
Due to EMC, net	33,345	2,759
Income taxes payable, current portion		68,823
Deferred revenue, current portion	450,326	363,317
Total current liabilities	721,940	670,012
Note payable to EMC	450,000	450,000
Deferred revenue, net of current portion	270,962	189,479
Deferred tax liability	25,613	27,327
Income taxes payable, net of current portion	25,471	18,265
Commitments and contingencies (see Note J)		
Stockholders equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 87,959 and 82,924 shares	880	829
Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3,000	3,000

Additional paid-in capital	1,668,847	1,352,788
Retained earnings (accumulated deficit)	40,268	(16,000)
Total stockholders equity	1,712,995	1,340,617
Total liabilities and stockholders equity	$ 3,206,981	$ 2,695,700

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 June 30, 2008	For the Three Months Ended June 30, 2007	For the Six Months Ended June 30, 2008	For the Six Months Ended June 30, 2007
Revenues:				
License	$ 284,233	$ 204,048	$ 578,213	$ 373,605
Services	171,895	92,777	316,090	181,915
	456,128	296,825	894,303	555,520
Operating expenses:				
Cost of license revenues	21,639	20,832	44,498	41,388
Cost of services revenues	58,892	27,985	113,203	51,453
Research and development	114,128	71,581	233,383	126,539
Sales and marketing	158,307	98,989	307,564	185,696
General and administrative	42,162	30,703	86,264	57,327
Operating income	61,000	46,735	109,391	93,117
Investment income	6,310	2,714	14,314	4,419
Interest expense with EMC, net	(3,579)	(7,791)	(9,398)	(6,519)
Other income (expense), net	370	(146)	824	(87)
Income before taxes	64,101	41,512	115,131	90,930
Income tax provision	11,765	7,288	19,740	15,626
Net income	$ 52,336	$ 34,224	$ 95,391	$ 75,304
Net income per weighted-average share, basic for Class A and Class B	$ 0.14	$ 0.10	$ 0.25	$ 0.23
Net income per weighted-average share, diluted for Class A and Class B	$ 0.13	$ 0.10	$ 0.24	$ 0.23
Weighted-average shares, basic for Class A and Class B	382,931	332,500	381,976	332,500
Weighted-average shares, diluted for Class A and Class B	398,979	332,501	398,258	332,501

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

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VMware, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	For the Three Months Ended June 30, 2008	For the Three Months Ended June 30, 2007	For the Six Months Ended June 30, 2008	For the Six Months Ended June 30, 2007
Cash flows from operating activities:				
Net income	$ 52,336	$ 34,224	$ 95,391	$ 75,304
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	39,459	23,622	76,893	44,819
Stock-based compensation, excluding amounts capitalized	42,072	15,973	84,233	27,617
Excess tax benefits from stock-based compensation	(56,735)		(79,427)	
Other adjustments	(278)	(429)	1,058	134
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	(25,132)	(52,451)	(24,286)	(6,090)
Other assets	(4,687)	(8,054)	(13,281)	(8,660)
Due to/from EMC, net	23,040	(33,902)	40,286	(90,080)
Accounts payable	(18,602)	14,349	(11,130)	12,381
Accrued expenses	11,349	10,508	(3,956)	11,468
Income taxes payable/receivable, net	(75,412)	22,813	(97,008)	37,509
Deferred income taxes, net	83,063	(16,037)	46,719	(22,628)
Deferred revenue	80,161	75,015	168,322	108,755
Net cash provided by operating activities	150,634	85,631	283,814	190,529
Cash flows from investing activities:				
Additions to property and equipment	(51,899)	(32,335)	(100,921)	(48,919)
Capitalized software development costs	(11,770)	(3,872)	(15,934)	(10,544)
Purchase of long-term investment	(1,750)		(1,750)	
Business acquisitions, net of cash acquired		(21,414)	(33,289)	(21,410)
Decrease (increase) in restricted cash		(6,382)	896	(5,694)
Net cash used in investing activities	(65,419)	(64,003)	(150,998)	(86,567)
Cash flows from financing activities:				
Proceeds from issuance of common stock	109,658		133,327	
Excess tax benefits from stock-based compensation	56,735		79,427	
Shares repurchased for tax withholdings on vesting of restricted stock	(17,359)		(36,478)	
Net cash provided by financing activities	149,034		176,276	
Net increase in cash and cash equivalents	234,249	21,628	309,092	103,962
Cash and cash equivalents at beginning of the period	1,306,011	258,468	1,231,168	176,134
Cash and cash equivalents at end of the period	$ 1,540,260	$ 280,096	$ 1,540,260	$ 280,096
Non-cash items:				

Changes in capital additions, accrued but not paid	$	(6,914)	$	$	12,196	$

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 virtual infrastructure software solutions from the desktop to the datacenter. Our virtual infrastructure software solutions run on industry-standard desktops and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

These accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the SEC) for interim financial reporting. These consolidated financial statements are unaudited and, in the opinion of management, include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware s consolidated financial condition, results of operations and cash flows for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2008. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s 2007 Annual Report on Form 10-K.

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

Principles of Consolidation

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

Use of Accounting Estimates

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

New Accounting Pronouncements

VMware adopted Financial Accounting Standards (FAS) FAS No. 157, Fair Value Measurements (FAS No. 157) on January 1, 2008. FAS No. 157 defines fair value, establishes a methodology for measuring fair value and expands the

VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)

(unaudited)

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

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

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

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

B. Significant Accounting Policies

Revenue Recognition

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

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

License revenue

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

VMware licenses its software under perpetual licenses through its direct sales force and through its channel of distributors, resellers, x86 system vendors and systems integrators. VMware defers revenue relating to products that have shipped into its channel until its products are sold through the channel. VMware obtains sell-through information from distributors and certain resellers on a monthly basis. For VMware s channel partners who do not report sell-through data, VMware determines sell-through based on payment of such distributors and certain resellers accounts receivable balances and other relevant factors. For software sold by x86 system vendors and bundled with their hardware, revenue is recognized in arrears upon the receipt of binding royalty reports.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)

(unaudited)

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

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

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

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

Services revenue

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

Multiple element arrangements

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

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

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

Research and Development and Capitalized Software Development Costs

Costs incurred in the research and development of new software products are expensed as incurred until technological feasibility is established. Technological feasibility is defined as the earlier of the completion of a detailed program design or a working model. Such costs include salaries and benefits, including stock-based compensation, consultants, facilities-related costs, equipment costs and depreciation. Software development costs incurred subsequent to establishing technological feasibility through the general release of the software products are capitalized. Upon general release of the products, capitalized costs are amortized over periods ranging from 18 to 24 months, which represent the products estimated useful lives.

VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)

(unaudited)

Unamortized software development costs were $57.5 million and $66.8 million at June 30, 2008 and December 31, 2007, respectively, and are included in other assets, net.

In the three months ended June 30, 2008 and 2007, VMware capitalized $14.8 million (including $3.0 million of stock-based compensation) and $4.4 million (including $0.5 million of stock-based compensation), respectively, of costs incurred for the development of software products. In the six months ended June 30, 2008 and 2007, VMware capitalized $19.9 million (including $3.9 million of stock-based compensation) and $12.0 million (including $1.5 million of stock-based compensation), respectively, of costs incurred for the development of software products. Amortization expense from capitalized amounts was $14.3 million and $8.7 million in the three months ended June 30, 2008 and 2007, respectively. Amortization expense from capitalized amounts was $29.1 million and $16.7 million in the six months ended June 30, 2008 and 2007, respectively.

Long-Lived Assets

Intangible assets, other than goodwill, are amortized over their estimated useful lives which range from one to nine years. In the three months ended June 30, 2008 and 2007, VMware amortized $3.8 million and $6.3 million, respectively, for purchased intangible assets. The amortization expense for the six months ended June 30, 2008 and 2007 was $7.7 million and $12.6 million, respectively.

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

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

Comprehensive Income

Comprehensive income is equal to net income.

C. Net Income per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. For purposes of computing basic net income per share, the weighted-average number of outstanding shares of common stock excludes potentially dilutive securities. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the period. Potentially dilutive securities include stock options, unvested restricted stock units, unvested restricted stock awards and other unvested restricted stock, using the treasury stock method. Securities are excluded from the computations of diluted net income per share if their effect would be anti-dilutive. As of June 30, 2008, VMware had 86.2 million shares of Class A common stock and 300.0 million shares of Class B common stock outstanding that were included in the calculation of basic earnings per share. For purposes of calculating earnings per share, VMware uses the two-class method. As both classes share the same rights in dividends, basic and diluted earnings per share are the same for both classes.

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)

(unaudited)

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
Net income	$ 52,336	$ 34,224	$ 95,391	$ 75,304
Weighted-average shares, basic for Class A and Class B	382,931	332,500	381,976	332,500
Effect of dilutive securities	16,048	1	16,282	1
Weighted-average shares, diluted for Class A and Class B	398,979	332,501	398,258	332,501
Net income per weighted-average share, basic for Class A and Class B	$ 0.14	$ 0.10	$ 0.25	$ 0.23
Net income per weighted-average share, diluted for Class A and Class B	$ 0.13	$ 0.10	$ 0.24	$ 0.23

For the three and six months ended June 30, 2008, stock options to acquire 4.5 million and 4.3 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 and six months ended June 30, 2007, stock options to acquire 35.7 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.

D. Fair Value Measurements

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

VMware s cash and cash equivalents as of June 30, 2008 were $1.5 billion and included $1.0 billion of money market securities, which are classified within Level 1 of the fair value hierarchy because the securities are valued using quoted prices in active markets for identical assets. There were no other financial assets or liabilities carried at fair value as of June 30, 2008.

E. Business Acquisitions, Goodwill and Intangible Assets

Business Acquisitions

VMware acquired two companies during the first half of 2008 for aggregate cash consideration of $33.3 million, net of cash acquired and including transaction costs. The acquisitions were not material, neither individually nor in the aggregate. Acquired intangibles totaled $9.4 million and have estimated useful lives of between one and eight years. The excess of the purchase price over the fair value of the net assets acquired was $38.6 million and is classified as goodwill on the consolidated balance sheet as of June 30, 2008.

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

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)

(unaudited)

On May 28, 2008, VMware announced a definitive agreement to acquire a privately-held application performance management software company. On July 1, 2008, the Company announced that it completed this acquisition. See Note N to VMware s consolidated financial statements.

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

Goodwill

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

Balance, January 1, 2008	$ 639,366
Goodwill acquired	38,575
Adjustments to purchase price allocations	6,397
Balance, June 30, 2008	$ 684,338

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

F. Property and Equipment, net

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

	June 30, 2008	December 31, 2007
Furniture and fixtures	$ 42,162	$ 30,678
Equipment and software	237,398	156,641
Buildings and improvements	177,149	129,752
Construction in progress	5,163	32,097
	461,872	349,168
Accumulated depreciation	(112,021)	(72,185)
	$ 349,851	$ 276,983

Depreciation expense was $21.4 million and $40.1 million for the three and six months ended June 30, 2008, respectively, and $8.6 million and $15.5 million for the three and six months ended June 30, 2007, respectively.

During the second quarter of 2008, VMware reviewed and revised the estimated useful lives of certain assets after considering (i) the estimated future benefits the Company expects to receive from those assets, (ii) the pattern of consumption of those benefits and (iii) the information available regarding those benefits. VMware increased the estimated useful lives of computers and other related equipment, which had carrying values of $42.6 million and $17.4 million, respectively, as of March 31, 2008, from 2 years to 3 years to match the length of the related warranty contracts. These changes in estimates will be accounted for prospectively. These changes in estimates reduced depreciation expense by $4.8 million and increased both basic and diluted earnings per share by $0.01 from what would have been reported otherwise in the second quarter of 2008.

G. Accrued Expenses

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

	June 30, 2008	December 31, 2007
Salaries, commissions, and benefits	$ 91,095	$ 93,678
Accrued partner liabilities	49,586	42,852
Other	30,602	37,080
	$ 171,283	$ 173,610

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VMWARE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS - (continued)

(unaudited)

H. Income Taxes

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

VMware s effective income tax rate was 18.4% and 17.1% for the three and six months ended June 30, 2008, respectively. The effective income tax rate was 17.6% and 17.2% for the three and six months ended June 30, 2007, respectively. The increase in the effective rate for the three months ended June 30, 2008 compared to the three months ended June 30, 2007 was primarily attributable to the expiration of the federal research tax credit, an increase in other non-deductible permanent differences and an increase in transfer pricing adjustments relative to the Company s forecasted annual pre-tax income. These increases in the effective tax rate were largely offset by the tax benefit resulting from a change in the mix of income from U.S. sources to international sources. Income earned abroad is considered indefinitely reinvested in the Company s foreign operations and no provision for U.S. taxes has been provided. The effective tax rates for the six months ended June 30, 2008 and June 30, 2007 were essentially the same at 17.1% and 17.2%, respectively. VMware derived a tax benefit resulting from a change in the mix of income from U.S. sources to international sources. This tax benefit, which decreased the effective tax rate, was largely offset by the increases in the effective tax rate primarily attributable to the expiration of the federal research tax credit, an increase in other non-deductible permanent differences and an increase in transfer pricing adjustments relative to the Company s forecasted annual pre-tax income. Income earned abroad is considered indefinitely reinvested in the Company s foreign operations and no provision for U.S. taxes has been provided.

As of June 30, 2008, VMware had $28.0 million of gross unrecognized tax benefits and $26.1 million of unrecognized tax benefits, net of federal tax benefit. The gross and net unrecognized tax benefits included interest and penalties of $0.9 million and $0.7 million respectively. The Company reports interest and penalties related to unrecognized tax benefits in income tax expense. If the total amount of net unrecognized tax benefits had been recognized, $7.6 million would have been recorded to goodwill and the remaining $18.5 million would have adjusted the Company s effective tax rate. The $26.1 million of net unrecognized tax benefits are not expected to be paid within the next 12 months and were classified in non-current income taxes payable. VMware does not expect significant changes to its unrecognized tax benefits within the next 12 months.

As of June 30, 2008, the Company had a net income tax receivable of $99.6 million, which was principally comprised of amounts due from EMC; however, this amount was net of approximately $7.9 million of current income taxes payable due to various governmental authorities. The receivable arose because the Company had a stand-alone taxable loss for the six months ended June 30, 2008, which was primarily attributable to tax deductions arising from both non-qualified stock option exercises and from restricted stock when the restrictions lapse. Under the tax sharing agreement with EMC, EMC is obligated to pay to VMware an amount equal to the tax benefit that EMC will recognize on its consolidated tax return.

I. 401(k) Plan

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

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

VMware matches pre-tax employee contributions up to 6% of eligible compensation during each pay period (subject to a $750 maximum match each quarter). Matching contributions are immediately 100% vested. During the three and six months ended June 30, 2008, VMware contributions for employees were $2.3 million and $4.3 million, respectively. Employees may elect to invest their contributions in a variety of funds. The Company s matching contribution mirrors the investment allocation of the employee s contribution.

J. Commitments and Contingencies

Litigation

VMware is named from time to time as a party to lawsuits in the normal course of its business. In such cases it is the Company s policy to defend against such claims, or if considered appropriate, negotiate a settlement on commercially

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reasonable terms. While the outcome of these matters is currently not determinable, based on currently available information, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on the Company. However, no assurance can be given that the Company will be able to negotiate settlements on commercially reasonable terms, or at all, or that any litigation resulting from such claims would not have a material adverse effect on the Company s consolidated financial position, liquidity, operating results, or consolidated financial statements taken as a whole.

Operating Lease Commitments

VMware leases office facilities and equipment under various operating leases. Facility leases generally include renewal options. VMware s future lease commitments at June 30, 2008 are as follows (table in thousands):

Remainder of 2008	$ 14,226
2009	29,121
2010	28,262
2011	26,113
2012	16,361
Thereafter	294,931
Total minimum lease payments	$ 409,014

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

K. Stockholders Equity

VMware Stock Purchase Plan

In June 2007, VMware adopted its 2007 Employee Stock Purchase Plan (the ESPP) that is intended to be qualified under Section 423 of the Code. A total of 6.4 million shares of VMware Class A common stock were reserved for issuance under the ESPP. Under the ESPP, eligible VMware employees are granted options to purchase shares at the lower of 85% of the fair market value of the stock at the time of grant or 85% of the fair market value at the time of exercise. Options to purchase shares were first granted under the ESPP on August 13, 2007, the date on which VMware s Form S-1 Registration Statement was declared effective by the SEC, and became exercisable on December 31, 2007. Thereafter, options to purchase shares will be granted twice yearly, on or about January 1 and July 1, and will be exercisable on or about the succeeding June 30 or December 31, respectively.

For the purchase period ended December 31, 2007, employees purchased 0.6 million shares under the ESPP at a purchase price per share of $24.65. This purchase period was completed in January 2008. For the purchase period ended June 30, 2008, employees purchased 0.4 million shares under the ESPP at a purchase price per share of $45.78. This purchase period was completed in June 2008.

VMware Stock Options

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

	Number of Shares	Weighted-Average Exercise Price
Outstanding, January 1, 2008	45,339	$ 26.76
Granted	3,680	58.39
Forfeited	(755)	36.79
Expired	(1)	24.28
Exercised	(4,583)	21.45
Outstanding, June 30, 2008	43,680	29.71

Total cash proceeds from the exercise of stock options for the six months ended June 30, 2008 were $99.0 million. The options exercised during the six months ended June 30, 2008 had a pre-tax intrinsic value of $192.3 million.

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VMware Restricted Stock

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

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

	Number of Shares	Weighted-Average Grant Date Fair Value
Restricted stock at January 1, 2008	3,565	$ 24.64
Granted	540	64.84
Vested	(1,703)	22.27
Forfeited	(9)	22.05
Restricted stock at June 30, 2008	2,393	35.40

As of June 30, 2008, the aggregate intrinsic value of VMware restricted stock was $127.0 million. These shares are scheduled to vest through 2012.

Shares Repurchased for Tax Withholdings

During the three months ended June 30, 2008, VMware repurchased 283,839 shares of Class A common stock, for $18.9 million to cover employee tax withholding obligations. Pursuant to the respective agreements, these shares were repurchased in conjunction with the net share settlement upon the vesting of restricted stock during the quarter. The $18.9 million is recorded as a reduction to retained earnings as of June 30, 2008.

Stock-Based Compensation Expense

The following table summarizes the components of total stock-based compensation expense included in VMware s consolidated income statements for the three and six months ended June 30, 2008 and 2007 (table in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2008	2007	2008	2007
Cost of license revenues	$ 276	$ 74	$ 539	$ 110
Cost of services revenues	3,795	919	7,056	1,413
Research and development	19,479	8,252	40,576	14,644
Sales and marketing	11,699	4,240	23,000	7,184
General and administrative	6,823	2,488	13,062	4,266

Stock-based compensation expense	$ 42,072	$ 15,973	$ 84,233	$ 27,617

For the three and six months ended June 30, 2008, VMware capitalized $3.0 million and $3.9 million, respectively, of stock-based compensation expense associated with capitalized software development. For the three and six months ended June 30, 2008, VMware capitalized an additional $0.3 million and $0.8 million, respectively, of stock-based compensation expense associated with software developed for internal use.

For the three and six months ended June 30, 2007, VMware capitalized $0.5 million and $1.5 million, respectively, of stock-based compensation expense associated with capitalized software development.

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Fair Value of VMware Options

The fair value of each option to acquire VMware Class A common stock granted during the three and six months ended June 30, 2008 and 2007 is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
VMware Stock Options	**2008**	**2007**	**2008**	**2007**
Dividend yield	None	None	None	None
Expected volatility	37.6%	39.2%	37.9%	39.2%
Risk-free interest rate	2.6%	5.0%	2.4%	5.0%
Expected term (in years)	3.4	3.4	3.4	3.4
Weighted-average fair value at grant date	$ 18.37	$ 7.97	$ 17.68	$ 7.97

No options were granted under the ESPP during the three months ended June 30, 2008 and 2007 and the six months ended June 30, 2007. Options to purchase shares under the ESPP were first granted on August 13, 2007 with subsequent grants on January 1, 2008 and July 1, 2008. The weighted-average fair value of options granted under the ESPP during the six months ended June 30, 2008 was $22.10 and was estimated using the Black-Scholes pricing model with the following assumptions: dividend yield of 0%; expected volatility of 37.3%; risk free interest rate of 3.4% and expected term of 0.5 years.

For all options granted in the three and six months ended June 30, 2008 and the three months ended June 30, 2007, volatility was based on an analysis of historical and implied volatility of publicly-traded companies with similar characteristics, including industry, size and financial leverage. The expected term was calculated based on the historical experience that VMware employees have had with EMC stock option grants as well as the expected term of similar grants of comparable companies. The risk-free interest rate was based on a treasury instrument whose term is consistent with the expected life of the stock options.

L. Related Party Transactions

VMware recognized professional services revenues of $3.8 million and $7.1 million, for services provided to EMC s customers pursuant to VMware s contractual agreements with EMC for the three and six months ended June 30, 2008, respectively. VMware recognized $1.9 million and $6.0 million of professional services revenues from such contractual arrangements with EMC for the three and six months ended June 30, 2007.

VMware recognized revenues from server and desktop products and services purchased by EMC for internal use of $3.6 million for both the three and six months ended June 30, 2008, pursuant to the Company s contractual agreements with EMC. As of June 30, 2008, $2.3 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 from EMC for $6.1 million, $3.1 million, $15.7 million and $3.6 million, in the three months ended June 30, 2008 and 2007, and the six months ended June 30, 2008 and 2007, respectively. Through the third quarter of 2007, the systems purchases from EMC were at EMC s cost. Since the fourth quarter of 2007, the systems purchases from EMC are at a discount off of EMC s list price.

For certain corporate functions provided by EMC, $2.4 million and $4.7 million of expenses were allocated to VMware by EMC in the three and six months ended June 30, 2007, respectively. In the three and six months ended June 30, 2008, these amounts were not significant.

In certain geographic regions where VMware does not have an established legal entity, the Company contracts with EMC subsidiaries for support services and EMC employees who are managed by VMware personnel. The costs incurred by EMC on VMware s behalf related to these employees were included as expenses in VMware s financial statements. These costs include expenses for salaries and benefits, travel, rent, insurance and service fees. The total of these other costs were $35.4 million and $74.8 million in the three and six months ended June 30, 2008, respectively, and $24.5 million and $50.4 million in the three and six months ended June 30, 2007, respectively.

As part of VMware s tax sharing agreement, VMware paid EMC the sum of $62.3 million for VMware s portion of their consolidated federal income taxes in the three months ended March 31, 2008, and no payments were made in the three months ended June 30, 2008. This amount differed from the amounts owed on a stand-alone basis and the differences are

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presented as a component of stockholders equity. In the three and six months ended June 30, 2007, the differences between the amount of tax calculated on a stand-alone basis and the amount of tax calculated per the tax sharing agreement were recorded as decreases in stockholders equity of $4.9 million and $11.4 million, respectively. In the three and six months ended June 30, 2008, this difference was not significant.

As of June 30, 2008, the Company had a net income tax receivable of $99.6 million, which was principally comprised of amounts due from EMC; however, this amount was net of approximately $7.9 million of current income taxes payable due to various governmental authorities. The receivable arose because the Company had a stand-alone taxable loss for the six months ended June 30, 2008, which was primarily attributable to tax deductions arising from both non-qualified stock option exercises and from restricted stock where the restrictions lapsed. Under the tax sharing agreement with EMC, EMC is obligated to pay to VMware an amount equal to the tax benefit that EMC will recognize on its consolidated tax return.

Interest expense with EMC, net, consists of interest expense on a note payable to EMC, offset by interest income that has been earned on VMware s intercompany balance with EMC. In the three months ended June 30, 2008, $3.7 million of interest expense was recorded related to a note payable with EMC and was included in the $3.6 million interest expense with EMC, net, recorded on the consolidated income statement. In the six months ended June 30, 2008, $9.7 million of interest expense was recorded related to a note payable with EMC and was included in the $9.4 million interest expense with EMC, net, recorded on