VMWARE, INC.
Form 10-Q
August 02, 2012

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, 2012
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 (State or other jurisdiction of incorporation or organization)	94-3292913 (I.R.S. Employer Identification Number)
3401 Hillview Avenue Palo Alto, CA (Address of principal executive offices)	94304 (Zip Code)

(650) 427-5000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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 July 26, 2012, the number of shares of common stock, par value $0.01 per share, of the registrant outstanding was 426,466,973 of which 126,466,973 shares were Class A common stock and 300,000,000 were Class B common

stock.

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VMware, VMworld, VMware vSphere, VMware vCloud, Zimbra, SpringSource, VMware vCenter, VMware vShield, Cloud Foundry, VMware View, VMware Horizon, Rabbit MQ, GemFire, Socialcast, SlideRocket, Digital Fuel, NeoAccel, PacketMotion, Shavlik and WaveMaker are registered trademarks or trademarks of VMware, Inc. in the United States and other jurisdictions. All other marks and names mentioned herein may be trademarks of their respective companies.

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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS
VMware, Inc.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Operating activities:				
Net income	$191,729	$220,158	$383,165	$345,970
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	89,392	74,709	175,158	155,658
Stock-based compensation, excluding amounts capitalized	100,900	85,442	182,706	166,015
Excess tax benefits from stock-based compensation	(32,701)	(101,256)	(86,383)	(151,264)
Gain on sale of Terremark investment	—	(56,000)	—	(56,000)
Other	373	2,864	(555)	3,826
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	(91,296)	(54,757)	135,254	26,583
Other assets	(69,444)	(16,133)	(117,150)	(34,053)
Due to/from EMC, net	(43,403)	(35,265)	12,145	25,435
Accounts payable	4,894	(11,105)	17,419	(1,707)
Accrued expenses	95,753	102,780	936	34,211
Income taxes receivable from EMC	—	141,000	—	176,444
Income taxes payable	12,367	4,674	67,733	37,601
Deferred income taxes, net	(1,416)	11,119	(36,371)	(958)
Unearned revenue	134,177	94,566	233,872	212,952
Net cash provided by operating activities	391,325	462,796	967,929	940,713
Investing activities:				
Additions to property and equipment	(44,336)	(95,186)	(78,007)	(122,232)
Purchase of leasehold interest (see Note H)	—	(173,126)	—	(173,126)
Capitalized software development costs	—	(25,437)	—	(52,859)
Purchases of available-for-sale securities	(1,253,605)	(529,038)	(1,955,068)	(1,127,805)
Sales of available-for-sale securities	348,437	223,491	770,754	376,588
Maturities of available-for-sale securities	277,099	277,390	534,076	492,969
Sale of strategic investments	—	76,000	—	78,513
Business acquisitions, net of cash acquired	(102,166)	(189,138)	(102,166)	(204,088)
Transfer of net assets under common control	—	(7,973)	—	(20,463)
Other investing	(2,677)	31,858	(4,174)	(27,142)
Net cash used in investing activities	(777,248)	(411,159)	(834,585)	(779,645)
Financing activities:				
Proceeds from issuance of common stock	33,554	110,543	144,595	200,714
Repurchase of common stock	(178,195)	(132,660)	(178,195)	(280,389)
Excess tax benefits from stock-based compensation	32,701	101,256	86,383	151,264
	(51,346)	(48,666)	(64,983)	(70,578)

Shares repurchased for tax withholdings on vesting of restricted stock				
Net cash provided by (used in) financing activities	(163,286)	30,473	(12,200)	1,011
Net increase (decrease) in cash and cash equivalents	(549,209)	82,110	121,144	162,079
Cash and cash equivalents at beginning of the period	2,626,109	1,708,934	1,955,756	1,628,965
Cash and cash equivalents at end of the period	$2,076,900	$1,791,044	$2,076,900	$1,791,044
Non-cash items:				
Changes in capital additions, accrued but not paid	$17,980	$(985)	$15,330	$6,221
Changes in tax withholdings on vesting of restricted stock, accrued but not paid	6,029	3,656	6,837	2,938

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,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Revenues:				
License	$517,222	$464,806	$999,149	$883,805
Services	605,804	456,404	1,179,059	881,126
Total revenues	1,123,026	921,210	2,178,208	1,764,931
Operating expenses (1):				
Cost of license revenues	56,553	48,928	113,296	104,946
Cost of services revenues	122,669	103,547	236,841	197,426
Research and development	248,594	189,241	470,984	358,404
Sales and marketing	391,501	314,560	754,913	617,484
General and administrative	91,799	78,042	173,099	146,277
Operating income	211,910	186,892	429,075	340,394
Investment income	6,945	3,715	12,688	7,121
Interest expense with EMC	(1,158)	(972)	(2,445)	(1,931)
Other income (expense), net	(3,560)	56,639	(1,275)	56,804
Income before income taxes	214,137	246,274	438,043	402,388
Income tax provision	22,408	26,116	54,878	56,418
Net income	$191,729	$220,158	$383,165	$345,970
Net income per weighted-average share, basic for Class A and Class B	$0.45	$0.52	$0.90	$0.83
Net income per weighted-average share, diluted for Class A and Class B	$0.44	$0.51	$0.88	$0.80
Weighted-average shares, basic for Class A and Class B	427,223	419,657	426,106	418,557
Weighted-average shares, diluted for Class A and Class B	434,647	430,473	434,014	429,984

(1) Includes stock-based compensation as follows:

Cost of license revenues	$524	$438	$964	$904
Cost of services revenues	7,103	5,740	12,922	11,328
Research and development	48,027	46,074	87,404	87,958
Sales and marketing	33,883	23,264	59,117	45,787
General and administrative	11,363	9,926	22,299	20,038

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

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

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Net income	$191,729	$220,158	$383,165	$345,970
Other comprehensive income:				
Changes in market value of available-for-sale securities:				
Unrealized gains (losses), net of taxes of $(96), $1,352, $1,028 and $1,196	(157)	2,029	1,677	1,794
Reclassification of (gains) losses recognized during the period, net of taxes of $(283), $(22,494), $53 and $(12,788)	(461)	(33,742)	86	(19,181)
Net change in market value of available-for-sale securities	(618)	(31,713)	1,763	(17,387)
Changes in market value of effective foreign currency forward exchange contracts:				
Unrealized gains (losses), net of taxes of $10, $0, $10 and $0	194	—	194	—
Reclassification of (gains) losses recognized during the period, net of taxes of $(40), $0, $10 and $0	(728)	—	50	—
Net change in market value of effective foreign currency forward exchange contracts	(534)	—	244	—
Total other comprehensive income	(1,152)	(31,713)	2,007	(17,387)
Total comprehensive income, net of taxes	$190,577	$188,445	$385,172	$328,583

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

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

	June 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$2,076,900	$1,955,756
Short-term investments	3,269,969	2,556,450
Accounts receivable, net of allowance for doubtful accounts of $2,492 and $3,794	748,698	882,857
Due from EMC, net	61,654	73,799
Deferred tax asset	151,704	128,471
Other current assets	127,528	80,439
Total current assets	6,436,453	5,677,772
Property and equipment, net	553,124	525,490
Capitalized software development costs, net and other	109,532	154,236
Deferred tax asset	172,190	156,855
Intangible assets, net	402,425	407,375
Goodwill	1,827,068	1,759,080
Total assets	$9,500,792	$8,680,808
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$77,026	$49,747
Accrued expenses and other	590,268	587,650
Unearned revenues	1,850,681	1,764,109
Total current liabilities	2,517,975	2,401,506
Note payable to EMC	450,000	450,000
Unearned revenues	1,091,709	944,309
Other liabilities	120,415	114,711
Total liabilities	4,180,099	3,910,526
Commitments and contingencies (see Note M)		
Stockholders’ equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 127,264 and 123,610 shares	1,273	1,236
Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3,000	3,000
Additional paid-in capital	3,377,466	3,212,264
Accumulated other comprehensive income	3,183	1,176
Retained earnings	1,935,771	1,552,606
Total stockholders’ equity	5,320,693	4,770,282
Total liabilities and stockholders’ equity	$9,500,792	$8,680,808

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 leader in virtualization and virtualization-based cloud infrastructure solutions utilized by businesses to help them transform the way they build, deliver and consume information technology (“IT”) resources in a manner that is evolutionary and based on their specific needs. VMware’s virtualization infrastructure software solutions run on industry-standard desktop computers and servers and support a wide range of operating system and application environments, as well as networking and storage infrastructures.

Accounting Principles

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

Unaudited Interim Financial Information

These accompanying unaudited consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial reporting. In the opinion of management, these unaudited consolidated financial statements include all adjustments, consisting of normal recurring adjustments and accruals, for a fair statement of VMware’s consolidated cash flows, results of operations and financial condition for the periods presented. Results of operations are not necessarily indicative of the results that may be expected for the full year 2012. Certain information and footnote disclosures typically included in annual consolidated financial statements have been condensed or omitted. Accordingly, these unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in VMware’s 2011 Annual Report on Form 10-K.

VMware was incorporated as a Delaware corporation in 1998, was acquired by EMC Corporation (“EMC”) in 2004 and conducted its initial public offering of VMware’s Class A common stock in August 2007. As of June 30, 2012, EMC holds approximately 79.3% of VMware’s outstanding common stock, including 38.7 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. VMware and EMC engage in intercompany transactions, including agreements regarding the use of EMC’s and VMware’s intellectual property and real estate, agreements regarding the sale of goods and services to one another, and an agreement for EMC to resell VMware's products and services to third party customers. In geographic areas where VMware has not established its own subsidiaries, VMware contracts with EMC subsidiaries for support services and for personnel who are managed by VMware. Additionally, beginning in the second quarter of 2011, VMware incurs costs to operate the Mozy service on behalf of EMC. These costs, plus a mark-up to approximate third-party costs and a management fee, are reimbursed to VMware by EMC and recorded as an offset to the costs VMware incurred on the consolidated statements of income. See Note O to the consolidated financial statements for further information regarding intercompany transactions between VMware and EMC.

Management believes the assumptions underlying the consolidated financial statements are reasonable. However, the amounts recorded for VMware's intercompany transactions with EMC may not be considered arm’s length with an unrelated third party by nature of EMC’s majority ownership of VMware. Therefore, the financial statements included herein may not necessarily reflect the cash flows, results of operations and financial condition had VMware engaged in such transactions with an unrelated third party during all periods presented. Accordingly, VMware’s historical financial information is not necessarily indicative of what the Company’s cash flows, results of operations and financial condition will be in the future if and when VMware contracts at arm’s length with unrelated third parties for the services the Company receives from and provides to EMC.

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

Principles of Consolidation

The consolidated financial statements include the accounts of VMware and its subsidiaries. All intercompany transactions and balances between VMware and its subsidiaries have been eliminated. All intercompany transactions

with EMC in the consolidated statements of cash flows will be settled in cash, and changes in the current intercompany balances are presented as a component of cash flows from operating activities.

Use of Accounting Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management

to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses during the reporting periods, and the disclosure of contingent liabilities at the date of the financial statements. Estimates are used for, but not limited to, capitalized software development costs, trade receivable valuation, certain accrued liabilities, useful lives of fixed assets and intangible assets, valuation of acquired intangibles, revenue reserves, income taxes, stock-based compensation and contingencies. Actual results could differ from those estimates.

New Accounting Pronouncements

In June 2011, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2011-05, Presentation of Comprehensive Income ("ASU 2011-05"). ASU 2011-05 eliminated the option to report other comprehensive income and its components in the statement of changes in equity. Comprehensive income must be presented in one continuous statement of comprehensive income or two separate consecutive statements. In December 2011, the FASB issued an amendment to ASU 2011-05 that defers the requirement to present reclassification adjustments out of accumulated other comprehensive income on the face of the consolidated statement of income. VMware adopted this accounting standard update, as amended, on January 1, 2012, and presents comprehensive income in accordance with the requirements of the standard in this Quarterly Report on Form 10-Q.

B. Research and Development and Capitalized Software Development Costs

Development costs of software to be sold, leased, or otherwise marketed are subject to capitalization beginning when the product's technological feasibility has been established and ending when the product is available for general release. Judgment is required in determining when technological feasibility is established, and as the Company's business, products and go-to-market strategy have evolved, management has continued to evaluate when technological feasibility is established. Following the release of vSphere 5 and the comprehensive suite of cloud infrastructure technologies in the third quarter of 2011, management determined that VMware's go-to-market strategy had changed from single solutions to product suite solutions. As a result of this change in strategy, and the related increased importance of interoperability between VMware's products, the length of time between achieving technological feasibility and general release to customers significantly decreased. For future releases, management expects VMware's products to be available for general release soon after technological feasibility has been established. VMware's expensed and capitalized research and development ("R&D") costs may not be comparable to VMware's peer companies due to differences in judgment as to when technological feasibility has been reached or differences in judgment regarding when the product is available for general release. Additionally, future changes in management's judgment as to when technological feasibility is established, or additional changes in VMware's business, including its go-to-market strategy, could materially impact the amount of costs capitalized. For example, if the length of time between technological feasibility and general availability were to increase again in the future, the amount of capitalized costs would likely increase.

Generally accepted accounting principles require annual amortization expense of capitalized software development costs to be the greater of the amounts computed using the ratio of current gross revenue to a product's total current and anticipated revenues, or the straight-line method over the product's remaining estimated economic life. To date, VMware has amortized these costs using the straight-line method as it is the greater of the two amounts. The costs are amortized over periods ranging from 18 to 24 months, which represent the product's estimated economic life. The ongoing assessment of the recoverability of these costs requires considerable judgment by management with respect to certain external factors such as anticipated future revenue, estimated economic life, and changes in software and hardware technologies. Material differences in amortization amounts could occur as a result of changes in the periods over which VMware actually generates revenues or the amounts of revenues generated.

Unamortized software development costs were $62.3 million and $104.9 million as of June 30, 2012 and December 31, 2011, respectively, and are included in capitalized software development costs, net and other on the consolidated balance sheets.

In the three and six months ended June 30, 2012, all software development costs were expensed as incurred and were included in R&D expenses on the accompanying consolidated statement of income. In the three months ended June 30, 2011, VMware capitalized $29.6 million (including $4.2 million of stock-based compensation) of costs incurred for the development of software products. In the six months ended June 30, 2011, VMware capitalized $61.9 million (including $9.0 million of stock-based compensation) of costs incurred for the development of software products. These amounts have been excluded from R&D expenses on the accompanying consolidated statements of income. Amortization expense from capitalized amounts was $20.8 million and $19.8 million for the three months ended June 30, 2012 and 2011, respectively. Amortization expense from capitalized amounts was $42.6 million and $48.3 million for the six months ended June 30, 2012 and 2011, respectively. Amortization expense is included in cost of license revenues on the consolidated statements of income.

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

C. Earnings per Share

Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average number of common shares outstanding and potentially dilutive securities outstanding during the period, as calculated using the treasury stock method. Potentially dilutive securities primarily include stock options, unvested restricted stock units, 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.

The following table sets forth the computations of basic and diluted net income per share for the three and six months ended June 30, 2012 and 2011 (table in thousands, except per share data):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Net income	$191,729	$220,158	$383,165	$345,970
Weighted-average shares, basic for Class A and Class B	427,223	419,657	426,106	418,557
Effect of dilutive securities	7,424	10,816	7,908	11,427
Weighted-average shares, diluted for Class A and Class B	434,647	430,473	434,014	429,984
Net income per weighted-average share, basic for Class A and Class B	$0.45	$0.52	$0.90	$0.83
Net income per weighted-average share, diluted for Class A and Class B	$0.44	$0.51	$0.88	$0.80

For the three months ended June 30, 2012 and 2011, stock options to purchase 0.4 million and 0.9 million shares, respectively, of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the three months ended June 30, 2012, 2.7 million shares of restricted stock were excluded from the diluted earnings per share calculations. For the three months ended June 30, 2011, no shares of restricted stock were excluded from the diluted earnings per share calculations.

For the six months ended June 30, 2012 and 2011, stock options to purchase 0.4 million and 1.2 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 six months ended June 30, 2012 and 2011, 1.5 million and 0.4 million shares of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive.

D. Investments

Investments as of June 30, 2012 and December 31, 2011 consisted of the following (tables in thousands):

	June 30, 2012			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. Government and agency obligations	$475,556	$1,220	$(73)	$476,703
U.S. and foreign corporate debt securities	1,488,144	2,800	(821)	1,490,123
Foreign governments and multi-national agency obligations	39,138	14	(29)	39,123
Municipal obligations	1,160,540	2,442	(756)	1,162,226
Asset-backed securities	36,648	53	(10)	36,691
Mortgage-backed securities	65,122	129	(148)	65,103
Total investments	$3,265,148	$6,658	$(1,837)	$3,269,969

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

	December 31, 2011			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. Government and agency obligations	$516,795	$1,842	$(23)	$518,614
U.S. and foreign corporate debt securities	1,134,009	1,404	(2,036)	1,133,377
Foreign governments and multi-national agency obligations	58,455	30	(87)	58,398
Municipal obligations	768,282	1,396	(437)	769,241
Asset-backed securities	27,107	2	(23)	27,086
Mortgage-backed securities	49,778	128	(172)	49,734
Total investments	$2,554,426	$4,802	$(2,778)	$2,556,450

Both the realized gains and realized losses on investments were not material for the three and six months ended June 30, 2012. During the three months ended June 30, 2011, a realized gain of $56.0 million was recorded in other income (expense), net on the consolidated income statement for the sale of VMware's investment in Terremark Worldwide, Inc. All other realized gains and losses on investments were not material for the three and six months ended June 30, 2011. In addition, VMware evaluated its investments as of June 30, 2012 and December 31, 2011 and determined that there were no unrealized losses that indicated an other-than-temporary impairment.

As of June 30, 2012 and December 31, 2011, VMware did not have investments in a material continuous unrealized loss position for twelve months or greater. Unrealized losses on investments as of June 30, 2012, and December 31, 2011, which have been in a net loss position for less than twelve months, were classified by investment category as follows (table in thousands):

	June 30, 2012		December 31, 2011	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government and agency obligations	$214,612	$(73)	$50,604	$(23)
U.S. and foreign corporate debt securities	500,126	(819)	539,228	(2,036)
Foreign governments and multi-national agency obligations	31,175	(29)	43,026	(87)
Municipal obligations	407,195	(756)	298,187	(406)
Asset-backed securities	9,399	(10)	20,025	(23)
Mortgage-backed securities	38,309	(148)	32,817	(172)
Total	$1,200,816	$(1,835)	$983,887	$(2,747)

Contractual Maturities

The contractual maturities of investments held at June 30, 2012 consisted of the following (table in thousands):

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	$1,275,888	$1,276,571
Due after 1 year through 5 years	1,929,232	1,933,370
Due after 5 years	60,028	60,028
Total investments	$3,265,148	$3,269,969

E. Fair Value Measurements

Generally accepted accounting principles provide that fair value is an exit price, representing the amount that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that is determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, generally accepted

accounting principles established a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) inputs are quoted prices in

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active markets for identical assets or liabilities; (Level 2) inputs other than the quoted prices included within Level 1 that are observable for the assets or liabilities, either directly or indirectly; and (Level 3) unobservable inputs for the assets or liabilities in which there is little or no market data, which requires VMware to develop its own assumptions. 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. VMware's Level 2 classification includes the remainder of the available-for-sale fixed income securities because these securities are priced using quoted market prices for similar instruments and non-binding market prices that are corroborated by observable market data. VMware obtains the fair values of its Level 2 financial instruments based upon fair values obtained from its custody bank. In addition, VMware obtains fair values of its Level 2 financial instruments from the asset manager of each of its portfolios. VMware validates the fair value provided by its custody bank by comparing it against the independent pricing information obtained from the asset managers. Independently, the custody bank and the asset managers use professional pricing services to gather pricing data which may include quoted market prices for identical or comparable instruments, or inputs other than quoted prices that are observable either directly or indirectly. VMware is ultimately responsible for the financial statements and underlying estimates. 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. These contracts were 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.

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 consolidated balance sheets, that were required to be measured at fair value as of June 30, 2012 and December 31, 2011 (tables in thousands):

	June 30, 2012		
	Level 1	Level 2	Total
Money-market funds	$1,644,790	$—	$1,644,790
U.S. Government and agency obligations	283,364	193,339	476,703
U.S. and foreign corporate debt securities	—	1,554,617	1,554,617
Foreign governments and multi-national agency obligations	—	39,123	39,123
Municipal obligations	—	1,168,226	1,168,226
Asset-backed securities	—	36,691	36,691
Mortgage-backed securities	—	65,103	65,103
Total cash equivalents and investments	$1,928,154	$3,057,099	$4,985,253

	December 31, 2011		
	Level 1	Level 2	Total
Money-market funds	$1,345,904	$—	$1,345,904
U.S. Government and agency obligations	170,744	347,870	518,614
U.S. and foreign corporate debt securities	—	1,143,378	1,143,378
Foreign governments and multi-national agency obligations	—	58,397	58,397
Municipal obligations	—	769,241	769,241
Asset-backed securities	—	27,086	27,086
Mortgage-backed securities	—	49,734	49,734
Total cash equivalents and investments	$1,516,648	$2,395,706	$3,912,354

F. Derivative Instruments

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.

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Cash Flow Hedging Activities
To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware entered into foreign currency forward contracts starting in the fourth quarter of 2011. 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 consolidated balance sheet, and is subsequently reclassified to the related operating expense line item in the consolidated statements of income in the same period that the underlying expenses are incurred. 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 consolidated statements of income as incurred. For the three and six months ended June 30, 2012, all amounts recognized on the consolidated statements of income related to VMware’s cash flow hedging program were immaterial.
VMware generally enters into cash flow hedges semi-annually with maturities of six months or less. As of June 30, 2012 and December 31, 2011, VMware had forward contracts to purchase currency designated as cash flow hedges with a total notional value of $11.0 million and $47.1 million, respectively. The fair value of these forward contracts was immaterial as of June 30, 2012 and therefore excluded from the fair value tables above. For the three and six months ended June 30, 2012, 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 consolidated statements of income. The gains and losses on VMware’s foreign currency forward contracts generally offset the majority of the gains and losses associated with the underlying foreign-currency denominated assets and liabilities that VMware hedges.
VMware’s foreign currency forward contracts are generally traded on a monthly basis with a typical contractual term of one month. As of June 30, 2012 and December 31, 2011, VMware had outstanding forward contracts with a total notional value of $261.5 million and $324.1 million, respectively. The fair value of these forward contracts was immaterial as of June 30, 2012 and December 31, 2011 and therefore excluded from the fair value tables above.
G. Business Combinations, Goodwill and Intangible Assets, Net
Business Combinations
The results of operations of the acquired businesses mentioned below have been included in VMware’s consolidated financial statements from the date of purchase. Pro forma results of operations have not been presented as the results of the acquired businesses were not material to VMware’s consolidated results of operations in the three and six months ended June 30, 2012 and 2011.
In the six months ended June 30, 2012, VMware acquired three businesses. The aggregate consideration for these acquisitions was $102.2 million, net of cash acquired. The following table summarizes the allocation of the consideration to the fair value of the tangible and intangible assets acquired in the six months ended June 30, 2012 (table in thousands):

Other current assets	$ 531	
Intangible assets	33,800	
Goodwill	70,798	
Other assets	106	
Total tangible and intangible assets acquired	105,235	
Unearned revenues	(100	)
Deferred tax liabilities, net	(1,460	)

Accrued liabilities and other	(1,509)
Total liabilities assumed	(3,069)
Fair value of tangible and intangible assets acquired and liabilities assumed	$ 102,166

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Intangible Assets, Net
Changes in the carrying amount of intangible assets, net, excluding goodwill for the six months ended June 30, 2012 consisted of the following (table in thousands):

Balance, January 1, 2012	$407,375
Additions to intangible assets related to business combinations	33,800
Change in accumulated amortization	(38,750)
Balance, June 30, 2012	$402,425

The following table summarizes the fair value of the intangible assets acquired by VMware through business combinations in the six months ended June 30, 2012 (table in thousands):

	Weighted-Average Useful Lives (in years)	Fair Value Amount
Purchased technology	5.9	$33,800
Total intangible assets acquired, net, excluding goodwill		$33,800

Goodwill
Changes in the carrying amount of goodwill for the six months ended June 30, 2012 consisted of the following (table in thousands):

Balance, January 1, 2012	$1,759,080
Increase in goodwill related to business combinations	70,798
Deferred tax adjustments to purchase price allocations on previous acquisitions	(2,814)
Other adjustments to purchase price allocations on previous acquisitions	4
Balance, June 30, 2012	$1,827,068

H. Property and Equipment, Net
Property and equipment, net, as of June 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	June 30, 2012	December 31, 2011
Equipment and software	$563,494	$512,754
Buildings and improvements	371,985	340,596
Furniture and fixtures	63,802	61,023
Construction in progress	75,670	68,707
Total property and equipment	1,074,951	983,080
Accumulated depreciation	(521,827)	(457,590)
Total property and equipment, net	$553,124	$525,490

Depreciation expense was $32.9 million and $31.3 million in the three months ended June 30, 2012 and 2011, respectively, and $65.7 million and $62.0 million in the six months ended June 30, 2012 and 2011, respectively.
In the three months ended June 30, 2011, VMware closed an agreement to purchase the right, title and interest in a ground lease covering the property and improvements located adjacent to VMware's existing Palo Alto, California campus for a total cost of $225.0 million. VMware paid the seller $45.0 million in the three months ended March 31, 2011 as a good faith deposit and in the three months ended June 30, 2011, VMware paid the remaining $180.0 million. Based upon the preliminary respective fair values, $51.9 million of the purchase price was recorded to property and equipment, net on the consolidated balance sheet for the estimated fair value of the buildings and site improvements. The remaining $173.1 million of the purchase price was attributed to the fair value of the ground lease and was recorded to intangible assets, net on the consolidated balance

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sheet. These amounts are reflected on the consolidated statements of cash flows for the three and six months ended June 30, 2011.
In the three months ended September 30, 2011, the gross amount classified to property and equipment, net was increased by $22.0 million to $73.9 million to reflect the final assumptions regarding VMware's intended use of the existing structures. As a result of this adjustment, the gross amount of the value recorded to intangible assets, net on the consolidated balance sheet was decreased by the same amount.
As of June 30, 2012 and December 31, 2011, construction in progress primarily represented buildings and site improvements related to VMware's Palo Alto campus expansion that had not yet been placed into service.
I. Accrued Expenses and Other
Accrued expenses and other as of June 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	June 30, 2012	December 31, 2011
Salaries, commissions, bonuses, and benefits	$279,223	$287,248
Accrued partner liabilities	110,274	124,359
Other	200,771	176,043
Total	$590,268	$587,650

Accrued partner liabilities relate to rebates and marketing development fund accruals for channel partners, system vendors and systems integrators, as well as accrued royalties.
J. Unearned Revenues
Unearned revenues as of June 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	June 30, 2012	December 31, 2011
Unearned license revenues	$375,644	$389,225
Unearned software maintenance revenues	2,356,977	2,133,512
Unearned professional services revenues	209,769	185,681
Total unearned revenues	$2,942,390	$2,708,418

Unearned license revenues are recognized either ratably or upon the delivery of existing products, future products or services. 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. VMware regularly offers product promotions as a strategy to improve awareness of its emerging products. To the extent promotional products have not been delivered and 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. At June 30, 2012, the ratable component represented over half of the total unearned license revenue balance. Unearned software maintenance revenues are attributable to VMware's maintenance contracts and are recognized ratably over terms of one to five years with a weighted-average remaining term at June 30, 2012 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.
K. Note Payable to EMC
In April 2007, VMware declared an $800.0 million dividend to EMC paid in the form of a note payable, with interest payable quarterly in arrears and original maturity date of April 2012. In August 2007, VMware repaid $350.0 million of the note payable, and as of June 30, 2012, $450.0 million remained outstanding. In June 2011, VMware and EMC amended and restated the note to extend the maturity date of the note to April 16, 2015 and to modify the principal amount of the note to reflect the outstanding balance of $450.0 million. The interest rate of the 90-day LIBOR plus 55

basis points continues to reset quarterly. For the three months ended June 30, 2012 and 2011, $1.2 million and $1.0 million, respectively, of interest expense were recorded related to the note payable. For the six months ended June 30, 2012 and 2011, $2.4 million and $1.9 million, respectively, of interest expense were recorded related to the note payable. The note may be repaid prior to the maturity date

without penalty. No repayments of principal were made during the three and six months ended June 30, 2012 and 2011.

L. Income Taxes

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

VMware's effective income tax rate was 10.5% and 10.6% for the three months ended June 30, 2012 and 2011, respectively. The effective income tax rate was 12.5% and 14.0%, respectively, for the six months ended June 30, 2012 and 2011. The lower effective rate for the three and six months ended June 30, 2012, compared with the three and six months ended June 30, 2011, was primarily attributable to a jurisdictional shift of income from the U.S. to lower-tax non-U.S. jurisdictions, partially offset by a decrease in the release of unrecognized tax benefits from uncertain tax positions as a percentage of income before tax, as well as by the expiration of the federal research tax credit.

VMware's rate of taxation in foreign jurisdictions is lower than the U.S. tax rate. VMware's international income is primarily earned by VMware's subsidiaries in Ireland, where the statutory tax rate is 12.5%. Management does not believe that any recent or currently expected developments in non-U.S. tax jurisdictions are reasonably likely to have a material impact on VMware's effective tax rate. As of June 30, 2012, VMware's total cash, cash equivalents, and short-term investments were $5,346.9 million, of which $2,694.0 million were held outside the U.S. If these overseas funds are needed for its operations in the U.S., VMware would be required to accrue and pay U.S. taxes on related undistributed earnings to repatriate these funds. However, all income earned abroad, except for previously taxed income for U.S. tax purposes, is considered indefinitely reinvested in VMware's foreign operations and no provision for U.S. taxes has been provided with respect thereto. At this time, it is not practicable to estimate the amount of tax that may be payable were VMware to repatriate these funds, and VMware's current plans do not demonstrate a need to repatriate them to fund its U.S. operations. VMware will meet its U.S. liquidity needs through cash flows from operations, external borrowings, or both. VMware utilizes a variety of tax planning and financing strategies in an effort to ensure that its worldwide cash is available in the locations in which it is needed.

As of June 30, 2012, VMware had gross unrecognized tax benefits totaling $87.3 million, which excludes $10.6 million of offsetting tax benefits. Approximately $82.6 million of VMware's net unrecognized tax benefits, not including interest, if recognized, would reduce income tax expense and lower VMware's effective tax rate in the period or periods recognized. The $90.1 million of net unrecognized tax benefits, including interest, were classified as a non-current liability on the consolidated balance sheet. It is reasonably possible that within the next 12 months audit resolutions could potentially reduce total unrecognized tax benefits by between approximately $7.0 million and $9.0 million. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.

VMware recognizes interest expense and penalties related to income tax matters in the income tax provision. VMware recognized approximately $0.4 million and $1.6 million in interest and penalties for the three and six months ended June 30, 2012 and had accrued $7.5 million of interest and penalties as of June 30, 2012, associated with the net unrecognized tax benefits. These amounts are included as components of the $90.1 million of net unrecognized tax benefits as of June 30, 2012.

M. Commitments and Contingencies

Litigation

From time to time, VMware is subject to legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to intellectual property, contracts, employment and other matters. VMware accrues for a liability when it is both probable that a liability has been incurred 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. These accruals are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. As of June 30, 2012 and December 31, 2011, 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 consolidated financial position and results of operations.

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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, 2012 were as follows (table in thousands):

2012	$26,395
2013	51,171
2014	43,814
2015	34,425
2016	29,044
Thereafter	562,814
Total minimum lease payments	$747,663

The amount of the future lease commitments after 2016 is primarily for the ground leases on VMware's Palo Alto, California headquarter facilities, which expire in 2046. As several of VMware's operating leases are payable in foreign currencies, the operating lease payments may fluctuate in response to changes in the exchange rate between the U.S. Dollar and the foreign currencies in which the commitments are payable.

N. Stockholders' Equity

VMware Stock Repurchase Programs

In February 2012, VMware's Board of Directors authorized the repurchase of up to $600.0 million of VMware's Class A common stock through the end of 2013. In February 2011, a committee of VMware's Board of Directors authorized the repurchase of up to $550.0 million of VMware's Class A common stock, which was completed in the second quarter of 2012.

From time to time, stock repurchases may be made pursuant to the February 2012 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.

In both the three and six months ended June 30, 2012, VMware repurchased and retired 1.8 million shares of its Class A common stock at a weighted-average price of $96.50 per share for an aggregate purchase price of $178.2 million, including commissions. In the three and six months ended June 30, 2011, VMware repurchased and retired 1.4 million shares and 3.2 million shares, respectively, of its Class A common stock at a weighted-average price of $91.60 per share and $88.50 per share, respectively, for an aggregate purchase price of $132.7 million and $280.4 million, respectively, including commissions. The amount of repurchased shares was classified as a reduction to additional paid-in capital. As of June 30, 2012, the authorized amount remaining for repurchase was $507.1 million.

VMware Employee Stock Purchase Plan

The following table summarizes Employee Stock Purchase Plan (the "ESPP") activity in the three and six months ended June 30, 2012 and 2011 (table in thousands, except per share amounts):

	Purchase Period Ended January 31,	
	2012	2011
Cash proceeds	$32,861	$26,813
Class A common shares purchased	424	407
Weighted-average price per share	$77.58	$65.90

As of June 30, 2012, $34.6 million of ESPP withholdings were recorded as a liability on the consolidated balance sheet for the next purchase in July 2012.

VMware Restricted Stock

VMware restricted stock units primarily consist 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.
In the first half of 2012, VMware granted performance stock unit (“PSU”) awards to certain of its executives and employees. The awards will vest through the first quarter of 2015 if certain employee specific or VMware designated performance targets are achieved. If minimum performance thresholds are achieved, each PSU award will convert into VMware’s Class A common stock at a ratio ranging from 0.5 to 3.0 shares for each 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 under that PSU award. As of June 30, 2012, 0.4 million PSUs were outstanding and are included in the table below.
The following table summarizes restricted stock activity since January 1, 2012 (stock units in thousands):

	Number of Stock Units	Weighted-Average Grant Date Fair Value (per stock unit)
Outstanding, January 1, 2012	9,540	$72.74
Granted	5,052	106.17
Vested	(2,148)	66.85
Forfeited	(748)	74.39
Outstanding, June 30, 2012	11,696	88.61

The total fair value of VMware stock units that vested in the six months ended June 30, 2012 was $199.9 million. As of June 30, 2012, stock units representing 11.7 million shares of VMware were outstanding, with an aggregate intrinsic value of $1,064.8 million based on VMware’s closing price as of June 30, 2012. These stock units are scheduled to vest through 2016.

VMware Shares Repurchased for Tax Withholdings

In both the three months ended June 30, 2012 and 2011, VMware repurchased or withheld and retired 0.6 million shares of Class A common stock, for $57.5 million and $52.3 million, respectively, to cover tax withholding obligations. In both the six months ended June 30, 2012 and 2011, VMware repurchased or withheld and retired 0.8 million shares of Class A common stock, for $72.0 million and $73.5 million, respectively, to cover tax withholding obligations. These amounts differ from the amounts of cash remitted for tax withholding obligations on the consolidated statement of cash flows due to the timing of payments. Pursuant to the respective award agreements, these shares were repurchased or withheld in conjunction with the net share settlement upon the vesting of restricted stock and restricted stock units during the period. The value of the repurchased or withheld shares, including restricted stock units, was classified as a reduction to additional paid-in capital.

O. Related Party Transactions

In the second quarter of 2011, VMware acquired certain assets relating to EMC’s Mozy cloud-based data storage and data center services, including certain data center assets and a license to certain intellectual property. EMC retained ownership of the Mozy business and its remaining assets. EMC continues to be responsible to Mozy customers for Mozy products and services and continues to recognize revenue from such products and services. VMware entered into an operational support agreement with EMC through the end of 2012, pursuant to which VMware took over responsibility to operate the Mozy service on behalf of EMC. Pursuant to the support agreement, costs incurred by VMware to support EMC’s Mozy services, plus a mark-up intended to approximate third-party costs and a management fee, are reimbursed to VMware by EMC. On the consolidated statements of income, in the three months ended June 30, 2012 and 2011, such amounts as described above were approximately $16.4 million and $12.2 million, respectively. In the six months ended June 30, 2012 and 2011, such amounts were $30.9 million and $12.2 million, respectively. These amounts were recorded as a reduction to the costs VMware incurred.

In the second quarter of 2010, VMware acquired certain software product technology and expertise from EMC's Ionix IT management business for cash consideration of $175.0 million. EMC retained the Ionix brand and will continue to offer customers the products acquired by VMware, pursuant to the ongoing reseller agreement between EMC and VMware. During the six months ended June 30, 2011, a $12.5 million contingent payment was made to EMC. This payment was recorded as an equity transaction and was an offset to the initial capital contribution from EMC. As of December 31, 2011, all contingent payments under the agreement had been made.

Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's hardware and sells them to end-users. In the three months ended June 30, 2012 and 2011, VMware recognized revenues of

$45.6 million and $14.2 million, respectively, from products and services sold pursuant to VMware's reseller arrangement with EMC. In the six months ended June 30, 2012 and 2011, VMware recognized revenues of $80.6 million and $34.2 million, respectively, from such contractual arrangement with EMC. As of June 30, 2012, $107.6 million of revenues from products and services sold under the reseller arrangement were included in unearned revenues.

In the three months ended June 30, 2012 and 2011, VMware recognized professional services revenues of $23.6 million and $16.4 million, respectively, for services provided to EMC's customers pursuant to VMware's contractual agreements with EMC. In the six months ended June 30, 2012 and 2011, VMware recognized professional services revenues of $42.3 million and $30.8 million, respectively, from such contractual agreements with EMC. As of June 30, 2012, $6.7 million of revenues from professional services to EMC customers were included in unearned revenues.

In the three months ended June 30, 2012 and 2011, VMware recognized revenues of $2.1 million and $0.5 million, respectively, from server and desktop products and services purchased by EMC for internal use pursuant to VMware's contractual agreements with EMC. In the six months ended June 30, 2012 and 2011, VMware recognized revenues of $3.8 million and $1.0 million, respectively, from such contractual agreements with EMC. As of June 30, 2012, $22.7 million of revenues from server and desktop products and services purchased by EMC for internal use were included in unearned revenues.

VMware purchased storage systems and software, as well as consulting services, from EMC for $5.9 million and $7.5 million in the three months ended June 30, 2012 and 2011, respectively, and for $23.9 million and $13.3 million in the six months ended June 30, 2012 and 2011, respectively.

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 consolidated statements of income and primarily include salaries, benefits, travel and rent. Additionally, EMC incurs certain administrative costs on VMware's behalf in the U.S. that are also recorded as expenses. The total cost of the services provided to VMware by EMC as described above was $21.2 million and $18.0 million in the three months ended June 30, 2012 and 2011, respectively, and $49.0 million and $42.7 million in the six months ended June 30, 2012 and 2011, respectively.

In the three and six months ended June 30, 2012, no payments were made by either VMware or EMC under the tax sharing agreement. In the three and the six months ended June 30, 2011, EMC paid VMware $141.0 million and $176.4 million, respectively, under the tax sharing agreement and no payments were made by VMware to EMC. Payments between VMware and EMC under the tax sharing agreement primarily relate to VMware's portion of federal income taxes on EMC's consolidated tax return. Payments from VMware to EMC primarily relate to periods for which VMware had stand-alone federal taxable income, while payments from EMC to VMware relate to periods for which VMware had a stand-alone federal taxable loss. 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 stand-alone basis and the difference is presented as a component of stockholders' equity. For all periods presented, the difference was not material.

In the three months ended June 30, 2012 and 2011, $1.2 million and $1.0 million, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on VMware's consolidated statements of income. In the six months ended June 30, 2012 and 2011, $2.4 million and $1.9 million, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on VMware's consolidated statements of income. VMware's interest expense as a separate, stand-alone company may be higher or lower than the amounts reflected in the consolidated financial statements.

As of June 30, 2012, VMware had $61.7 million net due from EMC, which consisted of $88.6 million due from EMC, partially offset by $26.9 million due to EMC. These amounts resulted from the related party transactions described above. In addition to the $61.7 million net due from EMC as of June 30, 2012, VMware had an immaterial amount of net income taxes payable to EMC, which is included in accrued expenses and other on VMware's consolidated balance sheets. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

P. Segment Information

VMware operates in one operating segment. 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

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based upon discrete financial information at the consolidated level. Since VMware operates in one operating segment, all required financial segment information can be found in the consolidated financial statements.
Revenues by geographic area for the three months ended June 30, 2012 and 2011 were as follows (table in thousands):

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
United States	$550,659	$450,327	$1,035,633	$849,877
International	572,367	470,883	1,142,575	915,054
Total	$1,123,026	$921,210	$2,178,208	$1,764,931

No country other than the United States had material revenues for the three and six months ended June 30, 2012 or 2011.
Long-lived assets by geographic area, which primarily include property and equipment, net, as of June 30, 2012 and December 31, 2011 were as follows (table in thousands):

	June 30, 2012	December 31, 2011
United States	$466,115	$429,678
International	45,331	46,477
Total	$511,446	$476,155

No country other than the United States accounted for 10% or more of these assets at June 30, 2012 or December 31, 2011, respectively.
Q. Subsequent Events
In July 2012, VMware, Inc. entered into a definitive agreement to acquire Nicira, Inc. ("Nicira"), a developer of software-defined networking solutions, for approximately $1,050.0 million in cash plus approximately $210.0 million of assumed unvested equity awards. The acquisition is subject to regulatory approvals and other customary closing conditions. The parties expect the acquisition to close during the second half of 2012. The acquisition has been approved by the boards of directors of both VMware and Nicira and the stockholders of Nicira.

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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.

Overview

Our primary source of revenues is the licensing of virtualization and virtualization-based cloud infrastructure solutions and related support and services for use by businesses and organizations of all sizes and across numerous industries in their information technology ("IT") infrastructure.

We have developed a multi-channel distribution model to expand our global presence and to reach various segments of the industry. In the second quarter and first half of 2012, we derived over 85% of our sales from our channel partners, which include distributors, resellers, system vendors and systems integrators. Sales to our channel partners often involve three tiers of distribution: a distributor, a reseller and an end-user customer. Our sales force works collaboratively with our channel partners to introduce them to customers and new sales opportunities. As we expand geographically, we expect to continue to add additional channel partners.

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

We expect to grow our business by broadening our virtualization infrastructure software solutions technology and product portfolio, increasing product awareness, promoting the adoption of virtualization and building long-term relationships with our customers through the adoption of enterprise license agreements ("ELAs"). Since the introduction of VMware vSphere in 2009, we have introduced more products that build on the vSphere foundation, including VMware vSphere 5 and a comprehensive suite of cloud infrastructure technologies, as well as VMware View 5. We plan to continue to introduce additional products in the future. We have made, and expect to continue to make, acquisitions designed to strengthen our product offerings or extend our strategy to deliver solutions that can be hosted at customer data centers or at service providers.

Our current financial focus is on long-term revenue growth to generate free cash flows to fund our expansion of industry segment share and to evolve our virtualization-based products for data centers, end-user devices and cloud computing through a combination of internal development and acquisitions. See "Non-GAAP Financial Measures" for further information on free cash flows. In evaluating our results, we also focus on operating margin excluding certain expenses which are included in our total operating expenses calculated in accordance with GAAP. The expenses excluded are stock-based compensation, the net effect of the amortization and capitalization of software development costs and certain other expenses consisting of employer payroll taxes on employee stock transactions, amortization of intangible assets and acquisition-related items. We believe this measure reflects our ongoing business in a manner that allows meaningful period-to-period comparisons. We are not currently focused on short-term operating margin expansion, but rather on investing at appropriate rates to support our growth and future product offerings in what may be a substantially more competitive environment.

Although our customers continue to adopt our product platform as a strategic investment that improves efficiency and flexibility for their business and enables substantial cost savings, we remain cautious about the macroeconomic environment. The volatility we are observing in both the world economy and individual sovereign nations may impact IT spending and demand for our products and services for the remainder of 2012. We expect to continue to manage our resources prudently, while making key investments in support of our long-term growth objectives.

Income Statement Presentation

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

As a consequence of the timing differences in the recognition of license revenues and software maintenance revenues, variability in operating margin can result from differences between when we quote and contract for our services and when the cost is incurred. Variability in operating margin can also result when we recognize previously unearned foreign denominated software maintenance and license revenues in future periods. Due to our use of the U.S. Dollar as our functional currency, unearned revenue remains at its historical rate when recognized into revenue while our operating expenses in future periods are based upon the foreign exchange rates at that time.

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Sources of Revenues

License revenues

Our license revenues consist of revenues earned from the licensing of our software products. These products are generally licensed on a perpetual basis. License revenues are recognized when the elements of revenue recognition for the licensed software are complete, generally upon electronic shipment of the software. 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. While some of our products are licensed on a subscription basis, subscription license revenues are not a material part of our business.

Pricing models have generally been based upon the physical infrastructure, such as the number of physical desktop computers or server processors, on which our software runs. We base pricing for some of our products on virtual, rather than purely physical, entitlements, while continuing to license such products on a perpetual basis. In the third quarter of 2011, we revised the pricing model for VMware vSphere 5 effective with its general availability. VMware vSphere 5 will continue to be licensed perpetually on a per-processor basis. The two physical constraints, number of cores and physical RAM, have been eliminated, however, and replaced with a single virtualization-based entitlement of virtual memory, or vRAM, which can be shared across a large pool of servers.

Software maintenance revenues

Software maintenance revenues are recognized ratably over the contract period. Our contract periods typically range from one to five years and include renewals of software maintenance sold after the initial software maintenance period expires. Vendor-specific objective evidence (“VSOE”) of fair value for software maintenance services is established by the rates charged in stand-alone sales of software maintenance contracts. Customers receive various types of technical support based on the level of support purchased. Customers who are party to software maintenance agreements with us are entitled to receive product updates and upgrades on a when-and-if-available basis.

Professional services revenues

Professional services include solution design, implementation and training. Professional services are not considered essential to the functionality of our products, as these services do not alter the product capabilities and may be performed by our customers or by other vendors. Professional services engagements performed for a fixed fee, for which we are able to make reasonably dependable estimates of progress toward completion, are recognized on a proportional performance basis based on hours incurred and estimated hours of completion. Professional services engagements that are on a time and materials basis are recognized based on hours incurred. Revenues on all other professional services engagements are recognized upon completion. Our professional services may be sold with software products or on a stand-alone basis. VSOE of fair value for professional services is based upon the standard rates we charge for such services when sold separately.

Operating Expenses

Cost of license revenues

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

Cost of services revenues

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

Research and development expenses

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

Sales and marketing expenses

Our sales and marketing expenses include personnel costs, sales commissions and related overhead associated with the sale and marketing of our license and services offerings, as well as the cost of product launches and certain marketing initiatives, including our annual VMworld conferences in the U.S. and Europe. 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.

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General and administrative expenses

Our general and administrative expenses include personnel and related overhead costs to support the overall business. These expenses include the costs associated with our facilities, finance, human resources, IT infrastructure and legal departments, as well as expenses related to corporate costs and initiatives.

Results of Operations

Revenues

Our revenues in the second quarter and first half of 2012 and 2011 were as follows:

	For the Three Months Ended June 30,			For the Six Months Ended June 30,		
	2012	2011	% Change	2012	2011	% Change
Revenues:						
License	$517.2	$464.8	11 %	$999.1	$883.8	13 %
Services:						
Software maintenance	519.1	386.3	34	1,011.4	750.1	35
Professional services	86.7	70.1	24	167.7	131.0	28
Total services	605.8	456.4	33	1,179.1	881.1	34
Total revenues	$1,123.0	$921.2	22	$2,178.2	$1,764.9	23
Revenues:						
United States	$550.7	$450.3	22 %	$1,035.6	$849.9	22 %
International	572.3	470.9	22	1,142.6	915.0	25
Total revenues	$1,123.0	$921.2	22	$2,178.2	$1,764.9	23

Total revenues increased by $201.8 or 22% to $1,123.0 in the second quarter of 2012 from $921.2 in the second quarter of 2011. Total revenues increased by $413.3 or 23% to $2,178.2 in the first half of 2012 from $1,764.9 in the first half of 2011.

In the second quarter and first half of 2012 we saw growth in license and services revenues, and growth in the United States and internationally, as compared with the second quarter and first half of 2011.

License Revenues

Software license revenues increased by $52.4 or 11% to $517.2 in the second quarter of 2012 from $464.8 in the second quarter of 2011. Software license revenues increased by $115.3 or 13% to $999.1 in the first half of 2012 from $883.8 in the first half of 2011. License revenues in the second quarter and first half of 2012 benefited from demand across our product offerings, as compared to the second quarter and first half of 2011.

In the second quarter of 2012, ELAs comprised 29% of total sales compared with 26% in the second quarter of 2011, and 26% in the first half of 2012 compared with 24% in the first half of 2011. We have promoted the adoption of virtualization and built long-term relationships with our customers through the adoption of ELAs. ELAs continue to be an important component of our revenue growth and are offered both directly by us and through certain channel partners. ELAs are a core element to our strategy to build long-term relationships with customers as they commit to our virtualization infrastructure software solutions in their data centers. ELAs provide a base from which to sell additional products, such as our application platform products, our end-user computing products and our cloud infrastructure and management products. Under a typical ELA, a portion of the revenues is attributed to the license and recognized immediately and the remainder is deferred and primarily recognized as software maintenance revenues in future periods. In addition, the initial maintenance period is typically longer for ELAs than for other types of license sales.

Services Revenues

Services revenues increased by $149.4 or 33% to $605.8 in the second quarter of 2012 from $456.4 in the second quarter of 2011. Services revenues increased by $297.9 or 34% to $1,179.1 in the first half of 2012 from $881.1 in the first half of 2011. The increase in services revenues during the second quarter and first half of 2012 was primarily attributable to growth in our software maintenance revenues.

Software maintenance revenues increased by $132.8 or 34% to $519.1 in the second quarter of 2012 from $386.3 in the second quarter of 2011. Software maintenance revenues increased by $261.3 or 35% to $1,011.4 in the first half of 2012 from

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$750.1 in the first half of 2011. In the second quarter and first half of 2012, software maintenance revenues benefited from strong renewals, multi-year software maintenance contracts sold in previous periods, and additional maintenance contracts sold in conjunction with new software license sales. In the second quarter and first half of 2012, 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.
Professional services revenues increased by $16.6 or 24% to $86.7 in the second quarter of 2012 from $70.1 in the second quarter of 2011. Professional services revenues increased by $36.7 or 28% to $167.7 in the first half of 2012 from $131.0 in the first half of 2011. Professional services revenues increased as growth in our license sales and installed-base led to additional demand for our professional services. As we continue to invest in our partners and expand our ecosystem of third-party professionals with expertise in our solutions to independently provide professional services to our customers, we do not expect our professional services revenues to constitute an increasing component of our revenue mix. As a result of this strategy, our professional services revenue can vary based on the delivery channels used in any given period as well as the timing of engagements.
Revenue Growth in Constant Currency
We invoice and collect in the Euro, the British Pound, the Japanese Yen and the Australian Dollar 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. In order to provide a comparable framework for assessing how our business performed excluding the effect of foreign currency fluctuations, management analyzes year-over-year revenue growth on a constant currency basis. Since we operate with the U.S. Dollar as our functional currency, unearned revenues for orders booked in currencies other than the U.S. Dollar are converted into U.S. Dollars at the exchange rate in effect for the month in which each order is booked. We calculate constant currency on license revenues recognized during the current period that were originally booked in currencies other than U.S. Dollars by comparing the exchange rates used to recognize revenue in the current period against the exchange rates used to recognize revenue in the comparable period. We do not calculate constant currency on services revenues, which include software maintenance revenues and professional services revenues.
For the second quarter of 2012, the year-over-year growth in license revenues measured on a constant currency basis was 13% compared with 11% as reported, and was 14% compared with 13% as reported year-over-year for the first half of 2012. The year-over-year growth in total revenues in the second quarter of 2012 measured on a constant currency basis was 23% compared with 22% as reported and was 24% compared with 23% as reported year-over-year in the first half of 2012.
Unearned Revenues
Our unearned revenues as of June 30, 2012, and December 31, 2011 were as follows:

	June 30, 2012	December 31, 2011
Unearned license revenues	$375.6	$389.2
Unearned software maintenance revenues	2,357.0	2,133.5
Unearned professional services revenues	209.8	185.7
Total unearned revenues	$2,942.4	$2,708.4

The complexity of our unearned revenues has increased over time as a result of acquisitions, an expanded product portfolio and a broader range of pricing and packaging alternatives. As of June 30, 2012, total unearned revenues increased by $234.0 or 9% to $2,942.4 from $2,708.4 at December 31, 2011. This increase was primarily due to growth in unearned software maintenance revenues, attributable to our growing base of maintenance contracts.
Unearned license revenues are recognized either ratably or upon the delivery of existing products, future products or services. 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. We regularly offer product promotions as a strategy to improve awareness of our emerging products. To the extent promotional products have not been delivered and 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. At June 30, 2012, the ratable component represented over half of the total unearned license revenue balance. Unearned software maintenance revenues are attributable to our maintenance contracts and are recognized ratably over terms from one to five years with a weighted-average remaining term at June 30, 2012 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. We believe our overall unearned revenue balance improves predictability of

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future revenues and that it is a key indicator of the health and growth of our business.

Operating Expenses

Information about our operating expenses for the second quarter and first half of 2012 and 2011 is as follows:

	For the Three Months Ended June 30, 2012					
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses	
Cost of license revenue	$21.5	$0.5	$20.8	$13.8	$56.6	
Cost of services revenue	114.1	7.1	—	1.5	122.7	
Research and development	197.7	48.0	—	2.9	248.6	
Sales and marketing	353.2	33.9	—	4.4	391.5	
General and administrative	78.3	11.4	—	2.0	91.7	
Total operating expenses	$764.8	$100.9	$20.8	$24.6	$911.1	
Operating income					$211.9	
Operating margin					18.9	%

	For the Three Months Ended June 30, 2011					
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses	
Cost of license revenue	$17.5	$0.4	$19.8	$11.2	$48.9	
Cost of services revenue	96.1	5.7	—	1.7	103.5	
Research and development	164.0	46.1	(25.4)	4.5	189.2	
Sales and marketing	286.6	23.3	—	4.7	314.6	
General and administrative	66.3	9.9	—	1.9	78.1	
Total operating expenses	$630.5	$85.4	$(5.6)	$24.0	$734.3	
Operating income					$186.9	
Operating margin					20.3	%

	For the Six Months Ended June 30, 2012					
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses	
Cost of license revenue	$42.7	$1.0	$42.6	$27.0	$113.3	
Cost of services revenue	220.9	12.9	—	3.0	236.8	
Research and development	378.0	87.4	—	5.6	471.0	
Sales and marketing	686.5	59.1	—	9.3	754.9	
General and administrative	148.2	22.3	—	2.6	173.1	
Total operating expenses	$1,476.3	$182.7	$42.6	$47.5	$1,749.1	
Operating income					$429.1	
Operating margin					19.7	%

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	For the Six Months Ended June 30, 2011				
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses
Cost of license revenue	$35.6	$0.9	$48.3	$20.1	$104.9
Cost of services revenue	182.7	11.3	—	3.4	197.4
Research and development	315.9	88.0	(52.9)	7.4	358.4
Sales and marketing	563.9	45.8	—	7.8	617.5
General and administrative	123.9	20.0	—	2.4	146.3
Total operating expenses	$1,222.0	$166.0	$(4.6)	$41.1	$1,424.5
Operating income					$340.4
Operating margin					19.3%

(1) Core operating expenses is a non-GAAP financial measure that excludes stock-based compensation, the net effect of the amortization and capitalization of software development costs and certain other expenses from our total operating expenses calculated in accordance with GAAP. The other expenses excluded are employer payroll taxes on employee stock transactions, amortization of intangible assets and acquisition-related items. See "Non-GAAP Financial Measures" for further information.

Operating margins decreased to 18.9% in the second quarter of 2012 from 20.3% in the second quarter of 2011. The decrease in our operating margin in the second quarter of 2012 compared with the second quarter of 2011 primarily relates to the year-over-year decrease in capitalized software development costs due to the change in our go-to-market strategy. Our operating margin in the first half of 2012 was flat compared with the first half of 2011 at 19.7% and 19.3%, respectively. Although the change was not significant, our operating margin in the first half of 2012 compared with the first half of 2011 was negatively impacted by the year-over-year decrease in capitalized software development costs. This negative impact was offset by increases in our revenues, which outpaced the increases in our core operating expenses and stock-based compensation.

Our core operating expenses reflect our business in a manner that allows meaningful period-to-period comparisons. Our core operating expenses are reconciled to the most comparable GAAP measure, "total operating expenses," in the table above.

Core Operating Expenses

The following discussion of our core operating expenses and the components comprising our core operating expenses highlights the factors that we focus on when evaluating our operating margin and operating expenses. The increases or decreases in operating expenses discussed in this section do not include changes relating to stock-based compensation, the net effect of the amortization and capitalization of software development costs and certain other expenses, which consist of employer payroll taxes on employee stock transactions, amortization of acquired intangible assets and acquisition-related items.

Core operating expenses increased by $134.3 or 21% in the second quarter of 2012 compared with the second quarter of 2011. Core operating expenses increased by $254.3 or 21% in the first half of 2012 compared with the first half of 2011. As quantified below, these increases were primarily due to an increase in employee-related expenses, which include salaries and benefits, bonuses, commissions, and recruiting and training. The increase in employee-related expenses was largely a result of an increase in headcount of over 2,000 employees in the second quarter of 2012 compared with the second quarter of 2011, driven by strategic hiring, business growth and business acquisitions. A portion of our core operating expenses, primarily the cost of personnel to deliver technical support on our products and professional services, marketing, and research and development, are denominated in foreign currencies, and are thus exposed to foreign exchange rate fluctuations. Core operating expenses benefited by $19.1 and $23.0 in the second quarter and first half of 2012, as compared with the second quarter and first half of 2011, due to the effect of fluctuations in the exchange rates between the U.S. Dollar and other currencies.

Cost of License Revenues

Core operating expenses in cost of license revenues increased by $4.0 or 23% in the second quarter of 2012 compared with the second quarter of 2011, and by $7.1 or 20% in the first half of 2012 compared with the first half of 2011. The increases were primarily due to an increase of $2.2 and $3.8 in the second quarter and first half of 2012, respectively, for IT development costs.

Cost of Services Revenues

Core operating expenses in cost of services revenues increased by $18.0 or 19% in the second quarter of 2012 compared with the second quarter of 2011, and by $38.2 or 21% in the first half of 2012 compared with the first half of 2011. The increases were primarily due to growth in employee-related expenses of $14.4 and $27.5 in the second quarter and first half of

2012, respectively, which were largely driven by incremental growth in headcount. Additionally, our third-party professional services costs increased by $4.6 and $8.8 in the second quarter and first half of 2012, respectively, to provide technical support and professional services primarily in connection with increased demand for services.

Research and Development Expenses

Core operating expenses for R&D increased by $33.7 or 21% in the second quarter of 2012 compared with the second quarter of 2011, and by $62.1 or 20% in the first half of 2012 compared with the first half of 2011. The increases were primarily due to growth in employee-related expenses of $28.2 and $52.9 in the second quarter and first half of 2012, respectively, which was primarily driven by incremental growth in headcount from strategic hiring and business acquisitions.

Sales and Marketing Expenses

Core operating expenses for sales and marketing increased by $66.6 or 23% in the second quarter of 2012 compared with the second quarter of 2011, and by $122.6 or 22% in the first half of 2012 compared with the first half of 2011. The increases were primarily due to growth in employee-related expenses of $54.5 and $99.9 in the second quarter and first half of 2012, respectively, driven by incremental growth in headcount. Additionally, the costs of marketing programs increased by $13.2 and $21.6 in the second quarter and first half of 2012, respectively. These increases were partially offset by the positive impact of $10.5 and $12.1, respectively, from fluctuations in the exchange rate between the U.S. Dollar and foreign currencies.

General and Administrative Expenses

Core operating expenses for general and administrative increased by $12.0 or 18% in the second quarter of 2012 compared with the second quarter of 2011, and by $24.3 or 20% in the first half of 2012 compared with the first half of 2011. The increases were primarily due to an increase of $4.3 and $10.2 in the second quarter and first half of 2012, respectively, related to employee-related expenses mostly due to incremental growth in headcount. General and administrative expenses also increased in the second quarter and first half of 2012 due to equipment and depreciation expenses of $3.3 and $4.6, respectively, to support increased headcount and IT security initiatives. Additionally, contractor costs primarily related to IT security initiatives contributed to the overall year-over-year change in expenses with an increase of $1.9 and $3.9 in the second quarter and first half of 2012, respectively.

Stock-Based Compensation Expense

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Stock-based compensation, excluding amounts capitalized	$100.9	$85.4	$182.7	$166.0
Stock-based compensation capitalized	—	4.2	—	9.0
Stock-based compensation, including amounts capitalized	$100.9	$89.6	$182.7	$175.0

Stock-based compensation expense increased by $11.3 and $7.7 in the second quarter and first half of 2012 compared to the second quarter and first half of 2011 primarily due to an increase of $35.9 and $54.9, respectively, for new awards issued to our existing employees, as well as an increase of $9.2 and $17.8, respectively, for awards made to new employees over the last year. Partially offsetting these increases was a decrease of $31.4 and $65.7, respectively, related to grants which became fully vested over the past year.

Stock-based compensation is recorded to each operating expense category based upon the function of the employee to whom the stock-based compensation relates and fluctuates based upon the value and number of awards granted. Compensation philosophy varies by function, resulting in different weightings of cash incentives versus equity incentives. As a result, functions with larger cash-based components, such as sales commissions, will have comparatively lower stock-based compensation expense than other functions.

As of June 30, 2012, the total unamortized fair value of our outstanding equity-based awards held by our employees was approximately $884.7 and is expected to be recognized over a weighted-average period of approximately 1.7 years.

Capitalized Software Development Costs, Net

Development costs of software to be sold, leased, or otherwise marketed are subject to capitalization beginning when the product's technological feasibility has been established and ending when the product is available for general release. Judgment is required in determining when technological feasibility is established, and as our business, products and go-to-market strategy have evolved, we have continued to evaluate when technological feasibility is established. Following the release of vSphere 5 and the comprehensive suite of cloud infrastructure technologies in the third quarter of 2011, we determined that VMware's go-

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to-market strategy had changed from single solutions to product suite solutions. As a result of this change in strategy, and the related increased importance of interoperability between our products, the length of time between achieving technological feasibility and general release to customers significantly decreased. We expect our products to be available for general release soon after technological feasibility has been established. Given that we expect the majority of our product offerings to be suites or to have key components that interoperate with our other product offerings, the costs incurred subsequent to achievement of technological feasibility are expected to be immaterial in future periods. In the second quarter and first half of 2012, all software development costs were expensed as incurred and were included in R&D expenses on the accompanying consolidated statement of income. In the second quarter and first half of 2011, we capitalized $29.6 (including $4.2 of stock-based compensation) and $61.9 (including $9.0 of stock-based compensation), respectively, of costs for the development of software products. The amounts capitalized in the second quarter and first half of 2011 primarily related to the development of VMware vSphere 5.

Our expensed and capitalized R&D costs may not be comparable to our peer companies due to differences in judgment as to when technological feasibility has been reached or differences in judgment regarding when the product is available for general release. Additionally, future changes in our judgment as to when technological feasibility is established, or additional changes in our business, including our go-to-market strategy, could materially impact the amount of costs capitalized. For example, if the length of time between technological feasibility and general availability was to increase again in the future, the amount of capitalized costs would likely increase.

In the second quarter of 2012, amortization expense from capitalized software development costs increased $1.0 to $20.8 from $19.8 in the second quarter of 2011. This increase was primarily due to the general release of VMware vSphere 5.0 in the second half of 2011. In the first half of 2012, amortization expense from capitalized software development costs decreased $5.7 to $42.6 from $48.3 in the first half of 2011. This decrease was primarily due to a decrease of $24.6 related to the amortization of prior versions of vSphere, as well as a decrease of $7.4 related to certain capitalized projects that were fully amortized prior to the end of the second quarter of 2012. These decreases were partially offset by an increase of $22.6 related to the general release of VMware vSphere 5.0 in the second half of 2011. Amortization expense from capitalized software development costs is included in cost of license revenues on our accompanying consolidated statements of income. In future periods, we expect our amortization expense from capitalized software development costs to decline as these costs are expected to be recorded as R&D expense as incurred given our current go-to-market strategy.

Other Operating Expenses

Other operating expenses consist of employer payroll tax on employee stock transactions and intangible amortization, which are recorded to each individual line of operating expense on our accompanying consolidated statements of income. Additionally, other operating expenses include acquisition-related items, which are recorded to general and administrative expense on our income statement.

Other operating expenses increased by $0.6 to $24.6 in the second quarter of 2012 from $24.0 in the second quarter of 2011. The increase in the second quarter of 2012 was primarily due to an increase in intangible amortization of $2.9 resulting from new acquisitions, which was primarily recorded to costs of license revenues on our income statement. The increase was partially offset by a decrease of $2.7 in employer payroll taxes on employee stock transactions, which was primarily attributable to a decrease in the number of awards exercised, sold or vested. Other operating expenses increased by $6.3 to $47.5 in the first half of 2012 from $41.1 in the first half of 2011. The increase in the first half of 2012 was primarily due to an increase in intangible amortization of $7.8 resulting from new business acquisitions, which was primarily recorded to costs of license revenues on our income statement. The increase was partially offset by a decrease of $1.7 in employer payroll taxes on employee stock transactions, which was primarily attributable to a decrease in the number of awards exercised, sold or vested.

Investment Income

Investment income increased by $3.2 to $6.9 in the second quarter of 2012 from $3.7 in the second quarter of 2011. Investment income increased by $5.6 to $12.7 in the first half of 2012 from $7.1 in the first half of 2011. Investment income primarily consists of interest earned on cash, cash equivalents and short-term investment balances partially offset by the amortization of premiums paid on fixed income securities. Investment income increased in the second quarter and first half of 2012 as compared with the second quarter and first half of 2011 due to an increase in the

average rate of interest earned, resulting from a reallocation of funds from cash equivalents to fixed income securities, and increased cash equivalent and short-term investment balances available for investment.

Other Income (Expense), Net

Other expense, net of $3.6 in second quarter of 2012 changed by $60.2 as compared with other income, net of $56.6 in second quarter of 2011. Other expense, net of $1.3 in first half of 2012 changed by $58.1 from other income, net of $56.8 in first half of 2011. The change in second quarter and first half of 2012 as compared with the second quarter and first half of 2011 was primarily due to a $56.0 gain recognized on the sale of our investment in Terremark Worldwide, Inc. in 2011.

Income Tax Provision

Our effective income tax rate was 10.5% and 10.6%, respectively, for the second quarter of 2012 and 2011. The effective income tax rate was 12.5% and 14.0%, respectively, for the first half of 2012 and 2011. The lower effective rate for the second quarter and first half of 2012, as compared with the second quarter and first half of 2011, was primarily attributable to a jurisdictional shift of income from the United States to lower-tax non-U.S. jurisdictions, partially offset by a decrease in the release of unrecognized tax benefits from uncertain tax positions as a percentage of income before tax, as well as by the expiration of the federal research tax credit.

Our rate of taxation in foreign jurisdictions is lower than our U.S. tax rate. Our international income is primarily earned by our subsidiaries in Ireland, where the statutory tax rate is 12.5%. We do not believe that any recent or currently expected developments in non-U.S. tax jurisdictions are reasonably likely to have a material impact on our effective tax rate. As of June 30, 2012, our total cash, cash equivalents, and short-term investments were $5,346.9, of which $2,694.0 were held outside the U.S. If these overseas funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes on related undistributed earnings to repatriate these funds. However, all income earned abroad, except for previously taxed income for U.S. tax purposes, is considered indefinitely reinvested in our foreign operations and no provision for U.S. taxes has been provided with respect thereto. At this time, it is not practicable to estimate the amount of tax that may be payable were we to repatriate these funds and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations. We will meet our U.S. liquidity needs through ongoing cash flows generated from our U.S. operations, external borrowings, or both. We utilize a variety of tax planning and financing strategies in an effort to ensure that our worldwide cash is available in the locations in which it is needed.

Although we file a federal consolidated tax return with EMC, we calculate our income tax provision on a stand-alone basis. Our effective tax rate in the periods presented is the result of the mix of income earned in various tax jurisdictions that apply a broad range of income tax rates. The rate at which the provision for income taxes is calculated differs from the U.S. federal statutory income tax rate primarily due to different tax rates in foreign jurisdictions where income is earned and considered to be indefinitely reinvested.

We have been included in the EMC consolidated group for U.S. federal income tax purposes, and expect to continue to be included in such consolidated group for periods in which EMC owns at least 80% of the total voting power and value of our outstanding stock as calculated for U.S. federal income tax purposes. The percentage of voting power and value calculated for U.S. federal income tax purposes may differ from the percentage of outstanding shares beneficially owned by EMC due to the greater voting power of our Class B common stock as compared to our Class A common stock and other factors. Each member of a consolidated group during any part of a consolidated return year is jointly and severally liable for tax on the consolidated return of such year and for any subsequently determined deficiency thereon. Should EMC’s ownership fall below 80% of the total voting power or value of our outstanding stock in any period, then we would no longer be included in the EMC consolidated group for U.S. federal income tax purposes, and thus no longer be liable in the event that any income tax liability was incurred, but not discharged, by any other member of the EMC consolidated group. Additionally, our U.S. federal income tax would be reported separately from that of the EMC consolidated group.

Our effective tax rate for the remainder of 2012 may be affected by such factors as changes in tax laws, regulations or rates, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation, the impact of accounting for business combinations, changes in our international organization, shifts in the amount of income before tax earned in the U.S. as compared with other regions in the world, and changes in overall levels of income before tax.

Our Relationship with EMC

As of June 30, 2012, EMC owned 38,664,000 shares of Class A common stock and all 300,000,000 shares of Class B common stock, representing 79.3% of our total outstanding shares of common stock and 97.2% of the combined voting power of our outstanding common stock.

In the second quarter of 2011, we acquired certain assets relating to EMC’s Mozy cloud-based data storage and data center services, including certain data center assets and a license to certain intellectual property. EMC retained ownership of the Mozy business and its remaining assets. EMC continues to be responsible to Mozy customers for

Mozy products and services and continues to recognize revenue from such products and services. We entered into an operational support agreement with EMC through the end of 2012, pursuant to which we took over responsibility to operate the Mozy service on behalf of EMC. Pursuant to the support agreement, costs incurred by us to support EMC's Mozy services, plus a mark-up intended to approximate third-party costs and a management fee, are reimbursed to us by EMC. On the consolidated statements of income, in the three months ended June 30, 2012 and 2011, such amounts as described above were approximately $16.4 and $12.2, respectively. In the six months ended June 30, 2012 and 2011, such amounts were $30.9 and $12.2, respectively. These amounts were recorded as a reduction to the costs we incurred.

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In the second quarter of 2010, we acquired certain software product technology and expertise from EMC's Ionix IT management business for cash consideration of $175.0. EMC retained the Ionix brand and will continue to offer customers the products acquired by us, pursuant to the ongoing reseller agreement between EMC and us. During the six months ended June 30, 2011, a $12.5 contingent payment was made to EMC. This payment was recorded as an equity transaction and was an offset to the initial capital contribution from EMC. As of December 31, 2011, all contingent payments under the agreement had been made.

Pursuant to an ongoing reseller arrangement with EMC, EMC bundles our products and services with EMC's hardware and sells them to end-users. In the three months ended June 30, 2012 and 2011, we recognized revenues of $45.6 and $14.2, respectively, from products and services sold pursuant to our reseller arrangement with EMC. In the six months ended June 30, 2012 and 2011, we recognized revenues of $80.6 and $34.2, respectively, from such contractual arrangement with EMC. As of June 30, 2012, $107.6 of revenues from products and services sold under the reseller arrangement were included in unearned revenues.

In the three months ended June 30, 2012 and 2011, we recognized professional services revenues of $23.6 and $16.4, respectively, for services provided to EMC's customers pursuant to our contractual agreements with EMC. In the six months ended June 30, 2012 and 2011, we recognized professional services revenues of $42.3 and $30.8, respectively, from such contractual agreements with EMC. As of June 30, 2012, $6.7 of revenues from professional services to EMC customers were included in unearned revenues.

In the three months ended June 30, 2012 and 2011, we recognized revenues of $2.1 and $0.5, respectively, from server and desktop products and services purchased by EMC for internal use pursuant to our contractual agreements with EMC. In the six months ended June 30, 2012 and 2011, we recognized revenues of $3.8 and $1.0, respectively, from such contractual agreements with EMC. As of June 30, 2012, $22.7 of revenues from server and desktop products and services purchased by EMC for internal use were included in unearned revenues.

We purchased storage systems and software, as well as consulting services, from EMC for $5.9 and $7.5 in the three months ended June 30, 2012 and 2011, respectively, and for $23.9 and $13.3 in the six months ended June 30, 2012 and 2011, respectively.

In certain geographic regions where we do not have an established legal entity, we contract with EMC subsidiaries for support services and EMC personnel who are managed by us. The costs incurred by EMC on our behalf related to these employees are passed on to us and we are charged a mark-up intended to approximate costs that would have been charged had we contracted for such services with an unrelated third party. These costs are included as expenses in our consolidated statements of income and primarily include salaries, benefits, travel and rent. Additionally, EMC incurs certain administrative costs on our behalf in the U.S. that are also recorded as expenses. The total cost of the services provided to us by EMC as described above was $21.2 and $18.0 in the three months ended June 30, 2012 and 2011, respectively, and $49.0 and $42.7 in the six months ended June 30, 2012 and 2011, respectively.

In the three and six months ended June 30, 2012, no payments were made by either us or EMC under the tax sharing agreement. In the three and the six months ended June 30, 2011, EMC paid us $141.0 and $176.4, respectively, under the tax sharing agreement and no payments were made by us to EMC. Payments between us and EMC under the tax sharing agreement primarily relate to our portion of federal income taxes on EMC's consolidated tax return. Payments from us to EMC primarily relate to periods for which we had stand-alone federal taxable income, while payments from EMC to us relate to periods for which we had a stand-alone federal taxable loss. The amounts that we either pay to or receive from EMC for our portion of federal income taxes on EMC's consolidated tax return differ from the amounts we would owe on a stand-alone basis and the difference is presented as a component of stockholders' equity. For all periods presented, the difference was not material.

In the three months ended June 30, 2012 and 2011, $1.2 and $1.0, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on our consolidated statements of income. In the six months ended June 30, 2012 and 2011, $2.4 and $1.9, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on our consolidated statements of income. Our interest expense as a separate, stand-alone company may be higher or lower than the amounts reflected in the consolidated financial statements.

As of June 30, 2012, we had $61.7 net due from EMC, which consisted of $88.6 due from EMC, partially offset by $26.9 due to EMC. These amounts resulted from the related party transactions described above. In addition to the $61.7 net due from EMC as of June 30, 2012, we had an immaterial amount of net income taxes payable to EMC, which is included in accrued expenses and other on our consolidated balance sheets. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.
By nature of EMC’s majority ownership of us, the amounts we recorded for our intercompany transactions with EMC may not be considered arm’s length with an unrelated third party. Therefore the financial statements included herein may not

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necessarily reflect our financial condition, results of operations and cash flows had we engaged in such transactions with an unrelated third party during all periods presented. Accordingly, our historical results should not be relied upon as an indicator of our future performance as a stand-alone company.

Liquidity and Capital Resources

At June 30, 2012 and 2011, we held cash, cash equivalents, and short-term investments as follows:

	June 30,	
	2012	2011
Cash and cash equivalents	$2,076.9	$1,791.0
Short-term investments	3,270.0	1,912.1
Total cash, cash equivalents and short-term investments	$5,346.9	$3,703.1

Our operating activities in the second quarter and first half of 2012 and 2011, respectively, generated sufficient cash to meet our operating needs. Our cash flows for the second quarter and first half of 2012 and 2011 were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2012	2011	2012	2011
Net cash provided by (used in):				
Operating activities	$391.3	$462.8	$967.9	$940.7
Investing activities	(777.2)	(411.2)	(834.6)	(779.6)
Financing activities	(163.3)	30.5	(12.2)	1.0
Net increase (decrease) in cash and cash equivalents	$(549.2)	$82.1	$121.1	$162.1

In evaluating our liquidity internally, we focus on long-term, sustainable growth in free cash flows and in non-GAAP cash flows from operating activities ("non-GAAP operating cash flows") over trailing twelve months periods, which we consider to be a relevant measure of our long-term progress. We define non-GAAP operating cash flows as net cash provided by operating activities less capitalized software development costs plus the excess tax benefits from stock-based compensation. We define free cash flows, also a non-GAAP financial measure, as non-GAAP operating cash flows less capital expenditures. See "Non-GAAP Financial Measures" for additional information.

Our non-GAAP operating cash flows and free cash flows for the three months and trailing twelve months ended June 30, 2012 and 2011 were as follows:

	For the Three Months Ended June 30,		For the Trailing Twelve Months Ended June 30,	
	2012	2011	2012	2011
Net cash provided by operating activities	$391.3	$462.8	$2,052.8	$1,544.0
Capitalized software development costs	—	(25.4)	(21.1)	(75.8)
Excess tax benefits from stock-based compensation	32.7	101.3	159.7	286.2
Non-GAAP operating cash flows	424.0	538.7	2,191.4	1,754.4
Capital expenditures	(44.3)	(95.2)	(185.9)	(193.8)
Free cash flows	$379.7	$443.5	$2,005.5	$1,560.6

Free cash flows increased by $444.9 or 29% to $2,005.5 for the trailing twelve months ended June 30, 2012 from $1,560.6 for the trailing twelve months ended June 30, 2011. The increase was primarily due to increased sales and related cash collections, partially offset by higher operating expenses which were primarily driven by headcount growth.

As of June 30, 2012, we held a diversified portfolio of money market funds and fixed income securities. Our fixed income securities were denominated in U.S. Dollars and consisted of highly liquid debt instruments of the U.S. government and its agencies, U.S. municipal obligations, and U.S. and foreign corporate debt securities. We limit the amount of our domestic and international investments with any single issuer and any single financial institution, and also monitor the diversity of the portfolio, thereby diversifying the credit risk. Within our portfolio, we held $39.1 of foreign government and agencies securities, $15.1 of which was deemed sovereign debt, at June 30, 2012. These sovereign debt securities had an average credit

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rating of AAA and were predominantly from Canada and France. None of the securities deemed sovereign debt were from Greece, Ireland, Italy, Portugal or Spain.
As of June 30, 2012, our total cash, cash equivalents and short-term investments were $5,346.9, of which $2,694.0 was held outside the U.S. If these overseas funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes on related undistributed earnings to repatriate these funds. However, our intent is to indefinitely reinvest our non-U.S. earnings in our foreign operations and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.
We expect to continue to generate positive cash flows from operations in 2012 and to use cash generated by operations as our primary source of liquidity. We believe that existing cash and cash equivalents, together with any cash generated from operations will be sufficient to meet normal operating requirements including strategic acquisitions and capital expenditures for at least the next twelve months.
Operating Activities
Cash provided by operating activities is driven by our net income, adjusted for non-cash items and changes in assets and liabilities. Non-cash adjustments include depreciation, amortization of intangible assets, amortization of premiums paid upon purchase of investments in our fixed income portfolio, stock-based compensation expense, excess tax benefits from stock-based compensation and other adjustments. Net changes in assets and liabilities were impacted by increases in unearned revenues in the periods presented, and we expect this trend to continue in the future.
Cash provided by operating activities decreased by $71.5 to $391.3 in the second quarter of 2012 from $462.8 in the second quarter of 2011. The decrease year-over-year was primarily driven by the timing of tax payments we received from EMC under the tax sharing agreement. Under the tax sharing agreement, EMC is obligated to pay us an amount equal to the tax benefit generated by us that EMC will recognize on its consolidated tax return. In the second quarter of 2012, we did not receive any amounts from EMC under the tax sharing agreement, but in the second quarter of 2011, we benefited from the collection of $141.0, which included amounts for both the 2011 and 2010 tax years. For 2012, we expect to pay U.S. federal state income taxes to EMC, therefore we do not expect to benefit from the collection of income tax receivables under the tax sharing agreement in 2012. Additionally, the overall change in our cash provided by operating activities year-over-year was impacted by increases in cash collections driven by growth in our sales to customers, which were partially offset by increases in our core operating expenses, primarily driven by headcount growth.
Cash provided by operating activities did not change significantly in the first half of 2012 compared to the first half of 2011. While cash collections from our customers increased in the first half of 2012 as a result of strong sales volume, they were partially offset by increases in our core operating expenses, primarily driven by headcount growth. Additionally, in the first half of 2011, we benefited from the collection of $176.4 from EMC under the tax sharing agreement. In the first half of 2012, there were no cash payments or receipts under the tax sharing agreement.
Investing Activities
Cash used in investing activities is generally attributable to the purchase of fixed income securities, business acquisitions, and capital expenditures. Cash provided by investing activities is primarily attributable to the sales or maturities of fixed income securities.
Total fixed income securities of $1,253.6 and $529.0 were purchased in the second quarter of 2012 and 2011, respectively. In the first half of 2012 and 2011, we purchased $1,955.1 and $1,127.8, respectively, of fixed income securities. All purchases of fixed income securities were classified as cash outflows from investing activities. We classified these investments as short-term investments on our consolidated balance sheets based upon the nature of the security and their availability for use in current operations or for other purposes, such as business acquisitions and strategic investments. These cash outflows were partially offset by cash inflows of $625.5 and $500.9 in the second quarter of 2012 and 2011, respectively, and $1,304.8 and $869.6 in the first half of 2012 and 2011, respectively, as a result of the sales and maturities of fixed income securities. Activity in our fixed income portfolio increased primarily from increased cash equivalent and short-term investment balances available for investment, including a reallocation of funds from cash equivalents to fixed income securities.
We did not capitalize any development costs for software to be sold, leased, or otherwise marketed in the second quarter and first half of 2012 as compared to $25.4 and $52.9 of costs capitalized in the second quarter and first half of

2011. Following the release of vSphere 5 and the comprehensive suite of cloud infrastructure technologies in the third quarter of 2011, we determined that VMware's go-to-market strategy had changed from single solutions to product suite solutions. As a result of this change in strategy, and the related increased importance of interoperability between our products, the length of time between achieving technological feasibility and general release to customers significantly decreased. As the vast majority of our products are now available for general release soon after technological feasibility has been established, we expect the costs incurred subsequent to the achievement of technological feasibility to continue to be immaterial in future periods and all software development costs will be expensed as incurred.

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In the second quarter of 2012 and 2011, we paid $102.2 and $189.1, respectively, and in the first half of 2012 and 2011, we paid $102.2 and $204.1, respectively, for business acquisitions. Business acquisitions are an important element of our strategy and we expect to continue to consider additional strategic business acquisitions in the future. Refer to Note G to the consolidated financial statements for further information.
In the second quarter of 2011, we closed an agreement to purchase all of the right, title and interest in a ground lease covering the property and improvements located adjacent to our existing Palo Alto, California campus for $225.0. We paid the seller $45.0 in the first quarter of 2011 as a good faith deposit, and in the second quarter of 2011, we paid the remaining $180.0. Based upon the respective preliminary fair values, $51.9 of the purchase price was recorded to property and equipment and the remaining $173.1 was recorded to intangible assets on the consolidated balance sheet. Refer to Note H to the consolidated financial statements for further information. On the consolidated statement of cash flows for the second quarter and first half of 2011, the $51.9 paid for the property is included within additions to property and equipment and the $173.1 paid for the intangible assets is separately disclosed within cash used in investing activities. Our renovation of the new property will be a multi-year project with capital investment extending into future periods. Our total capital expenditures for 2012 are expected to be approximately $320 to $340, which includes the continued renovation of our expanded campus.
In the second quarter of 2011, we sold our investment in Terremark Worldwide, Inc. for $76.0.
In July 2012, we entered into a definitive agreement to acquire Nicira, Inc., a developer of software-defined networking solutions, for approximately $1,050.0 in cash plus approximately $210.0 of assumed unvested equity awards. The acquisition is subject to regulatory approvals and other customary closing conditions and is expected to close during the second half of 2012.
Financing Activities
Proceeds from the issuance of our Class A common stock from the exercise of stock options and the purchase of shares under the VMware Employee Stock Purchase Plan (“ESPP”) were $33.6 and $110.5 in the second quarter of 2012 and 2011, respectively. Proceeds from the issuance of our Class A common stock from the exercise of stock options and the purchase of shares under the VMware Employee Stock Purchase Plan (“ESPP”) were $144.6 and $200.7 in the first half of 2012 and 2011, respectively.
In the second quarter of 2012 and 2011, we paid $178.2 and $132.7, including commissions, to repurchase and retire 1.8 million and 1.4 million shares, respectively, of our Class A common stock at a weighted-average price of $96.50 and $91.60 per share, respectively, as part of our stock repurchase programs. In the first half of 2012 and 2011, we paid $178.2 and $280.4, including commissions, to repurchase and retire 1.8 million and 3.2 million shares, respectively, of our Class A common stock at a weighted-average price of $96.50 and $88.50 per share, respectively, as part of our stock repurchase programs. From time-to-time, stock repurchases may be made pursuant to the stock repurchase authorizations in open market transactions or privately negotiated transactions as permitted by securities laws and other legal requirements. We are not obligated to purchase any shares under our stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased will depend on a variety of factors, including our 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 we feel that additional purchases are not warranted. As of June 30, 2012, the amount remaining for repurchase was $507.1. This amount is authorized for repurchases through the end of 2013.
There were additional cash outflows of $51.3 and $48.7 in the second quarter of 2012 and 2011, respectively, and $65.0 and $70.6 in the first half of 2012 and 2011, respectively, to cover tax withholding obligations in conjunction with the net share settlement upon the vesting of restricted stock units and restricted stock. Additionally, the excess tax benefit from stock-based compensation was $32.7 and $101.3 in the second quarter of 2012 and 2011, respectively, and $86.4 and $151.3 in the first half of 2012 and 2011, respectively, and is shown as a reduction to cash flows from operating activities and an increase to cash flows from financing activities. The year-over-year changes in the repurchase of shares to cover tax withholding obligations and the excess tax benefit from stock-based compensation in the second quarter and first half of 2012 were primarily due to changes in the market value of our stock and the number of awards exercised, sold or vested.

Future cash proceeds from issuances of common stock and the excess tax benefit from stock-based compensation and future cash outflows to repurchase our shares to cover tax withholding obligations will depend upon, and could fluctuate significantly from period-to-period based on, the market value of our stock, the number of awards exercised, sold or vested, the tax benefit realized and the tax-affected compensation recognized.

Note Payable to EMC

As of June 30, 2012, $450.0 remained outstanding on a note payable to EMC, with interest payable quarterly in arrears. In June 2011, we and EMC amended and restated the note to extend the maturity date of the note to April 16, 2015 and to modify the principal amount of the note to reflect the outstanding balance of $450.0. The interest rate of the 90-day LIBOR plus 55 basis points continues to reset quarterly.

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

Non-GAAP Financial Measures

Regulation S-K Item 10(e), “Use of Non-GAAP Financial Measures in Commission Filings,” defines and prescribes the conditions for use of non-GAAP financial information. Our measures of core operating expenses, non-GAAP operating cash flows and free cash flows each meet the definition of a non-GAAP financial measure.

Core Operating Expenses

Management uses the non-GAAP measure of core operating expenses to understand and compare operating results across accounting periods, for internal budgeting and forecasting purposes, for short- and long-term operating plans, to calculate bonus payments and to evaluate our financial performance, the performance of our individual functional groups and the ability of operations to generate cash. Management believes that by excluding certain expenses that are not reflective of our ongoing operating results, core operating expenses reflect our business in a manner that allows for meaningful period-to-period comparisons and analysis of trends in our business.

We define core operating expenses as our total operating expenses excluding the following components, which we believe are not reflective of our ongoing operational expenses. In each case, for the reasons set forth below, management believes that excluding the component provides useful information to investors and others in understanding and evaluating our operating results and future prospects in the same manner as management, in comparing financial results across accounting periods and to those of peer companies and to better understand the long-term performance of our core business.

- Stock-based compensation. Stock-based compensation expense is generally fixed at the time the stock-based instrument is granted and amortized over a period of several years. Although stock-based compensation is an important aspect of the compensation of our employees and executives, determining the fair value of some of the stock-based instruments we utilize involves a high degree of judgment and estimation and the expense recorded may bear little resemblance to the actual value realized upon the vesting or future exercise of the related stock-based awards. Furthermore, unlike cash compensation, the value of stock options, which is an element of our ongoing stock-based compensation expense, is determined using a complex formula that incorporates factors, such as market volatility, that are beyond our control. Additionally, in order to establish the fair value of performance-based stock awards, which are also an element of our ongoing stock-based compensation expense, we are required to apply judgment to estimate the probability of the extent to which performance objectives will be achieved.
- Amortization and capitalization of software development costs. Capitalized software development costs encompasses capitalization of development costs and the subsequent amortization of the capitalized costs over the useful life of the product. Amortization and capitalization of software development costs can vary significantly depending upon the timing of products reaching technological feasibility and being made generally available. In future periods, we expect our amortization expense from capitalized software development costs to decline as software development costs are expected to be recorded as R&D expense as incurred given our current go-to-market strategy, which has changed from single product solutions to product suite solutions. As a result of this change in strategy, and the related increased importance of interoperability between our products, the length of time between achieving technological feasibility and general release to customers has significantly decreased. Given that we expect the majority of our product offerings to be suites or to have key components that interoperate with our other product offerings, the costs incurred subsequent to achievement of technological feasibility are expected to be immaterial in future periods. For additional information, see “Results of Operations - Capitalized Software Development Costs, Net” above.
- Other expenses. Other expenses excluded are employer payroll taxes on employee stock transactions, amortization of intangible assets and acquisition-related items. The amount of employer payroll taxes on stock-based compensation is dependent on our stock price and other factors that are beyond our control and do not correlate to the operation of the business. Regarding the amortization of intangible assets, a portion of the purchase price of our acquisitions is generally allocated to intangible assets, such as intellectual property, and is subject to amortization. Additionally, the amount of an acquisition’s purchase price allocated to intangible assets and the term of its related amortization can vary significantly and are unique to each acquisition. Acquisition-related items include direct costs of acquisitions, such as transaction fees, which vary significantly and are unique to each acquisition. We also do not acquire businesses on a predictable cycle.

Non-GAAP operating cash flows and free cash flows

We define non-GAAP operating cash flows as net cash provided by operating activities less capitalized software development costs plus the excess tax benefits from stock-based compensation. We define free cash flows as non-GAAP operating cash flows less capital expenditures. As discussed above, when viewing operating results for evaluating our past performance and for planning purposes, management excludes certain items, including the effect of capitalizing and amortizing

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software development costs and items related to stock-based compensation, which are also excluded in the non-GAAP operating cash flows measure. Management also uses non-GAAP operating cash flows and free cash flows as measures of financial progress in our business, as they balance operating results, cash management and capital efficiency. In addition to quarterly free cash flows, management also focuses on trailing twelve month free cash flows, as free cash flows can be volatile in the short-term.

We believe that our measures of non-GAAP operating cash flows and free cash flows provide useful information to investors and others, as they allow for meaningful period-to-period comparisons of our operating cash flows for analysis of trends in our business. Additionally, we believe that information regarding non-GAAP operating cash flows and free cash flows provides investors and others with an important perspective on cash that we may choose to make available for strategic acquisitions and investments, the repurchase of shares, operations and other capital expenditures.

We deduct capitalization of software development costs from both measures because software development costs are considered to be a necessary component of our operations and the amount capitalized under GAAP can vary significantly from period-to-period depending upon the timing of products reaching technological feasibility and being made generally available. Consequently, software development costs paid out during a period that are capitalized under GAAP and do not impact GAAP operating cash flows for that period do result in a decrease to our measures of non-GAAP operating cash flows and non-GAAP free cash flows, thereby providing management with useful measures of cash flows generated from operations during the period. We add back the excess income tax benefits from stock-based compensation to our measures of non-GAAP operating cash flows and free cash flows as management internally views cash flows arising from income taxes as similar to operating cash flows rather than as financing cash flows as required under GAAP. Furthermore, we exclude capital expenditures on property and equipment from free cash flows because these expenditures are also considered to be a necessary component of our operations.

Limitations on the use of Non-GAAP financial measures

A limitation of our non-GAAP financial measures of core operating expenses, non-GAAP operating cash flows and free cash flows is that they do not have uniform definitions. Our definitions will likely differ from the definitions used by other companies, including peer companies, and therefore comparability may be limited. Thus, our non-GAAP measures of core operating expenses, non-GAAP operating cash flows and free cash flows should be considered in addition to, not as a substitute for, or in isolation from, measures prepared in accordance with GAAP. Additionally, in the case of stock-based compensation, if we did not pay out a portion of compensation in the form of stock-based compensation and related employer payroll taxes, the cash salary expense included in costs of revenues and operating expenses would be higher which would affect our cash position. Further, the non-GAAP measure of core operating expenses has certain limitations because it does not reflect all items of income and expense that affect our operations and are reflected in the GAAP measure of total operating expenses.

We compensate for these limitations by reconciling core operating expenses to the most comparable GAAP financial measure. Management encourages investors and others to review our financial information in its entirety, not to rely on any single financial measure and to view our non-GAAP financial measures in conjunction with the most comparable GAAP financial measures.

See "Results of Operations—Operating Expenses" for a reconciliation of the non-GAAP financial measure of core operating expenses to the most comparable GAAP measure, "total operating expenses," for the three and six months ended June 30, 2012 and 2011.

See "Liquidity and Capital Resources" for a reconciliation of non-GAAP operating cash flows and free cash flows to the most comparable GAAP measure, "net cash provided by operating activities," for the three and six months ended June 30, 2012 and 2011.

Critical Accounting Policies

Our consolidated financial statements are based on the selection and application of accounting principles generally accepted in the United States of America that require us to make estimates and assumptions about future events that affect the amounts reported in our financial statements and the accompanying notes. Future events and their effects cannot be determined with certainty. Therefore, the determination of estimates requires the exercise of judgment. Actual results could differ from those estimates, and any such differences may be material to our financial statements.

We believe that the critical accounting policies set forth within Item 7 of our 2011 Annual Report on Form 10-K may involve a higher degree of judgment and complexity in their application than our other significant accounting policies and represent the critical accounting policies used in the preparation of our financial statements. If different assumptions or conditions were to prevail, the results could be materially different from our reported results.

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Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements, including, without limitation, statements regarding: the potential role of our products in cloud computing and other shifts in computing infrastructures; expectations of, and our plans for, achieving future business growth; macroeconomic conditions; future product offerings; plans for future acquisitions; our view of the competitive landscape and our plans for maintaining our leadership position through continuing investments; our expectation that we will be able to fund strategic investments through operating cash flows generated by sales of our products and services; our plans for funding expansion of our industry segment share and developing long term relationships with our customers; our expectations to manage our resources prudently while making key investment in support of long term growth objectives; our plans for geographic expansion and adding additional channel partners; our relationship with EMC; our plans for meeting product development objectives and introducing new products; our plans for growing our business by broadening our product portfolio; our revenue outlook and mix; customer demand for our products; trends in enterprise license agreement ("ELA") size and renewals and information technology ("IT") spending in general; macroeconomic trends; the delivery of professional services to our customers; the sufficiency of our liquidity and capital reserves to fund our operations and business strategy; continuation of our stock repurchase program; factors affecting our tax position; the effects on us of potential developments in non-U.S. tax jurisdictions; our intention to indefinitely reinvest our overseas earnings in our foreign operations and our plans not to repatriate them to fund our U.S. operations; expected expenditures to improve the real estate parcel adjacent to our headquarters that we recently purchased; our anticipated capital spending for 2012; expectations that software development costs incurred subsequent to achievement of technological feasibility will be immaterial and software development costs will generally be expensed as incurred and that the subsequent amortization of such capitalized costs will decline for 2012; plans regarding interoperability among our future product offerings and for the increasing development of product suites; our expectation that stock-based compensation will increase in future periods; our plans regarding cash, cash equivalents and short-term investments held in non-U.S. accounts; our expectations with respect to costs associated with foreign currency fluctuation and internal development; and our belief that the resolution of pending claims, legal proceedings and investigations will not have a material adverse effect on us.

These forward-looking statements involve risks and uncertainties and the cautionary statements set forth above and those contained in the section of this report and our Annual Report on Form 10-K for the fiscal year ended December 31, 2011 entitled "Risk Factors" identify important factors that could cause actual results to differ materially from those predicted in any such forward-looking statements. We assume no obligation to, and do not currently intend to, update these forward-looking statements.

Available Information

Our website is located at www.vmware.com, and our investor relations website is located at http://ir.vmware.com. Our goal is to maintain the Investor Relations website as a portal through which investors can easily find or navigate to pertinent information about us, all of which is made available free of charge, including:

- our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports, as soon as reasonably practicable after we electronically file that material with or furnish it to the Securities and Exchange Commission ("SEC");
- announcements of investor conferences, speeches and events at which our executives talk about our product, service and competitive strategies. Archives of these events are also available for a limited time;
- additional information on financial metrics, including reconciliations of non-GAAP financial measures discussed in our presentations to the nearest comparable GAAP measure;
- press releases on quarterly earnings, product and service announcements, legal developments and international news;
- corporate governance information including our certificate of incorporation, bylaws, corporate governance guidelines, board committee charters, business conduct guidelines (which constitutes our code of business conduct and ethics) and other governance-related policies;
- other news, blogs and announcements that we may post from time to time that investors might find useful or interesting; and
- opportunities to sign up for email alerts and RSS feeds to have information pushed in real time.

The information found on our website is not part of, and is not incorporated by reference into, this or any other report we file with, or furnish to, the SEC.

Unless the context requires otherwise, we are referring to VMware, Inc. when we use the terms “VMware,” the “Company,” “we,” “our” or “us.”

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Exchange Risk

We operate in foreign countries, which expose us to market risk associated with foreign currency exchange rate fluctuations between the U.S. Dollar and various foreign currencies, the most significant of which is the Euro. International revenues as a percentage of total revenues were 51.0% and 51.1% in the second quarter of 2012 and 2011, respectively, and 52.5% and 51.8% in the first half of 2012 and 2011, respectively. We invoice and collect in the Euro, the British Pound, the Japanese Yen and the Australian Dollar in their respective regions. Additionally, a portion of our operating expenses, primarily the cost of personnel to deliver technical support on our products and professional services, sales and sales support and research and development, are denominated in foreign currencies, primarily those currencies in which we also invoice and collect. Revenues resulting from selling in local currencies and costs incurred in local currencies are exposed to foreign exchange rate fluctuations which can affect our operating income. As exchange rates vary, operating margins may differ materially from expectations.

Core operating expenses benefited by $19.1 million and $23.0 million in the second quarter and first half of 2012 due to fluctuations in the exchange rates between the U.S. Dollar and foreign currencies as compared with the same period in the prior year. We calculate the foreign currency impact on our operating expenses as the difference between operating expenses translated at current exchange rates and the same expenses translated at prior-period exchange rates.

To manage the risk associated with fluctuations in foreign currency exchange rates, we utilize derivative financial instruments, principally foreign currency forward contracts, as described below.

Cash Flow Hedging Activities. To mitigate our exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, we entered into foreign currency forward contracts starting in the fourth quarter of 2011. We expect to enter into cash flow hedges semi-annually with maturities of six months or less. As of June 30, 2012, we had foreign currency forward contracts to purchase approximately $11.0 million in foreign currency. The fair value of these forward contracts was immaterial as of June 30, 2012.

Balance Sheet Hedging Activities. We enter into foreign currency forward contracts to hedge a portion of our net outstanding monetary assets and liabilities against movements in certain foreign exchange rates. Our foreign currency forward contracts are generally traded on a monthly basis with a typical contractual term of one month. As of June 30, 2012, we had outstanding forward contracts with a total notional value of $261.5 million. The fair value of these forward contracts was immaterial as of June 30, 2012.

Sensitivity Analysis. There can be no assurance that our hedging activities will adequately protect us against the risks associated with foreign currency fluctuations. A hypothetical adverse foreign currency exchange rate movement of 10% would have resulted in a potential loss in fair value of our foreign currency forward contracts used in both the cash flow hedging and balance sheet hedging activities of $24.8 million as of June 30, 2012. This sensitivity analysis disregards any potentially offsetting gain that may be associated with the underlying foreign-currency denominated assets and liabilities that we hedge.

This analysis also assumes a parallel adverse shift of all foreign currency exchange rates against the U.S. Dollar; however, foreign currency exchange rates do not always move in such a manner and actual results may differ materially. We do not enter into speculative foreign exchange contracts for trading purposes. See Note F to the consolidated financial statements for further information.

Interest Rate Risk

Fixed Income Securities

Our fixed income investment portfolio is denominated in U.S. Dollars and consists of various holdings, types, and maturities.

Our primary objective for holding fixed income securities is to achieve an appropriate investment return consistent with preserving principal and managing risk. At any time, a sharp rise in interest rates or credit spreads could have a material adverse impact on the fair value of our fixed income investment portfolio. Hypothetical changes in interest rates of 50 basis points and 100 basis points would have changed the fair value of our fixed income investment portfolio as of June 30, 2012 by $20.8 million and $41.6 million, respectively. This sensitivity analysis assumes a parallel shift of all interest rates, however, interest rates do not always move in such a manner and actual results may

differ materially. We monitor our interest rate and credit risk, including our credit exposures to specific rating categories and to individual issuers. There were no impairment charges on our cash equivalents and fixed income securities during the second quarter of 2012. These instruments are not leveraged and we do not enter into speculative securities for trading purposes. See Notes D and E to the consolidated financial statements for further information.

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Note Payable to EMC

As of June 30, 2012, $450.0 million was outstanding on our consolidated balance sheet for the note payable to EMC. The interest rate on the note payable was 1.02% as of June 30, 2012 and 0.85% as of June 30, 2011. In the second quarter of 2012 and 2011, $1.2 million and $1.0 million, respectively, of interest expense was recorded in each period related to the note payable. In the first half of 2012 and 2011, $2.4 million and $1.9 million, respectively of interest expense was recorded in each period related to the note payable.

The note may be repaid, without penalty, at any time. In June 2011, we and EMC amended and restated the note to extend the maturity date of the note to April 16, 2015 and to modify the principal amount of the note to reflect the outstanding balance of $450.0 million. The amended agreement continues to bear an interest rate of the 90-day LIBOR plus 55 basis points, with interest payable quarterly in arrears. The interest rate on the note resets quarterly and is determined on the two business days prior to the first day of each fiscal quarter. If the interest rate on the note payable were to change 100 basis points from the June 30, 2012 rate, and assuming no additional repayments on the principal were made, our annual interest expense would change by $4.5 million.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We carried out an evaluation required by the Exchange Act, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) of the Exchange Act, as of the end of the period covered by this report. Based on this evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and to provide reasonable assurance that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosures.

Changes in Internal Controls Over Financial Reporting

There were no changes in our internal control over financial reporting during the fiscal quarter ended June 30, 2012 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Controls

Our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives as specified above. Management does not expect, however, that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all errors and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that mi