VMWARE, INC.
Form 10-Q
August 05, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-Q
(Mark One)

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

For the quarterly period ended June 30, 2014
OR

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

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

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

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

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

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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 28, 2014, the number of shares of common stock, par value $0.01 per share, of the registrant outstanding was 430,112,408 of which 130,112,408 shares were Class A common stock and 300,000,000 were Class B common stock.

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Revenues: | | | | |
| License | $614 | $531 | $1,175 | $1,019 |
| Services | 843 | 712 | 1,642 | 1,416 |
| Total revenues | 1,457 | 1,243 | 2,817 | 2,435 |
| Operating expenses (1): | | | | |
| Cost of license revenues | 46 | 55 | 96 | 112 |
| Cost of services revenues | 172 | 118 | 323 | 243 |
| Research and development | 317 | 261 | 610 | 532 |
| Sales and marketing | 544 | 442 | 1,018 | 859 |
| General and administrative | 179 | 96 | 330 | 194 |
| Realignment charges | (1) | 1 | (1) | 63 |
| Operating income | 200 | 270 | 441 | 432 |
| Investment income | 9 | 7 | 18 | 15 |
| Interest expense with EMC | (7) | (1) | (12) | (2) |
| Other income, net | — | 18 | — | 13 |
| Income before income taxes | 202 | 294 | 447 | 458 |
| Income tax provision | 35 | 49 | 81 | 40 |
| Net income | $167 | $245 | $366 | $418 |
| Net income per weighted-average share, basic for Class A and Class B | $0.39 | $0.57 | $0.85 | $0.98 |
| Net income per weighted-average share, diluted for Class A and Class B | $0.38 | $0.57 | $0.84 | $0.97 |
| Weighted-average shares, basic for Class A and Class B | 430,216 | 428,336 | 430,050 | 428,172 |
| Weighted-average shares, diluted for Class A and Class B | 434,199 | 431,987 | 434,218 | 432,406 |

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| (1) Includes stock-based compensation as follows: | | | | |
|---|---|---|---|---|
| Cost of license revenues | $1 | $— | $2 | $1 |
| Cost of services revenues | 11 | 7 | 20 | 14 |
| Research and development | 66 | 51 | 126 | 113 |
| Sales and marketing | 43 | 33 | 84 | 69 |
| General and administrative | 18 | 12 | 35 | 26 |
| Realignment charges | — | — | — | 6 |

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | $167 | $245 | $366 | $418 |
| Other comprehensive income: | | | | |
| Changes in market value of available-for-sale securities: | | | | |
| Unrealized gains (losses), net of taxes of $2, $(6), $2 and $(5) | 3 | (9) | 4 | (8) |
| Reclassification of (gains) realized during the period, net of taxes of $0, $0, $0 and $(1) | — | — | — | (1) |
| Net change in market value of available-for-sale securities | 3 | (9) | 4 | (9) |
| Changes in market value of effective foreign currency forward exchange contracts: | | | | |
| Unrealized (losses), net of $0 taxes for all periods | — | (1) | — | (1) |
| Net change in market value of effective foreign currency forward exchange contracts | — | (1) | — | (1) |
| Total other comprehensive income (loss) | 3 | (10) | 4 | (10) |
| Total comprehensive income, net of taxes | $170 | $235 | $370 | $408 |

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

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

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $2,054 | $2,305 |
| Short-term investments | 4,583 | 3,870 |
| Accounts receivable, net of allowance for doubtful accounts of $2 | 1,119 | 1,220 |
| Due from related parties, net | 40 | — |
| Deferred tax assets | 215 | 190 |
| Other current assets | 150 | 96 |
| Total current assets | 8,161 | 7,681 |
| Property and equipment, net | 936 | 845 |
| Other assets, net | 230 | 107 |
| Deferred tax assets | 135 | 60 |
| Intangible assets, net | 799 | 607 |
| Goodwill | 3,898 | 3,027 |
| Total assets | $14,159 | $12,327 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $102 | $109 |
| Accrued expenses and other | 826 | 608 |
| Due to related parties, net | — | 18 |
| Unearned revenues | 2,713 | 2,558 |
| Total current liabilities | 3,641 | 3,293 |
| Note payable to EMC | 1,500 | 450 |
| Unearned revenues | 1,676 | 1,534 |
| Other liabilities | 253 | 234 |
| Total liabilities | 7,070 | 5,511 |
| Contingencies (see Note I) | | |
| Stockholders' equity: | | |
| Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 129,983 and 130,349 shares | 1 | 1 |
| Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares | 3 | 3 |
| Additional paid-in capital | 3,399 | 3,496 |
| Accumulated other comprehensive income | 8 | 4 |
| Retained earnings | 3,678 | 3,312 |
| Total stockholders' equity | 7,089 | 6,816 |
| Total liabilities and stockholders' equity | $14,159 | $12,327 |

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Operating activities: | | | | |
| Net income | $167 | $245 | $366 | $418 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Depreciation and amortization | 81 | 88 | 164 | 179 |
| Stock-based compensation | 139 | 103 | 267 | 219 |
| Excess tax benefits from stock-based compensation | (11) | (26) | (26) | (48) |
| Deferred income taxes, net | (50) | 37 | (79) | 9 |
| Non-cash realignment charges | — | — | — | 14 |
| Gain on disposition of certain lines of business and other, net | — | (19) | — | (19) |
| Other | — | 1 | 2 | (1) |
| Changes in assets and liabilities, net of acquisitions: | | | | |
| Accounts receivable | (288) | (172) | 130 | 208 |
| Other assets | (13) | (34) | (43) | (75) |
| Due to/from related parties, net | (66) | (25) | (33) | 34 |
| Accounts payable | 3 | 26 | (8) | 18 |
| Accrued expenses | 160 | 92 | 56 | (23) |
| Income taxes receivable from EMC | — | 16 | — | 16 |
| Income taxes payable | 71 | (4) | 112 | (2) |
| Unearned revenues | 216 | 206 | 251 | 263 |
| Net cash provided by operating activities | 409 | 534 | 1,159 | 1,210 |
| Investing activities: | | | | |
| Additions to property and equipment | (76) | (75) | (153) | (153) |
| Purchases of available-for-sale securities | (1,445) | (918) | (1,976) | (1,655) |
| Sales of available-for-sale securities | 530 | 333 | 941 | 819 |
| Maturities of available-for-sale securities | 169 | 188 | 322 | 370 |
| Proceeds from disposition of certain lines of business | — | 31 | — | 31 |
| Purchase of strategic investments | (37) | (2) | (40) | (2) |
| Business acquisitions, net of cash acquired | — | — | (1,068) | (184) |
| Increase in restricted cash | — | (1) | (76) | (2) |
| Other investing | (3) | — | (10) | 1 |
| Net cash used in investing activities | (862) | (444) | (2,060) | (775) |
| Financing activities: | | | | |
| Proceeds from issuance of common stock | 11 | 47 | 99 | 115 |
| Proceeds from issuance of note payable to EMC | — | — | 1,500 | — |
| Repayment of note payable to EMC | — | — | (450) | — |
| Reduction in capital from EMC | — | — | (24) | — |
| Repurchase of common stock | (238) | (120) | (407) | (302) |
| Excess tax benefits from stock-based compensation | 11 | 26 | 26 | 48 |
| Shares repurchased for tax withholdings on vesting of restricted stock | (65) | (43) | (94) | (65) |

| | | | | |
|---|---|---|---|---|
| Net cash provided by (used in) financing activities | (281) | (90) | 650 | (204) |
| Net (decrease) increase in cash and cash equivalents | (734) | — | (251) | 231 |
| Cash and cash equivalents at beginning of the period | 2,788 | 1,840 | 2,305 | 1,609 |
| Cash and cash equivalents at end of the period | $2,054 | $1,840 | $2,054 | $1,840 |
| Non-cash items: | | | | |
| Changes in capital additions, accrued but not paid | $18 | $9 | $11 | $(4) |
| Fair value of stock options assumed in acquisition | — | — | 24 | — |

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

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

A. Overview and Basis of Presentation

Company and Background

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

Accounting Principles

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

Unaudited Interim Financial Information

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

As of June 30, 2014, EMC held approximately 79.8% of VMware’s outstanding common stock and 97.2% of the combined voting power of VMware’s outstanding common stock, including 43 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements.

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

Principles of Consolidation

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

Use of Accounting Estimates

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

New Accounting Pronouncements

During May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated revenue standard establishes principles for recognizing revenue and develops a common revenue standard for all industries. Upon adoption, entities will be required to recognize the amount of revenue that they expect to be entitled to for the transfer of promised goods or services to their customers. The updated standard is effective for the Company in the first quarter of 2017 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is not permitted.

The Company has not selected a transition method and is currently evaluating the effect that the updated standard will have on its consolidated financial statements and related disclosures.

B. Business Combinations, Definite-Lived Intangible Assets, Net and Goodwill

Business Combinations

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

Merger consideration totaling $300 million, including $75 million being held in escrow, is payable to certain employees of AirWatch subject to specified future employment conditions and will be recognized as expense over the requisite service period on a straight-line basis. Compensation expense of $41 million and $60 million was recognized during the three and six months ended June 30, 2014, respectively.

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

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

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

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

During the three months ended June 30, 2014, the preliminary allocation of the consideration to the fair value of the assets acquired and liabilities assumed was revised primarily to reflect adjustments to deferred taxes and the liability for employer related taxes. As a result, goodwill decreased $4 million in connection with these adjustments.

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

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

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

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

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Pro forma adjusted net income | $167 | $186 | $329 | $300 |

Definite-Lived Intangible Assets, Net

As of June 30, 2014, definite-lived intangible assets consisted of the following (amounts in table in millions):

| | June 30, 2014 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Lives (in years) | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Purchased technology | 6.4 | $703 | $(215) | $488 |
| Leasehold interest | 34.9 | 145 | (13) | 132 |
| Customer relationships and customer lists | 8.3 | 153 | (44) | 109 |
| Trademarks and tradenames | 8.4 | 65 | (10) | 55 |
| Other | 2.9 | 18 | (3) | 15 |
| Total definite-lived intangible assets | | $1,084 | $(285) | $799 |

As of December 31, 2013, definite-lived intangible assets consisted of the following (amounts in table in millions):

| | December 31, 2013 | | | |
|---|---|---|---|---|
| | Weighted-Average Useful Lives (in years) | Gross Carrying Amount | Accumulated Amortization | Net Book Value |
| Purchased technology | 6.6 | $580 | $(163) | $417 |
| Leasehold interest | 34.9 | 145 | (11) | 134 |
| Customer relationships and customer lists | 8.7 | 75 | (37) | 38 |
| Trademarks and tradenames | 9.1 | 24 | (7) | 17 |
| IPR&D | | 1 | — | 1 |
| Total definite-lived intangible assets | | $825 | $(218) | $607 |

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

Amortization expense for definite-lived intangible assets was $36 million and $26 million during the three months ended June 30, 2014 and 2013, respectively and $67 million and $55 million during the six months ended June 30, 2014 and 2013, respectively.

As of June 30, 2014, the remaining estimated annual amortization expense of the definite-lived intangibles is expected to be as follows (table in millions):

| | |
|---|---|
| Remainder of 2014 | $73 |
| 2015 | 140 |
| 2016 | 123 |
| 2017 | 116 |
| 2018 | 104 |
| Thereafter | 243 |
| Total | $799 |

Goodwill

The following table summarizes the changes in the carrying amount of goodwill during the six months ended June 30, 2014 (table in millions):

| | |
|---|---|
| Balance, January 1, 2014 | $3,027 |
| Increase in goodwill related to Airwatch business combination | 875 |
| Other | (4) |
| Balance, June 30, 2014 | $3,898 |

C. Realignment Charges

During January 2013, VMware approved and initiated a business realignment plan to streamline its operations. The realignment plan included the elimination of approximately 710 positions and personnel across all major functional groups and geographies. During the six months ended June 30, 2013, $63 million of realignment charges were recorded on the condensed consolidated statements of income, which consisted of workforce reduction charges and asset impairments. As of December 31, 2013, the plan had been completed.

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

D. Net Income per Share

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

The following table sets forth the computations of basic and diluted net income per share during the three and six months ended June 30, 2014 and 2013 (net income in millions, shares in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | $167 | $245 | $366 | $418 |
| Weighted-average shares, basic for Class A and Class B | 430,216 | 428,336 | 430,050 | 428,172 |
| Effect of dilutive securities | 3,983 | 3,651 | 4,168 | 4,234 |
| Weighted-average shares, diluted for Class A and Class B | 434,199 | 431,987 | 434,218 | 432,406 |
| Net income per weighted-average share, basic for Class A and Class B | $0.39 | $0.57 | $0.85 | $0.98 |
| Net income per weighted-average share, diluted for Class A and Class B | $0.38 | $0.57 | $0.84 | $0.97 |

During the three and six months ended June 30, 2014, stock options to purchase 1.1 million and 1.0 million shares, respectively, of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. During the three and six months ended June 30, 2013, stock options to purchase 1.0 million and 0.8 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.

During the three and six months ended June 30, 2014, the number of shares of restricted stock that were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive was not material. During the three and six months ended June 30, 2013, 3.1 million and 2.2 million shares, respectively, of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive.

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

E. Investments

Investments as of June 30, 2014 and December 31, 2013 consisted of the following (tables in millions):

| | June 30, 2014 | | | |
|---|---|---|---|---|
| | Cost or Amortized Cost | Unrealized Gains | Unrealized Losses | Aggregate Fair Value |
| U.S. Government and agency obligations | $570 | $1 | $— | $571 |
| U.S. and foreign corporate debt securities | 2,821 | 8 | (1) | 2,828 |
| Foreign governments and multi-national agency obligations | 38 | — | — | 38 |
| Municipal obligations | 920 | 3 | — | 923 |
| Asset-backed securities | 22 | — | — | 22 |
| Mortgage-backed securities | 201 | 1 | (1) | 201 |
| Total investments | $4,572 | $13 | $(2) | $4,583 |

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

VMware evaluated its fixed income investments as of June 30, 2014 and December 31, 2013 to determine whether or not any security had experienced an other-than-temporary decline in fair value. As of June 30, 2014 and December 31, 2013, VMware did not consider any of its fixed income investments to be other-than-temporarily impaired. The realized gains and realized losses on fixed income investments during the three and six months ended June 30, 2014 and 2013 were not material.

Unrealized losses on investments as of June 30, 2014 and December 31, 2013, which have been in a net loss position for less than twelve months, were classified by investment category as follows (table in millions):

| | June 30, 2014 | | December 31, 2013 | |
|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. and foreign corporate debt securities | $525 | $(1) | $750 | $(3) |
| Mortgage-backed securities | 58 | — | 91 | (1) |
| Total | $583 | $(1) | $841 | $(4) |

Unrealized losses on investments, which have been in a net loss position for twelve months or greater, were not material as of June 30, 2014 and December 31, 2013.

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

Strategic Investments
VMware evaluated the strategic investments in its portfolio that are accounted under the cost method, to assess whether any of its strategic investments were other-than-temporarily impaired. VMware uses Level 3 inputs as part of its impairment analysis, including, pre- and post-money valuations of recent financing events and the impact of those on its fully diluted ownership percentages, as well as other available information regarding the issuer's historical and forecasted performance. The estimated fair value of these investments is considered in VMware's impairment review if any events or changes in circumstances occur that might have a significant adverse effect on their value. During the three months ended June 30, 2013, VMware recognized an other-than-temporary impairment charge of $13 million for a non-recoverable strategic investment. Strategic investments are included in other assets, net on the condensed consolidated balance sheets.

Contractual Maturities
The contractual maturities of investments held at June 30, 2014 consisted of the following (table in millions):

| | Amortized Cost Basis | Aggregate Fair Value |
|---|---|---|
| Due within one year | $1,130 | $1,132 |
| Due after 1 year through 5 years | 3,217 | 3,226 |
| Due after 5 years | 225 | 225 |
| Total investments | $4,572 | $4,583 |

F. Fair Value Measurements
Certain financial assets and liabilities are measured at fair value on a recurring basis.
VMware's Level 1 classification of the fair value hierarchy includes money market funds and certain available-for-sale fixed income securities because these securities are valued using quoted prices in active markets for identical assets. Fixed income available-for-sale securities consist of high quality, investment-grade securities from diverse issuers.
VMware's Level 2 classification includes the remainder of the available-for-sale fixed income securities because these securities are priced using inputs other than quoted prices that are observable either directly or indirectly. The valuation techniques used to measure the fair value of financial instruments having Level 2 inputs were derived from non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models such as discounted cash flow techniques. VMware's procedures include controls to ensure that appropriate fair values are recorded such as comparing prices obtained from multiple independent sources. Additionally, VMware's Level 2 classification includes foreign currency forward contracts as the valuation inputs for these are based upon quoted prices and quoted pricing intervals from public data sources. The fair value of these contracts was not material for any period presented.
VMware does not have any material assets or liabilities that fall into Level 3 of the fair value hierarchy as of June 30, 2014 and December 31, 2013, and there have been no transfers between fair value measurement levels during both the three and six months ended June 30, 2014 and 2013.

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The following tables set forth the fair value hierarchy of VMware's money market funds and available-for-sale securities, including those securities classified within cash and cash equivalents on the condensed consolidated balance sheets, that were required to be measured at fair value as of June 30, 2014 and December 31, 2013 (tables in millions):

| | June 30, 2014 | | |
|---|---|---|---|
| | Level 1 | Level 2 | Total |
| Money-market funds | $1,409 | $— | $1,409 |
| U.S. Government and agency obligations | 436 | 135 | 571 |
| U.S. and foreign corporate debt securities | — | 2,888 | 2,888 |
| Foreign governments and multi-national agency obligations | — | 38 | 38 |
| Municipal obligations | — | 924 | 924 |
| Asset-backed securities | — | 22 | 22 |
| Mortgage-backed securities | — | 201 | 201 |
| Total | $1,845 | $4,208 | $6,053 |

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

G. Derivatives and Hedging Activity

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

Cash Flow Hedging Activities

To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign currencies, VMware enters into foreign currency forward contracts. The Company designates these forward contracts as cash flow hedging instruments as the accounting criteria for such designation has been met. Therefore, the effective portion of gains or losses resulting from changes in the fair value of these hedges is initially reported in accumulated other comprehensive income on the condensed consolidated balance sheet and is subsequently reclassified to the related operating expense line item in the condensed consolidated statements of income in the same period that the underlying expenses are incurred. During the three and six months ended June 30, 2014 and 2013, the effective portion of gains or losses reclassified to the condensed consolidated statements of income was not material. Interest charges or "forward points" on VMware's forward contracts are excluded from the assessment of hedge effectiveness and are recorded in other income, net in the condensed consolidated statements of income as incurred. VMware generally enters into cash flow hedges semi-annually with maturities of six months or less. As of June 30, 2014 and December 31, 2013, VMware had forward contracts to purchase foreign currency designated as cash flow hedges with a total notional value of $118 million and $82 million, respectively. The fair value of these forward contracts was immaterial as of June 30, 2014 and December 31, 2013. During the three and six months ended June 30, 2014 and 2013, all cash flow hedges were considered effective.

Balance Sheet Hedging Activities

In order to manage exposure to foreign currency fluctuations, VMware enters into foreign currency forward contracts to hedge a portion of its net outstanding monetary assets and liabilities against fluctuations in certain foreign exchange rates.

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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, net in the condensed consolidated statements of income.

VMware’s foreign currency forward contracts are generally traded on a monthly basis with a typical contractual term of one month. As of June 30, 2014 and December 31, 2013, VMware had outstanding forward contracts with a total notional value of $613 million and $498 million, respectively. The fair value of these forward contracts was immaterial as of June 30, 2014 and December 31, 2013 and therefore excluded from the fair value tables above. During the three months ended June 30, 2014 and 2013, VMware recognized a loss of $5 million and a gain of $5 million, respectively, relating to the settlement of foreign forward contracts. During the six months ended June 30, 2014 and 2013, VMware recognized a loss of $5 million and a gain of $16 million, respectively.

The combined gains and losses derived from the settlement of foreign forward contracts and the underlying foreign-currency denominated assets and liabilities were immaterial during the three and six months ended June 30, 2014. The combined gains and losses derived from the settlement of foreign forward contracts and underlying foreign-currency denominated assets and liabilities resulted in a net loss of $3 million during the three months ended June 30, 2013 and a net loss of $5 million during the six months ended June 30, 2013.

H. Unearned Revenues

Unearned revenues as of June 30, 2014 and December 31, 2013 consisted of the following (table in millions):

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Unearned license revenues | $476 | $465 |
| Unearned software maintenance revenues | 3,541 | 3,304 |
| Unearned professional services revenues | 372 | 323 |
| Total unearned revenues | $4,389 | $4,092 |

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or they are otherwise recognized ratably over the term of the arrangement. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive the future product at no additional charge. To the extent the future product has not been delivered and vendor-specific objective evidence (“VSOE”) of fair value cannot be established, the revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. In the event the arrangement does not include professional services, unearned license revenue may also be recognized ratably, if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance element of the arrangement does not exist. Total unearned license revenues may vary over periods for a variety of factors, including the type and level of promotions offered, and the timing of when the products are delivered upon general availability.

Unearned software maintenance revenues are attributable to VMware’s maintenance contracts and are generally recognized ratably, typically over terms of one to five years with a weighted-average remaining term at June 30, 2014 of approximately two years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

I. Contingencies

Litigation

VMware and the U.S. General Services Administration ("GSA") and the Department of Justice ("DOJ") are in ongoing discussions regarding VMware’s commercial and government sales practices covering the period between 2006 and 2013. During the three months ended June 30, 2014, VMware recognized a liability of approximately $11 million as the amount was determined to be both probable and reasonably estimable. VMware is cooperating with both the GSA and DOJ inquiries. VMware believes a loss in excess of the estimated $11 million liability is currently not determinable.

VMware is also subject to other legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to commercial, product liability, intellectual property, employment, class action, whistleblower and other matters. From time to time, VMware also receives inquiries from and has ongoing discussions with government entities on various matters. VMware accrues for a liability when a determination has been made that a loss is both probable of occurrence and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination of probability and the determination as to whether a loss is reasonably estimable. In making such judgments, VMware considers the impact of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. Legal costs are generally recognized as expense when incurred. As of June 30, 2014 and December 31, 2013, amounts accrued relating to these other matters arising as part of the ordinary course of business were considered immaterial. To the extent there is a reasonable possibility that the losses could exceed the amounts already accrued, VMware believes that the amount of any such additional loss would also be immaterial to VMware's condensed consolidated financial position, results of operations and cash flows.

J. Stockholders' Equity

VMware Stock Repurchases

The following table summarizes stock repurchase authorizations that remain open as of June 30, 2014 (amounts in table in millions):

| Authorization Date | Amount Authorized | Expiration Date | Status |
|---|---|---|---|
| August 7, 2013 | $700 | December 31, 2015 | Open |

From time to time, future stock repurchases may be made pursuant to the August 2013 authorization in open market transactions or privately negotiated transactions as permitted by securities laws and other legal requirements. VMware is not obligated to purchase any shares under its stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased will depend on a variety of factors, including VMware's stock price, cash requirements for operations and business combinations, corporate and regulatory requirements and other market and economic conditions. Purchases can be discontinued at any time that VMware feels additional purchases are not warranted. All shares repurchased under VMware's stock repurchase programs are retired. As of June 30, 2014, the cumulative authorized amount remaining for repurchase was $253 million.

The following table summarizes stock repurchase activity during the three and six months ended June 30, 2014 and 2013 (aggregate purchase price in millions, shares in thousands):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Aggregate purchase price | $ 238 | $ 120 | $ 407 | $ 302 |
| Class A common shares repurchased | 2,488 | 1,638 | 4,255 | 4,000 |
| Weighted-average price per share | $ 95.73 | $ 73.26 | $ 95.67 | $ 75.50 |

The amount of repurchased shares includes commissions and was classified as a reduction to additional paid-in capital.

VMware Stock Options

The following table summarizes option activity since January 1, 2014 (shares in thousands):

| | Number of Shares | Weighted-Average Exercise Price (per share) |
|---|---|---|
| Outstanding, January 1, 2014 | 5,756 | $ 44.12 |
| Granted | 1,912 | 34.85 |
| Forfeited | (87) | 32.56 |
| Exercised | (1,605) | 37.58 |
| Outstanding, June 30, 2014 | 5,976 | 43.09 |

The above table includes stock options substituted for unvested stock options in connection with business combinations. As a result, the weighted-average exercise price per share may be less than the VMware stock price at time of grant.

The stock options outstanding as of June 30, 2014 had an aggregate intrinsic value of $321 million based on VMware's closing price as of June 30, 2014.

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VMware Restricted Stock

VMware restricted stock primarily consists of restricted stock unit ("RSU") awards granted to employees. RSUs are valued based on the VMware stock price on the date of grant, and shares underlying RSU awards are not issued until the RSUs vest. Upon vesting, each RSU converts into one share of VMware Class A common stock.

VMware restricted stock also includes performance stock unit ("PSU") awards, which have been granted to certain of VMware's executives and employees. The PSU awards include performance conditions and, in certain cases, a time-based vesting component. Upon vesting, each PSU award will convert into VMware's Class A common stock at various ratios ranging from 0.5 to 3.0 shares per PSU, depending upon the degree of achievement of the performance target designated by each individual award. If minimum performance thresholds are not achieved, then no shares will be issued.

The following table summarizes restricted stock activity since January 1, 2014 (shares in thousands):

| | Number of Units | Weighted-Average Grant Date Fair Value (per unit) |
|---|---|---|
| Outstanding, January 1, 2014 | 12,856 | $85.85 |
| Granted | 3,847 | 95.31 |
| Vested | (2,738) | 94.25 |
| Forfeited | (565) | 86.34 |
| Outstanding, June 30, 2014 | 13,400 | 88.55 |

As of June 30, 2014, the 13.4 million units outstanding included 12.5 million of RSUs, 0.6 million of PSUs and 0.3 million of restricted stock. The above table includes RSUs issued for outstanding unvested RSUs in connection with business combinations.

The total fair value of VMware restricted stock, including restricted stock, RSUs and PSUs, that vested during the six months ended June 30, 2014 was $258 million. As of June 30, 2014, restricted stock representing 13.4 million shares of VMware's Class A common stock were outstanding, with an aggregate intrinsic value of $1,297 million based on VMware's closing price as of June 30, 2014.

Accumulated Other Comprehensive Income

The changes in components of accumulated other comprehensive income during the six months ended June 30, 2014 were as follows (table in millions):

| | Unrealized Gains on Available-for-Sale Securities | Total |
|---|---|---|
| Balance, January 1, 2014 | $4 | $4 |
| Other comprehensive gain before reclassifications, net of taxes of $2 | 4 | 4 |
| Other comprehensive income, net | 4 | 4 |
| Balance, June 30, 2014 | $8 | $8 |

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

K. Related Parties

EMC Reseller Arrangement, Other Services and Note Payable

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

•

- Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's products and sells them to end-users.
- EMC purchases products and services from VMware for internal use.

- VMware recognizes revenues for professional services based upon such contractual agreements with EMC.
- From time to time, VMware and EMC enter into agreements to collaborate on technology projects, and EMC pays VMware for services that VMware provides to EMC in connection with such projects.

Information about VMware's revenues and receipts from such arrangements with EMC during the three and six months ended June 30, 2014 and 2013 and unearned revenues as of June 30, 2014 and December 31, 2013 consisted of the following (table in millions):

| | Revenues and Receipts from EMC | | | | Unearned Revenues from EMC | |
|---|---|---|---|---|---|---|
| | Three Months Ended June 30, | | Six Months Ended June 30, | | As of June 30, | As of December 31, |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Reseller revenues | $43 | $35 | $89 | $72 | $203 | $188 |
| Professional services revenues | 18 | 30 | 40 | 46 | 10 | 12 |
| Internal-use revenues | 5 | 3 | 13 | 6 | 13 | 20 |
| Collaborative technology project receipts | — | 2 | — | 4 | n/a | n/a |

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

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

Information about VMware's costs from such arrangements with EMC during the three and six months ended June 30, 2014 and 2013 consisted of the following (table in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Purchases of products and services | $12 | $15 | $33 | $25 |
| Collaborative technology project costs | 3 | 2 | 7 | 2 |
| EMC subsidiary support and administrative costs | 35 | 27 | 76 | 63 |
| Interest expense on note payable | 7 | 1 | 12 | 2 |

Certain Stock-Based Compensation

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

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Pivotal
During 2013, VMware transferred certain assets and liabilities to Pivotal. VMware contributed certain assets, including intellectual property, to Pivotal, and Pivotal assumed substantially all liabilities related to certain VMware Cloud Application Platform products and services, including VMware’s Cloud Foundry, VMware vFabric (including Spring and GemFire) and Cetas organizations, except for certain tangible assets related to Cloud Foundry. As of June 30, 2014, VMware's ownership interest in Pivotal is 28%.
Additionally, VMware and Pivotal entered into an agreement pursuant to which VMware will act as the selling agent for the products and services it contributed to Pivotal in exchange for a customary agency fee. VMware also agreed to provide various transition services to Pivotal. Pursuant to the support agreement, costs incurred by VMware to support Pivotal services are reimbursed to VMware by Pivotal and are recorded as a reduction to the costs incurred by VMware. Information about VMware's revenues and costs from such arrangement with Pivotal during the three and six months ended June 30, 2014 and 2013 consisted of the following (table in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Revenues | $1 | $2 | $2 | $2 |
| Transition services | 1 | 8 | 3 | 8 |

Additionally, VMware purchased an immaterial amount of products and services for internal use from Pivotal during the three and six months ended June 30, 2014 and 2013.
Tax Sharing Agreement with EMC
Pursuant to a tax sharing agreement between VMware and EMC, VMware has made payments to EMC and EMC has made payments to VMware. The following table summarizes these payments made between VMware and EMC during the three and six months ended June 30, 2014 and 2013 (table in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Payments from VMware to EMC | $— | $— | $20 | $— |
| Payments from EMC to VMware | — | 16 | — | 16 |

Payments between VMware and EMC under the tax sharing agreement relate to VMware's portion of federal income taxes on EMC's consolidated tax return as well as state payments for combined states. Payments from EMC to VMware relate to periods where VMware had a stand-alone loss for U.S. federal and state income tax purposes or where VMware had federal tax credits in excess of federal tax liabilities. Payments from VMware to EMC are for estimated tax payments primarily for U.S. federal income tax purposes. The amounts that VMware either pays to or receives from EMC for its portion of federal income taxes on EMC’s consolidated tax return differ from the amounts VMware would owe on a separate return basis and the difference is presented as a component of stockholders’ equity. During the three and six months ended June 30, 2014 and 2013, the difference between the amount of tax calculated on a stand-alone basis and the amount of tax calculated per the tax sharing agreement was not material.

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Due To/From Related Parties, Net

As a result of the related-party transactions with EMC and Pivotal described above, amounts due to and from related parties, net as of June 30, 2014 consisted of the following (table in millions):

| | As of June 30, 2014 |
|---|---|
| Due to EMC | $(61) |
| Due from EMC | 108 |
| Due to Pivotal | (8) |
| Due from Pivotal | 1 |
| Due (to) from related parties, net | $40 |
| | |
| Income tax payable due to EMC | $(81) |

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

Note Payable to EMC

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

The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: $680 million due May 1, 2018, $550 million due May 1, 2020 and $270 million due December 1, 2022. The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the three and six months ended June 30, 2014, $7 million and $12 million, respectively, of interest expense was recognized. During the three and six months ended June 30, 2013, $1 million and $2 million, respectively, of interest expense was recognized.

L. Segment Information

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

Revenues by geographic area during the three and six months ended June 30, 2014 and 2013 were as follows (table in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| United States | $683 | $590 | $1,332 | $1,159 |
| International | 774 | 653 | 1,485 | 1,276 |
| Total | $1,457 | $1,243 | $2,817 | $2,435 |

It is not practicable for VMware to determine revenues by country other than the United States during the three and six months ended June 30, 2014 and 2013.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of June 30, 2014 and December 31, 2013 were as follows (table in millions):

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| United States | $777 | $741 |
| International | 79 | 58 |
| Total | $856 | $799 |

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No individual country other than the United States accounted for 10% or more of these assets as of June 30, 2014 and December 31, 2013, respectively.

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## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following management's discussion and analysis ("MD&A") is provided in addition to the accompanying condensed consolidated financial statements and notes to assist in understanding our results of operations and financial condition. Financial information as of June 30, 2014 should be read in conjunction with our consolidated financial statements for the year ended December 31, 2013 contained in our Form 10-K filed February 25, 2014.
All dollar amounts expressed as numbers in this MD&A (except share and per share amounts) are in millions. Period-over-period changes are calculated based upon the respective underlying, non-rounded data. Unless the context requires otherwise, we are referring to VMware, Inc. and its consolidated subsidiaries when we use the terms "VMware," the "Company," "we," "our" or "us."

### Overview

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

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

We pioneered the development and application of virtualization technologies with x86 server-based computing, separating application software from the underlying hardware. The benefits to our customers include lower IT costs and a more automated and resilient systems infrastructure capable of responding dynamically to variable business demands. Our broad and proven suite of virtualization technologies are designed to establish secure and, reliable IT environments and address a range of complex IT challenges that include cost reduction, operational inefficiencies, access to cloud computing capacity, business continuity and corporate end-user computing device management. Our solutions enable organizations to aggregate multiple servers, storage infrastructure and networks together into shared pools of capacity that can be allocated dynamically, securely and reliably to applications as needed. Once created, these internal computing infrastructures, or "clouds," can be dynamically extended by our customers to the public cloud environment. When linked, this results in a "hybrid" computing cloud of highly available internal and external computing resources that organizations can access on demand. Our customers' deployments range in size from a single virtualized server for small businesses to thousands of virtual machines for our Fortune 1000 enterprise customers.
We have articulated a vision for the software-defined data center ("SDDC"), where increasingly infrastructure is virtualized and delivered as a service, enabling control of the data center to be entirely automated by software. The SDDC is designed to transform the data center into an on-demand service that addresses application requirements by abstracting, pooling, and automating the services that are required from the underlying hardware. SDDC promises to dramatically simplify data center operations and lower costs. The VMware vCloud Suite, which is our first integrated solution toward realizing the SDDC vision and is based upon our VMware vSphere virtualization platform, was initially introduced in late 2012. The VMware vCloud Suite addresses virtualization of not only CPU and memory, but also networks and associated security services. In addition, the vCloud Suite delivers a new approach to management, leveraging policy-based automation. VMware vCloud Suite is engineered for hybrid cloud computing so that it federates with other pools of infrastructure.
We believe that our solutions enable organizations to realize significant operational and cost efficiencies as they transition their underlying legacy IT infrastructure. We work closely with more than 1,200 technology partners, including leading server, microprocessor, storage, networking, software and security vendors. We have shared the economic opportunities surrounding virtualization with our partners by facilitating solution development through open application programming interface ("APIs") formats and protocols and providing access to our source code and technology. The endorsement and support of our partners further enhances the awareness, reputation and adoption of our virtualization solutions.
We expect to grow our business by building long-term relationships with our customers, which includes continuing to sell our solutions through enterprise license agreements ("ELAs"). ELAs are comprehensive volume license offerings offered both directly by us and through certain channel partners that provide for multi-year maintenance and support.

Under a typical ELA, a portion of the revenues is attributed to license revenues and the remainder is primarily attributed to software maintenance revenues. In addition, the initial maintenance and support period is typically longer for ELAs compared to our transactional business. We believe that ELAs facilitate our objective of building long-term relationships with our customers as they commit to our virtual infrastructure solutions in their data centers. ELAs comprised 37% of our overall sales during each of the second quarters of 2014 and 2013, and 32% and 33% of our overall sales during the six months ended June 30, 2014 and 2013, respectively, with the balance primarily represented by our non-ELA, or transactional, business.

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On February 24, 2014, we acquired A.W.S. Holding, LLC (“AirWatch Holding”), the sole member and equity holder of AirWatch LLC (“AirWatch”). AirWatch is a leader in enterprise mobile management and security solutions. The acquisition of AirWatch expands our portfolio of mobile solutions within the enterprise mobile and security space.
We have grown our headcount during the three and six months ended June 30, 2014 due to organic growth and the AirWatch acquisition. The increased headcount has resulted in higher cash and stock-based employee-related expenses across our income statement expense categories when compared to the same periods in 2013 and we expect this trend to continue. See further discussion under "Results of Operations" below.

Results of Operations

Revenues

Our revenues during the three and six months ended June 30, 2014 and 2013 were as follows:

| | Three Months Ended June 30, | | | | | Six Months Ended June 30, | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | $ Change | % Change | | 2014 | 2013 | $ Change | % Change | |
| Revenues: | | | | | | | | | | |
| License | $614 | $531 | $84 | 16 | % | $1,175 | $1,019 | $156 | 15 | % |
| Services: | | | | | | | | | | |
| Software maintenance | 737 | 614 | 123 | 20 | | 1,438 | 1,220 | 219 | 18 | |
| Professional services | 106 | 98 | 7 | 8 | | 204 | 196 | 8 | 4 | |
| Total services | 843 | 712 | 130 | 18 | | 1,642 | 1,416 | 227 | 16 | |
| Total revenues | $1,457 | $1,243 | $214 | 17 | | $2,817 | $2,435 | $383 | 16 | |
| Revenues: | | | | | | | | | | |
| United States | $683 | $590 | $93 | 16 | % | $1,332 | $1,159 | $173 | 15 | % |
| International | 774 | 653 | 121 | 19 | | 1,485 | 1,276 | 209 | 16 | |
| Total revenues | $1,457 | $1,243 | $214 | 17 | | $2,817 | $2,435 | $383 | 16 | |

License Revenues

License revenues during the three and six months ended June 30, 2014 were up 16% and 15%, respectively, compared to the three and six months ended June 30, 2013. Our license revenue growth rate was favorably impacted during the three and six months ended June 30, 2014 compared to the same periods in the prior year as a result of increased sales of our integrated product suites, including VMware vCloud Suite. Our customers continue to shift to purchasing our suite solutions rather than purchasing certain products sold on a standalone basis such as vSphere. Our integrated product suites include various product offerings and are generally sold at a higher price than our products that are sold on an individual basis.

Our license revenue growth rate was negatively impacted by the contribution to Pivotal and the disposition of other net assets under our realignment plan during fiscal 2013. License revenues related to Pivotal and all dispositions under our realignment plan were $4 and $17 during the three and six months ended June 30, 2013, respectively.

Services Revenues

During the three and six months ended June 30, 2014, software maintenance revenues benefited from renewals, multi-year software maintenance contracts sold in previous periods, and additional maintenance contracts sold in conjunction with new software license sales. In each period presented, customers bought, on average, more than 24 months of support and maintenance with each new license purchased, which we believe demonstrates our customers' commitment to our SDDC strategy.

Our services revenue growth rate was negatively impacted by the contribution to Pivotal and the disposition of other net assets under our realignment plan. Service revenues related to Pivotal and all dispositions under our realignment plan were $4 and $34 during the three and six months ended June 30, 2013, respectively.

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Foreign Currency

We invoice and collect in the Euro, the British Pound, the Japanese Yen, the Australian Dollar and the Chinese Renminbi in their respective regions. As a result, our total revenues are affected by changes in the value of the U.S. Dollar against these currencies. Foreign currency fluctuations did not have a material impact when comparing license revenues during the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013, respectively.

Unearned Revenues

Our unearned revenues as of June 30, 2014 and December 31, 2013 were as follows:

| | June 30, 2014 | December 31, 2013 |
|---|---|---|
| Unearned license revenues | $476 | $465 |
| Unearned software maintenance revenues | 3,541 | 3,304 |
| Unearned professional services revenues | 372 | 323 |
| Total unearned revenues | $4,389 | $4,092 |

Unearned license revenues are generally recognized upon delivery of existing or future products or services, or they are otherwise recognized ratably over the term of the arrangement. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive the future product at no additional charge. To the extent the future product has not been delivered and vendor-specific objective evidence ("VSOE") of fair value cannot be established, the revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. In the event the arrangement does not include professional services, unearned license revenue may also be recognized ratably, if the customer is granted the right to receive unspecified future products or VSOE of fair value on the software maintenance element of the arrangement does not exist. Total unearned license revenues may vary over periods for a variety of factors, including the type and level of promotions offered, and the timing of when the products are delivered upon general availability.

Unearned software maintenance revenues are attributable to our maintenance contracts and are generally recognized ratably, typically over terms from one to five years with a weighted-average remaining term at June 30, 2014 of approximately two years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

Cost of License and Services Revenues, and Operating Expenses

Cost of License Revenues

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | $ Change | % Change | 2014 | 2013 | $ Change | % Change |
| Cost of license revenues | $45 | $55 | $(8) | (16)% | $94 | $111 | $(16) | (14)% |
| Stock-based compensation | 1 | — | — | — | 2 | 1 | — | 18 |
| Total expenses | $46 | $55 | $(8) | (15) | $96 | $112 | $(16) | (14) |
| % of License revenues | 8% | 10% | | | 8% | 11% | | |

Cost of license revenues decreased during the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013 primarily due to a decrease of $13 and $26, respectively, in amortization of capitalized software development costs which was partially offset by an increase of $5 and $7, respectively, in amortization of intangible assets.

As of December 31, 2013, all previously capitalized software development costs were fully amortized and as such, we do not expect significant amortization of capitalized software development costs during 2014.

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Cost of Services Revenues

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | $ Change | % Change | 2014 | 2013 | $ Change | % Change |
| Cost of services revenues | $ 161 | $ 111 | $ 50 | 44 % | $ 303 | $ 229 | $ 74 | 32 % |
| Stock-based compensation | 11 | 7 | 4 | 65 | 20 | 14 | 6 | 45 |
| Total expenses | $ 172 | $ 118 | $ 54 | 46 | $ 323 | $ 243 | $ 81 | 33 |
| % of Services revenues | 20 % | 17 % | | | 20 % | 17 % | | |

Cost of services revenues increased during the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013. The increases were primarily due to growth in cash-based employee-related expenses of $29 and $51, during the three and six months ended June 30, 2014, respectively, driven by incremental growth in headcount, both organic and through the AirWatch acquisition. Costs we incur to provide technical support increased by $9 and $14 during the three and six months ended June 30, 2014, respectively. Additionally, increases in equipment and depreciation costs contributed to the increases in cost of services revenues. The increase during the six months ended June 30, 2014 was partially offset by a decrease of $10 in operating expenses related to Pivotal.

Research and Development Expenses

Our research and development ("R&D") expenses include the personnel and related overhead associated with the R&D of new product offerings and the enhancements, including major upgrades, of our existing software offerings.

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | $ Change | % Change | 2014 | 2013 | $ Change | % Change |
| Research and development | $ 251 | $ 210 | $ 41 | 20 % | $ 484 | $ 419 | $ 65 | 16 % |
| Stock-based compensation | 66 | 51 | 15 | 29 | 126 | 113 | 13 | 11 |
| Total expenses | $ 317 | $ 261 | $ 56 | 21 | $ 610 | $ 532 | $ 78 | 15 |
| % of Total revenues | 22 % | 21 % | | | 22 % | 22 % | | |

R&D expenses increased during the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013. The increases were primarily due to growth in cash-based employee-related expenses of $24 and $51 during the three and six months ended June 30, 2014, respectively, and increases in stock-based compensation of $15 and $13, respectively, driven by incremental growth in headcount, both organic and through the AirWatch acquisition. Additionally, contractor costs of $7 and $12 contributed to the increases during the three and six months ended June 30, 2014, respectively, as well as increases in equipment and depreciation expenses. The increase during the six months ended June 30, 2014 was partially offset by a decrease of $15 in research and development expenses related to Pivotal.

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Sales and Marketing Expenses

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | $ Change | % Change | 2014 | 2013 | $ Change | % Change |
| Sales and marketing | $ 501 | $ 409 | $ 92 | 23 % | $ 934 | $ 790 | $ 145 | 18 % |
| Stock-based compensation | 43 | 33 | 10 | 30 | 84 | 69 | 15 | 21 |
| Total expenses | $ 544 | $ 442 | $ 102 | 23 | $ 1,018 | $ 859 | $ 159 | 19 |
| % of Total revenues | 37 % | 36 % | | | 36 % | 35 % | | |

Sales and marketing expenses increased during the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013 primarily driven by growth in cash-based employee-related expenses of $65 and $111, respectively, and an increase in stock-based compensation of $10 and $15, respectively, due to incremental growth in headcount, both organic and through the AirWatch acquisition. Costs incurred for travel and marketing programs also contributed to increases of $18 and $29, respectively, in expenses during the three and six months ended June 30, 2014 compared to the same periods in 2013. The increase in expenses during the six months ended June 30, 2014 was partially offset by a decrease of $10 in sales and marketing expenses related to Pivotal.

General and Administrative Expenses

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|---|---|---|---|---|---|---|---|---|
| | 2014 | 2013 | $ Change | % Change | 2014 | 2013 | $ Change | % Change |
| General and administrative | $ 161 | $ 84 | $ 77 | 91 % | $ 295 | $ 168 | $ 126 | 74 % |
| Stock-based compensation | 18 | 12 | 6 | 50 | 35 | 26 | 9 | 34 |
| Total expenses | $ 179 | $ 96 | $ 82 | 86 | $ 330 | $ 194 | $ 134 | 69 |
| % of Total revenues | 12 % | 8 % | | | 12 % | 8 % | | |

General and administrative expenses increased during the three and six months ended June 30, 2014 compared to the three and six months ended June 30, 2013. Certain key employees of AirWatch may be paid consideration upon the achievement of specified future employment conditions. Compensation expense relating to the future employment conditions of the key AirWatch employees of $41 and $60 was recognized during the three and six months ended June 30, 2014, respectively. Other cash-based employee-related expenses increased by $14 and $28 during the three and six months ended June 30, 2014, respectively, and stock-based compensation expenses increased $6 and $9, respectively, due to incremental growth in headcount, both organic and through the AirWatch acquisition. Costs of $11 related to certain litigation and other contingencies and IT development costs further contributed to the increases in expenses during the three and six months ended June 30, 2014 compared to the same periods in 2013.

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Realignment Charges

| | Six Months Ended June 30, | | | |
|---|---|---|---|---|
| | 2014 | 2013 | $ Change | % Change |
| Realignment charges | $(1 ) | $57 | $(59 ) | (102 )% |
| Stock-based compensation | — | 6 | (6 ) | (100 ) |
| Total expenses | $(1 ) | $63 | $(65 ) | (102 ) |

Realignment charges during the six months ended June 30, 2013 were incurred in connection with our realignment plan that was initiated in January 2013. The realignment plan was completed at December 31, 2013.

Interest Expense with EMC

Interest expense with EMC Corporation ("EMC") of $7 and $12 during the three and six months ended June 30, 2014, respectively, increased by $6 and $9 compared to the same periods in 2013 primarily as a result of the additional debt we assumed from EMC. See "Our Relationship with EMC" disclosure for further information.

Other Income, Net

Other income, net, decreased by $18 and $13 during the three and six months ended June 30, 2014, respectively, compared to the same periods in 2013, primarily due to a pre-tax gain of $32 recognized during the three and six months ended June 30, 2013 as a result of exiting certain lines of business under our business realignment plan. Partially offsetting this gain during the three and six months ended June 30, 2013 was an other-than-temporary impairment charge of $13 that we recognized in connection with a non-recoverable strategic investment.

Income Tax Provision

For the three months ended June 30, 2014 and 2013, our effective income tax rate was 17.5% and 16.8%, respectively. For the six months ended June 30, 2014 and 2013, our effective income tax rate was 18.1% and 8.7%, respectively. Our effective income tax rate when comparing the three and six months ended June 30, 2014 to the same periods in 2013 was primarily impacted by the expiration of the federal research credit on December 31, 2013. During January 2013, the United States Congress retroactively enacted the extension of the federal research credit through December 31, 2013.

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%. Recent developments in non-U.S. tax jurisdictions and unfavorable changes in non-U.S. tax laws and regulations could have an adverse effect on our effective tax rate. Additionally, if earnings are lower than anticipated in countries where the statutory tax rates are lower than the U.S. federal tax rate, this could also have an adverse effect on our effective tax rate. 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 to such income. Our intent is to indefinitely reinvest our non-U.S. funds in our foreign operations, and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

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 our U.S. federal income tax would be reported separately from that of the EMC consolidated group. Although we file a consolidated federal tax return with EMC, the income tax provision is calculated primarily as though we were a separate taxpayer. However, certain transactions that we and EMC are parties to are assessed using consolidated tax return rules. 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.

Our future effective tax rate may be affected by such factors as changes in tax laws, changes in our business, regulations, or rates, changing interpretation of existing laws or regulations, the impact of accounting for stock-based compensation, the

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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, 2014, EMC owned 43,025,000 shares of Class A common stock and all 300,000,000 shares of Class B common stock, representing 79.8% of our total outstanding shares of common stock and 97.2% of the combined voting power of our outstanding common stock.

EMC Reseller Arrangement, Other Services and Note Payable

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

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

Information about our revenues and receipts from such arrangements with EMC during the three and six months ended June 30, 2014 and 2013 and unearned revenues as of June 30, 2014 and December 31, 2013 consisted of the following (table in millions):

| | Revenues and Receipts from EMC | | | | Unearned Revenues from EMC | |
|---|---|---|---|---|---|---|
| | Three Months Ended June 30, | | Six Months Ended June 30, | | As of June 30, | As of December 31, |
| | 2014 | 2013 | 2014 | 2013 | 2014 | 2013 |
| Reseller revenues | $43 | $35 | $89 | $72 | $203 | $188 |
| Professional services revenues | 18 | 30 | 40 | 46 | 10 | 12 |
| Internal-use revenues | 5 | 3 | 13 | 6 | 13 | 20 |
| Collaborative technology project receipts | — | 2 | — | 4 | n/a | n/a |

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

- We purchase products and services for internal use from EMC.
- From time to time, we and EMC enter into agreements to collaborate on technology projects, and we pay EMC for services provided to us by EMC related to such projects.
- 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 condensed consolidated statements of income and primarily include salaries, benefits, travel and rent. EMC also incurs certain administrative costs on our behalf in the U.S. that are recorded as expenses in our condensed consolidated statements of income.
- We incur interest expense on our note payable with EMC. See below.

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Information about our costs from such arrangements with EMC during the three and six months ended June 30, 2014 and 2013 consisted of the following (table in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Purchases of products and services | $12 | $15 | $33 | $25 |
| Collaborative technology project costs | 3 | 2 | 7 | 2 |
| EMC subsidiary support and administrative costs | 35 | 27 | 76 | 63 |
| Interest expense on note payable | 7 | 1 | 12 | 2 |

Certain Stock-Based Compensation

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

Pivotal

During 2013, we transferred certain assets and liabilities to Pivotal. We contributed certain assets, including intellectual property to Pivotal, and Pivotal assumed substantially all liabilities, related to certain of our Cloud Application Platform products and services, including VMware's Cloud Foundry, VMware vFabric (including Spring and GemFire) and Cetas organizations, except for certain tangible assets related to Cloud Foundry. As of June 30, 2014, our ownership interest in Pivotal is 28%.

Additionally, we and Pivotal entered into an agreement pursuant to which we will act as the selling agent for the products and services we contributed to Pivotal in exchange for a customary agency fee. We also agreed to provide various transition services to Pivotal. Pursuant to the support agreement, costs incurred by us to support Pivotal services are reimbursed to us by Pivotal and are recorded as a reduction to the costs incurred by us. Information about our revenues and costs from such arrangement with Pivotal during the three and six months ended June 30, 2014 and 2013 consisted of the following (table in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Revenues | $1 | $2 | $2 | $2 |
| Transition services | 1 | $8 | 3 | $8 |

Additionally, we purchased an immaterial amount of products and services for internal use from Pivotal during the three and six months ended June 30, 2014 and 2013.

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Tax Sharing Agreement with EMC

Pursuant to a tax sharing agreement between us and EMC, we have made payments to EMC and EMC has made payments to us. The following table summarizes these payments made between us and EMC during the three and six months ended June 30, 2014 and 2013 (table in millions):

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Payments from us to EMC | $— | $— | $20 | $— |
| Payments from EMC to us | — | 16 | — | 16 |

Payments between us and EMC under the tax sharing agreement relate to our portion of federal income taxes on EMC's consolidated tax return as well as state payments for combined states. Payments from EMC to us relate to periods where we had a stand-alone loss for U.S. federal and state income tax purposes or where we had federal tax credits in excess of federal tax liabilities. Payments from us to EMC are for estimated tax payments primarily for U.S. federal income tax purposes. 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 separate return basis and the difference is presented as a component of stockholders’ equity. During the three and six months ended June 30, 2014 and 2013, the difference between the amount of tax calculated on a stand-alone basis and the amount of tax calculated per the tax sharing agreement was not material.

Due To/From Related Parties, Net

As a result of the related-party transactions with EMC and Pivotal described above, amounts due to and from related parties, net as of June 30, 2014 consisted of the following (table in millions):

| | As of June 30, 2014 | |
|---|---|---|
| Due to EMC | $(61 | ) |
| Due from EMC | 108 | |
| Due to Pivotal | (8 | ) |
| Due from Pivotal | 1 | |
| Due (to) from related parties, net | $40 | |
| | | |
| Income tax payable due to EMC | $(81 | ) |

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

Note Payable to EMC

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

The three notes issued may be prepaid without penalty or premium, and outstanding principal is due on the following dates: $680 due May 1, 2018, $550 due May 1, 2020 and $270 due December 1, 2022. The notes bear interest, payable quarterly in arrears, at the annual rate of 1.75%. During the three and six months ended June 30, 2014, $7 and $12, respectively, of interest expense was recognized. During the three and six months ended June 30, 2013, $1 and $2, respectively, of interest expense was recognized.

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 condensed consolidated financial statements included herein may not necessarily reflect our results of operations, financial position 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.

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Liquidity and Capital Resources

At June 30, 2014 and 2013, we held cash, cash equivalents and short-term investments as follows:

| | June 30, | |
|---|---|---|
| | 2014 | 2013 |
| Cash and cash equivalents | $2,054 | $1,840 |
| Short-term investments | 4,583 | 3,483 |
| Total cash, cash equivalents and short-term investments | $6,637 | $5,323 |

As of June 30, 2014, we held a diversified portfolio of money market funds and fixed income securities totaling $6,053. Our fixed income securities are 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. As of June 30, 2014, our total cash, cash equivalents and short-term investments were $6,637, of which $4,695 was held outside the U.S. If these overseas funds were 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 that cash generated by operations will be used as our primary source of liquidity. We also believe that existing cash and cash equivalents, together with any cash generated from operations will be sufficient to meet normal operating requirements for at least the next twelve months. While we believe our existing cash and cash equivalents and cash to be generated by operations will be sufficient to meet our normal operating requirements, our overall level of cash needs may be impacted by the number and size of acquisitions, investments and stock repurchases. On January 21, 2014, in connection with our agreement to acquire AirWatch, we and EMC entered into a note exchange agreement providing for the issuance of three promissory notes in the aggregate principal amount of $1,500. Please see below for further details regarding these promissory notes. Should we require additional liquidity, we may seek to arrange debt financing or enter into credit facilities.

Our cash flows summarized for the three and six months ended June 30, 2014 and 2013 were as follows:

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net cash provided by (used in): | | | | |
| Operating activities | $409 | $534 | $1,159 | $1,210 |
| Investing activities | (862) | (444) | (2,060) | (775) |
| Financing activities | (281) | (90) | 650 | (204) |
| Net (decrease) increase in cash and cash equivalents | $(734) | $— | $(251) | $231 |

Operating Activities

Cash provided by operating activities decreased by $125 and $51 during the three and six months ended June 30, 2014 from the three and six months ended June 30, 2013, respectively. The decrease during the three and six months ended June 30, 2014 was primarily driven by a decrease in profitability, change in deferred taxes, and an increase in accounts receivable compared to the same periods in 2013.

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 also impacted by the timing of purchases, sales and maturities of our available-for-sale securities.

Cash used in investing activities increased during the three and six months ended June 30, 2014 compared to the same periods in 2013 primarily due to increases in purchases of available-for-sale securities and purchases of strategic investments. Additionally, cash used in investing activities during the six months ended June 30, 2014 increased significantly as a result of our acquisition of AirWatch during the first quarter of 2014. The increase in restricted cash during the six months ended June 30, 2014 primarily relates to amounts due to certain AirWatch employees, subject to achievement of certain employment conditions.

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Financing Activities

Net cash provided by financing activities during the six months ended June 30, 2014 changed compared to net cash used in financing activities during the same period in 2013 primarily as a result of the note payable exchange agreement we entered into with EMC in connection with our acquisition of AirWatch.

Notes Payable to EMC

As of June 30, 2014, $1,500 remained outstanding on a note payable to EMC, with interest payable quarterly in arrears.

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

The three notes issued have the following principal amounts and maturity dates: $680 due May 1, 2018, $550 due May 1, 2020 and $270 due December 1, 2022.

The notes bear interest at the annual rate of 1.75%. Interest is payable quarterly in arrears. The notes may be prepaid without penalty or premium. We drew down on all three notes in late January 2014.

Critical Accounting Policies

Our condensed 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 2013 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.

New Accounting Pronouncements

During May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (Topic 606). The updated revenue standard establishes principles for recognizing revenue and develops a common revenue standard for all industries. Upon adoption, entities will be required to recognize the amount of revenue that they expect to be entitled to for the transfer of promised goods or services to their customers. The updated standard is effective for us in the first quarter of 2017 and permits the use of either the retrospective or cumulative effect transition method. Early adoption is not permitted.

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements, including, without limitation, statements regarding: achieving future business growth by building long-term relationships with our customers through the adoption of enterprise license agreements; our vision and expected benefits of the SDDC; increased operating expenses resulting from our acquisition of AirWatch; maintaining our industry leadership position; benefits of our products and services to customers; the recognition of unearned revenue; the impact of our relationship with EMC Corporation on taxes; acquisition accounting and the deductibility of goodwill and identifiable intangible assets for U.S. income tax purposes; the sufficiency of our liquidity and capital reserves to fund our operations and business strategy; our ability to generate positive cash flows from operations; continuation of our stock repurchase program; our effective tax rate and the effects of potential developments in U.S. and non-U.S. tax jurisdictions; future amortization of software development costs; our intent to indefinitely reinvest our overseas earnings in our foreign operations; the lack of a material adverse effect on us due to the resolution of pending claims, legal proceedings and investigations including the GSA and DOJ inquiries; and gains and losses associated with foreign currency fluctuations.

These forward-looking statements involve risks and uncertainties and the cautionary statements set forth above and those contained in the section of this report 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.

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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 products, services and competitive strategies;
- webcasts of our quarterly earnings calls and links to webcasts of investor conferences at which our executives appear (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.

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There were no material changes to our market risk exposures in the six months ended June 30, 2014. See Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk” of our 2013 Annual Report on Form 10-K for a detailed discussion of our market risk exposures.

## 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, as of the end of the period covered by this report, 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 most recent fiscal quarter ended June 30, 2014 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 misstatements

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due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

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PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Note I to the condensed consolidated financial statements in Part I, Item 1 of this Quarterly Report on Form 10-Q for a description of legal proceedings. See also the risk factor entitled "We may become involved in litigation and regulatory inquiries and proceedings that could negatively affect us" in Part II, Item 1A of this Quarterly Report on Form 10-Q for a discussion of potential risks to our results of operations and financial condition that may arise from legal proceedings.

ITEM 1A. RISK FACTORS

The risk factors that appear below could materially affect our business, financial condition and results of operations. The risks and uncertainties described below are not the only risks and uncertainties facing us. Our business is also subject to general risks and uncertainties that affect many other companies.

Risks Related to Our Business

As the market for our computer virtualization products has matured, we have been increasingly developing and marketing products and services targeted toward the delivery, management and automation of information technology ("IT") infrastructure, platforms and services through cloud-based solutions. If businesses do not find our cloud computing solutions compelling, our revenue growth and operating margins may decline.

Our products and services are based on computer virtualization and related technologies that have primarily been used for virtualizing on-premises data centers. As the market for data center virtualization has matured, we have increasingly directed our product development and marketing toward products and services that enable businesses to utilize virtualization as the foundation for cloud-based computing, management and automation of the delivery of IT resources, end-user computing and Infrastructure as a service ("IaaS") offerings including hybrid cloud services. Our success depends on organizations and our customers perceiving technological and operational benefits and cost savings associated with the increasing adoption of our virtualization-based infrastructure and management solutions for cloud computing, hybrid cloud services and end-user computing. As the market for our data center virtualization products mature and the scale of our business increases, it may be difficult to maintain previous rates of growth in our product sales. In addition, to the extent that our newer cloud computing infrastructure management and automation, or software-defined data center ("SDDC"), solutions, end-user computing, and hybrid cloud solutions are adopted more slowly or less comprehensively than we expect, our revenue growth rates may slow materially or our revenue may decline substantially.

The large majority of our revenues have come from our data center virtualization products including our flagship VMware vSphere product line. Decreases in demand for our data center virtualization products could adversely affect our results of operations and financial condition.

The large majority of our revenues have come from our data center virtualization products. Although we continue to develop other applications for our virtualization technology such as our end-user computing products and hybrid cloud services and expand our offerings into related areas, we expect that our data center virtualization products and related enhancements and upgrades will constitute a majority of our revenue for the foreseeable future. Declines and variability in demand for our data center virtualization products could occur as a result of:

- improved products or product versions being offered by competitors in our markets;
- competitive pricing pressures;
- failure to timely execute and implement our product strategy, which could lead to quality issues, integration issues with ecosystem partners, and difficulties in creating and marketing suites of interoperable solutions;
- failure to release new or enhanced versions of our data center virtualization products on a timely basis, or at all;
- technological change that we are unable to address with our data center virtualization products or that changes the way enterprises utilize our products; and
- general economic conditions.

Also, as more and more businesses achieve the virtualization of their data centers and other IT functions, the market for our VMware vSphere product line may become saturated. If we fail to introduce compelling new features in future upgrades to our VMware vSphere product line, develop new applications for our virtualization technology or provide product suites based on the VMware vSphere platform that address customer requirements for integration, automation and management of their IT systems, demand for VMware vSphere may decline.

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Due to our product concentration, our business, financial condition, results of operations, and cash flows would therefore be adversely affected by a decline in demand for our data center virtualization products.

Our new product and technology initiatives subject us to additional business, legal and competitive risks.

Over the last several years, we have introduced new product and technology initiatives that aim to leverage our virtualization infrastructure software products into the emerging areas of cloud computing and end-user computing as alternatives to the provisioning of physical computing resources.

One of VMware's core strategies is to deliver the software-defined data center. In 2010, we introduced the first of our vCenter and vCloud products, which we combined in 2011 with our vShield security product line to create our Cloud Infrastructure and Management ("CIM") Suite offering. In 2012, we delivered the vCloud Suite, which delivers a comprehensive suite for cloud computing in a single SKU with simplified licensing.

In 2012, we acquired two companies that furthered VMware's SDDC strategy - Dynamic Ops, a provider of cloud automation solutions that enable provisioning and management of IT services across heterogeneous environments, and Nicira, a developer of software-defined networking and a leader in network virtualization for open source initiatives. In 2013, we acquired Virsto Software, a developer of software that optimizes storage performance and utilization in virtual environments.

We also continue to expand and enhance our end-user computing offerings, such as VMware View and Horizon Suite, a solution that provides end users with a single place to get access to their applications, data and desktops and gives IT a single management console to manage entitlements, policies and security. In 2012, we acquired Wanova, a leading provider of intelligent desktop solutions that centralize and simplify the management of physical desktop images while enabling users to take advantage of the native performance of a PC. In 2013, we acquired Desktone, a leader in the Desktop-as-a-Service space.

In the second quarter of 2013, we introduced our hybrid cloud service called vCloud Hybrid Service. vCloud Hybrid Service is designed to deliver a public cloud as a service offering that is interoperable with our customers' existing VMware virtualized infrastructure, enabling customers to extend the same skills, tools, networking and security models across both on-premise and off-premise environments. We are currently making significant investments in developing and introducing new technologies and product offerings related to our SDDC, vCloud Hybrid Service and end user and mobile computing initiatives.

In the first quarter of 2014, we acquired AirWatch, a leader in enterprise mobility management and security solutions. The acquisition of AirWatch expands our portfolio of mobile solutions within the enterprise mobility and security space.

The expansion of our offerings to deliver the SDDC, address IT management and automation, and enhance our end-user computing capabilities and our hybrid cloud offerings subjects us to additional risks, such as the following:

- These initiatives may present new and difficult technological challenges. Significant investments will be required to acquire and develop solutions to those challenges. Customers may choose not to adopt our new product or service offerings and we may be unable to recoup or realize a reasonable return on our investments.
- Some of our new initiatives are hosted by third parties whom we do not control but whose failure to prevent service disruptions, or other failures or breaches may require us to issue credits or refunds or indemnify or otherwise be liable to customers or third parties for damages that may occur. Any transition of our services from a third party hosting service to our own data centers would also entail a risk of service disruption during a transition. We may be subject to claims if customers of these service offerings experience service disruptions or failures, security breaches, data losses or other quality issues.
- The success of these new offerings depends upon the cooperation of hardware, software and cloud hosting vendors to ensure interoperability with our products and offer compatible products and services to end users. If we are unable to obtain such cooperation, it may be difficult and more costly for us to achieve functionality and service levels that would make our new products and services attractive to end users.
- We will need to develop and implement appropriate go-to-market strategies and train our sales force in order to effectively market offerings in product categories in which we may have less experience than our competitors. Accordingly, end users could choose competing products and services over ours, even if such offerings are less advanced than ours.

- Our increasing focus on developing and marketing IT management and automation and IaaS (including software-defined networking and vCloud Hybrid Services), offerings that enable customers to transform their IT systems will require a greater focus on marketing and selling product suites and more holistic solutions, rather than selling on a product-by-product basis. Consequently, we will need to develop new strategies for marketing and selling our offerings, our customers’ purchasing decisions may become more complex and require additional levels of approval and the duration of sales cycles for our offerings may increase.

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- We will need to develop appropriate pricing strategies for our new product initiatives. For example, it has frequently been challenging for software companies to derive significant revenue streams from open source projects, such as certain of our offerings. Additionally, in some cases our new product initiatives are predicated on converting free and trial users to paying customers of the premium tiers of these services, and therefore we must maintain a sufficient conversion ratio for such services to be profitable. Also, certain of our new product initiatives have a subscription model. We may not be able to accurately predict subscription renewal rates or their impact on results, and because revenue is recognized for our services over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our results.
- The success of vCloud Hybrid Service will be dependent on the final global implementation of the offering and building successful go-to-market strategies. We will need to build sales expertise and infrastructure to support the new offering. This hybrid cloud offering involves significant risk and may not be accepted by customers. Further, this offering may lead our team to reduce the time spent on selling our existing product portfolio, which could have a material negative impact on revenues.
- Our new products and services may compete with offerings from companies who are members of our developer and technology partner ecosystem. Consequently, we may find it more difficult to continue to work together productively on other projects, and the advantages we derive from our ecosystem could diminish.
- The cloud computing and virtualized end-user computing industries are in early stages of development. Other companies seeking to enter and develop competing standards for the cloud computing space, such as Microsoft, IBM, Oracle, Google, Amazon and Cisco, and the end-user computing space, such as Citrix and Microsoft, have introduced or are likely to introduce their own initiatives that may compete with or not be compatible with our cloud and end-user computing initiatives which could limit the degree to which other vendors develop products and services around our offerings and end users adopt our platforms.
- Emerging IT sectors, such as those within IaaS, are frequently subject to a “first mover” effect pursuant to which certain product and service offerings can rapidly capture a significant portion of market share and developer attention. Therefore, if competitive product and service offerings in these sectors gain broad adoption before ours, it may be difficult for us to displace such offerings regardless of the comparative technical merit, efficacy or cost of our products and services.
- Developing and launching new technologies in new areas, as we are doing with our VMware NSX virtual networking, Virtual SAN virtual storage and vCloud Hybrid Service initiatives, requires significant investments of resources and often entails greater risk than incremental investments in existing industries. If these investments are not successful, our rate of growth may decline or reverse and our operating results will be negatively affected.
- Marketing and selling new technologies to enterprises requires significant investment of time and resources in order to educate customers on the benefits of our new product offerings. These investments can be costly and the additional effort required to educate both customers and our own sales force can distract from their efforts to sell existing products and services.

As our vSphere-related products continue to mature, our future revenue growth is increasingly dependent on revenue from our new product and technology offerings. Our newer initiatives may be less profitable than our established products, and we may not be successful enough in these newer activities to recoup our investments in them. If any of these risks were to occur, it could damage our reputation, limit our growth and negatively affect our operating results.

Our vCloud Hybrid Service offering relies upon a number of third-party providers for data center space, equipment, maintenance and other colocation services, and the loss of, or problems with, one or more of these providers may impede the growth of our vCloud Hybrid Service offerings, adversely impact our plans to expand the service and damage our reputation.

We launched our vCloud Hybrid Service cloud service offerings in 2013 in the United States and announced plans to expand the services globally. Our vCloud Hybrid Service offerings rely upon third-party providers to supply data center space, equipment maintenance and other colocation services. While we have entered into various agreements for the lease of data center space, equipment maintenance and other services, third parties could fail to live up to the contractual obligations under those agreements. For example, a data center landlord may fail to adequately maintain its facilities or provide an appropriate data center infrastructure for which it is responsible. If that were to happen, our ability to deliver services at levels acceptable to our customers and at levels that we have committed to could be impaired. Additionally, if the third parties that we rely on do fail to deliver on their obligations, our reputation could be damaged, our customers could lose confidence in us, and our ability to maintain and expand our vCloud Hybrid Service offerings would be impaired.

Ongoing uncertainty regarding global economic conditions and the stability of regional financial markets may reduce information technology spending below current expectations and therefore adversely impact our revenues, impede end-user adoption of new products and services and product and service upgrades, and adversely impact our competitive position.

Our business depends on the overall demand for information technology and on the economic health of our current and prospective customers. The purchase of our products and services is often discretionary and may involve a significant commitment of capital and other resources. Weak economic conditions or significant uncertainty regarding the stability of financial markets could adversely impact our business, financial condition and results of operations in a number of ways, including by lengthening sales cycles, affecting the size of enterprise license agreements ("ELAs") that customers will commit to, reducing the level of our non-ELA transactional sales, lowering prices for our products and services, reducing unit sales and reducing the rate of adoption of our products and services by new customers and the willingness of current customers to purchase upgrades to our existing products and services. For example, a recurrence of the sovereign debt crisis in Europe or that region's failure to recover from recession would threaten to suppress demand and our customers' access to credit in that region, which is an important market for our products and services. Additionally, in response to sustained economic uncertainty, many national and local governments that are current or prospective customers for our products and services, including the U.S. federal government, have made, or threatened to make, significant spending cutbacks which could reduce the amount of government spending on IT and the potential demand for our products and services from the government sector.

Regional economic uncertainty can also result in general and ongoing tightening in the credit markets, lower levels of liquidity, increases in the rates of default and bankruptcy and significant volatility in the credit, equity and fixed income markets. As a result, current or potential customers may be unable to fund software purchases, which could cause them to delay, decrease or cancel purchases of our products and services. Even if customers are willing to purchase our products and services, if they do not meet our credit requirements, we may not be able to record accounts receivable or unearned revenue or recognize revenues from these customers until we receive payment, which could adversely affect the amount of revenues we are able to recognize in a particular period.

In addition, although we plan to continue making strategic investments in our business, many of our competitors have significantly greater financial, technical and other resources than we do, and if the economic recovery is anemic or not sustained, they may be better positioned to continue investment in competitive technologies.

We expect to face increasing competition that could result in a loss of customers, reduced revenues or decreased operating margins.

The virtualization, cloud computing, end-user computing and software-defined data center industries are inter-related and rapidly evolving. We experienced increased competition during 2013 and expect it to remain intense throughout 2014. For example, Microsoft continues to make incremental improvements to its virtual infrastructure and virtual management products and is expected to release updated versions of its Hyper V virtualization product. In September 2012, Microsoft began shipping Windows Server 2012, which includes a more advanced version of its Hyper-V virtualization product which continues its push into the virtualization space, its System Center 2012 bundle of management products targeted at legacy and virtual environments and its VDI offering for smaller businesses. Microsoft also offers IaaS capabilities in Azure with a similar hybrid cloud message. We also face competition from other companies that have announced a number of new product initiatives, alliances and consolidation efforts. For example, Citrix Systems continues to enhance its end-user desktop and mobility offerings and their networking and cloud platform offerings. IBM, Google and Amazon have existing cloud computing offerings and announced new cloud computing initiatives. For example, Amazon released their Workspaces offering for the DaaS space. Additionally, Red Hat has released commercial versions of Linux that have virtualization capabilities as part of the Linux kernel ("KVM") and has also announced plans for cloud computing products. Other companies have indicated their intention to expand offerings of virtual management and cloud computing solutions as well. Additionally, our hybrid cloud computing offering, which allows enterprises to pool internal and external IT resources running on a common vSphere infrastructure competes with low-cost public cloud infrastructure offerings such as Amazon EC2 and Google Compute Engine. Enterprises and service providers have also shown significant interest in building their own clouds based on open source projects such as OpenStack.

Following our acquisition of Nicira and the resulting release of our NSX product, a number of competitors have announced software-defined networking offerings. Specifically, Cisco has announced plans to ship its Application Centric Infrastructure product.

We believe that the key competitive factors in the virtualization and cloud computing spaces include:

- the level of reliability, security and new functionality of product offerings;
- the ability to provide comprehensive and scalable solutions, including management and security capabilities;
- the ability to offer products and services that support multiple hardware platforms, operating systems, applications and application development frameworks;

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- the ability to deliver an intuitive end-user experience for accessing data, applications and services from a wide variety of end-user devices;
- the ability to effectively run traditional IT applications and emerging applications;
- the proven track record of formulating and delivering a roadmap of virtualization and cloud computing capabilities;
- the ability to attract and preserve a large installed base of customers;
- pricing of products and services, individually and in bundles;
- the ability to attract and preserve a large number of application developers to develop to a given cloud ecosystem;
- the ability to create and maintain partnering opportunities with hardware vendors, infrastructure software vendors and cloud service providers;
- the ability to develop robust indirect sales channels; and
- the ability to attract and retain cloud, virtualization and systems experts as key employees.

Existing and future competitors may introduce products and services in the same areas we serve or intend to serve, and competing products and services may have better performance, lower prices, better functionality and broader acceptance than our products and services. Our competitors may also add features to their virtualization, end-user and cloud computing products similar to features that presently differentiate our product offerings from theirs. Many of our current or potential competitors also have longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we do. This competition could result in increased pricing pressure and sales and marketing expenses, thereby materially reducing our operating margins, and could also prevent our new products and services from gaining market acceptance, thereby harming our ability to increase, or causing us to lose, market share. Increased competition also may prevent us from entering into or renewing service contracts on terms similar to those that we currently offer and may cause the length of our sales cycle to increase. Additionally, some of our competitors and potential competitors supply a wide variety of products and services to, and have well-established relationships with, our current and prospective end users. For example, small to medium sized businesses and companies in emerging markets that are evaluating the adoption of virtualization-based technologies and solutions may be inclined to consider Microsoft solutions because of their existing use of Windows and Office products. Some of these competitors have in the past and may in the future take advantage of their existing relationships to engage in business practices that make our products and services less attractive to our end users. Other competitors have limited or denied support for their applications running in VMware virtualization environments. These distribution, licensing and support restrictions, as well as other business practices that may be adopted in the future by our competitors, could materially impact our prospects regardless of the merits of our products and services. In addition, competitors with existing relationships with our current or prospective end users could in the future integrate competitive capabilities into their existing products and services and make them available without additional charge. For example, Oracle provides free server virtualization software intended to support Oracle and non-Oracle applications, and Microsoft offers its own server virtualization software packaged with its Windows Server product and offers built-in virtualization in the client version of Windows. As a result, existing VMware customers may elect to use products that are perceived to be “free” or “very low cost” instead of purchasing VMware products and services for certain applications where they do not believe that more advanced and robust capabilities are required. Competitors may also leverage open source technologies to offer zero or low cost products and services capable of putting pricing pressure on our own product offerings. By engaging in such business practices, our competitors can diminish competitive advantages we may possess by incentivizing end users to choose products that lack some of the technical advantages of our own offerings. In addition, even if customers find our products and services to be technically superior, they may choose to employ a “multiple-vendor” strategy, where they purposely deploy multiple vendors in their environment in order to prevent any one vendor from gaining too much control over their IT operations.

We also face potential competition from our partners. For example, third parties currently selling our products and services could build and market their own competing products and services or market competing products and services of other vendors. If we are unable to compete effectively, our growth and our ability to sell products and services at profitable margins could be materially and adversely affected, which could materially and adversely impact our financial condition and results of operations.

Industry alliances or consolidation may result in increased competition.

Some of our competitors have made acquisitions and entered into or extended partnerships or other strategic relationships to offer more comprehensive virtualization and cloud computing solutions than they individually had offered. Citrix Systems continues to invest in desktop virtualization marketing by continuing its collaboration with Microsoft and has acquired smaller players like Zenprise, Virtual Computer and Framehawk. IBM acquired SoftLayer to increase their data center footprint and grow their cloud business. Moreover, information technology companies are increasingly seeking to deliver top-to-bottom IT solutions to end users that combine enterprise-level hardware and software solutions to provide an alternative to our virtualization platform. For example, Oracle offers integrated hardware and software virtualization solutions, and Microsoft and Hewlett-Packard continue their collaboration based on Microsoft's cloud computing and virtualization platforms. In addition, Citrix offers an IaaS cloud services solution, and Red Hat continues to invest in the Open Virtualization Alliance ("OVA") to bolster KVM as a direct competitor to VMware vSphere. In 2012, Dell acquired Wyse Technologies to bolster its ability to serve the "cloud client" space and Quest to enhance its management and automation solutions. A number of competitors are active in the emerging software-defined networking space. For example, in 2013, Cisco acquired Insieme, and Juniper acquired Contrail Systems in late 2012. In June 2013, Oracle and Microsoft entered into a partnership pursuant to which Oracle now supports the use of Oracle products in Microsoft Hyper-V deployments as well as Windows Azure. In July 2014, Cisco and Microsoft announced an initiative to integrate Cisco data center solutions and networking switches with Microsoft cloud offerings and to jointly market and sell their data center and hybrid cloud solutions. We expect these trends to continue as companies attempt to strengthen or maintain their positions in the evolving virtualization infrastructure and enterprise IT solutions industry. Many of the companies driving this trend have significantly greater financial, technical and other resources than we do and may be better positioned to acquire and offer complementary products and technologies. The companies and alliances resulting from these possible combinations may create more compelling product and service offerings and be able to offer greater pricing flexibility than we can or may engage in business practices that make it more difficult for us to compete effectively, including on the basis of price, sales and marketing programs (such as providing greater incentives to our channel partners to sell a competitor's product), technology or product functionality. This competition could result in a substantial loss of customers or a reduction in our revenues, which could materially and adversely impact our financial condition and results of operations.

We may not be able to respond to rapid technological changes with new solutions and services offerings, which could have a material adverse effect on our sales and profitability.

The virtualization, cloud computing, end-user computing and SDDC industries are characterized by rapid technological changes, changing customer needs, frequent new software product introductions and evolving industry standards. The introduction of third-party solutions embodying new technologies and the emergence of new industry standards could make our existing and future software solutions obsolete and unmarketable. Cloud computing is proving to be a disruptive technology that will alter the way that businesses consume, manage and provide physical IT resources, applications, data and IT services. We may not be able to establish or sustain our thought leadership in the cloud computing and enterprise software fields, and our customers may not view our products and services as innovative and best-of-breed, which could result in a reduction in market share and our inability to command a pricing premium over competitor products and services. We may not be able to develop updated products and services that keep pace with technological developments and emerging industry standards and that address the increasingly sophisticated needs of our customers or that interoperate with new or updated operating systems and hardware devices or certify our products and services to work with these systems and devices. As a result, we may not be able to accurately predict the lifecycle of our software solutions, and they may become obsolete before we receive the amount of revenues that we anticipate from them. There is no assurance that any of our new offerings would be accepted in the marketplace. Significant reductions in server-related costs or the rise of more efficient infrastructure management software could also affect demand for our software solutions. As hardware and processors become more powerful, we will have to adapt our product and service offerings to take advantage of the increased capabilities. For example, while the introduction of more powerful servers presents an opportunity for us to provide better products for our customers, the migration of servers to microprocessors with an increasing number of multiple cores also allows an end user with a given number of licensed copies of our software to multiply the number of virtualization machines run per server socket without having to purchase additional licenses from us. If we are unable to revise our solutions and offerings in response to new technological developments, our ability to retain or increase market share and revenues in the virtualization software space could be materially adversely affected.

Our operating results may fluctuate significantly, which makes our future results difficult to predict and may result in our operating results falling below expectations or our guidance and cause the price of our Class A common stock to decline.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Our past results should not be relied upon as an indication of our future performance. In addition, a significant portion of our quarterly sales typically occurs during the last month of the quarter, which generally reflects customer buying patterns for enterprise technology. As a result, our quarterly operating results are difficult to predict even in the near term. If our revenues or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our Class A common stock would likely decline substantially.

In addition, factors that may affect our operating results include, among others:

- general economic conditions in our domestic and international markets and the effect that these conditions have on our customers’ capital budgets and the availability of funding for software purchases;

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- fluctuations in demand, adoption rates, sales cycles and pricing levels for our products and services;
- fluctuations in foreign currency exchange rates;
- changes in customers' budgets for information technology purchases and in the timing of their purchasing decisions;
- the timing of recognizing revenues in any given quarter, which, as a result of software revenue recognition policies, can be affected by a number of factors, including product announcements, beta programs and product promotions that can cause revenue recognition of certain orders to be deferred until future products to which customers are entitled become available;
- the sale of our products and services in the time frames we anticipate, including the number and size of orders in each quarter;
- our ability to develop, introduce and ship in a timely manner new products and services and enhancements that meet customer demand, certification requirements and technical requirements;
- the introduction of new pricing and packaging models for our product offerings;
- the timing of the announcement or release of upgrades or new products and services by us or by our competitors;
- our ability to maintain scalable internal systems for reporting, order processing, license fulfillment, product delivery, purchasing, billing and general accounting, among other functions;
- our ability to control costs, including our operating expenses;
- changes to our effective tax rate;
- the increasing scale of our business and its effect on our ability to maintain historical rates of growth;
- our ability to attract and retain highly skilled employees, particularly those with relevant experience in software development and sales;
- our ability to conform to emerging industry standards and to technological developments by our competitors and customers;
- renewal rates and the amounts of the renewals for ELAs as original ELA terms expire;
- the timing and amount of software development costs that may be capitalized beginning when technological feasibility has been established and ending when the product is available for general release;
- unplanned events that could affect market perception of the quality or cost-effectiveness of our products and solutions; and
- the recoverability of benefits from goodwill and acquired intangible assets, and the potential impairment of these assets.

The failure by customers to renew large license agreement transactions on a satisfactory basis could materially adversely affect our business, financial condition, operating results and cash flow.

Our core customers are large enterprises with multi-year enterprise license agreements, each of which involves substantial aggregate fee amounts. The failure to renew those transactions in the future, or to replace those enterprise license agreements with new transactions of similar scope, on terms that are commercially attractive to us could materially adversely affect our business, financial condition, operating results and cash flow.

Our current research and development efforts may not produce significant revenues for several years, if at all.

Developing our products and services is expensive. Our investment in research and development may not result in marketable products or services or may result in products and services that take longer to generate revenues, or may generate less revenues, than we anticipate. Our research and development expenses were approximately 22% of our total revenues during the first six months of 2014 and approximately 21% in the fiscal year 2013. Our future plans include significant investments in software research and development and related product opportunities. We believe that we must continue to dedicate a significant amount of resources to our research and development efforts to maintain our competitive position. However, we may not receive significant revenues from these investments for several years, if at all.

Our products and services are sold using ELAs and through our transactional business, and this strategy may not drive long-term sales and revenue growth.

We sell our products and services through two primary means, which we refer to as our ELA and our non-ELA, or transactional, sales.

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ELAs are comprehensive long-term license agreements that provide for multi-year maintenance and support and constitute an increasing percentage of total overall sales. In recent periods, 25% to 40% of our overall sales each quarter have been comprised of ELAs. These are generally larger size transactions, typically driven by our direct sales force and are primarily attractive to our larger enterprise customers.

Transactional sales, in contrast, tend to be smaller in scope, shorter in duration with a standard one-year maintenance term, and are principally driven by our sales channel partners. Historically, they have represented two-thirds to three-quarters of our overall sales.

During 2013, we expanded the sales of product suites, such as our vCloud suite, that integrate advanced management and automation features with our vSphere cloud infrastructure platform and which are primarily sold through ELAs. We believe that ELAs help us grow our business by building long-term relationships with our enterprise customers. Although our year-over-year growth rates for overall sales and ELA sales both increased in 2013 compared to 2012, the year-over-year growth rate for our transactional sales declined in 2013 compared to 2012. Although the growth rate for our transactional business increased during the first half of 2014, as we develop and add new product and service capabilities to our higher-end product offerings, and as our ELA volume continues to grow, we may not be successful in our strategy to increase the value of the products and services sold through the transactional business. Consequently, we may not be able to increase sales volumes in our transactional business or help attract new customers to our product ecosystem with our enhanced product features and capabilities.

If our overall go-to-market strategy is not successful, our growth rates may decline further, and our business, financial condition and results of operations could be materially adversely affected.

Our sales cycles can be long and unpredictable, our sales efforts require considerable time and expense, and timing of sales is subject to changing purchasing behaviors of our customers. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate significantly.

The timing of our revenues is difficult to predict. Our sales efforts involve educating our customers about the use and benefit of our products and services, including their technical capabilities, potential cost savings to an organization and advantages compared to lower-cost products and services offered by our competitors. Customers typically undertake a significant evaluation process that has in the past resulted in a lengthy sales cycle which typically lasts several months, and may last a year or longer. We spend substantial time, effort and money on our sales efforts without any assurance that our efforts will produce any sales. In addition, product and service purchases are frequently subject to budget constraints, economic conditions, multiple approvals, and unplanned administrative, processing and other delays. Moreover, the greater number of competitive alternatives, as well as announcements by our competitors that they intend to introduce competitive alternatives at some point in the future, can lengthen customer procurement cycles, cause us to spend additional time and resources to educate end users on the advantages of our product and service offerings and delay product and service sales. Economic downturns and uncertainty can also cause customers to add layers to their internal purchase approval processes, adding further time to a sales cycle. Additionally, as we sell more products and services to domestic and foreign governments, we may encounter lengthier sales cycles, complicated budgeting processes and complex procurement regulations. These factors can have a particular impact on the timing and length of our ELA sales cycles and our overall sales during any particular fiscal period may have greater variability as a greater portion of our sales is made utilizing ELAs.

Additionally, our quarterly sales have historically reflected an uneven pattern in which a disproportionate percentage of a quarter's total sales occur in the last month, weeks and days of each quarter. Similarly, our yearly sales have historically reflected a disproportionate percentage of the year's sales in the fourth fiscal quarter. These patterns make prediction of revenues, earnings and working capital for each financial period especially difficult and uncertain and increase the risk of unanticipated variations in financial condition and results of operations. We believe this uneven sales pattern is a result of many factors including the following:

- the tendency of customers to wait until late in a quarter to commit to a purchase in the hope of obtaining more favorable pricing;
- the fourth quarter influence of customers spending their remaining capital budget authorization prior to new budget constraints in the following year; and
- seasonal influences, such as holiday or vacation periods.

If sales expected from specific customers for a particular quarter are not realized in that quarter or at all, our results could fall short of public expectations and our business, financial condition and results of operations could be materially adversely affected.

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We are dependent on our management and our key development personnel, and the loss of key personnel may prevent us from implementing our business plan in a timely manner.

Our success depends largely upon the continued services of our existing management. We are also substantially dependent on the continued service of our key development personnel for product and service innovation and timely development and delivery of upgrades and enhancements to our existing products and services. The market for expert software developers upon whom we rely has become increasingly competitive. We generally do not have employment or non-compete agreements with our existing management or development personnel, and, therefore, they could terminate their employment with us at any time without penalty and could pursue employment opportunities with any of our competitors. Changes to management and key employees can also lead to additional unplanned losses of key employees. The loss of key employees could seriously harm our ability to release new products and services on a timely basis and could significantly help our competitors.

Because competition for our target employees is intense, we may not be able to attract and retain the highly skilled employees we need to support our planned growth, and our compensation expenses may increase.

To execute on our strategy, we must continue to attract and retain highly qualified personnel. Competition for these personnel is intense, especially for senior sales executives and engineers with high levels of experience in designing and developing software. We may not be successful in attracting and retaining qualified personnel. We have from time to time in the past experienced, and we expect to continue to experience in the future, difficulty in hiring and retaining highly skilled employees with appropriate qualifications. Many of the companies with which we compete for experienced personnel have greater resources than we have. Research and development personnel are also aggressively recruited by startup and emerging growth companies, which are especially active in many of the technical areas and geographic regions in which we conduct product and service development. In addition, in making employment decisions, particularly in the high-technology industry, job candidates often consider the value of the stock-based compensation they are to receive in connection with their employment. Declines in the value of our stock could adversely affect our ability to attract or retain key employees and result in increased employee compensation expenses. If we fail to attract new personnel or fail to retain and motivate our current personnel, our business and future growth prospects could be severely harmed.

Our success depends upon our ability to develop new products and services, integrate acquired products and services and enhance our existing products and services and develop appropriate business and pricing models.

If we are unable to develop new products and services, integrate acquired products and services, enhance and improve our products and support services in a timely manner, or position or price our products and services to meet market demand, customers may not buy new software licenses from us, update to new versions of our software or renew product support. In addition, information technology standards from both consortia and formal standards-setting forums as well as de facto marketplace standards are rapidly evolving. We cannot provide any assurance that the standards on which we choose to develop new products and services will allow us to compete effectively for business opportunities in emerging areas such as cloud computing.

New product and service development and introduction involves a significant commitment of time and resources and is subject to a number of risks and challenges including:

- managing the length of the development cycle for new products and services and product and service enhancements, which has frequently been longer than we originally expected;
- increasing complexity of our product offerings as we introduce product suites such as our vCloud Suite, which can significantly increase the development time and effort necessary to achieve the interoperability of product suite components while maintaining product quality;
- managing customers’ transitions to new products and services, which can result in delays in their purchasing decisions;
- adapting to emerging and evolving industry standards and to technological developments by our competitors and customers;
- entering into new or unproven markets with which we have limited experience;
- reacting to trends and predicting which technologies will be successful and develop into industry standards;
- tailoring our business and pricing models appropriately as we enter new markets and respond to competitive pressures and technological changes;

- incorporating and integrating acquired products and technologies; and
- developing or expanding efficient sales channels.

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In addition, if we cannot adapt our business models to keep pace with industry trends, our revenues could be negatively impacted. For example, if we increase our adoption of subscription-based pricing models for our products, we may fail to set pricing at levels appropriate to maintain our revenue streams or our customers may choose to deploy products from our competitors that they believe are priced more favorably. Additionally, we may fail to accurately predict subscription renewal rates or their impact on results of operations, and because revenue from subscriptions is recognized for our services over the term of the subscription, downturns or upturns in sales may not be immediately reflected in our results. As we offer more products that depend on converting users of free services to users of premium services and as such services grow in size, our ability to maintain or improve and to predict conversion rates will become more important.

Breaches of our cybersecurity systems could degrade our ability to conduct our business operations and deliver products and services to our customers, delay our ability to recognize revenue, compromise the integrity of our software products, result in significant data losses and the theft of our intellectual property, damage our reputation, expose us to liability to third parties, and require us to incur significant additional costs to maintain the security of our networks and data.

We increasingly depend upon our IT systems to conduct virtually all of our business operations, ranging from our internal operations and product development activities to our marketing and sales efforts and communications with our customers and business partners. Unauthorized parties have attempted to penetrate our network security and our website. Such cyberattacks threaten to misappropriate our proprietary information and cause interruptions of our IT services. Because the techniques used by unauthorized persons to access or sabotage networks change frequently and may not be recognized until launched against a target, we may be unable to anticipate these techniques. Further, if unauthorized access or sabotage remains undetected for an extended period of time, the effects of such breach could be exacerbated. In addition, sophisticated hardware and operating system software and applications that we produce or procure from third parties may contain defects in design or manufacture, including "bugs" and other problems that could unexpectedly interfere with the operation of the system. Our exposure to cybersecurity threats and negative consequences of cybersecurity breaches will likely increase as our vCloud Hybrid Service business expands and we store increasing amounts of customer data and host or manage parts of customers' businesses in cloud-based IT environments.

We have also outsourced a number of our business functions to third party contractors, and our business operations also depend, in part, on the success of our contractors' own cybersecurity measures. We also use third parties to provide colocation services (i.e. data center services) for our hybrid cloud offering. Similarly, we rely upon distributors, resellers, system vendors and systems integrators to sell our products and our sales operations depend, in part, on the reliability of their cybersecurity measures. Additionally, we depend upon our employees to appropriately handle confidential data and deploy our IT resources in safe and secure fashion that does not expose our network systems to security breaches and the loss of data. Accordingly, if our cybersecurity systems and those of our contractors, partners and vendors fail to protect against unauthorized access, sophisticated cyberattacks and the mishandling of data by our employees, contractors, partners or vendors, our ability to conduct our business effectively could be damaged in a number of ways, including:

- sensitive data regarding our business, including intellectual property and other proprietary data, could be stolen;
- our electronic communications systems, including email and other methods, could be disrupted, and our ability to conduct our business operations could be seriously damaged until such systems can be restored and secured;
- our ability to process customer orders and electronically deliver products and services could be degraded, and our distribution channels could be disrupted, resulting in delays in revenue recognition;
- defects and security vulnerabilities could be exploited or introduced into our software products or our hybrid cloud offering, thereby damaging the reputation and perceived reliability and security of our products and services and potentially making the data systems of our customers vulnerable to further data loss and cyberincidents; and
- personally identifiable or confidential data of our customers, employees and business partners could be stolen or lost.

Should any of the above events occur, we could be subject to significant claims for liability from our customers, regulatory actions from governmental agencies, our ability to protect our intellectual property rights could be compromised and our reputation and competitive position could be significantly harmed. Also, the regulatory and contractual actions, litigations, investigations, fines, penalties and liabilities relating to data breaches that result in losses of personally identifiable or credit card information of users of our services can be significant in terms of fines and reputational impact, and necessitate changes to our business operations that may be disruptive to us. Additionally, we could incur significant costs in order to upgrade our cybersecurity systems and remediate damages. Consequently, our financial performance and results of operations could be adversely affected.

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Our products and services are highly technical and may contain errors, defects or security vulnerabilities which could cause harm to our reputation and adversely affect our business.

Our products and services are highly technical and complex and, when deployed, have contained and may contain errors, defects or security vulnerabilities. Some errors in our products or services may only be discovered after a product or service has been installed and used by customers. Any errors, defects or security vulnerabilities discovered in our products or services after commercial release could result in loss of revenues or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, financial condition and results of operations. Undiscovered vulnerabilities in our products or services could expose them to hackers or other unscrupulous third parties who develop and deploy viruses, worms, and other malicious software programs that could attack our products or services. In the past, VMware has been made aware of public postings by hackers of portions of our source code. It is possible that the released source code could expose unknown security vulnerabilities in our products and services that could be exploited by hackers or others. We may also inherit unknown security vulnerabilities when we integrate the products or services of companies that we acquire into existing and new VMware products or services.

Actual or perceived security vulnerabilities in our products or services could harm our reputation and lead some customers to return products or services, to reduce or delay future purchases or to use competitive products or services. End users, who rely on our products and services for the interoperability of enterprise servers and applications that are critical to their information systems, may have a greater sensitivity to product errors and security vulnerabilities than customers for software products generally. Any security breaches could lead to interruptions, delays and data loss and protection concerns. By their nature, security breaches are often difficult to detect and the failure to detect a breach for an extended period of time could significantly increase the damage it could cause. In addition, we could face claims for product liability, tort or breach of warranty, including claims relating to changes to our products and services made by our channel partners. Our contracts with customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld, and customers and channel partners may seek indemnification from us for their losses and those of their customers. Defending a lawsuit, regardless of its merit, is costly and time-consuming and may divert management’s attention and adversely affect the market’s perception of us and our products and services. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, financial condition and results of operations could be adversely impacted.

Operating in foreign countries subjects us to additional risks that may harm our ability to increase or maintain our international sales operations and investments.

Revenues from customers outside the United States comprised approximately 53% of our total revenues in both the first six months ended 2014 and 2013. We have sales, administrative, research and development and technical support personnel in numerous countries worldwide. We expect to continue to add personnel in additional countries. Additionally, our investment portfolio includes investments in non-U.S. financial instruments and holdings in non-U.S. financial institutions, including European institutions. Our international operations subject us to a variety of risks, including:

- the difficulty of managing and staffing international offices and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- increased exposure to foreign currency exchange rate risk;
- difficulties in enforcing contracts and collecting accounts receivable, and longer payment cycles, especially in emerging markets;
- difficulties in delivering support, training and documentation in certain foreign markets;
- tariffs and trade barriers and other regulatory or contractual limitations on our ability to sell or develop our products and services in certain foreign markets;
- economic or political instability and security concerns in countries that are important to our international sales and operations;
- macroeconomic disruptions, such as monetary and credit crises, that can threaten the stability of local and regional financial institutions and decrease the value of our international investments;

- the overlap of different tax structures or changes in international tax laws;
- reduced protection for intellectual property rights, including reduced protection from software piracy, in some countries;
- difficulties in transferring funds from certain countries; and
- difficulties in maintaining appropriate controls relating to revenue recognition practices.

Additionally, as we continue to expand our business globally, we will need to maintain compliance with legal and regulatory requirements covering the foreign activities of U.S. corporations, such as export control requirements and the Foreign Corrupt Practices Act, as well as with local regulatory requirements in non-U.S. jurisdictions. These risks will increase as we expand our operations to locations with a higher incidence of corruption and fraudulent business practices. Our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. We expect a significant portion of our growth to occur in foreign countries, which can add to the difficulties in maintaining adequate management and compliance systems and internal controls over financial reporting, and increase challenges in managing an organization operating in various countries. In addition, potential fallout from recent disclosures related to the U.S. Internet and communications surveillance could also make foreign customers reluctant to purchase cloud computing products and services from U.S.-based companies and impair our growth rate in foreign markets.

Our failure to manage any of these risks successfully could negatively affect our reputation, limit our growth, harm our operations and reduce our international sales.

If operating system and hardware vendors do not cooperate with us or we are unable to obtain early access to their new products, or access to certain information about their new products to ensure that our solutions interoperate with those products, our product development efforts may be delayed or foreclosed.

Our products interoperate with Windows, Linux and other operating systems and the hardware devices of numerous manufacturers. Developing products that interoperate properly requires substantial partnering, capital investment and employee resources, as well as the cooperation of the vendors and developers of the operating systems and hardware. Operating system and hardware vendors may not provide us with early access to their technology and products, assist us in these development efforts or share with or sell to us any application programming interfaces, or APIs, formats or protocols we may need. If they do not provide us with the necessary early access, assistance or proprietary technology on a timely basis, we may experience product development delays or be unable to expand our products into other areas. To the extent that software or hardware vendors develop products that compete with ours or those of our controlling stockholder, EMC Corporation (“EMC”), they may have an incentive to withhold their cooperation, decline to share access or sell to us their proprietary APIs, protocols or formats, or engage in practices to actively limit the functionality, compatibility and certification of our products. To the extent that we enter into collaborations or joint development and marketing arrangements with certain hardware and software vendors, vendors who compete with our collaborative partners may similarly choose to limit their cooperation with us. In addition, hardware or operating system vendors may fail to certify or support or continue to certify or support our products for their systems. If any of the foregoing occurs, our product development efforts may be delayed or foreclosed and our business and results of operations may be adversely affected.

We rely on distributors, resellers, system vendors and systems integrators to sell our products and services, and our failure to effectively develop, manage or prevent disruptions to our distribution channels and the processes and procedures that support them could cause a reduction in the number of end users of our products and services.

Our future success is highly dependent upon maintaining and increasing the number of our relationships with distributors, resellers, system vendors and systems integrators. Because we rely on distributors, resellers, system vendors and systems integrators, we may have little or no contact with the ultimate users of our products and services, thereby making it more difficult for us to establish brand awareness, ensure proper delivery and installation of our products and services, service ongoing customer requirements, estimate end-user demand and respond to evolving customer needs.

Recruiting and retaining qualified channel partners and training them in the use of our technology and product offerings requires significant time and resources. In order to develop and expand our distribution channel, we must continue to expand and improve our processes and procedures that support our channel, including our investment in systems and training, and those processes and procedures may become increasingly complex and difficult to manage. The time and expense required for sales and marketing organizations of our channel partners to become familiar with our product and service offerings, including our new product and service developments, may make it more difficult to introduce those products and services to end users and delay end-user adoption of our product and service offerings.

We generally do not have long-term contracts or minimum purchase commitments with our distributors, resellers, system vendors and systems integrators, and our contracts with these channel partners do not prohibit them from offering products or services that compete with ours. Our competitors may be effective in providing incentives to existing and potential channel partners to favor products and services of our competitors or to prevent or reduce sales of our products and services. Certain system vendors now offer competing virtualization products preinstalled on their server products and services. Additionally, our competitors could attempt to require key distributors to enter into exclusivity arrangements with them or otherwise apply their pricing or marketing leverage to discourage distributors from offering our products and services. Accordingly, our channel partners may choose not to offer our products and services exclusively or at all. Our failure to maintain and increase the number of relationships with channel partners would likely lead to a loss of end users of our products and services, which would result in us receiving lower revenues from our channel partners. Three of our distributors each accounted for 10% or more of revenues during the first six months of 2014. Our agreements with distributors are typically terminable by either party upon 30 to 90 days' prior written notice to the other party, and neither party has any obligation to purchase or sell any products or services under the agreements. While we believe that we have in place, or would have in place by the date of any such termination, agreements with replacement distributors sufficient to maintain our revenues from distribution, if we were to lose the distribution services of a significant distributor, such loss could have a negative impact on our results of operations until such time as we arrange to replace these distribution services with the services of existing or new distributors.

The concentration of our product sales among a limited number of distributors and the weakness in credit markets increase our potential credit risk. Additionally, weakness in credit markets could affect the ability of our distributors, resellers and customers to comply with the terms of credit we provide in the ordinary course of business. Accordingly, if our distributors, resellers and customers find it difficult to obtain credit or comply with the terms of their credit obligations, it could cause significant fluctuations or declines in our product revenues.

Three of our distributors each accounted for 10% or more of revenues during the first six months of 2014. We anticipate that sales of our products to a limited number of distributors will continue to account for a significant portion of our total product revenues for the foreseeable future. The concentration of product sales among certain distributors increases our potential credit risks. For example, approximately 40% of our total accounts receivable as of June 30, 2014 was from our three largest distributors. Some of our distributors may experience financial difficulties, which could adversely impact our collection of accounts receivable. One or more of these distributors could delay payments or default on credit extended to them. Our exposure to credit risks of our distributors may increase if our distributors and their customers are adversely affected by global or regional economic conditions. Additionally, we provide credit to distributors, resellers, and certain end-user customers in the normal course of business. Credit is generally extended to new customers based upon a credit evaluation. Credit is extended to existing customers based on ongoing credit evaluations, prior payment history, and demonstrated financial stability. We often allow distributors and customers to purchase and receive shipments of products in excess of their established credit limit. We are unable to recognize revenue from such shipments until the collection of those amounts becomes reasonably assured. Any significant delay or default in the collection of significant accounts receivable could result in an increased need for us to obtain working capital from other sources, possibly on worse terms than we could have negotiated if we had established such working capital resources prior to such delays or defaults. Any significant default could result in a negative impact on our results of operations and delay our ability to recognize revenue.

Our revenues, collection of accounts receivable and financial results may be adversely impacted by fluctuation of foreign currency exchange rates. Although foreign currency hedges can offset some of the risk related to foreign currency fluctuations, we will continue to experience foreign currency gains and losses in certain instances where it is not possible or cost effective to hedge our foreign currency exposures.

Our revenues and our collection of accounts receivable may be adversely impacted as a result of fluctuations in the exchange rates between the U.S. Dollar and foreign currencies. For example, we have distributors in foreign countries that may incur higher costs in periods when the value of the U.S. Dollar strengthens against foreign currencies. One or more of these distributors could delay payments or default on credit extended to them as a result. Any significant delay or default in the collection of significant accounts receivable could result in an increased need for us to obtain working capital from other sources. If we determine that the amount of accounts receivable that is uncollectible is greater than our estimates, we would recognize an increase in bad debt expense, which would have a negative impact on our results of operations. In addition, in periods when the value of the U.S. Dollar strengthens, we may need to offer additional discounts, reduce prices or offer other incentives to mitigate the negative effect on demand.

We invoice and collect in certain non-U.S. Dollar denominated currencies, thereby conducting a portion of our revenue transactions in currencies other than the U.S. Dollar. Although this practice may alleviate credit risk from our distributors during periods when the U.S. Dollar strengthens, it shifts the risk of currency fluctuations to us and may negatively impact our revenues, anticipated cash flows and financial results due to fluctuations in foreign currency exchange rates, particularly the Euro, the British Pound, the Japanese Yen and the Australian Dollar relative to the U.S. Dollar. While variability in operating margin may be reduced due to invoicing in certain of the local currencies in which we also recognize expenses, increased exposure to foreign currency fluctuations will introduce additional risk

for variability in revenue-related components of our condensed consolidated financial statements.
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. Although we expect the gains and losses on our foreign currency forward contracts to generally offset the majority of the gains and losses associated with the underlying foreign-currency denominated assets and liabilities that we hedge, our hedging transactions may not yield the results we expect. Additionally, we expect to continue to experience foreign currency gains and losses in certain instances where it is not possible or cost effective to hedge our foreign currency exposures.

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We may become involved in litigation and regulatory inquiries and proceedings that could negatively affect us.
From time to time, we are involved in various legal, administrative and regulatory proceedings, claims, demands and investigations relating to our business, which may include claims with respect to commercial, product liability, intellectual property, employment, class action, whistleblower and other matters. In the ordinary course of business, VMware also receives inquiries from and has discussions with government entities regarding the compliance of its contracting and sales practices with laws and regulations. Such matters can be time-consuming, divert management's attention and resources and cause us to incur significant expenses. While no formal legal proceedings that we expect to have a material impact on our financial condition or results of operations have been commenced, there can be no assurance that actions will not be taken in the future. Furthermore, because litigation and the outcome of regulatory proceedings are inherently unpredictable, it is possible that our business, financial condition or results of operations could be negatively affected by an unfavorable resolution of one or more of such proceedings, claims, demands or investigations.
Our business is subject to a variety of U.S. and international laws and regulations regarding data protection.
Our business is subject to federal, state and international laws and regulations regarding privacy and protection of personal data. As Internet commerce continues to evolve, regulation by federal, state and foreign governments or agencies in the areas of data privacy and data security is likely to increase. Other nations currently have data privacy laws that, in some respects, are more stringent than privacy standards in the United States. As we expand our operations in these countries, our liability exposure the complexity and cost of compliance with data and privacy requirements will likely increase. We collect contact and other personal or identifying information from our customers. Additionally, in connection with some of our new product initiatives, including our web-based services, mobile services and our vCloud Hybrid Service offering, we expect that our customers may increasingly use our services to store and process personal information and other user data. We post, on our websites, our privacy policies and practices concerning our treatment of personal data. We also often include privacy commitments in our contracts. Any failure by us to comply with our posted privacy policies, other federal, state or international privacy-related or data protection laws and regulations, or the privacy commitments contained in our contracts could result in proceedings against us by governmental entities or others, which could have a material adverse effect on our business, financial condition and results of operations. In addition, the increased attention focused upon liability issues as a result of lawsuits and legislative proposals could harm our reputation or otherwise impact the growth of our business. It is possible that these laws and regulations may be interpreted and applied in a manner that is inconsistent with our data practices. If so, in addition to the possibility of fines and penalties, a governmental order requiring that we change our data practices could result, which in turn could have a material adverse effect on our business. Compliance with such an order may involve significant costs or require changes in business practices that result in reduced revenue. Noncompliance could result in penalties being imposed on us or we could be ordered to cease conducting the noncompliant activity.
In addition to government regulation, privacy advocacy and industry groups or other third parties may propose new and different self-regulatory standards that either legally or contractually apply to our customers or us. Any inability to adequately address privacy concerns, even if unfounded, or comply with applicable privacy or data protection laws, regulations and standards, could result in additional cost and liability to us, damage our reputation, reduce sales and harm our business.
Additionally, our virtualization technology is used by cloud computing vendors, and we have expanded our involvement in the delivery and provision of cloud computing through business alliances with various providers of cloud computing services and software and expect to continue to do so in the future. The application of U.S. and international data privacy laws to cloud computing vendors is uncertain, and our existing contractual provisions may prove to be inadequate to protect us from claims for data loss or regulatory noncompliance made against cloud computing providers who we may partner with. Accordingly, the failure to comply with data protection laws and regulations by our customers and business partners who provide cloud computing services could have a material adverse effect on our business.
Since some of our products and services are web-based, our customers store their data on our servers and our vendors' servers. This data may include personal data. It may also include protected health information ("PHI") that may be

subject to federal, state and international health care privacy, data privacy or security laws, including the Health Insurance Portability and Accountability Act (“HIPAA”). HIPAA has been amended by the Health Information Technology for Economic and Clinical Health Act (“HITECH Act”) with the result of increased civil penalties. As a result of HIPAA and the HITECH Act, business associates who have access to PHI provided by covered entities and other business associates are now directly subject to HIPAA. When our customers place PHI into our web-based services, including vCloud Hybrid Service or our services hosted on our vCloud Hybrid Service, we may be required to comply with HIPAA’s data security requirements and may be liable for sanctions and penalties for failure to do so. Any systems failure or compromise of our security that results in the release of our customers’ data could (i) subject us to substantial damage claims from our customers, (ii) expose us to costly regulatory remediation, and (iii) harm our reputation and brand. We may also need to expend significant resources to protect against security breaches.

If we fail to comply with our customer contracts or government contracting regulations, our business could be adversely affected.

Our contracts with our customers may include unique and specialized performance requirements. In particular, our contracts with federal, state, local and non-U.S. governmental customers and our arrangements with distributors and resellers who may sell directly to governmental customers are subject to various procurement regulations, contract provisions and other requirements relating to their formation, administration and performance. Any failure by us to comply with provisions in our customer contracts or any violation of government contracting regulations could result in the imposition of various civil and criminal penalties, which may include termination of contracts, forfeiture of profits, suspension of payments and, in the case of our government contracts, fines and suspension from future government contracting. Further, any negative publicity related to our customer contracts or any proceedings surrounding them, regardless of its accuracy, may damage our business and affect our ability to compete for new contracts. In the ordinary course of business, VMware also receives inquiries from and has ongoing discussions with government entities regarding the compliance of its contracting and sales practices with laws and regulations. VMware is currently cooperating with the U.S. General Services Administration and the Department of Justice in their inquiries regarding our government sales practices between 2006 and 2013. During the three months ended June 30, 2014, VMware recognized a liability of approximately $11 million in connection with this matter as the loss was determined to be both probable and reasonably estimable. While no formal legal proceedings that are expected to have a material impact on our financial condition or results of operations have been commenced, there can be no assurance that actions will not be commenced in the future. If our customer contracts are terminated, if we are suspended from government work or fines or other government sanctions are imposed, or if our ability to compete for new contracts is adversely affected, our business, operating results or financial condition could be adversely affected.

If we are unable to protect our intellectual property rights, our competitive position could be harmed or we could be required to incur significant expenses to enforce our rights.

We depend on our ability to protect our proprietary technology. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. As such, despite our efforts, the steps we have taken to protect our proprietary rights may not be adequate to preclude misappropriation of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation or infringement is uncertain, particularly in countries outside of the United States. Further, with respect to patent rights, we do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims. To the extent that additional patents are issued from our patent applications, which are not certain, they may be contested, circumvented or invalidated in the future. Moreover, the rights granted under any issued patents may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, we rely on confidentiality or license agreements with third parties in connection with their use of our products and technology. There is no guarantee that such parties will abide by the terms of such agreements or that we will be able to adequately enforce our rights, in part because we rely on “click-wrap” and “shrink-wrap” licenses in some instances.

Detecting and protecting against the unauthorized use of our products, technology proprietary rights, and intellectual property rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Such litigation could result in substantial costs and diversion of management resources, either of which could harm our business, financial condition and results of operations, and there is no guarantee that we would be successful. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to protecting their technology or intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property, which could result in a substantial loss of our market share.

We provide access to our hypervisor and other selected source code to partners, which creates additional risk that our competitors could develop products that are similar to or better than ours.

Our success and ability to compete depend substantially upon our internally developed technology, which in some cases is incorporated in the source code for our products. We seek to protect the source code, design code, documentation and other information relating to our software, under trade secret, copyright, and other applicable laws. However, we have chosen to provide access to our hypervisor and other selected source code to several dozen of our partners for co-development, as well as for open APIs, formats and protocols. Though we generally control access to our source code and other intellectual property, and enter into confidentiality or license agreements with such partners, as well as with our employees and consultants, this combination of procedural and contractual safeguards may be insufficient to protect our trade secrets and other rights to our technology. Our protective measures may be inadequate, especially because we may not be able to prevent our partners, employees or consultants from violating any agreements or licenses we may have in place or abusing their access granted to our source code. Improper disclosure or use of our source code could help competitors develop products similar to or better than ours.

We are, and may in the future be, subject to claims by others that we infringe or contribute to the infringement of their proprietary technology, which could force us to pay damages or prevent us from using certain technology in our products.

Companies in the software and technology industries own large numbers of patents, copyrights, trademarks, and trade secrets and frequently enter into litigation based on allegations of infringement or other violations of intellectual property rights. This risk may increase as the number of products and competitors in our market increases as computing, networking, storage, and software technologies increasingly converge. The threat of intellectual property infringement claims against us may increase in the future because of constant technological change in the segments in which we compete, extensive patent coverage of existing technologies and the rapid rate of issuance of new patents, it is possible that the number of these claims may grow. Additionally, there is an increased risk that our competitors will use their intellectual property rights to limit our freedom to operate and exploit our products or to otherwise block us from taking full advantage of our markets.

In addition, as a well-known information technology company, we risk being the subject to an increasing number of intellectual property infringement claims, including claims by entities that do not have operating businesses of their own and therefore limit our ability to seek counterclaims for damages and injunctive relief. Any claim of infringement by a third party, even one without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business, operating results and financial condition. Third parties may also assert infringement claims against our customers and channel partners. Any of these claims could require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and channel partners from claims of infringement of proprietary rights of third parties in connection with the use of our products. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or channel partners, which could negatively affect our results of operations.

Our use of “open source” software in our products could negatively affect our ability to sell our products and subject us to possible litigation.

A significant portion of the products, technologies or services acquired, licensed, developed or offered by us may incorporate so-called “open source” software, and we may incorporate open source software into other products in the future. Such open source software is generally licensed by its authors or other third parties under open source licenses, including, for example, the GNU General Public License, the GNU Lesser General Public License, “Apache-style” licenses, “BSD-style” licenses and other open source licenses. We monitor our use of open source software in an effort to avoid subjecting our products to conditions we do not intend. Although we believe that we have complied with our obligations under the various applicable licenses for open source software that we use, there is little or no legal precedent governing the interpretation of many of the terms of most of these licenses, and therefore the potential impact of these terms on our business is somewhat unknown and may result in unanticipated obligations regarding our products and technologies. For example, we may be subjected to certain conditions, including requirements that we offer our products that use the open source software for no cost, that we make available source code for modifications or derivative works we create based upon incorporating, using or distributing the open source software, or that we license such modifications or derivative works under the terms of the particular open source license. Any of these obligations could have an adverse impact on our intellectual property rights and our ability to derive revenue from products incorporating the open source software.

If an author or other third party that distributes such open source software were to allege that we had not complied with the conditions of one or more of these licenses, we could be required to incur significant legal expenses defending against such allegations. Although we have received inquiries regarding open source license compliance for software used in our products, no formal legal proceedings that would have a material impact on our results of operations or financial condition have been filed. However, there can be no assurance that actions will not be taken in the future. If our defenses were not successful, we could be subject to significant damages. We could also be enjoined from the distribution of our products that contained the open source software or be required to modify our products in order to comply with the conditions of the open source license(s) in question, thereby disrupting the distribution and sale of some of our products. In addition, if we combine our proprietary software with open source software in a certain manner, under some open source licenses we could be required to release the source code of our proprietary software, which could substantially help our competitors develop products that are similar to or better than ours.

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In addition to risks related to license requirements, usage of open source software exposes us to risks that differ from the use of third-party commercial software because open source licensors generally do not provide warranties or assurance of title or controls on origin of the software. In addition, many of the risks associated with usage of open source software such as the lack of warranties or assurances of title cannot be eliminated and could, if not properly addressed, negatively affect our business. We have established processes to help address these risks, including a review process for screening requests from our development organizations for the use of open source and conducting appropriate due diligence of the use of open source software in the products developed by companies we acquire, but we cannot ensure that our processes will be sufficient, all open source software will be submitted for approval prior to use in our products, or all open source software is discovered during due diligence.

We offer a number of products under open source licenses that subject us to additional risks and challenges, which could result in increased development expenses, delays or disruptions to the release or distribution of those software solutions, and increased competition.

Several of our product offerings are distributed under open source licenses. Additionally, in July 2012, we acquired Nicira whose expertise is in software-defined networking and whose principal products contain some open source software. Software solutions that are substantially or mostly based on open source software subject us to a number of risks and challenges:

- If open source software programmers, most of whom we do not employ, do not continue to develop and enhance open source technologies, our development expenses could be increased and our product release and upgrade schedules could be delayed.
- One of the characteristics of open source software is that anyone can modify the existing software or develop new software that competes with existing open source software. As a result, competition can develop without the degree of overhead and lead time required by traditional proprietary software companies. It is also possible for new competitors with greater resources than ours to develop their own open source solutions, potentially reducing the demand for, and putting price pressure on, our solutions.
- It is possible that a court could hold that the licenses under which our open source products and services are developed and licensed are not enforceable or that someone could assert a claim for proprietary rights in a program developed and distributed under them. Any ruling by a court that these licenses are not enforceable, or that open source components of our product or services offerings may not be liberally copied, modified or distributed, may have the effect of preventing us from distributing or developing all or a portion of our products or services. In addition, licensors of open source software employed in our offerings may, from time to time, modify the terms of their license agreements in such a manner that those license terms may no longer be compatible with other open source licenses in our offerings or our end-user license agreement or terms of service, and thus could, among other consequences, prevent us from continuing to distribute the software code subject to the modified license or terms of service.
- Actions to protect and maintain ownership and control over our intellectual property could adversely affect our standing in the open source community, which in turn could limit our ability to continue to rely on this community, upon which we are dependent, as a resource to help develop and improve our open source products and services.

If we are unable to successfully address the challenges of integrating offerings based upon open source technology into our business, our ability to realize revenues from such offerings will be negatively affected and our development costs may increase.

Acquisitions could disrupt our business, cause dilution to our stockholders and harm our business, financial condition and results of operations.

We have acquired in the past and plan to acquire in the future other businesses, products or technologies. Acquisitions can involve significant risks and uncertainties, which include:

- disrupting our ongoing operations, diverting management from day-to-day responsibilities, increasing our expenses, and adversely impacting our business, financial condition and results of operations;
- failure of the acquired business to further our business strategy;
- uncertainties in achieving the expected benefits of an acquisition, including enhanced revenues, technology, human resources, cost savings, operating efficiencies and other synergies;

- reducing cash available for operations, stock repurchase programs and other uses and resulting in potentially dilutive issuances of equity securities or the incurrence of debt;
- incurring amortization expense related to identifiable intangible assets acquired that could impact our operating results;

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- difficulty integrating the operations, systems, technologies, products and personnel of the acquired businesses effectively;
- retaining and motivating key personnel from acquired companies;
- assuming the liabilities of the acquired business, including acquired litigation-related liabilities, and potential litigation arising from a proposed or completed acquisition;
- maintaining good relationships with customers or business partners of the acquired business or our own customers as a result of any integration of operations;
- product liability, customer liability or intellectual property liability associated with the sale of the acquired business's products;
- unidentified issues not discovered during the diligence process, including issues with the acquired business's intellectual property, product quality, security, privacy practices, accounting practices or legal contingencies;
- maintaining or establishing acceptable standards, controls, procedures or policies with respect to the acquired business; and
- risks relating to the challenges and costs of closing a transaction.

Additionally, we may not be able to find suitable acquisition candidates, and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we may not ultimately strengthen our competitive position or achieve our goals, or they may be viewed negatively by customers, financial markets or investors. If our acquisitions do not meet our expectations, or if our strategic focus subsequently changes, we may choose to abandon certain acquired product lines and divest from acquired businesses. For example, in 2013, we divested certain business activities, including SlideRocket, Shavlik, and Zimbra. It is generally difficult for an acquirer to completely recover the cost of an acquisition which is subsequently divested. Accordingly, divestitures of acquired businesses and products may result in us taking charges for impairment of assets and goodwill, and result in cash expenditures in connection with headcount reductions.

The risks described above may be exacerbated as a result of managing multiple acquisitions at the same time. We may also face difficulties due to the lack of experience in new markets, products or technologies or the initial dependence on unfamiliar supply or distribution partners.

In addition to business acquisitions, we also seek to invest in businesses such as ventured financed companies and joint ventures that offer complementary products, services or technologies. These investments are accompanied by risks similar to those encountered in an acquisition of a business. Additionally, we do not control entities where we have a minority investment, and therefore cannot ensure that these investments and joint ventures will make decisions that promote or are complementary to our business strategy.

If our goodwill or amortizable intangible assets become impaired, we may be required to record a significant charge to earnings.

We may not realize all the economic benefit from our acquisitions of other companies, which could result in an impairment of goodwill or intangibles. Since the start of 2013, our goodwill balance increased by $1,050 million or 36.9% primarily as a result of acquisitions made since January 1, 2013. We review our amortizable intangible assets for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. We test goodwill for impairment at least annually. Factors that may be considered a change in circumstances, indicating that the carrying value of our goodwill or amortizable intangible assets may not be recoverable, include a decline in stock price and market capitalization or cash flows, reduced future cash flow estimates, and slower growth rates in our industry. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud. As a result, our stockholders could lose confidence in our financial reporting, which could harm our business and the trading price of our Class A common stock.

In order to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, we need to maintain our processes and systems and adapt them to changes in our business requirements and regulation. We may seek to automate certain processes to improve efficiencies and better ensure ongoing compliance but such automation may itself disrupt existing internal controls and introduce unintended vulnerability to error or fraud. This continuous process of maintaining and adapting our internal controls and compliance with Section 404 is expensive and time-consuming, and requires significant management attention. We cannot be certain that our internal control measures will continue to provide adequate control over our financial processes and reporting and ensure compliance with Section 404. Furthermore, as our business grows and changes and as we expand through acquisitions of other companies, our internal controls may become more complex and we will require

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significantly more resources to ensure our internal controls overall remain effective. Failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to meet our reporting obligations. If we or our independent registered public accounting firm identify material weaknesses, the disclosure of that fact, even if quickly remedied, could reduce the market's confidence in our financial statements and harm our stock price. In addition, if we are unable to continue to comply with Section 404, our non-compliance could subject us to a variety of administrative sanctions, including the suspension or delisting of our Class A common stock from the New York Stock Exchange and the inability of registered broker-dealers to make a market in our Class A common stock, which could reduce our stock price.

Problems with our information systems could interfere with our business and could adversely impact our operations.

We rely on our information systems and those of third parties for processing customer orders, delivery of products, providing services and support to our customers, billing and tracking our customers, fulfilling contractual obligations and otherwise running our business. Any disruption in our information systems and those of the third parties upon whom we rely could have a significant impact on our business. In addition, we continuously work to enhance our information systems. The implementation of these types of enhancements is frequently disruptive to the underlying business of an enterprise, which may especially be the case for us due to the size and complexity of our business. Additionally, our information systems may not support new business models and initiatives and significant investments could be required in order to upgrade them. Any disruptions relating to our systems enhancements, particularly any disruptions impacting our operations during the implementation period, could adversely affect our business in a number of respects. Additionally, delays in adapting our information systems to address new business models could limit the success or result in the failure of such initiatives and impair the effectiveness of our internal controls. Even if we do not encounter these adverse effects, the implementation of these enhancements may be much more costly than we anticipated. If we are unable to successfully implement the information systems enhancements as planned, our financial condition, results of operations and cash flows could be negatively impacted.

Our financial results may be adversely impacted by higher than expected tax rates, and we may have exposure to additional tax liabilities.

As a multinational corporation, we are subject to income taxes as well as non-income based taxes, such as payroll, sales, use, value-added, net worth, property and goods and services taxes, in both the United States and various foreign jurisdictions. Our domestic and international tax liabilities are subject to the allocation of revenues and expenses in different jurisdictions and the timing of recognizing revenues and expenses. Additionally, the amount of income taxes paid is subject to our interpretation of applicable tax laws in the jurisdictions in which we file and changes to tax laws. Significant judgment is required in determining our worldwide provision for income taxes and other tax liabilities. From time to time, we are subject to income and non-income tax audits. While we believe we have complied with all applicable income tax laws, there can be no assurance that a governing tax authority will not have a different interpretation of the law and assess us with additional taxes. Should we be assessed with additional taxes, there could be a material adverse effect on our financial condition or results of operations.

Our future effective tax rate 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, and changes in overall levels of income before tax. For example, the U.S. federal research credit, which provided a significant reduction in our effective tax rate, expired on December 31, 2013. Without the reinstatement of the U.S. federal research credit, we expect our 2014 effective tax rate to be higher than the 2013 effective tax rate.

In addition, in the ordinary course of our global business, there are many intercompany transactions and calculations where the ultimate tax determination is uncertain. Although we believe that our tax estimates are reasonable, we cannot ensure that the final determination of tax audits or tax disputes will not be different from what is reflected in our historical income tax provisions and accruals.

Additionally, our rate of taxation in foreign jurisdictions is lower than the U.S. tax rate. Our international income is primarily earned by our subsidiaries in Ireland, where the statutory tax rate is 12.5%. Recent developments in non-U.S. tax jurisdictions and unfavorable changes in non-U.S. tax laws and regulations could have an adverse effect on VMware's effective tax rate if earnings are lower than anticipated in countries where the statutory tax rates are lower than the U.S. federal tax rate. 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 to such income. If management determines these overseas funds are needed for our operations in the U.S., we would be required to accrue U.S. taxes on the related undistributed earnings in the period management determines the earnings will no longer be indefinitely invested outside the United States and to repatriate these funds.

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Our business is subject to the risks of earthquakes, fire, floods and other natural catastrophic events such as pandemics, and to interruption by man-made problems, such as computer viruses, unanticipated disruptions in local infrastructure or terrorism, which could result in delays or cancellations of customer orders or the deployment of our products and services.

Our corporate headquarters are located in the San Francisco Bay Area, a region known for seismic activity. A significant natural disaster, such as an earthquake, fire, flood or other act of God, could have a material adverse impact on our business, financial condition and results of operations. As we continue to grow internationally, increasing amounts of our business will be located in foreign countries that may be more subject to political or social instability that could disrupt operations. Furthermore, some of our new product initiatives and business functions are hosted and carried out by third parties that may be vulnerable to disruptions of these sorts, many of which may be beyond our control. In addition, our servers are vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems. Unanticipated disruptions in services provided through localized physical infrastructure, such as utility or telecommunication outages, can curtail the functioning of local offices as well as critical components of our information systems, and adversely affect our ability to process orders, provide services, respond to customer requests and maintain local and global business continuity. Natural disasters that affect the manufacture of IT products, such as the 2011 flooding in Thailand, can also delay customer spending on our software, which is often coupled with customer purchases of new servers and IT systems. Furthermore, acts of terrorism or war could cause disruptions in our or our customers' business or the economy as a whole, and disease pandemics could temporarily sideline a substantial part of our or our customers' workforce at any particular time. To the extent that such disruptions result in delays or cancellations of customer orders, or the deployment or availability of our products and services, our revenues would be adversely affected. Additionally, any such catastrophic event could cause us to incur significant costs to repair damages to our facilities, equipment and infrastructure.

Changes in accounting principles and guidance, or their interpretation, could result in unfavorable accounting charges or effects, including changes to our previously-filed financial statements, which could cause our stock price to decline.

We prepare our condensed consolidated financial statements in accordance with accounting principles generally accepted in the United States. These principles are subject to interpretation by the SEC and various bodies formed to interpret and create appropriate accounting principles and guidance. A change in these principles or guidance, or in their interpretations, may have a significant effect on our reported results and retroactively affect previously reported results.

Risks Related to Our Relationship with EMC

As long as EMC controls us, other holders of our Class A common stock will have limited ability to influence matters requiring stockholder approval.

As of June 30, 2014, EMC owned 43,025,000 shares of our Class A common stock and all 300,000,000 shares of our Class B common stock, representing 79.8% of the total outstanding shares of common stock or 97.2% of the voting power of outstanding common stock. The holders of our Class A common stock and our Class B common stock have identical rights, preferences and privileges except with respect to voting and conversion rights, the election of directors, certain actions that require the consent of holders of Class B common stock and other protective provisions as set forth in our certificate of incorporation. Holders of our Class B common stock are entitled to 10 votes per share of Class B common stock on all matters except for the election of our Group II directors, in which case they are entitled to one vote per share, and the holders of our Class A common stock are entitled to one vote per share of Class A common stock. The holders of Class B common stock, voting separately as a class, are entitled to elect 80% of the total number of directors on our board of directors that we would have if there were no vacancies on our board of directors at the time. These are our Group I directors. Subject to any rights of any series of preferred stock to elect directors, the holders of Class A common stock and the holders of Class B common stock, voting together as a single class, are entitled to elect our remaining directors, which at no time will be less than one director-our Group II director(s). Accordingly, the holders of our Class B common stock currently are entitled to elect 8 of our 9 directors. If EMC transfers shares of our Class B common stock to any party other than a successor-in-interest or a subsidiary of EMC prior to a distribution to its stockholders under Section 355 of the Internal Revenue Code of 1986, as amended (a "355 distribution"), those shares will automatically convert into Class A common stock. Additionally, if, prior to a

355 distribution, EMC's ownership falls below 20% of the outstanding shares of our common stock, all outstanding shares of Class B common stock will automatically convert to Class A common stock. Following a 355 distribution, shares of Class B common stock may convert to Class A common stock if such conversion is approved by VMware stockholders after the 355 distribution. For so long as EMC or its successor-in-interest beneficially owns shares of our common stock representing at least a majority of the votes entitled to be cast by the holders of outstanding voting stock, EMC will be able to elect all of the members of our board of directors.

In addition, until such time as EMC or its successor-in-interest beneficially owns shares of our common stock representing less than a majority of the votes entitled to be cast by the holders of outstanding voting stock, EMC will have the ability to take stockholder action without the vote of any other stockholder and without having to call a stockholder meeting, and holders of our Class A common stock will not be able to affect the outcome of any stockholder vote during this period. As a result, EMC will have the ability to control all matters affecting us, including:

- the composition of our board of directors and, through our board of directors, any determination with respect to our business plans and policies;
- any determinations with respect to mergers, acquisitions and other business combinations;
- our acquisition or disposition of assets;
- our financing activities;
- certain changes to our certificate of incorporation;
- changes to the agreements we entered into in connection with our transition to becoming a public company;
- corporate opportunities that may be suitable for us and EMC;
- determinations with respect to enforcement of rights we may have against third parties, including with respect to intellectual property rights;
- the payment of dividends on our common stock; and
- the number of shares available for issuance under our stock plans for our prospective and existing employees.

Our certificate of incorporation and the master transaction agreement entered into between us and EMC in connection with our initial public offering (“IPO”) also contain provisions that require that as long as EMC beneficially owns at least 20% or more of the outstanding shares of our common stock, the prior affirmative vote or written consent of EMC (or its successor-in-interest) as the holder of the Class B common stock is required (subject in each case to certain exceptions) in order to authorize us to:

- consolidate or merge with any other entity;
- acquire the stock or assets of another entity in excess of $100 million;
- issue any stock or securities except to our subsidiaries or pursuant to our employee benefit plans;
- establish the aggregate annual amount of shares we may issue in equity awards;
- dissolve, liquidate or wind us up;
- declare dividends on our stock;
- enter into any exclusive or exclusionary arrangement with a third party involving, in whole or in part, products or services that are similar to EMC’s; and
- amend, terminate or adopt any provision inconsistent with certain provisions of our certificate of incorporation or bylaws.

If EMC does not provide any requisite consent allowing us to conduct such activities when requested, we will not be able to conduct such activities and, as a result, our business and our operating results may be harmed. EMC’s voting control and its additional rights described above may discourage transactions involving a change of control of us, including transactions in which holders of our Class A common stock might otherwise receive a premium for their shares over the then-current market price. EMC is not prohibited from selling a controlling interest in us to a third party and may do so without the approval of the holders of our Class A common stock and without providing for a purchase of any shares of Class A common stock held by persons other than EMC. Accordingly, shares of Class A common stock may be worth less than they would be if EMC did not maintain voting control over us or if EMC did not have the additional rights described above.

In the event EMC is acquired or otherwise undergoes a change of control, any acquirer or successor will be entitled to exercise the voting control and contractual rights of EMC, and may do so in a manner that could vary significantly from EMC’s historic practice.

By becoming a stockholder in our company, holders of our Class A common stock are deemed to have notice of and have consented to the provisions of our certificate of incorporation and the master transaction agreement with respect to the limitations that are described above.

Our business and that of EMC overlap, and EMC may compete with us, which could reduce our market share.

EMC and we are both IT infrastructure companies providing products and services related to storage management, back-up, disaster recovery, security, system management and automation, provisioning and resource management.

There can be no assurance that EMC will not engage in increased competition with us in the future. In addition, the intellectual property agreement that we have entered into with EMC provides EMC the ability to use our source code and intellectual property, which, subject to limitations, it may use to produce certain products that compete with ours. EMC's rights in this regard extend to its majority-owned subsidiaries, which could include joint ventures where EMC holds a majority position and one or more of our competitors hold minority positions.

EMC could assert control over us in a manner which could impede our growth or our ability to enter new markets or otherwise adversely affect our business. Further, EMC could utilize its control over us to cause us to take or refrain from taking certain actions, including entering into relationships with channel, technology and other marketing partners, enforcing our intellectual property rights or pursuing business combinations, other corporate opportunities or product development initiatives that could adversely affect our competitive position, including our competitive position relative to that of EMC in markets where we compete with them. In addition, EMC maintains significant partnerships with certain of our competitors, including Microsoft.

EMC's competition in certain markets may affect our ability to build and maintain partnerships.

Our existing and potential partner relationships may be affected by our relationship with EMC. We partner with a number of companies that compete with EMC in certain markets in which EMC participates. EMC's majority ownership in us might affect our ability to effectively partner with these companies. These companies may favor our competitors because of our relationship with EMC.

EMC competes with certain of our significant channel, technology and other marketing partners, including IBM and Hewlett-Packard. Pursuant to our certificate of incorporation and other agreements that we have with EMC, EMC may have the ability to impact our relationship with those of our partners that compete with EMC, which could have a material adverse effect on our results of operations or our ability to pursue opportunities which may otherwise be available to us.

Our investment in Pivotal Software, Inc. ("Pivotal," previously known as "GoPivotal, Inc.") may not prove successful.

In April 2013, we contributed technology and transferred employees to Pivotal, a subsidiary of EMC, established to focus on Big Data and Cloud Application Platforms. Pivotal is led by Paul Maritz, its Chief Executive Officer and our former Chief Executive Officer, and includes most employees and resources formerly working within EMC's Greenplum and Pivotal Labs organizations, and our former vFabric (including Spring and Gemfire), Cloud Foundry and Cetas organizations, as well as related efforts. Pivotal's ability to operate successfully will require, among other factors:

- successfully integrating technology from both us and EMC;
- creating offerings for which there is suitable demand in the marketplace;
- developing an effective go-to-market strategy;
- successfully competing and differentiating its offerings from those of its competitors; and
- having access to adequate financial resources to fund its operations.

In the event that Pivotal is unable to operate successfully, we may be asked to contribute capital resources to Pivotal or accept dilution in our ownership interest, and we may be unable to realize any value from the technology and resources that we contributed to Pivotal.

In order to preserve the ability for EMC to distribute its shares of our Class B common stock on a tax-free basis, we may be prevented from pursuing opportunities to raise capital, to effectuate acquisitions or to provide equity incentives to our employees, which could hurt our ability to grow.

Beneficial ownership of at least 80% of the total voting power is required in order for EMC to affect a tax-free spin-off of VMware or certain other tax-free transactions. We have agreed that for so long as EMC or its successor-in-interest continues to own greater than 50% of the voting control of our outstanding common stock, we will not knowingly take or fail to take any action that could reasonably be expected to preclude EMC's or its successor-in-interest's ability to undertake a tax-free spin-off. Additionally, under our certificate of incorporation and the master transaction agreement we entered into with EMC, we must obtain the consent of EMC or its successor-in-interest, as the holder of our Class B common stock, to issue stock or other VMware securities, except pursuant to employee benefit plans (provided that we obtain Class B common stockholder approval of the aggregate annual number of shares to be granted under such plans), which could cause us to forgo capital raising or acquisition opportunities that would otherwise be available to us. As a result, we may be precluded from pursuing certain growth initiatives.

Third parties may seek to hold us responsible for liabilities of EMC, which could result in a decrease in our income.

Third parties may seek to hold us responsible for EMC’s liabilities. Under our master transaction agreement with EMC, EMC will indemnify us for claims and losses relating to liabilities related to EMC’s business and not related to our business.

However, if those liabilities are significant and we are ultimately held liable for them, we cannot be certain that we will be able to recover the full amount of our losses from EMC.

Although we have entered into a tax sharing agreement with EMC under which our tax liabilities for most transactions will effectively be determined as if we were not part of any consolidated, combined or unitary tax group of EMC Corporation or its subsidiaries, we nonetheless could be held liable for the tax liabilities of other members of these groups.

We have historically been included in EMC's consolidated group for U.S. federal income tax purposes, as well as in certain consolidated, combined or unitary groups that include EMC Corporation or certain of its subsidiaries for state and local income tax purposes. Pursuant to our tax sharing agreement with EMC, we and EMC generally will make payments to each other such that, with respect to tax returns for any taxable period in which we or any of our subsidiaries are included in EMC's consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of EMC Corporation or its subsidiaries, the amount of taxes to be paid by us will be determined, subject to certain adjustments, as if we and each of our subsidiaries included in such consolidated, combined or unitary group filed our own consolidated, combined or unitary tax return.

We have been included in the EMC consolidated group for U.S. federal income tax purposes since our acquisition by EMC, 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. 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. Similarly, in some jurisdictions, each member of a consolidated, combined or unitary group for state, local or foreign income tax purposes is jointly and severally liable for the state, local or foreign income tax liability of each other member of the consolidated, combined or unitary group. Accordingly, for any period in which we are included in the EMC consolidated group for U.S. federal income tax purposes or any other consolidated, combined or unitary group of EMC Corporation and/or its subsidiaries, we could be liable in the event that any income tax liability was incurred, but not discharged, by any other member of any such group.

Any inability to resolve favorably any disputes that arise between us and EMC with respect to our past and ongoing relationships may result in a significant reduction of our revenues and earnings.

Disputes may arise between EMC and us in a number of areas relating to our ongoing relationships, including:

- labor, tax, employee benefit, indemnification and other matters arising from our separation from EMC;
- our reseller arrangements with EMC;
- employee retention and recruiting;
- business combinations involving us;
- our ability to engage in activities with certain channel, technology or other marketing partners;
- sales or dispositions by EMC of all or any portion of its ownership interest in us;
- the nature, quality and pricing of services EMC has agreed to provide us or we have agreed to provide to EMC;
- arrangements with third parties that are exclusionary to EMC;
- arrangements with EMC for collaborative product or technology development, marketing and sales activities involving our technology, employees and other resources;
- business opportunities that may be attractive to both EMC and us; and
- product or technology development or marketing activities or customer agreements which may require the consent of EMC.

We may not be able to resolve any potential conflicts, and even if we do, the resolution may be less favorable than if we were dealing with an unaffiliated party.

The agreements we enter into with EMC may be amended upon agreement between the parties. While we are controlled by EMC, we may not have the leverage to negotiate amendments to these agreements if required on terms as favorable to us as those we would negotiate with an unaffiliated third party.

Our CEO and some of our directors own EMC common stock or equity awards to acquire EMC common stock, and some of our directors hold management positions with EMC, which could cause conflicts of interests that result in our not acting on opportunities we otherwise may have.

Our CEO and some of our directors own EMC common stock or equity awards to purchase EMC common stock. In addition, some of our directors are executive officers or directors of EMC, and EMC, as the sole holder of our Class B common

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stock, is entitled to elect 8 of our 9 directors. Ownership of EMC common stock, restricted shares of EMC common stock and equity awards to purchase EMC common stock by our directors and the presence of executive officers or directors of EMC on our board of directors could create, or appear to create, conflicts of interest with respect to matters involving both us and EMC that could have different implications for EMC than they do for us. Provisions of our certificate of incorporation and the master transaction agreement between EMC and us address corporate opportunities that are presented to our directors or officers that are also directors or officers of EMC. There can be no assurance that the provisions in our certificate of incorporation or the master transaction agreement will adequately address potential conflicts of interest or that potential conflicts of interest will be resolved in our favor, or that we will be able to take advantage of corporate opportunities presented to individuals who are officers or directors of both us and EMC. As a result, we may be precluded from pursuing certain growth initiatives.

EMC's ability to control our board of directors may make it difficult for us to recruit independent directors.

So long as EMC beneficially owns shares of our common stock representing at least a majority of the votes entitled to be cast by the holders of outstanding voting stock, EMC can effectively control and direct our board of directors. Further, the interests of EMC and our other stockholders may diverge. Under these circumstances, persons who might otherwise accept our invitation to join our board of directors may decline.

We are a "controlled company" within the meaning of the New York Stock Exchange rules and, as a result, are relying on exemptions from certain corporate governance requirements that provide protection to stockholders of companies that are not "controlled companies."

EMC owns more than 50% of the total voting power of our common stock and, as a result, we are a "controlled company" under the New York Stock Exchange corporate governance standards. As a controlled company, we are exempt under the New York Stock Exchange standards from the obligation to comply with certain New York Stock Exchange corporate governance requirements, including the requirements:

- that a majority of our board of directors consists of independent directors;
- that we have a corporate governance and nominating committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities;
- that we have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities; and
- for an annual performance evaluation of the nominating and governance committee and compensation committee.

While we have voluntarily caused our Compensation and Corporate Governance Committee to currently be composed entirely of independent directors in compliance with the requirements of the New York Stock Exchange, we are not required to maintain the independent composition of the committee. As a result of our use of the "controlled company" exemptions, holders of our Class A common stock will not have the same protection afforded to stockholders of companies that are subject to all of the New York Stock Exchange corporate governance requirements.

Our historical financial information as a majority-owned subsidiary of EMC may not be representative of the results of a completely independent public company.

The financial information covering the periods included in this Quarterly Report on Form 10-Q does not necessarily reflect what our financial condition, results of operations or cash flows would have been had we been a completely independent entity during those periods. 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 condensed consolidated statements of income. Additionally, we and EMC engage in intercompany transactions, including agreements regarding the use of EMC's and our intellectual property and real estate, agreements regarding the sale of goods and services to one another and to Pivotal, and an agreement for EMC to resell our products and services to third party customers. If EMC were to distribute its shares of our common stock to its stockholders or otherwise divest itself of all or a significant portion of its VMware shares, there would be numerous implications to VMware, including the fact that VMware would lose the benefit of these arrangements with EMC. There can be no assurance that VMware would be able to renegotiate these arrangements with EMC or replace them on the same or similar terms. Additionally, our business could face significant disruption and uncertainty as we transition from these arrangements with EMC. Moreover, our historical financial information is not necessarily indicative of what our financial condition, results of operations or cash flows will be in the future if and when we contract at arm’s length with independent third parties for the services we have received and currently receive from EMC. During the three and six months ended June 30, 2014, we recognized revenues of $66 million and $141 million, respectively, and as of June 30, 2014, $226 million of sales were included in unearned revenues from such transactions with EMC. For

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additional information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our condensed consolidated financial statements and notes thereto.

Risks Related to Owning Our Class A Common Stock

The price of our Class A common stock has fluctuated substantially in recent years and may fluctuate substantially in the future.

The trading price of our Class A common stock has fluctuated significantly since our IPO in August 2007. For example, between January 1, 2013 and June 30, 2014, the closing trading price of our Class A common stock was volatile, ranging between $65.53 and $111.80 per share. Our trading price could fluctuate substantially in the future due to the factors discussed in this Risk Factors section and elsewhere in this Quarterly Report on Form 10-Q.

Substantial amounts of Class A common stock are held by our employees, EMC and Cisco, and all of the shares of our Class B common stock, which may be converted to Class A common stock upon request of the holder, are held by EMC. Shares of Class A common stock held by EMC (including shares of Class A common stock that might be issued upon the conversion of Class B common stock) are eligible for sale subject to the volume, manner of sale and other restrictions of Rule 144 of the Securities Act of 1933, as amended (the "Securities Act"), which allows the holder to sell up to the greater of 1% of our outstanding Class A common stock or our four-week average weekly trading volume during any three-month period and following the expiration of their contractual restrictions. Additionally, EMC possesses registration rights with respect to the shares of our common stock that it holds. If EMC chooses to exercise such rights, its sale of the shares that are registered would not be subject to the Rule 144 limitations. If a significant amount of the shares that become eligible for resale enter the public trading markets in a short period of time, the market price of our Class A common stock may decline.

Additionally, broad market and industry factors may decrease the market price of our Class A common stock, regardless of our actual operating performance. The stock market in general and technology companies in particular have often experienced extreme price and volume fluctuations. In addition, in the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted, including against us, and, if not resolved swiftly, can result in substantial costs and a diversion of management's attention and resources.

If securities or industry analysts change their recommendations regarding our stock adversely, our stock price and trading volume could decline.

The trading market for our Class A common stock is influenced by the research and reports that industry or securities analysts publish about us, our business, our market or our competitors. If any of the analysts who cover us change their recommendation regarding our stock adversely, or provide more favorable relative recommendations about our competitors, our stock price would likely decline.

Delaware law and our certificate of incorporation and bylaws contain anti-takeover provisions that could delay or discourage takeover attempts that stockholders may consider favorable.

Provisions in our certificate of incorporation and bylaws will have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

- the division of our board of directors into three classes, with each class serving for a staggered three-year term, which prevents stockholders from electing an entirely new board of directors at any annual meeting;
- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors;
- following a 355 distribution of Class B common stock by EMC to its stockholders, the restriction that a beneficial owner of 10% or more of our Class B common stock may not vote in any election of directors unless such person or group also owns at least an equivalent percentage of Class A common stock or obtains approval of our board of directors prior to acquiring beneficial ownership of at least 5% of Class B common stock;
- the prohibition of cumulative voting in the election of directors or any other matters, which would otherwise allow less than a majority of stockholders to elect director candidates;
- the requirement for advance notice for nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders' meeting;
-

the ability of the board of directors to issue, without stockholder approval, up to 100,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of common stock; and

- in the event that EMC or its successor-in-interest no longer owns shares of our common stock representing at least a majority of the votes entitled to be cast in the election of directors, stockholders may not act by written consent and may not call special meetings of the stockholders.

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Until such time as EMC or its successor-in-interest ceases to beneficially own 20% or more of the outstanding shares of our common stock, the affirmative vote or written consent of the holders of a majority of the outstanding shares of the Class B common stock will be required to:

- amend certain provisions of our bylaws or certificate of incorporation;
- make certain acquisitions or dispositions;
- declare dividends, or undertake a recapitalization or liquidation;
- adopt any stockholder rights plan, "poison pill" or other similar arrangement;
- approve any transactions that would involve a merger, consolidation, restructuring, sale of substantially all of our assets or any of our subsidiaries or otherwise result in any person or entity obtaining control of us or any of our subsidiaries; or
- undertake certain other actions.

In addition, we have elected to apply the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our certificate of incorporation and bylaws and under Delaware law could discourage potential takeover attempts and could reduce the price that investors might be willing to pay for shares of our common stock.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

- (a) Sales of Unregistered Securities

None.

- (b) Use of Proceeds from Public Offering of Common Stock

None.

- (c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Purchases of equity securities during the three months ended June 30, 2014:

| | Total Number of Shares Purchased (1) | Average Price Paid Per Share (1) | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Approximate Dollar Value of Shares That May Yet Be Purchased Under the Publicly Announced Plans or Programs (1)(2) |
|---|---|---|---|---|
| April 1 – April 30, 2014 | 569,501 | $ 100.75 | 569,501 | $ 433,887,572 |
| May 1 – May 31, 2014 | 1,423,955 | 93.44 | 1,423,955 | 300,838,478 |
| June 1 – June 30, 2014 | 494,936 | 96.54 | 494,936 | 253,059,490 |
| | 2,488,392 | 95.73 | 2,488,392 | 253,059,490 |

(1) In August 2013, VMware's Board of Directors authorized the repurchase of up to $700 million of VMware's Class A common stock through the end of 2015. VMware's Class A common stock has been, and may in the future be, purchased pursuant to our stock repurchase authorizations, from time to time, in the open market or through private transactions, subject to market conditions. We are not obligated to purchase any shares under our stock repurchase program. Subject to applicable laws, repurchases under our stock repurchase program may be made at such times and in such amounts as we deem appropriate. 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 under our stock repurchase program can be discontinued at any time that we feel additional purchases are not warranted.

(2) Represents the amounts remaining in the VMware stock repurchase authorizations.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

| Exhibit Number | Exhibit Description | Filed Herewith | Incorporated by Reference Form/ File No. | Date |
|---|---|---|---|---|
| 3.1 | Amended and Restated Certificate of Incorporation | | S-1/A-2 | 7/9/2007 |
| 3.2 | Amended and Restated Bylaws | | 8-K | 3/8/2011 |
| 31.1 | Certification of Principal Executive Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. | X | | |
| 31.2 | Certification of Principal Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. | X | | |
| 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | X | | |
| 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. | X | | |
| 101.INS | XBRL Instance Document | X | | |
| 101.SCH | XBRL Taxonomy Extension Schema | X | | |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase | X | | |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase | X | | |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase | X | | |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase | X | | |

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

VMWARE, INC.

Dated: August 5, 2014

By: /s/ Kevan Krysler
Kevan Krysler
Senior Vice President, Chief Accounting Officer
(Principal Accounting Officer)

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