

VMWARE, INC.  
 Form 10-Q  
 November 05, 2014  
 UNITED STATES  
 SECURITIES AND EXCHANGE COMMISSION  
 Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended September 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

VMWARE, INC.

(Exact name of registrant as specified in its charter)

|  |   |
|--|---|
| Delaware   | 94-3292913                              |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification Number) |

|  |            |
|--|------------|
| 3401 Hillview Avenue                                 | 94304      |
| Palo Alto, CA  | (Zip Code) |
| (Address of principal executive offices)             |            |
| (650) 427-5000                                       |            |
| (Registrant's telephone number, including area code) |            |

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

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

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

As of October 31, 2014, the number of shares of common stock, par value \$0.01 per share, of the registrant outstanding was 430,484,596 of which 130,484,596 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 Air, CloudVolumes, AirWatch, vShield, Deskton, Dynamic Ops, Nicira, Wanova and Virsto are registered trademarks or trademarks of VMware or its subsidiaries 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<br>September 30, |         | Nine Months Ended<br>September 30, |         |
|--|-------------------------------------|---------|------------------------------------|---------|
|  | 2014                                | 2013    | 2014                               | 2013    |
| Revenues:  |                                     |         |                                    |         |
| License  | \$639                               | \$564   | \$1,814                            | \$1,583 |
| Services   | 876                                 | 725     | 2,519                              | 2,141   |
| Total revenues   | 1,515                               | 1,289   | 4,333                              | 3,724   |
| Operating expenses (1):  |                                     |         |                                    |         |
| Cost of license revenues   | 46                                  | 51      | 143                                | 163     |
| Cost of services revenues  | 196                                 | 132     | 519                                | 375     |
| Research and development   | 327                                 | 266     | 936                                | 797     |
| Sales and marketing  | 529                                 | 449     | 1,550                              | 1,308   |
| General and administrative   | 169                                 | 103     | 498                                | 298     |
| Realignment charges  | 6                                   | 1       | 4                                  | 64      |
| Operating income   | 242                                 | 287     | 683                                | 719     |
| Investment income  | 11                                  | 7       | 28                                 | 21      |
| Interest expense with EMC  | (7                                  | ) (1    | ) (18                              | ) (3    |
| Other income (expense), net  | (2                                  | ) 15    | (2                                 | ) 29    |
| Income before income taxes   | 244                                 | 308     | 691                                | 766     |
| Income tax provision   | 50                                  | 47      | 131                                | 87      |
| Net income   | \$194                               | \$261   | \$560                              | \$679   |
| Net income per weighted-average share, basic for<br>Class A<br>and Class B | \$0.45                              | \$0.61  | \$1.30                             | \$1.58  |
| Net income per weighted-average share, diluted for<br>Class A and Class B  | \$0.45                              | \$0.60  | \$1.29                             | \$1.57  |
| Weighted-average shares, basic for Class A and Class B                     | 430,463                             | 429,709 | 430,408                            | 428,690 |
| Weighted-average shares, diluted for Class A and Class<br>B                | 434,118                             | 433,182 | 434,656                            | 432,916 |

(1) Includes stock-based compensation as follows:

|                            |     |     |     |     |
|----------------------------|-----|-----|-----|-----|
| Cost of license revenues   | \$1 | \$1 | \$2 | \$2 |
| Cost of services revenues  | 11  | 7   | 31  | 21  |
| Research and development   | 61  | 52  | 187 | 165 |
| Sales and marketing        | 43  | 37  | 128 | 106 |
| General and administrative | 17  | 16  | 51  | 42  |
| 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 |        | Nine Months Ended |        |   |
|---|--------------------|--------|-------------------|--------|---|
|   | September 30,      |        | September 30,     |        |   |
|   | 2014               | 2013   | 2014              | 2013   |   |
| Net income  | \$ 194             | \$ 261 | \$ 560            | \$ 679 |   |
| Other comprehensive income:   |                    |        |                   |        |   |
| Changes in market value of available-for-sale securities:   |                    |        |                   |        |   |
| Unrealized gains (losses), net of taxes of \$(2), \$3, \$1 and \$(2)                                | (3                 | ) 5    | 2                 | (3     | ) |
| Reclassification of (gains) realized during the period, net of taxes of \$(1), \$0, \$(2) and \$(1) | (1                 | ) —    | (2                | ) (1   | ) |
| Net change in market value of available-for-sale securities   | (4                 | ) 5    | —                 | (4     | ) |
| Changes in market value of effective foreign currency forward exchange contracts:                   |                    |        |                   |        |   |
| Unrealized (losses), net of \$0 taxes for all periods   | (3                 | ) (1   | ) (3              | ) (1   | ) |
| Reclassification of (gains) losses realized during the period, net of \$0 taxes for all periods     | (1                 | ) 1    | —                 | —      |   |
| Net change in market value of effective foreign currency forward exchange contracts                 | (4                 | ) —    | (3                | ) (1   | ) |
| Total other comprehensive income (loss)   | (8                 | ) 5    | (3                | ) (5   | ) |
| Total comprehensive income, net of taxes  | \$ 186             | \$ 266 | \$ 557            | \$ 674 |   |

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)

|   | September 30,<br>2014 | December 31,<br>2013 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Current assets:   |                       |                      |
| Cash and cash equivalents   | \$2,293               | \$2,305              |
| Short-term investments  | 4,801                 | 3,870                |
| Accounts receivable, net of allowance for doubtful accounts of \$2  | 957                   | 1,220                |
| Deferred tax assets   | 232                   | 190                  |
| Other current assets  | 249                   | 96                   |
| Total current assets  | 8,532                 | 7,681                |
| Property and equipment, net   | 969                   | 845                  |
| Other assets, net   | 155                   | 107                  |
| Deferred tax assets   | 156                   | 60                   |
| Intangible assets, net  | 772                   | 607                  |
| Goodwill  | 3,935                 | 3,027                |
| Total assets  | \$14,519              | \$12,327             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                       |                      |
| Current liabilities:  |                       |                      |
| Accounts payable  | \$150                 | \$109                |
| Accrued expenses and other  | 779                   | 608                  |
| Due to related parties, net   | 17                    | 18                   |
| Unearned revenues   | 2,725                 | 2,558                |
| Total current liabilities   | 3,671                 | 3,293                |
| Notes payable to EMC  | 1,500                 | 450                  |
| Unearned revenues   | 1,650                 | 1,534                |
| Other liabilities   | 262                   | 234                  |
| Total liabilities   | 7,083                 | 5,511                |
| Contingencies (see Note I)  |                       |                      |
| Stockholders' equity:   |                       |                      |
| Class A common stock, par value \$.01; authorized 2,500,000 shares; issued and outstanding 131,103 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  | 3,553                 | 3,496                |
| Accumulated other comprehensive income  | 1                     | 4                    |
| Retained earnings   | 3,872                 | 3,312                |
| Total VMware, Inc.'s stockholders' equity   | 7,430                 | 6,816                |
| Non-controlling interests   | \$6                   | \$—                  |
| Total stockholders' equity  | \$7,436               | \$6,816              |
| Total liabilities and stockholders' equity  | \$14,519              | \$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<br>September 30, |        | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|--------|------------------------------------|----------|
|  | 2014                                | 2013   | 2014                               | 2013     |
| Operating activities:  |                                     |        |                                    |          |
| Net income   | \$ 194                              | \$ 261 | \$ 560                             | \$ 679   |
| Adjustments to reconcile net income to net cash provided<br>by operating activities: |                                     |        |                                    |          |
| Depreciation and amortization  | 91                                  | 82     | 255                                | 261      |
| Stock-based compensation   | 133                                 | 113    | 399                                | 332      |
| Excess tax benefits from stock-based compensation                                    | (8                                  | ) (12  | ) (34                              | ) (60    |
| Deferred income taxes, net   | (36                                 | ) 32   | (115                               | ) 41     |
| Non-cash realignment charges   | —                                   | —      | —                                  | 15       |
| Gain on disposition of certain lines of business and other,<br>net                   | —                                   | (12    | ) —                                | (31      |
| Other  | —                                   | 4      | —                                  | 3        |
| Changes in assets and liabilities, net of acquisitions:                              |                                     |        |                                    |          |
| Accounts receivable  | 163                                 | 152    | 293                                | 360      |
| Other assets   | (27                                 | ) 4    | (70                                | ) (72    |
| Due to/from related parties, net   | 57                                  | 49     | 25                                 | 84       |
| Accounts payable   | 49                                  | (2     | ) 41                               | 16       |
| Accrued expenses   | (60                                 | ) (69  | ) (4                               | ) (91    |
| Income taxes receivable from EMC   | —                                   | —      | —                                  | 15       |
| Income taxes payable   | 65                                  | (2     | ) 178                              | (4       |
| Unearned revenues  | (15                                 | ) 37   | 237                                | 300      |
| Net cash provided by operating activities  | 606                                 | 637    | 1,765                              | 1,848    |
| Investing activities:  |                                     |        |                                    |          |
| Additions to property and equipment  | (100                                | ) (94  | ) (254                             | ) (247   |
| Purchases of available-for-sale securities   | (998                                | ) (573 | ) (2,974                           | ) (2,227 |
| Sales of available-for-sale securities   | 610                                 | 253    | 1,551                              | 1,072    |
| Maturities of available-for-sale securities  | 162                                 | 227    | 483                                | 597      |
| Proceeds from disposition of certain lines of business                               | —                                   | 6      | —                                  | 37       |
| Purchase of strategic investments  | (1                                  | ) (7   | ) (41                              | ) (7     |
| Business acquisitions, net of cash acquired  | (44                                 | ) —    | (1,112                             | ) (184   |
| Increase in restricted cash  | —                                   | (1     | ) (76                              | ) (3     |
| Other investing  | —                                   | —      | (10                                | ) (1     |
| Net cash used in investing activities  | (371                                | ) (189 | ) (2,433                           | ) (963   |
| Financing activities:  |                                     |        |                                    |          |
| Proceeds from issuance of common stock   | 59                                  | 70     | 158                                | 185      |
| Proceeds from issuance of notes payable to EMC                                       | —                                   | —      | 1,500                              | —        |
| Repayment of note payable to EMC   | —                                   | —      | (450                               | ) —      |
| Reduction in capital from EMC  | —                                   | —      | (24                                | ) —      |
| Proceeds from non-controlling interests  | 7                                   | —      | 7                                  | —        |
| Repurchase of common stock   | (43                                 | ) (90  | ) (450                             | ) (392   |
| Excess tax benefits from stock-based compensation                                    | 8                                   | 12     | 34                                 | 60       |
|  | (27                                 | ) (17  | ) (119                             | ) (84    |

Shares repurchased for tax withholdings on vesting of restricted stock

|  |         |         |         |         |      |   |
|--|---------|---------|---------|---------|------|---|
| Net cash provided by (used in) financing activities                              | 4       | (25     | )       | 656     | (231 | ) |
| Net increase (decrease) in cash and cash equivalents                             | 239     | 423     | (12     | )       | 654  |   |
| Cash and cash equivalents at beginning of the period                             | 2,054   | 1,840   | 2,305   | 1,609   |      |   |
| Cash and cash equivalents at end of the period                                   | \$2,293 | \$2,263 | \$2,293 | \$2,263 |      |   |
| Non-cash items:  |         |         |         |         |      |   |
| Changes in capital additions, accrued but not paid                               | \$(14   | )       | \$(3    | )       | \$(3 | ) |
| Changes in tax withholdings on vesting of restricted stock, accrued but not paid | 3       | (2      | )       | 4       | (1   | ) |
| Fair value of stock options assumed in acquisition                               | 1       | —       | 25      | —       |      |   |

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 and services 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 September 30, 2014, EMC Corporation (“EMC”) held approximately 79.6% of VMware’s outstanding common stock and 97.2% of the combined voting power of VMware’s outstanding common stock, including 43 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements.

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

Principles of Consolidation

The condensed consolidated financial statements include the accounts of VMware and subsidiaries in which VMware has a controlling financial interest. Non-controlling interests are presented as a separate component within total stockholders' equity and represent the equity and cumulative pro-rata share of the results of operations attributable to the non-controlling interests. Net earnings attributable to the non-controlling interests are eliminated within other income (expense), net in the condensed consolidated statements of income and are not presented separately as they were not material for the periods presented. All intercompany transaction and account balances between VMware and its subsidiaries have been eliminated in consolidation. Transactions with EMC and Pivotal are generally settled in cash. Changes in the intercompany balances with EMC and Pivotal are presented as a component of cash flows from operating, investing and financing activities.

Use of Accounting Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the reported amounts of revenues and expenses



during the reporting periods, and the disclosure of contingent liabilities at the date of the financial statements. Estimates are used for, but not limited to trade receivable valuation, marketing rebates, useful lives assigned to fixed assets and intangible assets, valuation of goodwill and definite-lived intangibles, income taxes, stock-based compensation and contingencies. Actual results could differ from those estimates.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## 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, Joint Venture, Definite-Lived Intangible Assets, Net and Goodwill

## Business Combinations

## Acquisition of CloudVolumes, Inc.

On August 20, 2014, VMware acquired all of the outstanding shares of CloudVolumes, Inc. (“CloudVolumes”) for approximately \$45 million of cash. CloudVolumes is a provider of real-time application delivery technology that enables enterprises to deliver native applications to virtualized environments on-demand. VMware acquired CloudVolumes to expand VMware's end-user computing group. The preliminary purchase price primarily included \$9 million of identifiable intangible assets and approximately \$37 million of goodwill that is expected to be non-deductible for tax purposes. The impact of this acquisition was not material to VMware's consolidated financial statements.

## Acquisition of AirWatch LLC

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 \$101 million was recognized during the three and nine months ended September 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 |   |

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

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. Subsequent adjustments made to the initial preliminary allocation of the consideration primarily relate 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.

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<br>(in years) | Weighted-Average<br>Useful Lives<br>(in years) | Fair Value<br>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<br>September 30, |       | Nine Months Ended<br>September 30, |       |
|-------------------------------|-------------------------------------|-------|------------------------------------|-------|
|                               | 2014                                | 2013  | 2014                               | 2013  |
| Pro forma adjusted net income | \$194                               | \$200 | \$523                              | \$500 |

**Joint Venture**

During the three months ended September 30, 2014, VMware established a joint venture intended to expand the VMware vCloud Air services (formerly vCloud Hybrid Service) in Japan. Cash contributions of \$8 million and \$7 million were made by VMware and the non-controlling interest, respectively, in proportion to their respective ownership interest. At September 30, 2014, VMware had a controlling interest in the joint venture and approximately 51% of the ownership. Accordingly, VMware consolidated the financial results of the joint venture. The non-controlling interest's share of the earnings in the joint venture was not material during the three months ended September 30, 2014.

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Definite-Lived Intangible Assets, Net

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

|   | September 30, 2014                             |                          |                             |                   |
|---|--|--------------------------|-----------------------------|-------------------|
|   | Weighted-Average<br>Useful Lives<br>(in years) | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Book<br>Value |
| Purchased technology                      | 6.5  | \$702                    | \$(232)                     | ) \$470           |
| Leasehold interest                        | 34.9   | 145                      | (14)                        | ) 131             |
| Customer relationships and customer lists | 8.3  | 153                      | (49)                        | ) 104             |
| Trademarks and tradenames                 | 8.4  | 65                       | (11)                        | ) 54              |
| Other                                     | 2.9  | 18                       | (5)                         | ) 13              |
| Total definite-lived intangible assets    |  | \$1,083                  | \$(311)                     | ) \$772           |

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

|   | December 31, 2013                              |                          |                             |                   |
|---|--|--------------------------|-----------------------------|-------------------|
|   | Weighted-Average<br>Useful Lives<br>(in years) | Gross Carrying<br>Amount | Accumulated<br>Amortization | Net Book<br>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           |

Amortization expense for definite-lived intangible assets was \$37 million and \$104 million during the three and nine months ended September 30, 2014, respectively and \$25 million and \$81 million during the three and nine months ended September 30, 2013, respectively.

As of September 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 | \$37  |
| 2015              | 142   |
| 2016              | 124   |
| 2017              | 117   |
| 2018              | 105   |
| Thereafter        | 247   |
| Total             | \$772 |

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## Goodwill

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

|   |         |   |
|---|---------|---|
| Balance, January 1, 2014  | \$3,027 |   |
| Increase in goodwill related to AirWatch business combination     | 875     |   |
| Increase in goodwill related to CloudVolumes business combination | 37      |   |
| Other   | (4      | ) |
| Balance, September 30, 2014                                       | \$3,935 |   |

## C. Realignment Charges

During the three months ended September 30, 2014, VMware eliminated approximately 90 positions across all major functional groups and geographies to streamline its operations. As a result of these actions, \$7 million of realignment charges was recognized during the three months ended September 30, 2014 on the condensed consolidated statements of income, which consisted of workforce reduction charges. An immaterial credit was also recognized during the three months ended September 30, 2014. As of September 30, 2014, \$5 million remained in accrued expenses and other on the condensed consolidated balance sheet and is expected to be paid by the end of 2014.

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 nine months ended September 30, 2013, \$64 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)

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## 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 nine months ended September 30, 2014 and 2013 (net income in millions, shares in thousands):

|  | Three Months Ended |         | Nine Months Ended |         |
|--|--------------------|---------|-------------------|---------|
|  | September 30,      |         | September 30,     |         |
|  | 2014               | 2013    | 2014              | 2013    |
| Net income   | \$194              | \$261   | \$560             | \$679   |
| Weighted-average shares, basic for Class A and Class B                 | 430,463            | 429,709 | 430,408           | 428,690 |
| Effect of dilutive securities  | 3,655              | 3,473   | 4,248             | 4,226   |
| Weighted-average shares, diluted for Class A and Class B               | 434,118            | 433,182 | 434,656           | 432,916 |
| Net income per weighted-average share, basic for Class A and Class B   | \$0.45             | \$0.61  | \$1.30            | \$1.58  |
| Net income per weighted-average share, diluted for Class A and Class B | \$0.45             | \$0.60  | \$1.29            | \$1.57  |

The following table sets forth the weighted-average common share equivalents of Class A common stock that were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive (shares in thousands):

|                           | Three Months Ended |       | Nine Months Ended |       |
|---------------------------|--------------------|-------|-------------------|-------|
|                           | September 30,      |       | September 30,     |       |
|                           | 2014               | 2013  | 2014              | 2013  |
| Anti-dilutive securities: |                    |       |                   |       |
| Employee stock options    | 1,180              | 1,181 | 1,244             | 892   |
| Restricted stock units    | 107                | 2,357 | 37                | 919   |
| Total                     | 1,287              | 3,538 | 1,281             | 1,811 |

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VMware, Inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (continued)

(unaudited)

## E. Investments

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

|   | September 30, 2014           |                     |                      |                         |
|---|------------------------------|---------------------|----------------------|-------------------------|
|   | Cost or<br>Amortized<br>Cost | Unrealized<br>Gains | Unrealized<br>Losses | Aggregate<br>Fair Value |
| U.S. government and agency obligations                    | \$556                        | \$—                 | \$—                  | \$556                   |
| U.S. and foreign corporate debt securities                | 3,045                        | 5                   | (3                   | ) 3,047                 |
| Foreign governments and multi-national agency obligations | 32                           | —                   | —                    | 32                      |
| Municipal obligations                                     | 930                          | 3                   | —                    | 933                     |
| Asset-backed securities                                   | 28                           | —                   | —                    | 28                      |
| Mortgage-backed securities                                | 206                          | —                   | (1                   | ) 205                   |
| Total investments   | \$4,797                      | \$8                 |                      |                         |