VMWARE, INC.
Form 10-Q
November 01, 2012

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

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

For the quarterly period ended September 30, 2012
OR

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

For transition period from to
Commission File Number 001-33622

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x		Accelerated filer	¨
Non-accelerated filer	o	(Do not check if a smaller reporting company)	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x
As of October 25, 2012, the number of shares of common stock, par value $0.01 per share, of the registrant outstanding was 427,762,903 of which 127,762,903 shares were Class A common stock and 300,000,000 were Class

B common stock.

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

respective companies.

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PART I
FINANCIAL INFORMATION

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Operating activities:				
Net income	$156,768	$177,538	$539,933	$523,508
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	86,434	73,985	261,592	229,643
Stock-based compensation, excluding amounts capitalized	119,487	88,379	302,193	254,394
Excess tax benefits from stock-based compensation	(24,531)	(46,428)	(110,914)	(197,692)
Gain on sale of Terremark investment	—	—	—	(56,000)
Other	(735)	6,968	(1,290)	10,794
Changes in assets and liabilities, net of acquisitions:				
Accounts receivable	67,054	46,174	202,308	72,757
Other assets	(4,713)	(57,402)	(121,863)	(91,455)
Due to/from EMC, net	15,479	17,505	27,624	42,940
Accounts payable	8,699	(10,846)	26,118	(12,553)
Accrued expenses	(63,917)	(19,539)	(62,981)	14,672
Income taxes receivable from EMC	—	69,796	—	246,240
Income taxes payable	59,933	14,321	127,666	51,922
Deferred income taxes, net	(33,727)	10,231	(70,098)	9,273
Unearned revenue	49,987	152,829	283,859	365,781
Net cash provided by operating activities	436,218	523,511	1,404,147	1,464,224
Investing activities:				
Additions to property and equipment	(74,812)	(54,948)	(152,819)	(177,180)
Purchase of leasehold interest (see Note H)	—	22,043	—	(151,083)
Capitalized software development costs	—	(21,139)	—	(73,998)
Purchases of available-for-sale securities	(764,574)	(955,686)	(2,719,642)	(2,083,491)
Sales of available-for-sale securities	882,348	231,705	1,653,102	608,293
Maturities of available-for-sale securities	234,028	231,738	768,104	724,707
Sale of strategic investments	—	—	—	78,513
Business acquisitions, net of cash acquired	(1,242,048)	(99,522)	(1,344,214)	(303,610)
Transfer of net assets under common control	—	(1,930)	—	(22,393)
Other investing	(8,183)	(3,230)	(12,357)	(30,372)
Net cash used in investing activities	(973,241)	(650,969)	(1,807,826)	(1,430,614)
Financing activities:				
Proceeds from issuance of common stock	69,628	84,572	214,223	285,286
Repurchase of common stock	(128,817)	(210,527)	(307,012)	(490,916)
Excess tax benefits from stock-based compensation	24,531	46,428	110,914	197,692
	(25,019)	(34,230)	(90,002)	(104,808)

Shares repurchased for tax withholdings on vesting of restricted stock				
Net cash used in financing activities	(59,677)	(113,757)	(71,877)	(112,746)
Net decrease in cash and cash equivalents	(596,700)	(241,215)	(475,556)	(79,136)
Cash and cash equivalents at beginning of the period	2,076,900	1,791,044	1,955,756	1,628,965
Cash and cash equivalents at end of the period	$1,480,200	$1,549,829	$1,480,200	$1,549,829
Non-cash items:				
Changes in capital additions, accrued but not paid	$(16,956)	$15,126	$(1,626)	$21,347
Changes in tax withholdings on vesting of restricted stock, accrued but not paid	(3,587)	(2,125)	3,250	813
Fair value of stock options assumed in acquisition	16,625	—	16,625	—

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

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VMware, Inc.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(unaudited)

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Revenues:				
License	$491,121	$443,597	$1,490,270	$1,327,402
Services	642,563	498,266	1,821,622	1,379,392
Total revenues	1,133,684	941,863	3,311,892	2,706,794
Operating expenses (1):				
Cost of license revenues	60,338	46,063	173,634	151,009
Cost of services revenues	119,024	106,678	355,865	304,104
Research and development	259,907	199,655	730,891	558,059
Sales and marketing	411,535	331,626	1,166,448	949,110
General and administrative	92,537	77,120	265,636	223,397
Operating income	190,343	180,721	619,418	521,115
Investment income	7,505	4,351	20,193	11,472
Interest expense with EMC	(1,162)	(915)	(3,607)	(2,846)
Other income (expense), net	(1,539)	(998)	(2,814)	55,806
Income before income taxes	195,147	183,159	633,190	585,547
Income tax provision	38,379	5,621	93,257	62,039
Net income	$156,768	$177,538	$539,933	$523,508
Net income per weighted-average share, basic for Class A and Class B	$0.37	$0.42	$1.26	$1.25
Net income per weighted-average share, diluted for Class A and Class B	$0.36	$0.41	$1.24	$1.21
Weighted-average shares, basic for Class A and Class B	427,142	422,030	426,902	420,247
Weighted-average shares, diluted for Class A and Class B	433,288	431,881	434,438	431,846

(1) Includes stock-based compensation as follows:

Cost of license revenues	$561	$367	$1,525	$1,271
Cost of services revenues	7,816	6,068	20,738	17,396
Research and development	60,194	46,663	147,598	134,621
Sales and marketing	51,662	24,763	110,779	70,550
General and administrative	11,914	10,518	34,213	30,556

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

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	$156,768	$177,538	$539,933	$523,508
Other comprehensive income:				
Changes in market value of available-for-sale securities:				
Unrealized gains (losses), net of taxes of $2,731, $(798), $4,037 and $282	4,456	(1,198)	6,586	423
Reclassification of gains realized during the period, net of taxes of $(331), $(194), $(495) and $(12,866)	(541)	(290)	(808)	(19,298)
Net change in market value of available-for-sale securities	3,915	(1,488)	5,778	(18,875)
Changes in market value of effective foreign currency forward exchange contracts:				
Unrealized gains, net of taxes of $(31), $0, $(31) and $0	1,272	—	1,272	—
Reclassification of gains realized during the period, net of taxes of $(10), $0, $(10) and $0	(194)	—	(50)	—
Net change in market value of effective foreign currency forward exchange contracts	1,078	—	1,222	—
Total other comprehensive income (loss)	4,993	(1,488)	7,000	(18,875)
Total comprehensive income, net of taxes	$161,761	$176,050	$546,933	$504,633

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

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

	September 30, 2012	December 31, 2011
ASSETS		
Current assets:		
Cash and cash equivalents	$1,480,200	$1,955,756
Short-term investments	2,914,419	2,556,450
Accounts receivable, net of allowance for doubtful accounts of $1,976 and $3,794	683,695	882,857
Due from EMC, net	46,175	73,799
Deferred tax asset	156,747	128,471
Other current assets	154,167	80,439
Total current assets	5,435,403	5,677,772
Property and equipment, net	579,998	525,490
Capitalized software development costs, net and other	94,702	154,236
Deferred tax asset	111,087	156,855
Intangible assets, net	765,590	407,375
Goodwill	2,893,333	1,759,080
Total assets	$9,880,113	$8,680,808
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$72,462	$49,747
Accrued expenses and other	576,043	587,650
Unearned revenues	1,876,208	1,764,109
Total current liabilities	2,524,713	2,401,506
Note payable to EMC	450,000	450,000
Unearned revenues	1,117,058	944,309
Other liabilities	223,543	114,711
Total liabilities	4,315,314	3,910,526
Commitments and contingencies (see Note M)		
Stockholders' equity:		
Class A common stock, par value $.01; authorized 2,500,000 shares; issued and outstanding 128,336 and 123,610 shares	1,283	1,236
Class B convertible common stock, par value $.01; authorized 1,000,000 shares; issued and outstanding 300,000 shares	3,000	3,000
Additional paid-in capital	3,459,801	3,212,264
Accumulated other comprehensive income	8,176	1,176
Retained earnings	2,092,539	1,552,606
Total stockholders' equity	5,564,799	4,770,282
Total liabilities and stockholders' equity	$9,880,113	$8,680,808

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

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

A. Overview and Basis of Presentation

Company and Background

VMware, Inc. (“VMware” or the “Company”) is the leader in virtualization and virtualization-based cloud infrastructure solutions utilized by businesses to help them transform the way they build, deliver and consume information technology (“IT”) resources in a manner that is evolutionary and based on their specific needs. VMware’s virtualization infrastructure software solutions, 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.

Unaudited Interim Financial Information

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

VMware was incorporated as a Delaware corporation in 1998, was acquired by EMC Corporation (“EMC”) in 2004 and conducted its initial public offering of VMware’s Class A common stock in August 2007. As of September 30, 2012, EMC holds approximately 79.2% of VMware’s outstanding common stock, including 39.2 million shares of VMware’s Class A common stock and all of VMware’s Class B common stock. VMware is a majority-owned and controlled subsidiary of EMC, and its results of operations and financial position are consolidated with EMC’s financial statements. VMware and EMC engage in intercompany transactions, including agreements regarding the use of EMC’s and VMware’s intellectual property and real estate, agreements regarding the sale of goods and services to one another, and an agreement for EMC to resell VMware’s products and services to third party customers. In geographic areas where VMware has not established its own subsidiaries, VMware contracts with EMC subsidiaries for support services and for personnel who are managed by VMware. Additionally, beginning in the second quarter of 2011, VMware incurs costs to operate the Mozy service on behalf of EMC. These costs, plus a mark-up to approximate third-party costs and a management fee, are reimbursed to VMware by EMC and recorded as an offset to the costs VMware incurred on the consolidated statements of income. See Note O to the consolidated financial statements for further information regarding intercompany transactions between VMware and EMC.

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

Principles of Consolidation

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

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

Use of Accounting Estimates

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

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

New Accounting Pronouncements

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

B. Business Combinations, Goodwill and Intangible Assets, Net

Business Combinations

The results of operations of the acquired businesses described below have been included in VMware's consolidated financial statements from the dates of purchase.

Acquisition of Nicira, Inc.

On August 24, 2012, VMware acquired all of the outstanding capital stock of Nicira, Inc. ("Nicira"), a developer of software defined networking solutions, under the terms of an Agreement and Plan of Merger entered into in July. This acquisition expands VMware's product portfolio to provide a suite of software defined networking capabilities.

The aggregate consideration was $1,099.6 million, net of cash acquired, including cash of $1,083.0 million and the fair value of assumed equity attributed to pre-combination services of $16.6 million. Of this consideration, VMware deposited into escrow $100.0 million of consideration otherwise payable in the merger to holders of Nicira stock and equity awards. This amount will be held in escrow as the sole remedy for indemnification claims under the merger agreement, if any, for a period of one year following the completion of the merger. Additionally, VMware assumed all of Nicira's unvested stock options and restricted stock outstanding at the completion of the acquisition. The fair value of the assumed equity awards for post-combination services was $152.4 million and was not included in the consideration transferred. Of the $152.4 million, $25.8 million was recorded as stock-based compensation expense on the consolidated statements of income in the three months ended September 30, 2012. The remaining fair value of $126.6 million attributed to post-combination services is being recognized over the awards' remaining requisite service periods, which extend through the first half of 2016.

In accordance with the merger agreement, the assumed unvested stock options converted into 1.1 million stock options to purchase VMware Class A common stock. The weighted-average acquisition-date fair value of the stock options was determined using the Black-Scholes option pricing model with the following weighted-average assumptions: i) market price of $92.21 per share, which was the closing price of VMware's Class A common stock on the acquisition date; ii) expected term of 2.7 years; iii) risk-free interest rate of 0.3%; iv) annualized volatility of 35.7%; and v) no dividend yield. The weighted-average acquisition-date fair value per share of the assumed stock options was $88.39. The assumed restricted stock converted into 0.6 million shares of restricted VMware Class A common stock. The fair value of the restricted stock was based on the acquisition-date closing price of $92.21 per share for VMware's Class A common stock.

As of September 30, 2012, the accounting for the Nicira acquisition had not been finalized due to pending items on the valuation of acquired assets and liabilities, including unrecognized tax benefits. Based on a preliminary assessment, VMware recorded provisional amounts for these items in its consolidated financial statements as of September 30, 2012. During the measurement period, VMware may record adjustments to the provisional amounts

recorded. No goodwill is expected to be deductible for tax purposes.

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

The following table summarizes the allocation of the consideration to the fair value of the tangible and intangible assets acquired and liabilities assumed on August 24, 2012 (table in thousands):

Intangible assets	$334,600
Goodwill	947,956
Total intangible assets acquired	1,282,556
Deferred tax liabilities, net	(78,247)
Income tax payable	(103,822)
Other current liabilities, net of current assets	(863)
Total liabilities assumed	(182,932)
Fair value of intangible assets acquired and net liabilities assumed	$1,099,624

The following table summarizes the fair value of the intangible assets acquired by VMware in conjunction with the Nicira acquisition (amounts in table in thousands):

	Weighted-Average Useful Lives (in years)	Fair Value Amount
Purchased technology	7.0	$266,000
Trademarks and tradenames	10.0	20,100
In-process research and development (“IPR&D”)		48,500
Total intangible assets acquired, net, excluding goodwill		$334,600

IPR&D relates to one project which is expected to be completed by the end of 2012. The value assigned to the IPR&D project was determined using a discounted cash flow model with a discount rate of 17%. Upon completion, the project will be amortized over its projected remaining useful life. The estimated costs to complete the project are not material.

Supplemental information on an unaudited pro forma basis, as if Nicira had been acquired on January 1, 2011, is presented as follows (table in thousands, except per share amounts):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Pro forma adjusted total revenue	$1,134,338	$942,722	$3,313,954	$2,709,344
Pro forma adjusted net income	159,320	151,798	483,045	443,335
Pro forma adjusted net income per weighted-average share, diluted for Class A and Class B	$0.37	$0.35	$1.11	$1.03

Pro forma adjustments primarily include intangible amortization, stock-based compensation expense and related tax effects.

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

Other 2012 Business Combinations

In the nine months ended September 30, 2012, VMware acquired five businesses in addition to Nicira. The aggregate consideration for these five acquisitions was $261.2 million, net of cash acquired. The following table summarizes the allocation of the consideration to the fair value of the tangible and intangible assets acquired and liabilities assumed (table in thousands):

Intangible assets	$ 88,100
Goodwill	189,958
Total intangible assets acquired	278,058
Deferred tax liabilities, net	(11,791)
Other acquired liabilities, net of acquired assets	(5,053)
Total liabilities assumed	(16,844)
Fair value of intangible assets acquired and net liabilities assumed	$ 261,214

VMware anticipates that $14.7 million of the goodwill acquired will be deductible for income tax purposes. The following table summarizes the fair value of the intangible assets acquired by VMware through business combinations, excluding Nicira, in the nine months ended September 30, 2012 (amounts in table in thousands):

	Weighted-Average Useful Lives (in years)	Fair Value Amount
Purchased technology	6.5	$ 63,600
Customer relationships and customer lists	8.0	20,300
In-process research and development		4,200
Total intangible assets acquired, net, excluding goodwill		$ 88,100

Pro forma results of operations have not been presented as the results of the acquired businesses were not material, individually or in the aggregate, to VMware’s consolidated results of operations in the three and nine months ended September 30, 2012 and 2011.

Intangible Assets, Net

The following table summarizes the changes in the carrying amount of intangible assets, net, excluding goodwill for the nine months ended September 30, 2012 (table in thousands):

Balance, January 1, 2012	$ 407,375
Additions to intangible assets related to business combinations	422,700
Change in accumulated amortization	(64,485)
Balance, September 30, 2012	$ 765,590

Goodwill

The excess of the consideration for acquisitions over the fair values assigned to the assets acquired and liabilities assumed, which represents the goodwill resulting from acquisitions, was allocated to VMware’s one operating segment. Management believes that the goodwill mainly represents the synergies expected from combining the technologies of VMware with those of the acquired businesses, including complementary products that will enhance the Company’s overall product portfolio.

The following table summarizes the changes in the carrying amount of goodwill for the nine months ended September 30, 2012 (table in thousands):

Balance, January 1, 2012	$1,759,080
Increase in goodwill related to business combinations	1,137,914
Deferred tax adjustments to purchase price allocations on previous acquisitions	(3,550)
Other adjustments to purchase price allocations on previous acquisitions	(111)
Balance, September 30, 2012	$2,893,333

C. Research and Development and Capitalized Software Development Costs

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

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

Unamortized software development costs were $47.5 million and $104.9 million as of September 30, 2012 and December 31, 2011, respectively, and are included in capitalized software development costs, net and other on the consolidated balance sheets.

In the three and nine months ended September 30, 2012, all software development costs related to product offerings were expensed as incurred and were included in R&D expenses on the accompanying consolidated statements of income. In the three months ended September 30, 2011, VMware capitalized $24.5 million (including $3.4 million of stock-based compensation) of costs incurred for the development of software products. In the nine months ended September 30, 2011, VMware capitalized $86.4 million (including $12.4 million of stock-based compensation) of costs incurred for the development of software products. These amounts were excluded from R&D expenses on the accompanying consolidated statements of income. Amortization expense from capitalized amounts was $14.9 million and $14.4 million for the three months ended September 30, 2012 and 2011, respectively. Amortization expense from capitalized amounts was $57.5 million and $62.7 million for the nine months ended September 30, 2012 and 2011,

respectively. Amortization expense is included in cost of license revenues on the consolidated statements of income.
D. Earnings per Share
Basic net income per share is computed by dividing net income by the weighted-average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted-average

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

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	$156,768	$177,538	$539,933	$523,508
Weighted-average shares, basic for Class A and Class B	427,142	422,030	426,902	420,247
Effect of dilutive securities	6,146	9,851	7,536	11,599
Weighted-average shares, diluted for Class A and Class B	433,288	431,881	434,438	431,846
Net income per weighted-average share, basic for Class A and Class B	$0.37	$0.42	$1.26	$1.25
Net income per weighted-average share, diluted for Class A and Class B	$0.36	$0.41	$1.24	$1.21

For the three months ended September 30, 2012 and 2011, stock options to purchase 0.5 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. For the three months ended September 30, 2012, 3.3 million shares of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the three months ended September 30, 2011, shares of restricted stock excluded from the diluted earnings per share calculations were not material.

For the nine months ended September 30, 2012 and 2011, stock options to purchase 0.4 million and 0.9 million shares, respectively, of VMware Class A common stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the nine months ended September 30, 2012, 2.0 million shares of restricted stock were excluded from the diluted earnings per share calculations because their effect would have been anti-dilutive. For the nine months ended September 30, 2011, shares of restricted stock excluded from the diluted earnings per share calculations were not material.

E. Investments

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

	September 30, 2012			
	Cost or Amortized Cost	Unrealized Gains	Unrealized Losses	Aggregate Fair Value
U.S. Government and agency obligations	$370,559	$1,353	$(3)	$371,909
U.S. and foreign corporate debt securities	1,436,449	6,649	(274)	1,442,824
Foreign governments and multi-national agency obligations	42,167	27	(2)	42,192
Municipal obligations	970,550	3,968	(307)	974,211
Mortgage-backed securities	83,460	147	(324)	83,283
Total investments	$2,903,185	$12,144	$(910)	$2,914,419

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

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

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

	September 30, 2012		December 31, 2011	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Government and agency obligations	$21,844	$(4)	$50,604	$(23)
U.S. and foreign corporate debt securities	168,937	(267)	539,228	(2,036)
Foreign governments and multi-national agency obligations	10,039	(2)	43,026	(87)
Municipal obligations	180,850	(302)	298,187	(406)
Asset-backed securities	—	—	20,025	(23)
Mortgage-backed securities	47,315	(310)	32,817	(172)
Total	$428,985	$(885)	$983,887	$(2,747)

Contractual Maturities

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

	Amortized Cost Basis	Aggregate Fair Value
Due within one year	$872,935	$873,951
Due after 1 year through 5 years	1,947,165	1,957,545
Due after 5 years	83,085	82,923
Total investments	$2,903,185	$2,914,419

F. Fair Value Measurements

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

participants would use in pricing an asset or liability. As a basis for considering such assumptions, generally accepted accounting principles established a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level 1) inputs are quoted prices in active markets for identical assets or liabilities; (Level 2) inputs other than the quoted prices included within Level 1 that are

observable for the assets or liabilities, either directly or indirectly; and (Level 3) unobservable inputs for the assets or liabilities in which there is little or no market data, which requires VMware to develop its own assumptions.
VMware's Level 1 classification of the fair value hierarchy includes money market funds and certain available-for-sale fixed income securities because these securities are valued using quoted prices in active markets for identical assets.
VMware's Level 2 classification includes the remainder of the available-for-sale fixed income securities because these securities are priced using quoted market prices for similar instruments and non-binding market prices that are corroborated by observable market data. VMware obtains the fair values of its Level 2 financial instruments based upon fair values obtained from its custody bank. In addition, VMware obtains fair values of its Level 2 financial instruments from the asset manager of each of its portfolios. VMware validates the fair value provided by its custody bank by comparing it against the independent pricing information obtained from the asset managers. Independently, the custody bank and the asset managers use professional pricing services to gather pricing data which may include quoted market prices for identical or comparable instruments, or inputs other than quoted prices that are observable either directly or indirectly. VMware is ultimately responsible for the financial statements and underlying estimates.
Additionally, VMware's Level 2 classification includes foreign currency forward contracts as the valuation inputs for these are based upon quoted prices and quoted pricing intervals from public data sources. 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.
The following tables set forth the fair value hierarchy of VMware's money market funds and available-for-sale securities, including those securities classified within cash and cash equivalents on the consolidated balance sheets, that were required to be measured at fair value as of September 30, 2012 and December 31, 2011 (tables in thousands):

	September 30, 2012		
	Level 1	Level 2	Total
Money-market funds	$1,070,745	$—	$1,070,745
U.S. Government and agency obligations	236,089	135,820	371,909
U.S. and foreign corporate debt securities	—	1,446,824	1,446,824
Foreign governments and multi-national agency obligations	—	42,192	42,192
Municipal obligations	—	974,211	974,211
Mortgage-backed securities	—	83,283	83,283
Total	$1,306,834	$2,682,330	$3,989,164

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

G. Derivative Instruments

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

exchange contracts for trading purposes.
Cash Flow Hedging Activities
To mitigate its exposure to foreign currency fluctuations resulting from operating expenses denominated in certain foreign

currencies, VMware entered into foreign currency forward contracts starting in the fourth quarter of 2011. The Company designates these forward contracts as cash flow hedging instruments as the accounting criteria for such designation has been met. Therefore, the effective portion of gains or losses resulting from changes in the fair value of these hedges is initially reported in accumulated other comprehensive income on the consolidated balance sheet, and is subsequently reclassified to the related operating expense line item in the consolidated statements of income in the same period that the underlying expenses are incurred. Interest charges or "forward points" on VMware's forward contracts are excluded from the assessment of hedge effectiveness and are recorded in other income (expense), net in the consolidated statements of income as incurred. For the three and nine months ended September 30, 2012, all amounts recognized on the consolidated statements of income related to VMware's cash flow hedging program were immaterial.

VMware generally enters into cash flow hedges semi-annually with maturities of six months or less. As of September 30, 2012 and December 31, 2011, VMware had forward contracts to purchase foreign currency designated as cash flow hedges with a total notional value of $37.8 million and $47.1 million, respectively. The fair value of these forward contracts was immaterial as of September 30, 2012 and therefore excluded from the fair value tables above. For the three and nine months ended September 30, 2012, all cash flow hedges were considered effective.

Balance Sheet Hedging Activities

In order to manage exposure to foreign currency fluctuations, VMware enters into foreign currency forward contracts to hedge a portion of its net outstanding monetary assets and liabilities against movements in certain foreign exchange rates. These forward contracts are not designated as hedging instruments under applicable accounting guidance, and therefore all changes in the fair value of the forward contracts are reported in other income (expense), net in the consolidated statements of income. The gains and losses on VMware's foreign currency forward contracts generally offset the majority of the gains and losses associated with the underlying foreign-currency denominated assets and liabilities that VMware hedges.

VMware's foreign currency forward contracts are generally traded on a monthly basis with a typical contractual term of one month. As of September 30, 2012 and December 31, 2011, VMware had outstanding forward contracts with a total notional value of $260.8 million and $324.1 million, respectively. The fair value of these forward contracts was immaterial as of September 30, 2012 and December 31, 2011 and therefore excluded from the fair value tables above.

H. Property and Equipment, Net

Property and equipment, net, as of September 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	September 30, 2012	December 31, 2011
Equipment and software	$589,594	$512,754
Buildings and improvements	390,710	340,596
Furniture and fixtures	63,821	61,023
Construction in progress	86,859	68,707
Total property and equipment	1,130,984	983,080
Accumulated depreciation	(550,986)	(457,590)
Total property and equipment, net	$579,998	$525,490

Depreciation expense was $30.9 million and $31.7 million in the three months ended September 30, 2012 and 2011, respectively, and $96.6 million and $93.7 million in the nine months ended September 30, 2012 and 2011, respectively.

In the three months ended June 30, 2011, VMware closed an agreement to purchase the right, title and interest in a ground lease covering the property and improvements located adjacent to VMware's existing Palo Alto, California campus for a total cost of $225.0 million. Based upon the preliminary respective fair values, $51.9 million of the purchase price was recorded to property and equipment, net on the June 30, 2011 consolidated balance sheet for the

estimated fair value of the buildings and site improvements. The remaining $173.1 million of the purchase price was attributed to the fair value of the ground lease and was primarily recorded to intangible assets, net on the June 30, 2011 consolidated balance sheet.

In the three months ended September 30, 2011, the gross amount classified to property and equipment, net was increased by $22.0 million to $73.9 million to reflect the final assumptions regarding VMware's intended use of the existing structures. As a result of this adjustment, the gross amount of the value recorded to intangible assets, net on the consolidated balance sheet was decreased by the same amount. The $22.0 million adjustment is reflected on the consolidated statement of

cash flows for the three months ended September 30, 2011. For the nine months ended September 30, 2011, the final value of $73.9 million paid and attributed to the property is included within additions to property and equipment and the $151.1 million paid and attributed to intangible assets is separately disclosed within cash used in investing activities on the consolidated statement of cash flows.

As of September 30, 2012 and December 31, 2011, construction in progress primarily represented buildings and site improvements related to VMware's Palo Alto campus expansion that had not yet been placed into service.

I. Accrued Expenses and Other

Accrued expenses and other as of September 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	September 30, 2012	December 31, 2011
Salaries, commissions, bonuses, and benefits	$222,453	$287,248
Accrued partner liabilities	106,454	124,359
Other	247,136	176,043
Total	$576,043	$587,650

Accrued partner liabilities relate to rebates and marketing development fund accruals for channel partners, system vendors and systems integrators, as well as accrued royalties.

J. Unearned Revenues

Unearned revenues as of September 30, 2012 and December 31, 2011 consisted of the following (table in thousands):

	September 30, 2012	December 31, 2011
Unearned license revenues	$366,141	$389,225
Unearned software maintenance revenues	2,415,324	2,133,512
Unearned professional services revenues	211,801	185,681
Total unearned revenues	$2,993,266	$2,708,418

Unearned license revenues are recognized either ratably or upon the delivery of existing products, future products or services. Future products include, in some cases, emerging products that are offered as part of product promotions where the purchaser of an existing product is entitled to receive a promotional product at no additional charge. VMware regularly offers product promotions as a strategy to improve awareness of its emerging products. To the extent promotional products have not been delivered and vendor-specific objective evidence ("VSOE") of fair value cannot be established, the revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. Increasingly, unearned license revenue may also be recognized ratably, which is generally due to a right to receive unspecified future products or a lack of VSOE of fair value on the software maintenance element of the arrangement. At September 30, 2012, the ratable component represented over half of the total unearned license revenue balance. Unearned software maintenance revenues are attributable to VMware's maintenance contracts and are recognized ratably over terms of one to five years with a weighted-average remaining term at September 30, 2012 of approximately 1.9 years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered.

K. Note Payable to EMC

In April 2007, VMware declared an $800.0 million dividend to EMC paid in the form of a note payable, with interest payable quarterly in arrears and original maturity date of April 2012. In August 2007, VMware repaid $350.0 million of the note payable, and as of September 30, 2012, $450.0 million remained outstanding. In June 2011, VMware and EMC amended and restated the note to extend the maturity date of the note to April 16, 2015 and to modify the principal amount of the note to reflect the outstanding balance of $450.0 million. The interest rate of the 90-day LIBOR plus 55 basis points continues to reset quarterly. For the three months ended September 30, 2012 and 2011, $1.2 million and $0.9 million, respectively, of interest expense were recorded related to the note payable. For the nine

months ended September 30, 2012 and 2011, $3.6 million and $2.8 million, respectively, of interest expense were recorded related to the note payable. The note may be repaid prior to the maturity date without penalty. No repayments of principal were made during the three and nine months ended September 30,

2012 and 2011.

L. Income Taxes

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

VMware's effective income tax rate was 19.7% and 3.1% for the three months ended September 30, 2012 and 2011, respectively. The higher effective rate for the three months ended September 30, 2012 compared with the three months ended September 30, 2011 was primarily attributable to a change in mix of profitability of the domestic and international operations and the expiration of the federal research credit at the end of 2011. The effective income tax rate was 14.7% and 10.6% for the nine months ended September 30, 2012 and 2011, respectively. The higher effective rate for the nine months ended September 30, 2012 compared with the nine months ended September 30, 2011 was primarily attributable to the items discussed above for the three months ended September 30, 2012, as well as the year-over-year effect of a release in uncertain tax benefits in the nine months ended September 30, 2011 due to a closure of a tax audit.

VMware's rate of taxation in foreign jurisdictions is lower than the U.S. tax rate. VMware's international income is primarily earned by VMware's subsidiaries in Ireland, where the statutory tax rate is 12.5%. Management does not believe that any recent or currently expected developments in non-U.S. tax jurisdictions are reasonably likely to have a material impact on VMware's effective tax rate. As of September 30, 2012, VMware's total cash, cash equivalents, and short-term investments were $4,394.6 million, of which $2,920.0 million were held outside the U.S. If these overseas funds are needed for its operations in the U.S., VMware would be required to accrue and pay U.S. taxes on related undistributed earnings to repatriate these funds. However, all income earned abroad, except for previously taxed income for U.S. tax purposes, is considered indefinitely reinvested in VMware's foreign operations and no provision for U.S. taxes has been provided with respect thereto. At this time, it is not practicable to estimate the amount of tax that may be payable were VMware to repatriate these funds, and VMware's current plans do not demonstrate a need to repatriate them to fund its U.S. operations. VMware will meet its U.S. liquidity needs through cash flows from operations, external borrowings, or both. VMware utilizes a variety of tax planning and financing strategies in an effort to ensure that its worldwide cash is available in the locations in which it is needed.

As of September 30, 2012, VMware had gross unrecognized tax benefits totaling $193.2 million, which excludes $12.5 million of offsetting tax benefits. In the third quarter of 2012, VMware increased its reserve for uncertain tax positions by $102.1 million. If recognized, approximately $184.7 million of VMware's net unrecognized tax benefits, not including interest, would reduce income tax expense and lower VMware's effective tax rate in the period or periods recognized. The $193.3 million of net unrecognized tax benefits, including interest, were classified as a non-current liability on the consolidated balance sheet. It is reasonably possible that within the next 12 months audit resolutions could potentially reduce total unrecognized tax benefits by between approximately $7.0 million and $9.0 million. Audit outcomes and the timing of audit settlements are subject to significant uncertainty.

VMware recognizes interest expense and penalties related to income tax matters in the income tax provision. VMware recognized approximately $1.1 million and $2.7 million in interest and penalties for the three and nine months ended September 30, 2012 and had accrued $8.6 million of interest and penalties as of September 30, 2012, associated with the net unrecognized tax benefits. These amounts are included as components of the $193.3 million of net unrecognized tax benefits as of September 30, 2012.

M. Commitments and Contingencies

Litigation

From time to time, VMware is subject to legal, administrative and regulatory proceedings, claims, demands and investigations in the ordinary course of business, including claims with respect to intellectual property, contracts,

employment and other matters. VMware accrues for a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination of probability and the determination as to whether a loss is reasonably estimable. These accruals are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular matter. As of September 30, 2012 and December 31, 2011, the amounts accrued were not material. To the extent there is a reasonable possibility that the losses could exceed the amounts already accrued, management believes that the amount of any such additional loss would also be immaterial to VMware's consolidated financial position and results of operations.

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Operating Lease Commitments
VMware leases office facilities and equipment under various operating leases. Facility leases generally include renewal options. VMware's future lease commitments at September 30, 2012 were as follows (table in thousands):

2012	$13,342
2013	53,049
2014	47,619
2015	38,794
2016	32,627
Thereafter	574,930
Total minimum lease payments	$760,361

The amount of the future lease commitments after 2016 is primarily for the ground leases on VMware's Palo Alto, California headquarter facilities, which expire in 2046. As several of VMware's operating leases are payable in foreign currencies, the operating lease payments may fluctuate in response to changes in the exchange rate between the U.S. Dollar and the foreign currencies in which the commitments are payable.
N. Stockholders' Equity
VMware Stock Repurchase Programs
In February 2012, VMware's Board of Directors authorized the repurchase of up to $600.0 million of VMware's Class A common stock through the end of 2013. In February 2011, a committee of VMware's Board of Directors authorized the repurchase of up to $550.0 million of VMware's Class A common stock, which was completed in the second quarter of 2012.
From time to time, stock repurchases may be made pursuant to the February 2012 authorization in open market transactions or privately negotiated transactions as permitted by securities laws and other legal requirements. VMware is not obligated to purchase any shares under its stock repurchase programs. The timing of any repurchases and the actual number of shares repurchased will depend on a variety of factors, including VMware's stock price, cash requirements for operations and business combinations, corporate and regulatory requirements and other market and economic conditions. Purchases can be discontinued at any time that VMware feels additional purchases are not warranted. All repurchased shares are retired.
The following table summarizes stock repurchase activity in the three and nine months ended September 30, 2012 and September 30, 2011 (table in thousands, except per share amounts):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Aggregate purchase price	$128,817	$210,527	$307,012	$490,916
Class A common shares repurchased	1,458	2,371	3,305	5,539
Weighted-average price per share	$88.35	$88.81	$92.91	$88.63

The amount of repurchased shares includes commissions and was classified as a reduction to additional paid-in capital. As of September 30, 2012, the authorized amount remaining for repurchase was $378.3 million.
VMware Employee Stock Purchase Plan
The following table summarizes Employee Stock Purchase Plan (the "ESPP") activity in the three and nine months ended September 30, 2012 and 2011 (table in thousands, except per share amounts):

	Purchase Period Ended			
	July 31,		January 31,	
	2012	2011	2012	2011
Cash proceeds	$36,511	$30,151	$32,861	$26,813
Class A common shares purchased	473	409	424	407
Weighted-average price per share	$77.15	$73.70	$77.58	$65.90

As of September 30, 2012, $21.4 million of ESPP withholdings were recorded as a liability on the consolidated balance sheet for the next purchase in January 2013.

VMware Restricted Stock

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

In the first nine months of 2012, VMware granted performance stock unit (“PSU”) awards to certain of its executives and employees. The awards will vest through the first quarter of 2015 if certain employee specific or VMware designated performance targets are achieved. If minimum performance thresholds are achieved, each PSU award will convert into VMware’s Class A common stock at a ratio ranging from 0.5 to 3.0 shares for each PSU, depending upon the degree of achievement of the performance target designated by each individual award. If minimum performance thresholds are not achieved, then no shares will be issued under that PSU award. Stock-based compensation expense for the PSUs is recognized over the requisite service periods of the awards based on expected levels of achievement of the performance targets. The expected levels of achievement are reassessed over the requisite service periods and, to the extent that these expected levels change, stock-based compensation expense is adjusted through a cumulative catch-up adjustment in the period of change and the remaining unrecognized stock-based compensation expense is recorded over the remaining requisite service period. As such, the total amount of the expense and the timing that the expense is recognized could fluctuate. As of September 30, 2012, 0.4 million PSUs were outstanding and are included in the table summarizing restricted stock activity below.

The following table summarizes restricted stock activity since January 1, 2012 (awards in thousands):

	Number of Awards	Weighted-Average Grant Date Fair Value (per award)
Outstanding, January 1, 2012	9,540	$72.74
Granted	7,025	103.11
Vested	(2,795)	63.74
Forfeited	(1,095)	77.98
Outstanding, September 30, 2012	12,675	91.52

The total fair value of VMware restricted stock awards, including restricted stock and restricted stock units, that vested in the nine months ended September 30, 2012 was $260.8 million. As of September 30, 2012, restricted stock awards, including restricted stock, restricted stock units and performance stock units, representing 12.7 million shares of VMware’s Class A common stock were outstanding, with an aggregate intrinsic value of $1,226.1 million based on VMware’s closing price as of September 30, 2012. These awards are scheduled to vest through 2016.

VMware Shares Repurchased for Tax Withholdings

In the three months ended September 30, 2012 and 2011, VMware repurchased or withheld and retired 0.2 million and 0.3 million shares, respectively, of Class A common stock, for $21.4 million and $32.1 million, respectively, to cover tax withholding obligations. In the nine months ended September 30, 2012 and 2011, VMware repurchased or withheld and retired 1.0 million and 1.1 million shares, respectively, of Class A common stock, for $93.2 million and $105.6 million, respectively, to cover tax withholding obligations. These amounts differ from the amounts of cash remitted for tax withholding obligations on the consolidated statements of cash flows due to the timing of payments. Pursuant to the respective award agreements, these shares were repurchased or withheld in conjunction with the net share settlement upon the vesting of restricted stock and restricted stock units during the period. The value of the repurchased or withheld shares, including restricted stock units, was classified as a reduction to additional paid-in capital.

O. Related Party Transactions

In the second quarter of 2011, VMware acquired certain assets relating to EMC’s Mozy cloud-based data storage and data center services, including certain data center assets and a license to certain intellectual property. EMC retained ownership of the Mozy business and its remaining assets. EMC continues to be responsible to Mozy customers for Mozy products and services and continues to recognize revenue from such products and services. VMware entered into an operational support agreement with EMC through the end of 2012, pursuant to which VMware took over responsibility to operate the Mozy service on behalf

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of EMC. Pursuant to the support agreement, costs incurred by VMware to support EMC's Mozy services, plus a mark-up intended to approximate third-party costs and a management fee, are reimbursed to VMware by EMC. On the consolidated statements of income, in the three months ended September 30, 2012 and 2011, such amounts as described above were approximately $16.6 million and $13.1 million, respectively. In the nine months ended September 30, 2012 and 2011, such amounts were $47.5 million and $25.3 million, respectively. These amounts were recorded as a reduction to the costs VMware incurred.

In 2010, VMware acquired certain software product technology and expertise from EMC's Ionix IT management business for cash consideration of $175.0 million. EMC retained the Ionix brand and will continue to offer customers the products acquired by VMware, pursuant to an ongoing reseller agreement between EMC and VMware. During the three and nine months ended September 30, 2011, $1.9 million and $14.4 million, respectively, of contingent amounts were paid to EMC. These payments were recorded as equity transactions and were offsets to the initial capital contribution from EMC. As of December 31, 2011, all contingent payments under the agreement had been made.

Pursuant to an ongoing reseller arrangement with EMC, EMC bundles VMware's products and services with EMC's products and sells them to end-users. In the three months ended September 30, 2012 and 2011, VMware recognized revenues of $26.8 million and $16.7 million, respectively, from products and services sold pursuant to VMware's reseller arrangement with EMC. In the nine months ended September 30, 2012 and 2011, VMware recognized revenues of $107.5 million and $50.9 million, respectively, from such contractual arrangement with EMC. As of September 30, 2012, $132.7 million of revenues from products and services sold under the reseller arrangement were included in unearned revenues.

In the three months ended September 30, 2012 and 2011, VMware recognized professional services revenues of $21.2 million and $13.2 million, respectively, for services provided to EMC's customers pursuant to VMware's contractual agreements with EMC. In the nine months ended September 30, 2012 and 2011, VMware recognized professional services revenues of $63.5 million and $44.0 million, respectively, from such contractual agreements with EMC. As of September 30, 2012, $5.4 million of revenues from professional services to EMC customers were included in unearned revenues.

In the three months ended September 30, 2012 and 2011, VMware recognized revenues of $3.0 million and $1.0 million, respectively, from products and services purchased by EMC for internal use pursuant to VMware's contractual agreements with EMC. In the nine months ended September 30, 2012 and 2011, VMware recognized revenues of $6.8 million and $2.0 million, respectively, from such contractual agreements with EMC. As of September 30, 2012, $23.4 million of revenues from products and services purchased by EMC for internal use were included in unearned revenues.

VMware purchased products and services from EMC for $4.2 million and $3.8 million in the three months ended September 30, 2012 and 2011, respectively, and for $28.1 million and $17.2 million in the nine months ended September 30, 2012 and 2011, respectively.

In certain geographic regions where VMware does not have an established legal entity, VMware contracts with EMC subsidiaries for support services and EMC personnel who are managed by VMware. The costs incurred by EMC on VMware's behalf related to these employees are passed on to VMware and VMware is charged a mark-up intended to approximate costs that would have been charged had VMware contracted for such services with an unrelated third party. These costs are included as expenses in VMware's consolidated statements of income and primarily include salaries, benefits, travel and rent. Additionally, EMC incurs certain administrative costs on VMware's behalf in the U.S. that are also recorded as expenses in VMware's consolidated statements of income. The total cost of the services provided to VMware by EMC as described above was $26.4 million and $21.1 million in the three months ended September 30, 2012 and 2011, respectively, and $75.5 million and $63.8 million in the nine months ended September 30, 2012 and 2011, respectively.

In the three and nine months ended September 30, 2012, no payments were made by either VMware or EMC under the tax sharing agreement. In the three and nine months ended September 30, 2011, EMC paid VMware $100.0

million and $276.4 million, respectively, under the tax sharing agreement and no payments were made by VMware to EMC. Payments between VMware and EMC under the tax sharing agreement primarily relate to VMware's portion of federal income taxes on EMC's consolidated tax return. Payments from VMware to EMC primarily relate to periods for which VMware had stand-alone federal taxable income, while payments from EMC to VMware relate to periods for which VMware had a stand-alone federal taxable loss. The amounts that VMware either pays to or receives from EMC for its portion of federal income taxes on EMC's consolidated tax return differ from the amounts VMware would owe on a stand-alone basis and the difference is presented as a component of stockholders' equity. For all periods presented, the difference was not material.

In the three months ended September 30, 2012 and 2011, $1.2 million and $0.9 million, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on VMware's consolidated statements of income. In the nine months ended September 30, 2012 and 2011, $3.6 million and $2.8 million, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on VMware's

consolidated statements of income. VMware's interest expense as a separate, stand-alone company may be higher or lower than the amounts reflected in the consolidated financial statements.

As of September 30, 2012, VMware had $46.2 million net due from EMC, which consisted of $79.2 million due from EMC, partially offset by $33.0 million due to EMC. These amounts resulted from the related party transactions described above. In addition to the $46.2 million net due from EMC as of September 30, 2012, VMware had an immaterial amount of net income taxes receivable from EMC, which is included in other current assets on VMware's consolidated balance sheet. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

Effective September 1, 2012, VMware's former CEO, Paul Maritz, was succeeded as Chief Executive Officer of VMware by Pat Gelsinger. Pat Gelsinger was the President and Chief Operating Officer of EMC Information Infrastructure Products. Paul Maritz remains a board member of VMware and took on a new technology strategist role at EMC. With the exception of a long-term incentive performance award from EMC that Pat Gelsinger agreed to cancel in consideration of a new performance stock unit award from VMware, both Paul Maritz and Pat Gelsinger retained and continue to vest in their respective equity awards that they held as of September 1, 2012. Stock-based compensation expense related to Pat Gelsinger's EMC awards will be recognized on VMware's consolidated statements of income over the awards' remaining requisite service periods. Stock-based compensation expense related to Paul Maritz's VMware awards will be recognized as an expense by EMC.

P. Segment Information

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

Revenues by geographic area for the three and nine months ended September 30, 2012 and 2011 were as follows (table in thousands):

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
United States	$553,573	$443,413	$1,589,206	$1,293,290
International	580,111	498,450	1,722,686	1,413,504
Total	$1,133,684	$941,863	$3,311,892	$2,706,794

No country other than the United States had material revenues for the three and nine months ended September 30, 2012 or 2011.

Long-lived assets by geographic area, which primarily include property and equipment, net, as of September 30, 2012 and December 31, 2011 were as follows (table in thousands):

	September 30, 2012	December 31, 2011
United States	$494,504	$429,678
International	45,116	46,477
Total	$539,620	$476,155

No country other than the United States accounted for 10% or more of these assets at September 30, 2012 or December 31, 2011, respectively.

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

All dollar amounts expressed as numbers in this MD&A (except share and per share amounts) are in millions.

Overview

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

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

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

We expect to grow our business by broadening our virtualization infrastructure software solutions technology and product portfolio, increasing product awareness, promoting the adoption of virtualization and building long-term relationships with our customers through the adoption of enterprise license agreements ("ELAs"). Since the introduction of VMware vSphere in 2009, we have introduced more products that build on the vSphere foundation, including VMware vSphere 5 and a comprehensive suite of cloud infrastructure technologies, as well as VMware View 5. Additionally, in the third quarter of 2012, we released VMware vCloud Suite 5.1, which integrates our virtualization, cloud infrastructure and management portfolio into a comprehensive solution consisting of cloud infrastructure and management products, expertise and ecosystem support. VMware vCloud Suite 5.1 is our first solution to deliver a software defined data center ("SDDC"). The SDDC architecture abstracts all hardware resources and pools them into aggregate capacity, enabling automation to safely and efficiently parcel it out as needed for applications. The SDDC delivers IT services for cloud computing by extending and simplifying the benefits of virtualization to every domain in the data center: compute, storage, networking, and management functionality. We plan to continue to introduce additional products in the future that expand and promote the use of the vSphere foundation and the SDDC. In addition, we have made acquisitions that strengthen our product offerings or extend our strategy to deliver broader virtualization solutions. For example, in August 2012 we acquired Nicira, Inc. ("Nicira"), a developer of software defined networking solutions, which expands our product portfolio to provide a suite of software defined networking capabilities. Business acquisitions are an important element of our strategy and we expect to continue to consider additional strategic business acquisitions in the future.

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

expansion, but rather on investing at appropriate rates to support our growth and future product offerings in what may be a substantially more competitive environment.

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

Income Statement Presentation

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

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

Sources of Revenues

License revenues

Our license revenues consist of revenues earned from the licensing of our software products. These products are generally licensed on a perpetual basis. License revenues are recognized when the elements of revenue recognition for the licensed software are complete, generally upon electronic shipment of the software. The revenues allocated to the software license included in multiple-element contracts represent the residual amount of the contract after the fair value of the other elements has been determined. While some of our products are licensed on a subscription basis, subscription license revenues are not a material part of our business.

Pricing models have generally been based upon the physical infrastructure, such as the number of physical desktop computers or server processors, on which our software runs. We base pricing for some of our products on virtual, rather than purely physical, entitlements, while continuing to license such products on a perpetual basis. In 2011, we revised the pricing model for VMware vSphere 5 so that while it continued to be licensed perpetually on a per-processor basis, the two physical constraints, number of cores and physical RAM, had been eliminated. These physical constraints were replaced with a single virtualization-based entitlement of virtual memory, or vRAM, which could be shared across a large pool of servers. In the third quarter of 2012, we revised the pricing model again for VMware vSphere when sold on a perpetual basis, continuing to license on a per-processor basis but with no core, vRAM or number of virtual machine limits. The revised pricing model did not impact our revenue recognition policies.

Software maintenance revenues

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

Professional services revenues

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

Operating Expenses

Cost of license revenues

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

related overhead associated with the physical and electronic delivery of our software products.

Cost of services revenues

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

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Research and development expenses

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

Sales and marketing expenses

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

General and administrative expenses

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

Results of Operations

Revenues

Our revenues in the third quarter and first nine months of 2012 and 2011 were as follows:

	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2012	2011	% Change		2012	2011	% Change	
Revenues:								
License	$491.1	$443.6	11	%	$1,490.3	$1,327.4	12	%
Services:								
Software maintenance	550.6	426.8	29		1,562.0	1,176.9	33	
Professional services	92.0	71.5	29		259.6	202.5	28	
Total services	642.6	498.3	29		1,821.6	1,379.4	32	
Total revenues	$1,133.7	$941.9	20		$3,311.9	$2,706.8	22	
Revenues:								
United States	$553.6	$443.4	25	%	$1,589.2	$1,293.3	23	%
International	580.1	498.5	16		1,722.7	1,413.5	22	
Total revenues	$1,133.7	$941.9	20		$3,311.9	$2,706.8	22	

Total revenues increased by $191.8 or 20% to $1,133.7 in the third quarter of 2012 from $941.9 in the third quarter of 2011. Total revenues increased by $605.1 or 22% to $3,311.9 in the first nine months of 2012 from $2,706.8 in the first nine months of 2011.

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

License Revenues

Software license revenues increased by $47.5 or 11% to $491.1 in the third quarter of 2012 from $443.6 in the third quarter of 2011. Software license revenues increased by $162.9 or 12% to $1,490.3 in the first nine months of 2012 from $1,327.4 in the first nine months of 2011. License revenues in the third quarter and first nine months of 2012 increased as compared to the third quarter and first nine months of 2011 due to continued demand for our product offerings.

In the third quarter of 2012, ELAs comprised 24% of total sales compared with 22% in the third quarter of 2011, and 25% in the first nine months of 2012 compared with 24% in the first nine months of 2011. We have promoted the adoption of virtualization and built long-term relationships with our customers through the adoption of ELAs. ELAs continue to be an important component of our revenue growth and are offered both directly by us and through certain channel partners. ELAs are a core element to our strategy to build long-term relationships with customers as they commit to our virtualization infrastructure software solutions in their data centers. ELAs provide a base from which to

sell additional products, such as our application platform products, our end-user computing products and our cloud infrastructure and management products. Under

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a typical ELA, a portion of the revenues is attributed to the license and recognized immediately and the remainder is deferred and primarily recognized as software maintenance revenues in future periods. In addition, the initial maintenance period is typically longer for ELAs than for other types of license sales.

Services Revenues

Services revenues increased by $144.3 or 29% to $642.6 in the third quarter of 2012 from $498.3 in the third quarter of 2011. Services revenues increased by $442.2 or 32% to $1,821.6 in the first nine months of 2012 from $1,379.4 in the first nine months of 2011. The increase in services revenues during the third quarter and first nine months of 2012 was primarily attributable to growth in our software maintenance revenues.

Software maintenance revenues increased by $123.9 or 29% to $550.6 in the third quarter of 2012 from $426.8 in the third quarter of 2011. Software maintenance revenues increased by $385.1 or 33% to $1,562.0 in the first nine months of 2012 from $1,176.9 in the first nine months of 2011. In the third quarter and first nine months of 2012, software maintenance revenues benefited from strong renewals, multi-year software maintenance contracts sold in previous periods, and additional maintenance contracts sold in conjunction with new software license sales. In the third quarter and first nine months of 2012, customers bought, on average, more than 24 months of support and maintenance with each new license purchased, which we believe illustrates our customers' commitment to VMware as a core element of their data center architecture and hybrid cloud strategy.

Professional services revenues increased by $20.4 or 29% to $92.0 in the third quarter of 2012 from $71.5 in the third quarter of 2011. Professional services revenues increased by $57.1 or 28% to $259.6 in the first nine months of 2012 from $202.5 in the first nine months of 2011. Professional services revenues increased as growth in our license sales and installed-base led to additional demand for our professional services. As we continue to invest in our partners and expand our ecosystem of third-party professionals with expertise in our solutions to independently provide professional services to our customers, we do not expect our professional services revenues to constitute an increasing component of our revenue mix. As a result of this strategy, our professional services revenue can vary based on the delivery channels used in any given period as well as the timing of engagements.

Revenue Growth in Constant Currency

We invoice and collect in the Euro, the British Pound, the Japanese Yen and the Australian Dollar in their respective regions. As a result, our total revenues are affected by changes in the value of the U.S. Dollar against these currencies. In order to provide a comparable framework for assessing how our business performed excluding the effect of foreign currency fluctuations, management analyzes year-over-year revenue growth on a constant currency basis. Since we operate with the U.S. Dollar as our functional currency, unearned revenues for orders booked in currencies other than the U.S. Dollar are converted into U.S. Dollars at the exchange rate in effect for the month in which each order is booked. We calculate constant currency on license revenues recognized during the current period that were originally booked in currencies other than U.S. Dollars by comparing the exchange rates used to recognize revenue in the current period against the exchange rates used to recognize revenue in the comparable period. For the third quarter of 2012, the year-over-year growth in license revenues measured on a constant currency basis was 14% compared with 11% as reported, and was 14% compared with 12% as reported year-over-year for the first nine months of 2012. We do not calculate constant currency on services revenues, which include software maintenance revenues and professional services revenues.

Unearned Revenues

Our unearned revenues as of September 30, 2012, and December 31, 2011 were as follows:

	September 30, 2012	December 31, 2011
Unearned license revenues	$366.1	$389.2
Unearned software maintenance revenues	2,415.3	2,133.5
Unearned professional services revenues	211.9	185.7
Total unearned revenues	$2,993.3	$2,708.4

The complexity of our unearned revenues has increased over time as a result of acquisitions, an expanded product portfolio and a broader range of pricing and packaging alternatives. As of September 30, 2012, total unearned revenues increased by $284.9 or 11% to $2,993.3 from $2,708.4 at December 31, 2011. This increase was primarily

due to growth in unearned software maintenance revenues, attributable to our growing base of maintenance contracts. Unearned license revenues are recognized either ratably or upon the delivery of existing products, future products or services. Future products include, in some cases, emerging products that are offered as part of product promotions where the

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purchaser of an existing product is entitled to receive a promotional product at no additional charge. We regularly offer product promotions as a strategy to improve awareness of our emerging products. To the extent promotional products have not been delivered and VSOE of fair value cannot be established, the revenue for the entire order is deferred until such time as all product delivery obligations have been fulfilled. Increasingly, unearned license revenue may also be recognized ratably, which is generally due to a right to receive unspecified future products or a lack of VSOE of fair value on the software maintenance element of the arrangement. At September 30, 2012, the ratable component represented over half of the total unearned license revenue balance. The amount of total unearned license revenues may vary over periods due to the type and level of promotions offered, as well as due to the portion of license contracts sold with a ratable recognition element. Unearned software maintenance revenues are attributable to our maintenance contracts and are recognized ratably over terms from one to five years with a weighted-average remaining term at September 30, 2012 of approximately 1.9 years. Unearned professional services revenues result primarily from prepaid professional services, including training, and are generally recognized as the services are delivered. We believe our overall unearned revenue balance improves predictability of future revenues and that it is a key indicator of the health and growth of our business.

Operating Expenses

Information about our operating expenses for the third quarter and first nine months of 2012 and 2011 is as follows:

	For the Three Months Ended September 30, 2012				
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses
Cost of license revenue	$25.6	$0.6	$14.9	$19.2	$60.3
Cost of services revenue	110.1	7.8	—	1.1	119.0
Research and development	197.8	60.2	—	1.9	259.9
Sales and marketing	356.3	51.7	—	3.5	411.5
General and administrative	78.7	11.8	—	2.1	92.6
Total operating expenses	$768.5	$132.1	$14.9	$27.8	$943.3
Operating income					$190.3
Operating margin					16.8 %

	For the Three Months Ended September 30, 2011				
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses
Cost of license revenue	$18.5	$0.4	$14.4	$12.8	$46.1
Cost of services revenue	99.0	6.1	—	1.6	106.7
Research and development	170.9	46.7	(21.1)	3.2	199.7
Sales and marketing	302.6	24.8	—	4.2	331.6
General and administrative	65.4	10.4	—	1.2	77.0
Total operating expenses	$656.4	$88.4	$(6.7)	$23.0	$761.1
Operating income					$180.7
Operating margin					19.2 %

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	For the Nine Months Ended September 30, 2012					
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses	
Cost of license revenue	$68.3	$1.5	$57.5	$46.3	$173.6	
Cost of services revenue	331.0	20.7	—	4.2	355.9	
Research and development	575.8	147.6	—	7.5	730.9	
Sales and marketing	1,042.8	110.8	—	12.8	1,166.4	
General and administrative	226.9	34.3	—	4.5	265.7	
Total operating expenses	$2,244.8	$314.9	$57.5	$75.3	$2,692.5	
Operating income					$619.4	
Operating margin					18.7	%

	For the Nine Months Ended September 30, 2011					
	Core Operating Expenses (1)	Stock-Based Compensation	Capitalized Software Development Costs, net	Other Operating Expenses	Total Operating Expenses	
Cost of license revenue	$54.1	$1.2	$62.7	$33.0	$151.0	
Cost of services revenue	281.8	17.4	—	4.9	304.1	
Research and development	486.8	134.6	(74.0)	10.7	558.1	
Sales and marketing	866.5	70.6	—	12.0	949.1	
General and administrative	189.3	30.6	—	3.5	223.4	
Total operating expenses	$1,878.5	$254.4	$(11.3)	$64.1	$2,185.7	
Operating income					$521.1	
Operating margin					19.3	%

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

Our operating margin decreased to 16.8% in the third quarter of 2012 from 19.2% in the third quarter of 2011. Our operating margin in the first nine months of 2012 decreased to 18.7% in the third quarter of 2012 from 19.3% in the first nine months of 2011. The decreases in our operating margins in the third quarter of 2012 compared with the third quarter of 2011 and in the first nine months of 2012 compared with the first nine months of 2011 primarily relate to the year-over-year impact on operating margins from the decreases in capitalized software development costs, partially offset by the year-over-year increases in our revenues, which outpaced the increases in our core operating expenses. Additionally, our operating margin in the third quarter of 2012 compared with the third quarter of 2011 was impacted by the increase in stock-based compensation expense.

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

Core Operating Expenses

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

consist of employer payroll taxes on employee stock transactions, amortization of acquired intangible assets and acquisition-related items.

Core operating expenses increased by $112.0 or 17% in the third quarter of 2012 compared with the third quarter of 2011. Core operating expenses increased by $366.4 or 20% in the first nine months of 2012 compared with the first nine months of 2011. As quantified below, these increases were primarily due to increases in employee-related expenses, which include salaries and benefits, bonuses, commissions, and recruiting and training, and which increased largely as a result of increases in

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headcount. Our headcount as of September 30, 2012 was over 13,300, compared with approximately 12,700 as of June 30, 2012 and compared with approximately 10,900 as of September 30, 2011. These increases in headcount were driven by strategic hiring, business growth and business acquisitions. A portion of our core operating expenses, primarily the cost of personnel to deliver technical support on our products and professional services, marketing, and research and development, are denominated in foreign currencies, and are thus exposed to foreign exchange rate fluctuations. Core operating expenses benefited by $24.0 and $46.9 in the third quarter and first nine months of 2012, respectively, as compared with the third quarter and first nine months of 2011, due to the effect of fluctuations in the exchange rates between the U.S. Dollar and other currencies.

Cost of License Revenues

Core operating expenses for cost of license revenues increased by $7.1 or 38% in the third quarter of 2012 compared with the third quarter of 2011, and by $14.2 or 26% in the first nine months of 2012 compared with the first nine months of 2011. The increases were primarily due to an increase of $3.0 and $6.8 in the third quarter and first nine months of 2012, respectively, for IT development costs. Additionally, cost of license revenues increased by $2.7 and $3.7 in the third quarter and first nine months of 2012, respectively, related to royalty and licensing costs for technology licensed from third-party providers that is used in our products.

Cost of Services Revenues

Core operating expenses for cost of services revenues increased by $11.1 or 11% in the third quarter of 2012 compared with the third quarter of 2011, and by $49.2 or 17% in the first nine months of 2012 compared with the first nine months of 2011. The increases were primarily due to growth in employee-related expenses of $14.6 and $42.2 in the third quarter and first nine months of 2012, respectively, which were largely driven by incremental growth in headcount. Additionally, our third-party professional services costs increased by $10.6 in the first nine months of 2012 to provide technical support and professional services primarily in connection with increased demand for services. The increase in the third quarter of 2012 was partially offset by a decrease of $4.4 due to the completion of certain IT development projects.

Research and Development Expenses

Core operating expenses for R&D increased by $26.8 or 16% in the third quarter of 2012 compared with the third quarter of 2011, and by $89.0 or 18% in the first nine months of 2012 compared with the first nine months of 2011. The increases were primarily due to growth in employee-related expenses of $29.8 and $82.7 in the third quarter and first nine months of 2012, respectively, which was primarily driven by incremental growth in headcount from strategic hiring and business acquisitions. These increases were partially offset by the positive impact of $4.2 and $8.5, respectively, from fluctuations in the exchange rate between the U.S. Dollar and foreign currencies.

Sales and Marketing Expenses

Core operating expenses for sales and marketing increased by $53.6 or 18% in the third quarter of 2012 compared with the third quarter of 2011, and by $176.2 or 20% in the first nine months of 2012 compared with the first nine months of 2011. The increases were primarily due to growth in employee-related expenses of $49.2 and $149.1 in the third quarter and first nine months of 2012, respectively, driven by incremental growth in headcount. Additionally, the costs of marketing programs increased by $6.0 and $27.7 in the third quarter and first nine months of 2012, respectively. These increases were partially offset by the positive impact of $13.0 and $25.1, respectively, from fluctuations in the exchange rate between the U.S. Dollar and foreign currencies.

General and Administrative Expenses

Core operating expenses for general and administrative increased by $13.4 or 20% in the third quarter of 2012 compared with the third quarter of 2011, and by $37.7 or 20% in the first nine months of 2012 compared with the first nine months of 2011. The increases were primarily due to an increase of $5.8 and $16.0 in the third quarter and first nine months of 2012, respectively, related to employee-related expenses mostly due to incremental growth in headcount. General and administrative expenses also increased in the third quarter of 2012 due to an increase of $4.2 and $8.2, respectively, in corporate expenses, including contributions to our charitable foundation. Also contributing to the increase in expenses in the third quarter and first nine months of 2012 were equipment and depreciation expenses of $2.9 and $7.5, respectively, to support increased headcount. Additionally, contractor costs primarily related to IT security initiatives contributed to the overall year-over-year change in expenses with an increase of $2.5

and $6.4 in the third quarter and first nine months of 2012, respectively.

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Stock-Based Compensation Expense

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2012	2011	2012	2011
Stock-based compensation, excluding amounts capitalized	$132.1	$88.4	$314.9	$254.4
Stock-based compensation capitalized	—	3.4	—	12.4
Stock-based compensation, including amounts capitalized	$132.1	$91.8	$314.9	$266.8

Stock-based compensation expense increased by $40.4 and $48.0 in the third quarter and first nine months of 2012 compared to the third quarter and first nine months of 2011 primarily due to an increase of $28.6 and $83.5, respectively, for new awards issued to our existing employees, as well as an increase of $9.0 and $26.8, respectively, for awards made to new employees over the last year. Partially offsetting these increases was a decrease of $18.6 and $84.3, respectively, related to grants which became fully vested over the past year.

Additionally, stock-based compensation expense increased by $26.5 in the third quarter and first nine months of 2012 in connection with our acquisition of Nicira in August 2012. As part of this acquisition, we assumed all of Nicira's unvested stock options and restricted stock. The fair value of the assumed equity awards attributed to post-combination services was $152.4, of which $25.8 was recognized in the third quarter of 2012. The remaining fair value of $126.6 is being recognized as stock-based compensation expense over the awards' remaining requisite service periods, which extends through the first half of 2016.

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

As of September 30, 2012, the total unamortized fair value of our outstanding equity-based awards held by our employees was approximately $1,015.7, and is expected to be recognized over a weighted-average period of approximately 1.6 years.

Capitalized Software Development Costs, Net

Development costs of software to be sold, leased, or otherwise marketed are subject to capitalization beginning when the product's technological feasibility has been established and ending when the product is available for general release. Judgment is required in determining when technological feasibility is established, and as our business, products and go-to-market strategy have evolved, we have continued to evaluate when technological feasibility is established. Following the release of vSphere 5 and the comprehensive suite of cloud infrastructure technologies in the third quarter of 2011, we determined that our go-to-market strategy had changed from single solutions to product suite solutions. As a result of this change in strategy, and the related increased importance of interoperability between our products, the length of time between achieving technological feasibility and general release to customers significantly decreased. We expect our products to be available for general release soon after technological feasibility has been established. Given that we expect the majority of our product offerings to be suites or to have key components that interoperate with our other product offerings, the costs incurred subsequent to achievement of technological feasibility are expected to be immaterial in future periods. In the third quarter and first nine months of 2012, all software development costs related to product offerings were expensed as incurred and were included in R&D expenses on the accompanying consolidated statement of income. In the third quarter and first nine months of 2011, we capitalized $24.5 (including $3.4 of stock-based compensation) and $86.4 (including $12.4 of stock-based compensation), respectively, of costs for the development of software products. The amounts capitalized in the third quarter and first nine months of 2011 primarily related to the development of VMware vSphere 5.

Our expensed and capitalized R&D costs may not be comparable to our peer companies due to differences in judgment as to when technological feasibility has been reached or differences in judgment regarding when the product is available for general release. Additionally, future changes in our judgment as to when technological feasibility is

established, or additional changes in our business, including our go-to-market strategy, could materially impact the amount of costs capitalized. For example, if the length of time between technological feasibility and general availability was to increase again in the future, the amount of capitalized costs would likely increase.

In the third quarter of 2012, amortization expense from capitalized software development costs increased $0.5 to $14.9 from $14.4 in the third quarter of 2011. In the first nine months of 2012, amortization expense from capitalized software development costs decreased $5.2 to $57.5 from $62.7 in the first nine months of 2011. These changes were primarily due to both the timing of new product releases and the completion of amortization for other product releases, including different

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versions of vSphere. Amortization expense from capitalized software development costs is included in cost of license revenues on our accompanying consolidated statements of income. In future periods, we expect our amortization expense from capitalized software development costs to decline as these costs are expected to be recorded as R&D expense as incurred given our current go-to-market strategy.

Other Operating Expenses

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

Other operating expenses increased by $4.8 to $27.8 in the third quarter of 2012 from $23.0 in the third quarter of 2011. The increase in the third quarter of 2012 was primarily due to an increase in intangible amortization of $7.0 resulting from new acquisitions, which was primarily recorded to costs of license revenues on our income statement. The increase was partially offset by a decrease of $3.0 in employer payroll taxes on employee stock transactions, which was primarily attributable to a decrease in the number of awards exercised, sold or vested. Other operating expenses increased by $11.2 to $75.3 in the first nine months of 2012 from $64.1 in the first nine months of 2011. The increase in the first nine months of 2012 was primarily due to an increase in intangible amortization of $14.8 resulting from new business acquisitions, which was primarily recorded to costs of license revenues on our income statement. The increase was partially offset by a decrease of $4.7 in employer payroll taxes on employee stock transactions, which was primarily attributable to a decrease in the number of awards exercised, sold or vested.

Investment Income

Investment income increased by $3.1 to $7.5 in the third quarter of 2012 from $4.4 in the third quarter of 2011. Investment income increased by $8.7 to $20.2 in the first nine months of 2012 from $11.5 in the first nine months of 2011. Investment income primarily consists of interest earned on cash, cash equivalents and short-term investment balances partially offset by the amortization of premiums paid on fixed income securities. Investment income increased in the third quarter and first nine months of 2012 as compared with the third quarter and first nine months of 2011 due to increased cash equivalent and short-term investment balances available for investment, as well as increases in the average rate of interest earned, resulting from a reallocation of funds from cash equivalents to fixed income securities. Additionally, realized gains earned upon the liquidation of securities in connection with the acquisition of Nicira increased investment income in the third quarter of 2012.

Other Income (Expense), Net

Other expense, net of $1.5 in the third quarter of 2012 changed by $0.5 as compared with other expense, net of $1.0 in the third quarter of 2011. Other expense, net of $2.8 in the first nine months of 2012 changed by $58.6 from other income, net of $55.8 in the first nine months of 2011. The change in first nine months of 2012 as compared with the first nine months of 2011 was primarily due to a $56.0 gain recognized on the sale of our investment in Terremark Worldwide, Inc. in 2011.

Income Tax Provision

Our effective income tax rate was 19.7% and 3.1% for the third quarter of 2012 and 2011, respectively. The higher effective rate for the third quarter of 2012 compared with the third quarter of 2011 was primarily attributable to a change in mix of profitability of our domestic and international operations and the expiration of the federal research credit at the end of 2011. The effective income tax rate was 14.7% and 10.6% for the first nine months of 2012 and 2011, respectively. The higher effective rate for the first nine months of 2012 compared with the first nine months of 2011 was primarily attributable to the items discussed above for the third quarter of 2012, as well as the year-over-year effect of a release in uncertain tax benefits in the first nine months of 2011 due to a closure of a tax audit.

Our rate of taxation in foreign jurisdictions is lower than our U.S. tax rate. Our international income is primarily earned by our subsidiaries in Ireland, where the statutory tax rate is 12.5%. We do not believe that any recent or currently expected developments in non-U.S. tax jurisdictions are reasonably likely to have a material impact on our effective tax rate. As of September 30, 2012, our total cash, cash equivalents, and short-term investments were $4,394.6, of which $2,920.0 were held outside the U.S. If these overseas funds are needed for our operations in the

U.S., we would be required to accrue and pay U.S. taxes on related undistributed earnings to repatriate these funds. However, all income earned abroad, except for previously taxed income for U.S. tax purposes, is considered indefinitely reinvested in our foreign operations and no provision for U.S. taxes has been provided with respect thereto. At this time, it is not practicable to estimate the amount of tax that may be payable were we to repatriate these funds, and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations. We will meet our U.S. liquidity needs through cash flows from operations, external borrowings, or both. We utilize a variety of tax planning and financing strategies in an effort to ensure that our worldwide cash is available in the locations in which it is needed.

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

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

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

Our Relationship with EMC

As of September 30, 2012, EMC owned 39,163,000 shares of Class A common stock and all 300,000,000 shares of Class B common stock, representing 79.2% of our total outstanding shares of common stock and 97.1% of the combined voting power of our outstanding common stock.

In the second quarter of 2011, we acquired certain assets relating to EMC's Mozy cloud-based data storage and data center services, including certain data center assets and a license to certain intellectual property. EMC retained ownership of the Mozy business and its remaining assets. EMC continues to be responsible to Mozy customers for Mozy products and services and continues to recognize revenue from such products and services. We entered into an operational support agreement with EMC through the end of 2012, pursuant to which we took over responsibility to operate the Mozy service on behalf of EMC. Pursuant to the support agreement, costs incurred by us to support EMC's Mozy services, plus a mark-up intended to approximate third-party costs and a management fee, are reimbursed to us by EMC. On the consolidated statements of income, in the three months ended September 30, 2012 and 2011, such amounts as described above were approximately $16.6 and $13.1, respectively. In the nine months ended September 30, 2012 and 2011, such amounts were $47.5 and $25.3, respectively. These amounts were recorded as a reduction to the costs we incurred.

In 2010, we acquired certain software product technology and expertise from EMC's Ionix IT management business for cash consideration of $175.0. EMC retained the Ionix brand and will continue to offer customers the products acquired by us, pursuant to an ongoing reseller agreement between EMC and us. During the three and nine months ended September 30, 2011, $1.9 and $14.4, respectively, of contingent amounts were paid to EMC. These payments were recorded as equity transactions and were offsets to the initial capital contribution from EMC. As of December 31, 2011, all contingent payments under the agreement had been made.

Pursuant to an ongoing reseller arrangement with EMC, EMC bundles our products and services with EMC's products and sells them to end-users. In the three months ended September 30, 2012 and 2011, we recognized revenues of $26.8 and $16.7, respectively, from products and services sold pursuant to our reseller arrangement with EMC. In the nine months ended September 30, 2012 and 2011, we recognized revenues of $107.5 and $50.9, respectively, from such contractual arrangement with EMC. As of September 30, 2012, $132.7 of revenues from products and services sold under the reseller arrangement were included in unearned revenues.

In the three months ended September 30, 2012 and 2011, we recognized professional services revenues of $21.2 and $13.2, respectively, for services provided to EMC's customers pursuant to our contractual agreements with EMC. In the nine months ended September 30, 2012 and 2011, we recognized professional services revenues of $63.5 and $44.0, respectively, from such contractual agreements with EMC. As of September 30, 2012, $5.4 of revenues from professional services to EMC customers were included in unearned revenues.
In the three months ended September 30, 2012 and 2011, we recognized revenues of $3.0 and $1.0, respectively, from products and services purchased by EMC for internal use pursuant to our contractual agreements with EMC. In the nine months ended September 30, 2012 and 2011, we recognized revenues of $6.8 and $2.0, respectively, from such contractual agreements

with EMC. As of September 30, 2012, $23.4 of revenues from products and services purchased by EMC for internal use were included in unearned revenues.

We purchased products and services from EMC for $4.2 and $3.8 in the three months ended September 30, 2012 and 2011, respectively, and for $28.1 and $17.2 in the nine months ended September 30, 2012 and 2011, respectively.

In certain geographic regions where we do not have an established legal entity, we contract with EMC subsidiaries for support services and EMC personnel who are managed by us. The costs incurred by EMC on our behalf related to these employees are passed on to us and we are charged a mark-up intended to approximate costs that would have been charged had we contracted for such services with an unrelated third party. These costs are included as expenses in our consolidated statements of income and primarily include salaries, benefits, travel and rent. Additionally, EMC incurs certain administrative costs on our behalf in the U.S. that are also recorded as expenses. The total cost of the services provided to us by EMC as described above was $26.4 and $21.1 in the three months ended September 30, 2012 and 2011, respectively, and $75.5 and $63.8 in the nine months ended September 30, 2012 and 2011, respectively.

In the three and nine months ended September 30, 2012, no payments were made by either us or EMC under the tax sharing agreement. In the three and nine months ended September 30, 2011, EMC paid us $100.0 and $276.4, respectively, under the tax sharing agreement and no payments were made by us to EMC. Payments between us and EMC under the tax sharing agreement primarily relate to our portion of federal income taxes on EMC’s consolidated tax return. Payments from us to EMC primarily relate to periods for which we had stand-alone federal taxable income, while payments from EMC to us relate to periods for which we had a stand-alone federal taxable loss. The amounts that we either pay to or receive from EMC for our portion of federal income taxes on EMC’s consolidated tax return differ from the amounts we would owe on a stand-alone basis and the difference is presented as a component of stockholders’ equity. For all periods presented, the difference was not material.

In the three months ended September 30, 2012 and 2011, $1.2 and $0.9, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on our consolidated statements of income. In the nine months ended September 30, 2012 and 2011, $3.6 and $2.8, respectively, of interest expense was recorded related to the note payable to EMC and included in interest expense with EMC on our consolidated statements of income. Our interest expense as a separate, stand-alone company may be higher or lower than the amounts reflected in the consolidated financial statements.

As of September 30, 2012, we had $46.2 net due from EMC, which consisted of $79.2 due from EMC, partially offset by $33.0 due to EMC. These amounts resulted from the related party transactions described above. In addition to the $46.2 net due from EMC as of September 30, 2012, we had an immaterial amount of net income taxes receivable from EMC, which is included in other current assets on our consolidated balance sheet. Balances due to or from EMC which are unrelated to tax obligations are generally settled in cash within 60 days of each quarter-end. The timing of the tax payments due to and from EMC is governed by the tax sharing agreement with EMC.

Effective September 1, 2012, our former CEO, Paul Maritz, was succeeded as Chief Executive Officer of VMware by Pat Gelsinger. Pat Gelsinger was the President and Chief Operating Officer of EMC Information Infrastructure Products. Paul Maritz remains a board member of VMware and took on a new technology strategist role at EMC. With the exception of a long-term incentive performance award from EMC that Pat Gelsinger agreed to cancel in consideration of a new performance stock unit award from us, both Paul Maritz and Pat Gelsinger retained and continue to vest in their respective equity awards that they held as of September 1, 2012. Stock-based compensation expense related to Pat Gelsinger’s EMC awards will be recognized on our consolidated statements of income over the awards’ remaining requisite service periods. Stock-based compensation expense related to Paul Maritz’s VMware awards will be recognized as an expense by EMC.

By nature of EMC’s majority ownership of us, the amounts we recorded for our intercompany transactions with EMC may not be considered arm’s length with an unrelated third party. Therefore the financial statements included herein may not necessarily reflect our financial condition, results of operations and cash flows had we engaged in such transactions with an unrelated third party during all periods presented. Accordingly, our historical results should not be relied upon as an indicator of our future performance as a stand-alone company.

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Liquidity and Capital Resources

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

	September 30, 2012	2011
Cash and cash equivalents	$1,480.2	$1,549.8
Short-term investments	2,914.4	2,426.9
Total cash, cash equivalents and short-term investments	$4,394.6	$3,976.7

As of September 30, 2012, we held a diversified portfolio of money market funds and fixed income securities totaling $3,989.2. Our fixed income securities were denominated in U.S. Dollars and consisted of highly liquid debt instruments of the U.S. government and its agencies, U.S. municipal obligations, and U.S. and foreign corporate debt securities. We limit the amount of our domestic and international investments with any single issuer and any single financial institution, and also monitor the diversity of the portfolio, thereby diversifying the credit risk. Within our portfolio, we held $42.2 of foreign government and agencies securities, $10.0 of which was deemed sovereign debt, at September 30, 2012. These sovereign debt securities had an average credit rating of AAA and were predominantly from Canada. None of the securities deemed sovereign debt were from Greece, Ireland, Italy, Portugal or Spain.

As of September 30, 2012, our total cash, cash equivalents and short-term investments were $4,394.6, of which $2,920.0 was held outside the U.S. If these overseas funds are needed for our operations in the U.S., we would be required to accrue and pay U.S. taxes on related undistributed earnings to repatriate these funds. However, our intent is to indefinitely reinvest our non-U.S. earnings in our foreign operations and our current plans do not demonstrate a need to repatriate them to fund our U.S. operations.

We expect to continue to generate positive cash flows from operations in 2012 and to use cash generated by operations as our primary source of liquidity. We believe that existing cash and cash equivalents, together with any cash generated from operations will be sufficient to meet normal operating requirements including strategic acquisitions and capital expenditures for at least the next twelve months.

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

	For the Three Months Ended September 30, 2012	2011	For the Nine Months Ended September 30, 2012	2011
Net cash provided by (used in):				
Operating activities	$436.2	$523.5	$1,404.1	$1,464.2
Investing activities	(973.2)	(651.0)	(1,807.8)	(1,430.6)
Financing activities	(59.7)	(113.8)	(71.9)	(112.7)
Net decrease in cash and cash equivalents	$(596.7)	$(241.3)	$(475.6)	$(79.1)

Operating Activities

Cash provided by operating activities is driven by our net income, adjusted for non-cash items and changes in assets and liabilities. Non-cash adjustments include depreciation and amortization, stock-based compensation expense, excess tax benefits from stock-based compensation and other adjustments. Net changes in assets and liabilities were impacted by increases in unearned revenues in the periods presented, and we expect this trend to continue in the future.

Cash provided by operating activities decreased by $87.3 to $436.2 in the third quarter of 2012 from $523.5 in the third quarter of 2011. Cash provided by operating activities decreased by $60.1 to $1,404.1 in the first nine months of 2012 from $1,464.2 in the first nine months of 2011. The decrease in both periods was primarily driven by the timing of tax payments we received from EMC under the tax sharing agreement. Under the tax sharing agreement, EMC is obligated to pay us an amount equal to the tax benefit generated by us that EMC will recognize on its consolidated tax return. In the third quarter and first nine months of 2012, we did not receive any amounts from EMC under the tax sharing agreement, but in the third quarter and first nine months of 2011, we benefited from the collection of $100.0 and $276.4, respectively, which included amounts for both the 2011 and 2010 tax years. For 2012, we expect to pay

U.S. federal state income taxes to EMC, therefore we do not expect to benefit from the collection of income tax receivables under the tax sharing agreement in 2012.

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In addition to the impact of the decrease in cash received from EMC under the tax sharing agreement in both the third quarter and first nine months of 2012, cash provided by operating activities benefited from increases in cash collections driven by growth in sales to our customers and was negatively impacted by increases in our core operating expenses, primarily due to headcount. In the third quarter of 2012, increases in our cash collections were offset by increases in our core operating expenses. As a result, there was not a significant net impact to our cash provided by operating activities from these sources. In the first nine months of 2012, increases in cash collections from customers outpaced the increases in our core operating expenses. Additionally, the excess tax benefit from stock-based compensation decreased by $86.8 in the first nine months of 2012, which positively impacted our cash provided by operating activities. This change was primarily due to changes in the market value of our stock and the number of equity awards exercised, sold or vested.

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

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

	For the Three Months Ended		For the Trailing Twelve Months Ended	
	September 30,		September 30,	
	2012	2011	2012	2011
Net cash provided by operating activities	$436.2	$523.5	$1,965.6	$1,870.8
Capitalized software development costs	—	(21.1)	—	(90.0)
Excess tax benefits from stock-based compensation	24.5	46.4	137.7	254.0
Non-GAAP operating cash flows	460.7	548.8	2,103.3	2,034.8
Capital expenditures	(74.8)	(54.9)	(205.7)	(217.6)
Free cash flows	$385.9			